Some Practical Advice (From a Monetarist) To the Fed

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Two Monetarist Principles

The quantity theory of money.

And the proposition that monetary policy works best when conducted according to a pre-announced rule.

Two Pieces of Advice

End Interest on Reserves

To make monetary policy more effective and help preserve the favorable environment of nominal stability we've enjoyed since the 1980s.

Fortify AIT

Announce a rule or at least outline a more detailed strategy to support the new average inflation targeting framework.

End Interest On Reserves

The Fed began paying interest on reserves during an emergency: the financial crisis of 2008.

The Fed continues to pay interest on reserves today, long after the crisis ended.

Interest on reserves, however, interferes greatly with the Fed's ability to use its traditional monetary policy tools to achieve its stabilization goals, threatens the efficiency of the private financial system, and even puts at risk the Fed's own independence.

End Interest On Reserves

The Fed began paying interest on reserves in October 2008. Why?

To facilitate emergency lending …

… without creating inflation.

This bears repeating: interest on reserves was *designed* to allow the Fed to conduct emergency lending on a large scale without creating inflation.

End Interest On Reserves

What are the biggest challenges the Fed faces today?

The first concerns the threat of sustained low inflation.

Despite years of extraordinary low interest rates and wave after wave of quantitative easing, inflation remains stubbornly below 2 percent.

But should this really surprise us, when the *whole point* of interest on reserves was to allow the Fed to expand greatly the size of its balance sheet without fueling inflation?

End Interest On Reserves

Last year’s spikes in money market rates discussed by Darrell Duffie confirm that, despite everything, the supply of reserves was insufficient to meet demand. From a macroeconomic perspective, this means monetary policy was too tight.

Bill Nelson described how, in other ways, regulatory policy has shifted the demand curve for reserves even further to the right – again, from a macroeconomic perspective, this is deflationary.

And remember what Friedman and Schwartz taught us about 1937.

End Interest On Reserves

What are the biggest challenges facing the Fed today?

The second concerns “mission creep” and the threat of lost independence.

Lending and asset-purchase programs authorized by the CARES Act could have been administered by the Treasury.

Instead, the Fed stepped in to play that role.

End Interest On Reserves

That was a mistake: it let the cat out of the bag.

Now *everyone* knows that interest on reserves lets the Fed buy *any* asset and make *any* kind of loan without fueling inflation.

The power is enormous and open to abuse.

End Interest On Reserves

Do we want the Fed to become a giant state-run financial intermediary, capable of crowding out private competitors and making its asset allocation decisions under political influence?

Or do we want the Fed to go back to being our nation’s central bank, managing the supply of reserves to stabilize the aggregate nominal price level?

Fortify AIT

There is a lot to like about the FOMC’s new AIT objective.

It recognizes that even with a 2 percent inflation target, actual inflation won’t equal 2 percent in any given quarter or even any given year.

Instead, it seeks to guard against modest, but persistent, deviations from target that would cumulate over time to push the levels of nominal magnitudes far away from where they were expected to be when “long-term contracts were signed” (i.e., when long-term financial plans were made).

Fortify AIT

But the FOMC's description of AIT is incomplete.

"Following periods when inflation has been running persistently below 2 percent, appropriate monetary policy will likely aim to achieve inflation moderately above 2 percent for some time."

Likely? Moderately? For some time?

And will the FOMC act symmetrically following periods of above-target inflation?

Fortify AIT

The FOMC's statement describes a set of actions likely to be taken if the economy evolves as expected.

But there is no hint of a contingency plan, a strategy, or a rule that would help shape expectations of what will happen should the economy behave otherwise.

Precisely because there is so much uncertainty about the future trajectory of the recovery, the FOMC needs to fortify its average inflation target with a more detailed rule or strategy.