Comments on James Hamilton’s “Perspectives on U.S. Monetary Policy Tools and Instruments”

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Macro and Micro Questions

• What is “monetary policy?” (Macro)

• Why smooth interest rates? (Macro/Micro)

• How to smooth interest rates more efficiently? (Micro)
What is Monetary Policy?

• In a market economy, relative prices adjust to keep in balance the supply of and demand for individual goods and services, thereby allowing real variables to respond efficiently to shocks.

• Under a fiat money regime, it is up to the central bank to conduct monetary policy in a way that pins down the behavior of the aggregate price level and, by extension, all other nominal variables.

• In theory, the central bank does this by exercising its monopoly power over the supply of base money.
What is Monetary Policy?

• In practice, the Fed implements monetary policy by targeting the federal funds rate.

• Before the crisis, it did this by actively managing the supply of base money.

• Under the new floor system, however, the Fed can change the funds rate by changing the interest rate on reserves, without conducting open market operations right away.
What is Monetary Policy?

• Even under a floor system, however, all monetary policy actions taken to influence the trajectory for the aggregate price level must be supported sooner or later by open market operations that have implications for the supply of base money, and hence the size and composition of the Fed’s balance sheet.

Why Smooth Interest Rates?

• Macro: Interest rate instability may create real instability over the period when the aggregate price level is fixed (Poole 1970).

• But do spending decisions really adjust based on daily fluctuations in the federal funds rate?

• Micro: Liquidity can be created at constant, zero marginal cost, so the opportunity cost of holding liquid assets should remain low and stable too (Friedman 1969).
How to Smooth Rates More Efficiently?

• In theory, corridor and floor systems rely on market mechanisms to stabilize interest rates.

• If the federal funds rate rises above the discount rate, banks will borrow from the Fed and lend in the interbank market, pushing the funds rate back down.

• If the federal funds rate falls below the interest rate on reserves, banks will borrow in the interbank market to increase their deposits at the Fed, pushing the funds rate back up.
How to Smooth Rates More Efficiently?

• Historically, however, the discount rate hasn’t always set a ceiling for the funds rate.

• And, more recently, the interest rate on reserves hasn’t set a floor.

• Unexploited arbitrage opportunities – deviations from the law of one price – are a sign of microeconomic inefficiency.
Message to the Fed

• Set up a clean floor or corridor system, unencumbered by formal or informal regulatory constraints and institutional complications, and let financial markets smooth interest rates for you!

• Then, you can focus on your more basic, macroeconomic objective: maintaining an environment of nominal stability within which the real economy can produce robust growth in incomes and jobs.