

What's the matter with the Fed?

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ECONOMIC POLICIES FOR THE 21ST CENTURY

I would like to acknowledge the many helpful comments and suggestions I received from my Dartmouth colleague Andrew T. Levin.

I think something is wrong with monetary policy. But my discontent has little to do with the level of the Fed Funds rate and much to do with ideas that frame the Fed's view of the world and the public's understanding of the Fed.

So here are three ideas about monetary policy that I believe are *wrong*, three ideas that, I fear, have led the Fed and the public astray.

Low long-term interest rates everywhere and always stimulate economic activity.

The tradeoff between unemployment and inflation provides a complete and sufficient guide for monetary policy.

The Fed's decision-making process and communications are good enough for the world's largest economy and oldest constitutional democracy.

To be clear, I *disagree* with these statements; I think they are *not true*. Let me explain why and why it matters.

1. *Low long-term interest rates do not everywhere and always stimulate the economy. The shape of the yield curve, not the level of long-term rates, is the more important lever of monetary policy.*

I understand how lowering long-term interest rates, persistently, would lower the discount rate on future cash flows, increase the value of financial assets, and create a wealth effect that might marginally increase the propensity to consume. But how does pulling down the level of long-term interest rates stimulate the growth of credit? Simply asking this question, for several years now, has made me something of a heretic.

By lowering the discount rate we can increase the price of *existing* assets. We also will have lowered the cost of borrowing for new borrowers and, in this way, we will have increased *demand* for credit. But to have an impact on *aggregate demand* for the whole economy, we need to stimulate *maturity transformation* and the production of *new* assets. We need to increase the *supply* of credit, don't we?

Consider the idea that we could reduce hunger in America by using the federal government's powers to press down prices of agricultural products, as low as possible for as many years as possible. It is easy to see how lowering the price might increase demand for farm products. But what would happen to supply? What about the farmers? Why is it obvious that, over several years (in the medium term), this would not work in farm products but it is so widely assumed that it would work for credit?

This generation of economists has spent their lives working with models of the economy that included the *assumption* that if you lower long-term interest rates both demand for and supply of credit will increase. Having assumed this for so long, the idea that demand and supply of credit can be simultaneously determined (by lower long-term rates) has become part of the macro-economic belief system. But that does not make it so.

There are, however, special conditions in finance that can stimulate both the demand for and the supply of credit. These special conditions hold when *short-term* interest rates are lowered significantly and the change is expected to be *temporary*. These special conditions are reflected in a *steep yield curve*.

Conventional monetary policy has, in the past, had a greater impact on short-term interest rates than on longer-term ones, leading to steep yields curves when monetary policy is easy and flat yield curves when policy is tight.

When yield curves steepen, lenders profit from wider net-interest margins (between borrowing short and lending long). This provides a powerful incentive to engage in maturity transformation and expand the supply of credit. Borrowers face a different incentive. When the structure of the yield curve is at its lowest, *provided it is expected to be temporary*, borrowers face a time-limited opportunity to borrow at rates lower than are likely to prevail in the future. With these special conditions, lower short-term rates and a steep yield curve can, simultaneously and strongly, stimulate both the demand for and the supply of credit and create the acceleration of aggregate demand that we associate with economic recovery.¹

But to solve the zero interest-rate boundary, the Fed decided that flat yield curves not steep ones would do a better job. Thus the Fed's mantra was to bring down long-term rates both with its balance sheet and its forward-guiding words. Of course, none of us have access to the counterfactual. But we do know that flatter yield curves reduce the incentive for maturity transformation from what it otherwise would have been.

Consider the following tragedy in three acts.

In Act I we see Alan Greenspan in the early 1990's getting ready for bed. Before he turns out the light, he gets down on his knees and prays. "Thank you, Lord," he says. "Thank you for the steep yield curve with which we are recapitalizing the American financial system."

In Act II we see the same scene but Greenspan is ten years older and this time we hear him say: "Why me, Lord? Why do you torment me with this

¹ See Kiley, Michael T., "The Aggregate Demand Effects of Short- and Long-Term Interest Rates," Finance and Economics Discussion Series, Divisions of Research & Statistics and Monetary Affairs, Federal Reserve Board, Washington, D.C. (2012-54).

conundrum of low long-term interest rates? Don't you realize how this is complicating the recovery?"

In Act III it is now 2012. We no longer see Greenspan and, instead, we see central bankers from all over the world having a great party to celebrate their success in creating persistently low long-term interest rates. Then we see these same central bankers wondering why bank lending and the recovery have been so weak, but sagely assuring themselves: "Headwinds."

Before the crisis the Fed was painfully naïve about leverage in the financial system. From 2010 onward, the Fed did everything in its power to flatten the yield curve, creating a wealth effect but retarding credit creation from what it might have been. This limited the stimulus to final demand. It also reduced revenues from maturity transformation, limiting the capacity of lenders to write down non-performing loans and repair their balance sheets more promptly.

Whether consciously or unconsciously, whether in haste or in ignorance, the Fed made a Faustian bargain to achieve wealth sooner but have trouble later, to pump up asset prices but to constrain maturity transformation and complicate the exit from its extraordinary policies.

Of course, the ubiquitous "headwinds" are holding back the transition to a more normal monetary policy. But the Fed's efforts to normalize policy are also being held back by a volatility trap of the Fed's own making: once you start targeting financial asset prices, once you have created a wealth effect, how and when do you stop?

Monetary policy needs to be informed by an understanding of how the financial system actually works in fact, not just in theory.

Monetary policy that is not based on a deep understanding of maturity transformation is not really *monetary* policy at all.

2. *The trade-off between unemployment and inflation does not provide a complete and sufficient guide for monetary policy, either as a matter of experience or as a matter of law.*

It recently occurred to me that in order to believe that the Phillip's Curve is a complete guide for monetary policy, one would also need to believe that *deflation dynamics* are simply the mirror image of *inflation dynamics*. I do not believe this.

The output gap and the nexus between aggregate demand and potential growth describe a set of forces that contribute to both inflationary and deflationary pressures that are reflected in the Phillip's Curve. Permit me simply to label these Type 1 forces.

Without attempting a complete taxonomy, permit me also to identify a second set of forces associated with changes in asset prices, particularly falling ones. We can think of asset price deflation, or debt deflation as described by Irving Fisher,² or “balance sheet recessions” as more recently described by Richard Koo.³ These concepts share a focus on the balance sheet combination of fixed liabilities and variable asset prices and the contractionary dynamics that occur when asset prices or incomes decline sharply relative to fixed liabilities.

The experience of American farmers in the depressions of the 1870s and 1890s, our national experience in the Great Depression, our experience in the Savings & Loan crisis of the late 1980s, the “underwater homeowners” of 2006 and the oil producers of 2016, all reflect this painful balance sheet mismatch. Let’s call these Type 2 forces.

The gravest deflationary risks to price stability, and also to stable output and employment, occur when we experience both Type 1 and Type 2 deflationary pressures at the same time, as Irving Fisher so wisely observed in 1933.⁴ He also described how deflation caused by debt “reacts on debt” creating contractionary forces that are hard to quell:

Each dollar of debt unpaid becomes a bigger dollar, and if the over-indebtedness with which we start was great enough, the liquidation of debts cannot keep up with the fall in prices which it causes. In that case, the liquidation defeats itself.⁵

Why does this matter? Accommodative monetary policy, both before the crisis and since, intended to increase both asset prices and credit in order to reduce the risk of Type 1 deflationary pressures from weak demand. But pushing asset prices and leverage higher also increases the risk of Type 2 deflationary pressures, by exposing more balance sheets to greater volatility mismatches – as we so painfully rediscovered in the financial crisis.

Why is it so hard for the Fed to acknowledge that prolonged periods of monetary accommodation may exacerbate the risk of future deflationary pressures? Wasn’t it exactly a worry about the combination of Type 1 and Type 2 deflationary forces that inspired the Fed to its heroic actions in 2007 and 2008? So, shouldn’t we be able to recognize, *ex ante*, that the risk of Type 2 deflationary pressures should be a

² Fisher, Irving, “The debt-deflation theory of great depressions”, *Econometrica* (1933).

³ Koo, Richard C., *The Escape from Balance Sheet Recession and the QE Trap*, (2015).

⁴ Fisher, Irving, paragraph 30 (1933). “. . . [W]hen a deflation occurs from other than debt causes and without any great volume of debt, the resulting evils are much less. It is the combination of the both – the debt disease coming first, then precipitating the dollar disease – which works the greatest havoc.”

⁵ Fisher, Irving, paragraph 32 (1933).

constraint on what accommodative policy can do to reduce the risk of Type 1 pressures from weak demand?

Sadly, former Governor Jeremy Stein was too-lonely a voice at the Fed arguing that monetary policy needed to take account of the risk of credit market overheating.⁶

I do appreciate that the Fed's two most recent chairs have not made the mistake, that other central bankers have, of claiming that there are "no limits" to what accommodative monetary policy can do to fight deflation. But instead of acknowledging what those limits are, the Fed has conceived of there being a contrast between the objectives of monetary policy, defined by the so-called "dual mandate", and the objectives of financial stability which are deemed to be of distinct and secondary importance.⁷ As I have argued elsewhere, this is misguided as it ignores the deflationary risks that are a consequence of financial instability.⁸

Unfortunately, the Fed has studiously avoided addressing these inter-temporal tradeoffs by claiming that its statutory mandate compels it to consider only a single tradeoff between the goals of maximum employment and price stability. But Section 2A of the Federal Reserve Act does no such thing; there is no dual mandate from Congress.⁹ By ignoring 31 out of the 38 operative words in its actual mandate, the Fed has asserted *de facto* goal independence, even if the surprisingly deferential members of Congress appear to accept the Fed's faux fidelity to the statute.

I am open-minded about revising the Fed's mandate. But there are features of the actual mandate I would not want to give up.

The Fed's actual mandate is to maintain the growth of the money and credit commensurate with potential growth. Deep down, all central bankers understand that this is the essence of the job, reflecting the central importance of productivity.

The Fed's actual mandate also has the benefit of focusing attention on the medium term – the only horizon over which one can sensibly think about calibrating money and credit growth with potential growth *as a means to the ultimate goals of*

⁶ Stein, Jeremy C., "Overheating in Credit Markets: Origins, Measurement, and Policy Responses", at the "Restoring Household Financial Stability after the Great Recession: Why Household Balance Sheets Matter" research symposium, Federal Reserve Bank of St. Louis, February 7, 2013.

⁷ Yellen, Janet, "Monetary Policy and Financial Stability", Michel Camdessus Central Banking Lecture, International Monetary Fund, July 2, 2014.

⁸ Fisher, Peter, "Financial Stability and the Hemianopsia of Monetary Policy", NABE 32nd Annual Economic Policy Conference, March 7, 2016, forthcoming in *Business Economics*.

⁹ "The Board of Governors of the Federal Reserve System and the Federal Open Market Committee ***shall maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates.***" 12 USC 225a (emphasis supplied).

maximum employment, stable prices and moderate long-term interest rates, *which must of necessity take place even further in the future.*

If monetary policy is simply trying to calibrate demand for resources with the supply of resources in a single temporal dimension, in the near term, it will too heavily discount the risk of instability in the future.

Monetary policy needs to recognize that Type 2 deflationary pressures are a foreseeable consequence of accommodative policy.

Monetary policy needs to aim its actions at more than one temporal dimension.

3. *The Fed's decision-making process and communications are not consistent with what we can and should expect; legislative reform is needed to improve both the individual accountability and the democratic accountability of those who have a say in our nation's monetary policy.*

The decision-making process and communications of the Federal Open Market Committee reflect a phony consensus that obscures accountability and increases inertia.

After its meetings the Committee issues a statement that members unanimously – or nearly unanimously – agree to. But each member anonymously makes their own projection of the expected forward path of overnight rates (in the notorious “dot plot”). Members also seem to feel free to vote for the consensus but dissent in their speeches. This leaves the Chair as the only member effectively accountable for the outcome. But the Chair cannot act until she or he gets all – or almost all – of the voting members to agree, given the norm of decisions by consensus.

Even more oddly, over the years the Committee has backed into the habit of striving *not* to change policy at its meetings or, more precisely, to avoiding having its statements suggest a change in policy, if at all possible.

Monetary policy only has effect to the extent that it changes expectations. But the Committee tries to avoid having its announcements “disturb” the market and seems to take pride that its statements do not change expectations. In this way, the Committee fabricates the impression that the market understands its reaction function, leaving actual changes in policy – the ones that do change our expectations – to occur somewhere other than in the Committee’s statements, most often in speeches by the Chair.

Imagine if the Supreme Court routinely gave hints of its decisions in speeches by the Chief Justice. Imagine if we read the Court’s opinions principally to see if they ratified the Chief Justice’s trial balloons. Imagine court watchers breathlessly awaiting speeches by the Chief Justice, and presumed swing voters, to find out

which way particular rulings would likely come out. Imagine if the Court almost always decided cases unanimously but Justices gave frequent speeches that reflected profound disagreements. Imagine how odd we would think it if the Court's actual decisions rarely changed our understanding of the law. I don't think we would be proud of this; I think we would be embarrassed.

The Fed's decision-making and communications process is broken and has been for some time. It reflects badly on the Fed's credibility and legitimacy. It undermines the Fed's actual independence but explains the Committee's reliance on decisions by consensus.

I have come around to the Bank of England's approach of individual accountability. Each Committee member should be accountable for their own vote as if they were the sole decision maker. The substantial benefits of reducing inertia and of having each member publicly accountable for their own views are well worth the cost of uncertainty surrounding the occasional close vote.

I have great fondness for the history of the Federal Reserve System and for the role of the Reserve Banks. Compared to the many other agency problems that plague our financial system (in both public and private spheres) the current appointment process for Reserve Bank presidents does not loom very large for me.

But that is the wrong comparison. The appointment process for Reserve Bank presidents is an unnecessary distraction for monetary policy. It carries with it the cost of undermining the Fed's legitimacy without any unique or irreplaceable benefits.

Given the sweeping powers the Fed has exercised in recent years and is likely to continue to exercise, as well as the outsized role that the Fed's balance sheet has taken on in our financial system, it is time to fix the appointment process for Reserve Bank presidents so that everyone who has a say in our nation's monetary policy is appointed by our elected representatives. The current process is not consistent with what we expect in the exercise of profound governmental powers in our democracy, nor is it consistent with how monetary policy-makers are selected in other countries.

The Committee is also too large to be an effective decision-making body for either monetary policy strategy or tactics. But we should, I believe, maintain a federal system that reflects the idea that not all wisdom is located in Washington. We should also make the Fed more specifically accountable for its actions.

To accomplish these objectives, I would like to see the Federal Reserve Act amended in the following ways.¹⁰

I would consolidate from twelve to eight Reserve Banks and have each Reserve Bank president be nominated by the President of the United States and confirmed by the U.S. Senate to a single, fixed eight-year term.¹¹

I would eliminate the current Board of Governors in Washington and leave only a single chairperson in Washington who would also be nominated by the President and confirmed by the Senate to a single, fixed eight-year term.

All of the powers of the current Board of Governors and the Federal Open Market Committee would be vested in the committee (or board) composed of these nine individuals, each of whom would have their own research staffs to support them.¹²

To increase accountability, Congress should require that the Fed set specific objectives for itself. At the start of each year, the Fed should be required (a) to specify its objectives for inflation, employment or output growth for the calendar year three years hence (that is, at the start of Year 1 for Year 3), (b) to specify how it plans to achieve those objectives and (c) to account for the economy's prior year performance against the objectives set by the Fed three years earlier.¹³ This report should be of and by the entire committee and those who dissent from the annual report should be required to spell out their own objectives, plans and assessments in dissenting opinions.

With these changes, I believe we would have a Fed that is both more accountable to our elected representatives and one that is more effectively independent of the political cycle. We would have a Fed that aims its policies at the medium term. And we would have a Fed that maintains a federal and national character.

¹⁰ This reform proposal has much in common with the more incremental approach recently spelled out by Andrew T. Levin (<http://www.tinyurl.com/LevinProposal>), as both aim to make the Fed a fully public institution with greater transparency and accountability.

¹¹ My suggestion would be that Reserve Banks would become U.S. government owned corporations, and their directors would be appointed, from within their districts, by the President, who could perhaps delegate this duty to the Secretary of the Treasury, without Senate confirmation.

¹² I would suggest sequentially staggered terms for the nine members so that in the second year of every other four-year presidential term, the terms of two members, both the Chair and one Reserve Bank president, would expire. In each other year in the eight-year cycle, one Reserve Bank president's term would expire. Thus, within 18 months of start of every other presidential term, the President would be able to nominate three out of the nine members including the Chair.

¹³ This proposed annual report requirement is similar to one of the ideas put forward by Allan Meltzer in "What's Wrong With the Federal Reserve: What Would Restore Independence?" *Business Economics*, Vol. 48, No. 2, page 101.

I also hope we would have a Fed brave enough to extract itself from the fiction that low long-term interest rates everywhere and always stimulate the economy and a Fed with the courage to carry out its actual statutory mandate.