Bernanke: Central banks must be independent

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May 25, 2010 – *The Wall Street Journal*

With Congress getting close to finalizing an overhaul of the U.S. financial regulatory system, Federal Reserve Chairman Ben Bernanke weighed in against provisions in the proposed legislation that would subject the central bank to more political scrutiny.

In a speech at the Bank of Japan Wednesday, the Fed chief argued before an international audience that central banks that are independent from politics are better at managing the economy. He also detailed the steps the Fed has taken to become more transparent and accountable to the public, two conditions he said were needed in return for greater independence.

The Fed is waging a battle against a proposal approved by the House in December that would subject the central bank's decisions to audits by the Government Accountability Office, an investigative arm of Congress. Bernanke is strongly opposed to the measure, which is part of the government's broader efforts to overhaul regulation to avoid a repeat of the financial crisis.

A central bank that's subject to political influence could be pressed to keep interest rates low to boost the economy and jobs, Bernanke said. While that could be popular at first—and helpful in an election campaign—it will lead to higher inflation in the future, hurting the economy's long-term prospects.

"Thus, political interference in monetary policy can generate undesirable boom-bust cycles that ultimately lead to both a less stable economy and higher inflation," the Fed chief said in prepared remarks to an international conference in Tokyo.

The regulatory overhaul bill approved by the Senate last week has a watered down version of the House audit bill, which the Fed broadly supports. However, it includes a provision opposed by the Fed that would give the U.S. president the power to appoint the head of the New York Fed, a move that would make it easier to exert pressure on the central bank. The House and Senate bills must now be reconciled by Congress, with the final overhaul package seen signed into law by July 4.

History shows that central banks in the U.S., the U.K., Europe and Japan, once shielded from political pressure, have a better track record at managing the economy, Bernanke said.

Since interest rate decisions take time to impact the economy, a long-term view is needed at the Fed as it aims to achieve full employment and stable prices. That wouldn't be possible if there are short-term political interests that must be satisfied.

Bernanke sought to lay out the steps the Fed has taken to become more transparent and accountable, including publishing the minutes of its policy-setting meetings and by giving regular updates of the composition of its balance sheet. The Fed gives weekly updates on its portfolio, while listed companies report quarterly.

The Fed is also giving weekly updates on a U.S. dollar loan program with other central banks that was revived this month to help alleviate financial market strains resulting from Europe's debt crisis. Some U.S. lawmakers say the facility amounts to bailing out foreigners, but the Fed actually made money when it was used during the financial crisis in 2008 and 2009.

The Fed is "committed to exploring new ways to enhance transparency without compromising our mandated monetary policy and financial stability objectives," Bernanke said.

The Fed chief said he'd welcome legislation that would clarify the role the central bank and other regulators should play in unwinding big financial firms that pose a risk to the entire economy.

The Senate bill gives the Fed the power to supervise them, while other regulators would have to decide how to deal with the firm if it faces collapse. The U.S. government and the Fed had to scramble to put together a rescue for American International Group Inc. in 2008, in what Bernanke has said was the decision that angered him the most during the financial crisis.

Following criticism that it was too secretive about the bailouts and emergency loans made during the financial crisis, the Fed has released more details about its actions over the past three years. But in the courts, the central bank is continuing its fight to shield the names of the cash-strapped banks that borrow from it.

The Senate bill would require the Fed to disclose key details of loans made to firms during the financial crisis. But it would only be a one-time inquiry into emergency lending activities made months ago, something the Fed can live with.

The Fed is against any prompt disclosure of the identities of banks that come to its discount window, citing the stigma that would keep some banks from approaching it in times of crisis. The central bank is appealing a federal-court ruling in a Freedom of Information Act suit brought by Bloomberg News that would force more disclosure of details of its lending than the Senate bill would.

Bernanke said the Fed should retain its ability to give discount-window loans and act as lender of last resort independently from politicians. The central bank should also be free to buy securities—such as the Fed's $1.25 trillion purchase of mortgage-backed assets—without interference, because the impact on the economy is the same as when interest rates are changed.

"Indeed the costs of undue government influence on the central bank's quantitative easing decisions could be especially large, since such influence might be tantamount to giving the government the ability to demand the monetization of its debt, an outcome that should be avoided at all costs."