Department of Economics University of Maryland

Economics 325

Intermediate Macroeconomic Analysis

Supplement 10

Professor Sanjay Chugh

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The following symposium, which appeared in the *Wall Street Journal* on September 9, 2010, collects short essays by several leading monetary economists and macroeconomists offering their views the most prudent short- and medium-term paths for monetary policy to follow. You should be able to use the monetary frameworks we will begin studying in Chapter 14 to understand the channels by which "conventional" interest-rate policy can affect aggregate demand as well as how "quantitative easing" programs more broadly defined can affect aggregate demand. The joint fiscal-monetary framework of Chapter 15 offers an analytical framework with which you should be able to understand Mishkin's analysis of debt monetization.

OPINION

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What Should the Federal Reserve Do Next?

Near-zero interest rates and unprecedented asset purchases by the Fed have failed to return the U.S. economy to robust growth.

Editor's note: A prolonged period of near-zero interest rates and unprecedented asset purchases by the Federal Reserve has failed to return the U.S. economy to robust growth or make an appreciable dent in unemployment. It is now commonly asserted that the Fed is "out of ammunition." Is it? We asked six authorities on monetary policy what the Fed should do next.

• John B. Taylor: Return to Rule-Based Policy

• Richard W. Fisher: Uncertainty Causes 'Liquidity Hoarding'

• Frederic S. Mishkin: Don't Monetize the Debt

• Ronald McKinnon: Avoid the Zero Interest Rate Trap

• Vincent Reinhart: Treasury Purchase Shock and Awe

• Allan H. Meltzer: Focus on the Long Term

Return to Rule-Based Policy

By John B. Taylor

To establish Fed policy going forward, the best place to start is to consider what has worked in the past. During the two decades before the recent financial crisis, the Fed employed a reasonably rule-based strategy for adjusting the money supply and the interest rate. The interest rate rose by predictable amounts when inflation increased, and it fell by predictable amounts during recessions.

Economists cite the Taylor rule—which says that the Fed's target interest rate should be one-and-a-half times the inflation rate, plus one-half times the shortfall of GDP from potential plus one—as evidence that this approach worked. Performance was good during the 1980s and 1990s when policy was close to the rule. And it was poor when policy was far away from the rule, as it was during the 1970s and the Great Depression.

Unfortunately, leading up to and during the recent crisis, the Fed deviated from this framework. It held interest rates too low for too long from 2002 to 2005, and after the crisis began to flare up in 2007 it engaged in massive discretionary credit operations. While some actions helped halt the panic in the fall of 2008, others, like the unpredictable on-again off-again bailouts, brought it on and left a legacy of uncertainty that's holding back recovery now.

So the answer to the question is simple: Get back to the rule-based policy that was working before the crisis. To get there without causing more market disruption, announce and follow a clear exit rule, in which the Fed's bloated balance sheet is gradually pared back by predictable amounts as the economic recovery picks up.

Such a policy would be a much better stimulus than another large dose of quantitative easing in which the Fed's balance sheet explodes even further, raising more uncertainty about how it will ever be unwound. A rules-based monetary policy could also serve as a model for fiscal policy—an area where increased predictability and certainty are sorely needed.

Mr. Taylor, a professor of economics at Stanford and a fellow at the Hoover Institution, is the author of "Getting Off Track: How Government Actions and Interventions Caused, Prolonged and Worsened the Financial Crisis" (Hoover Press, 2009).

Uncertainty Causes 'Liquidity Hoarding'

By Richard W. Fisher

The Fed plays a crucial role in conditioning the economy. But it does not play the only role. Fiscal and regulatory authorities share significant responsibility for incentivizing economic behavior through taxes, spending and rule making.

The minutes of the last Federal Open Market Committee (FOMC) meeting noted that "a number of participants reported that business contacts again indicated that uncertainty about future taxes, regulations, and health-care costs made them reluctant to expand their workforces." This uncertainty about fiscal and regulatory matters makes it difficult to create the jobs Americans need. Yet without robust job growth, consumption will be weak and economic recovery meek.

One might assume that with more than $1 trillion in excess bank reserves and significant amounts of cash held by businesses, the gas tank of those who have the capacity to hire is reasonably full. One might also conclude that the Fed, having cut the cost of interbank overnight lending to near zero and used quantitative easing to coax the entire yield curve downward, has driven the cost of gas to virtually nil for businesses that are creditworthy. And yet businesses still aren't hiring.

Can the Fed do more to propel job creation?

Barring an unforeseen shock, I would be reluctant to expand the Fed's balance sheet unless fiscal and regulatory initiatives are aligned with the needs of job creators. Otherwise, further accommodation might be pushing on a string. In the worst case, it could flood the engine of the economy with gas that might later ignite inflation.

Of course, if the fiscal and regulatory authorities are able to dispel the angst that FOMC participants are reporting, further accommodation may not be needed. If businesses are more certain about future policy, they'll release the liquidity they're now hoarding.

Mr. Fisher is president and CEO of the Federal Reserve Bank of Dallas.

Don't Monetize the Debt

By Frederic S. Mishkin

The Federal Reserve is facing a very difficult situation. Right now, it is not achieving either of its objectives: Inflation has been running well below the generally accepted target level of 2%, while unemployment is stuck above 9%.

This combination would normally call for additional monetary policy easing, but the conventional tool of lowering the fed funds rate is no longer an option. Instead, the Fed's recent announcement that it will reinvest payments from agency debt and mortgage-backed securities into long-term Treasurys has opened the door to large-scale asset purchases. Should the Fed pull the trigger?

Purchasing long-term Treasurys might suggest that the Fed is accommodating the fiscal authorities by monetizing the debt—thereby weakening the government's incentives to come to grips with our long-term fiscal problems. In addition, major holdings of long-term securities expose the Fed's balance sheet to potentially large losses if interest rates rise.

Such losses would result in severe criticism of the Fed and a weakening of its independence. Both the weakening of its independence and the perception that the Fed is willing to monetize the debt could lead to increased expectations for inflation sometime in the future. That would make it much harder for the Fed to contain inflation and promote a healthy economy.

Expanding the Fed's balance sheet through large-scale asset purchases can be necessary in extraordinary circumstances, such as during the depths of the recent financial crisis. But in relatively normal times, the costs of using this tool are sufficiently high that it should not be used lightly.

Mr. Mishkin is a professor of finance and economics at the Graduate School of Business at Columbia University, a former governor of the Federal Reserve's Board of Governors, and the author of "Macroeconomics: Policy and Practice," forthcoming from Addison-Wesley.

Avoid the Zero Interest Rate Trap

By Ronald McKinnon

With fears of a double-dip recession mounting, the Fed is considering buying additional U.S. Treasury bonds to further drive down longer-term interest rates. But ultra-low interest rates will fail to stimulate the economy in the near term and the long term.

In the near term, any increase in aggregate demand for investment or consumption from lower rates may well be offset by a supply-side constraint on bank credit expansion. In the longer term, near-zero interest rates will seriously impair important financial institutions such as defined-benefit pension plans.

What's more, America's low interest policies create outflows of "hot" money that force down interest rates elsewhere, most notably in China. This helps inflate asset bubbles that could come back to haunt the world economy.

So how should the Fed spring today's low-interest trap while stimulating the economy? Any plans to directly drive down longer-term interest rates on Treasurys should be abandoned. Bank intermediation is already curtailed because interest rates are too low to compensate the risk of taking on new liabilities.

But something more positive is necessary to promote the recovery of interbank, and then retail bank, lending. The Fed has the legal authority to be an active but "neutral" financial intermediary to replicate a properly functioning interbank market.

By accepting deposits and making loans at all terms to maturity, the Fed could nudge rates up to, say, 2% on short-term deposits with a modest upslope in the yield curve to approximately 4% at long term. Because the Fed can suppress counterparty risk by acting as broker-dealer in the interbank markets, it could behave as a neutral auctioneer by setting interest rates to balance the flow of bank funds.

This would eliminate the fear banks have of dealing with each other and get money moving again, but it would also pose technical problems—not the least of which are the huge overhangs of excess reserves in large commercial banks and toxic mortgage-backed securities on the Fed's own balance sheet.

But how to deal with these issues is a story for another time. Right now the crying need is to spring the near zero interest rate liquidity trap.

Mr. McKinnon is a professor of economics at Stanford University and a senior fellow at the Stanford Institution for Economic Policy Research.

Treasury Purchase Shock and Awe

By Vincent Reinhart

Readings on the economy have been sluggish and inflation has been slower than the Fed expected earlier in the summer. The situation warrants a response.

With the fed funds rate pinned at zero, the requisite easing action must take an unconventional form. For the reasons Chairman Ben Bernanke spelled out in his Jackson Hole speech in August, large-scale asset purchases seem to be the most promising.

Spending depends on the confidence of households and investors, and right now they seem legitimately worried both about near-term slack in the economy and longer-term overcommitment by the government. Moreover, as Carmen Reinhart and I documented at the Jackson Hole Symposium on Aug. 27, the performance of the economy may be impaired because of the financial crisis for a long time to come.

As a consequence, the Fed has to be both aggressive and nimble. The Fed should promise to purchase government and mortgage-related securities between its regularly scheduled meetings as long as activity is forecast to be subpar and inflation is low or headed down. Purchases of, say, $100 billion every six-to-eight weeks would add up to a number worthy of shock and awe for those with a somber economic outlook.

But those foreseeing a quick return to above-trend growth or expecting a slower trend would similarly be reassured that the Fed would not keep its foot on the accelerator for too long. Most importantly, by linking to economic conditions, the Fed would not be providing an open-ended promise to monetize the federal debt.

Mr. Reinhart, a former director of the Federal Reserve Board's Division of Monetary Affairs, is a resident scholar at the American Enterprise Institute.

Focus on the Long Term

By Allan H. Meltzer

When Congress established the Fed in 1913, it gave it a dual mandate: high employment and price stability. In its nearly 100-year history, the Fed has achieved both objectives only rarely: 1923-1928, a few years in the mid-1950s and early 1960s, and from 1985 to 2004, when the Fed followed the Taylor rule that incorporates Congress's mandate. Those 20 years when the Fed followed the rule were the longest sustained period of stable growth and low inflation in Federal Reserve history.

In "A History of the Federal Reserve," I concluded that the principal mistakes the Fed has made have resulted from giving excessive attention to current events and forecasts of highly uncertain near-term developments. By focusing on the short-term, the Fed neglects the longer-term consequences of its actions. The transcripts of FOMC show that the members are paying little attention to medium- and longer-term consequences. A rule would change that.

A rule prevents the Fed from responding to the cries of the day traders in the market—the ones now screaming about an unlikely deflation to improve their portfolio—and the pressures from politicians anxious to increase their votes. At times like the present, a rule helps the Fed to recognize that current problems are mainly the result of mistaken government policies that create massive uncertainty.

The Fed added more than a trillion dollars of excess reserves to respond to the financial crisis. Most are still available for bank loans. Adding a few hundred billion to the trillion dollars already available would help the bond speculators, but would do little for the economy that banks could not do now.

There is very little that the Fed can do to change the near-term, but it can have important influence on the future. The Fed has sacrificed much of its independence during this crisis by helping the Treasury carry out fiscal policy. Adopting and following a rule, like the Taylor rule, is an effective way to regain independence.

Mr. Meltzer is a professor of economics at Carnegie Mellon University, a visiting scholar at the American Enterprise Institute, and the author of "A History of the Federal Reserve" (University of Chicago Press, 2003 and 2010).