Federal Reserve Policy in the Great Recession

By Allan H. Meltzer

Over-response to short-run events and neglect of longer-term consequences of its actions is one of the main errors that the Federal Reserve makes repeatedly. The current recession offers many examples of actions that some characterize as bold and innovative. I regard many of these actions as inappropriate for an allegedly independent central bank because they involve credit allocation, fill the Fed's portfolio with an unprecedented volume of long-term assets, evade or neglect the dual mandate, distort the credit markets, and initiate other actions that are not the responsibility of a central bank.

Purchasing more than $ 1 trillion of long-term mortgages is credit allocation. How can the mortgage-related securities be sold later when inflation rises while the housing market remains troubled? The Fed has no plan. Selling Treasury securities to finance mortgage or other purchases is a fiscal operation. Money doesn't change, and the purchase reduces the interest payment made to the Treasury. Selling two-year Treasuries to finance purchases of longer-term bonds also doesn't change reserves or money. It is debt management and should be left to the Treasury.

Bailing out Bear Stearns and accepting $30 billion of low quality assets in March 2008 is high on the list of mistaken actions in this recession. That reminded financial markets that too-big-to-fail (TBTF) not only remained part of operating policy but that the policy now included non-banks and medium-sized financial firms. The bailout policy kept in place and even extended support for banks and others that earned high returns on risky assets but shifted many of the losses to taxpayers.

Without warning, the Fed and the Treasury changed TBTF policy in October, allowing Lehman Brothers to fail. That policy did not continue. Days later, the Fed bailed out American International Group by investing $ 180 billion in the failing company. These shifts in policy greatly increased uncertainty about what would happen next. Financial firms and others responded by greatly increasing the demand for cash. The Fed responded appropriately by acting as lender of last resort to financial markets at home and abroad by increasing the supply of cash assets.

What occurred next is a model of what a well-run central bank should not do. The Fed explained that the increase in cash assets was almost entirely short-term assets. These would decline over time and would be withdrawn. That didn't happen. The Fed replaced the short-term assets with longer-term assets and undertook credit allocation to stimulate the housing market by buying mortgage-related securities. It explained that these holdings would decline over time as borrowers paid interest and some principal. Again, that didn't happen. The Fed purchased long-dated Treasury securities to prevent its balance sheet from shrinking.

The excessive concern about the near-term makes the Fed give too much attention to the daily yammering that is called financial market commentary. Much of the commentary is self-serving. In the summer of 2010, the commentators warned repeatedly that deflation and a recession were likely. The Fed responded by adopting QE2, a bond purchase program. Market speculators bought long-term bonds ahead of the program and profited. If the Fed had waited a few more months it would have found that forecasts of deflation and renewed recession were wrong.

Did the Fed's response prevent the predicted outcomes? Unlikely, because after the Fed announced purchases of $ 600 billion of long-term Treasury debt their massive excess reserves rose $500 billion. The dollar fell against most currencies. Several countries purchased dollars to slow exchange rate appreciation, absorbing most of the remaining $ 100 billion. Exchange rate depreciation raised import prices. The Fed pays little attention to the exchange rate except when there is a crisis.

Soon after the end of QE2, the Fed announced that it would keep the federal funds rate near zero for the next two years, until 2013. The main effect of this action is to keep expected future interest rates from rising. The Fed can then point to expected future interest rates as evidence that markets believe inflation will not occur. The exchange rate and prices send a different message. The dollar depreciated 15 percent or more in the past year against weak currencies like the euro and the yen. The market commentators pay little attention to the dollar because they know that the Fed ignores the exchange rate.

The most recent Fed action is the attempt to “twist the yield curve” by buying long-term debt and selling short-term. Reserves and money do not change. This is not a monetary action. The Fed is again engaging in debt management or credit market policy that is the province of the Treasury. The Fed responded again to the financial market soothsayers who warned of another recession. We know that was wildly wrong. The preliminary estimate of third quarter growth is 2.5 percent, double the second quarter rate. Of course, in advance of the Fed’s announcement, the market again lowered bond yields, so some nimble speculators gained. How does that help the economy or the unemployed? It is a mistake that the current Fed keeps making.

The last attempt to twist the yield curve was in the early 1960s. Both Federal Reserve and outside researchers concluded that the policy failed. A main reason is that the Treasury market is a large, active market. Traders sell what the Treasury buys and buy what the Treasury sells, thereby reversing the change in yields that the Fed wants to achieve. The speculators profited from the Fed’s announcement, but lost if they held Treasury bonds very long. Soon bond yields were higher than before the announcement.

Recent Fed actions have much in common. They reward the day traders in the bond market and have little if any effect on employment and output. Also, they show the very short-term focus that dominates Federal Reserve activity. The United States has major long-term problems. Housing is one, the budget and current account balances are others. Dollar devaluation contributes to export growth, but it raises imports because the market adjusts oil and other import prices for dollar depreciation. The cost of importing oil and other commodities rises, increasing the value of imports and hindering necessary reductions in the current account balance.

The current Fed and many others ignore money growth. The reason always given is that monetary velocity is unstable. That claim is true only because the Fed focuses on the near-term and ignores the longer-term consequences of its actions. I agree that quarterly changes in monetary velocity are often unpredictable. The same is not true of annual movements, as shown by numerous studies of the demand for money based on annual data.

In my Fed history, I showed a chart relating base velocity to a long-term interest rate for the years 1919-1997. The chart includes data for most of Fed history, years of war, depression, inflation, deflation, years on the gold exchange standard, pegged interest rates, and disinflation. As usual in my work, I use the long-term interest rate because it is a better measure of expected inflation than the short-term rate.

Insert Chart 1 here

The chart shows remarkable stability. When interest rates in the 1960s returned to the 1920s values, base velocity returned to the mid-1920s levels also. Further the long right tail shows the rise in interest rates and base velocity during the inflationary 1970s. That tail also shows that base velocity and interest rates declined along the same path in the 1980s.

The Fed's excessive attention to monthly and quarterly events leads them to ignore the information in money growth and velocity. That's a mistake, an error that contributed to the inflation of the 1970s and is repeated now. It reflects the undue concentration on the near-term and neglect of the consequences of their actions. Surely we and they know that there are long lags between policy action and its effects.

Why does the Fed ignore money growth and the longer-term consequences of its actions? Their near-term forecasts have large errors, about as large as private forecast errors. Research has shown that policy actions are not absorbed within a quarter. Monetary lags are much longer. It is true that staff models give the members of FOMC information about the medium- and longer-term future, but the members do not agree on the model and often disagree with the forecast. Several presidents have independent forecasts. No effort is made to reconcile differences about the future. In nearly one hundred years, the Fed has not agreed on a model for the economy. It doesn't attempt to reach consensus.

Why does the Fed persist in its short-sighted actions? I believe that actual or perceived political pressure is the main reason. From its very beginning the Board has been the conduit for political influence. Over time, Congress has increased the relative position of the Board and reduced the influence of the Reserve Bank presidents and the Bank's directors. The 1935 act shifted the balance. Additional shifts came at other times including the recent financial crisis when the Board and the New York Fed acted on bailouts and lending without discussion by the FOMC and Congress further limited the role of Bank directors.. And currently Congressmen Frank has reopened a periodically recurring discussion of the role of the presidents. To increase political influence, especially his, he proposes to eliminate the presidents' influence from decisions. Congress gave the Board a dual mandate. Congressman Frank opposes the presidents who dissent because they remind FOMC members that one part of the dual mandate, future inflation, is highly likely.

The dual mandate calls on the Fed to respond to unemployment and inflation. In its long history, it has rarely achieved both goals. The successful periods are 1923-28, a few years in the 1950s and 1960s, and 1985-2003. The last is by far the longest period of stable growth and low inflation. The few recessions in these years were short and mild. During this period, the Fed appears to have approximately followed a Taylor rule. That rule calls for response to both elements of the dual mandate. Most often the Fed concentrates on one of the two variables. During the inflationary 1970s, most attention was on unemployment. Brief attempts to reduce inflation ended when the unemployment rate rose above six or seven percent. During the early Volcker years, 1979-82, policy concentrated on reducing inflation. Current policy again works to reduce unemployment.

To put it bluntly, pursuing one part of the dual mandate, then switching to the other part, and back again is inefficient. The result in the 1970s was that the Fed did not achieve either of its mandated goals. Both inflation and the unemployment rate rose during the decade. The Fed continued to operate on the belief that there was a tradeoff between the two goals; it claimed that higher inflation reduced unemployment. The instantaneous or short-term effect may be consistent with their Phillips curve model. As noted, the actual changes over time were that inflation and unemployment rose together.

Shortly after Paul Volcker began the disinflation policy, he went on a Sunday talk show. The Phillips curve was widely accepted, so he was asked what he would do when unemployment increased. His reply denied the relevance of the Phillips curve for policy. Volcker responded by pointing out that the question implied that he would have to trade off one goal for the other. Instead, he said, that unemployment and inflation rose together. Reducing inflation would bring down the unemployment rate. Volcker repeated that message to the Fed staff, and he did not use their forecasts of inflation and unemployment. We now know that he was right.

Alan Greenspan also did not find the staff's Phillips curve forecasts useful for policy decisions, as he told the staff more than once. The Bernanke Fed continues to use the Phillips curve to forecast inflation despite its own history during the Volcker and Greenspan years and the large amount of econometric evidence showing that changes in expected output are one main reason that Phillips curve forecasts are inaccurate and unreliable.

Once again, the current Fed gives excessive attention to the near-term, over which they have little influence. It ignores the medium- and longer-term consequences of its actions. These are more subject to the influence of their actions. And given the low level of interest rates and the massive amount of idle excess reserves, I find political pressure as the likely explanation of recent additions to excess reserves and attempts to further lower long-term interest rates. The Fed can tell the Congress that they are "doing something." One can only hope that at some point, the Fed will remember both that there is another half to its dual mandate and that excess demand for money is not why current unemployment remains around 9 percent. Interest rates and excess reserves both show that we do not have a restrictive monetary policy.

Financial failures are another perennial Fed problem. In its nearly one hundred year history, the Fed has never announced its policy as lender of last resort. From the 1970s on, it acted on the belief that some banks were too-big-to-fail. Although the FOMC discussed last resort policy at times, the Fed never committed itself to a policy rule about assistance. And its actions are not always consistent. Drexel Burnham was permitted to fail and later Lehman. But Bear Stearns was sold to J P Morgan Chase after the Fed bought $30 billion of the most risky assets. It has sustained a large loss of taxpayers' money.

Absence of a crisis rule has serious consequences. Uncertainty increases when no one can know what the Fed will do. Troubled banks urge Congress to demand a bailout. Enforcing a rule is not easy, but it is certainly better than encouraging excessive risk taking and shifting the cost of banker mistakes to the public.

The Dodd-Frank law gives responsibility for deciding on bailouts to a committee chaired by the Secretary of the Treasury. I regard this as foolish. Once the crisis or failures start, the committee will always chose to do the bailout rather than risk contagion. Deciding one at a time under pressure is not a substitute for a clear policy statement announced in advance and implemented without hesitation. The familiar Bagehot rule is an example that worked well in the past.

The Dodd-Frank law replaces the rule of law with the rule of regulators. A more effective way to reduce both risk and failures is to require more equity capital. My proposal ties the amount of capital to the size of the banks portfolio. As size increase, the ratio of capital to assets rises. Instead of subsidizing size by protecting large banks, this proposal penalizes size to reduce large risks to the public.

What Should Be Done?

Economists and central bankers have discussed monetary rules for decades. A common response of those who oppose a rule, or rule-like behavior, is that a central banker's judgment is better than any rule. The evidence we have disposes of that claim. The longest period of low inflation and relatively stable growth that the Fed has achieved was the 1985-2003 period when it followed a Taylor rule. Discretionary judgments, on the other hand, brought the Great Depression, the Great Inflation, numerous inflations and recessions. The Fed contributed to the current crisis by keeping interest rates too low for too long.

No rule can be correct all the time. Rule-like behavior calls on the Fed to announce a rule, like the Taylor rule. If it believes there is reason to depart from the rule, it should announce its decision. If its decision turns out wrong, it should offer an explanation and offer to resign. The president can accept the explanation or the resignations. That closes the current large gap between Federal Reserve authority and political responsibility.

Rule-like behavior forces the Fed to look ahead to the time when today's policy actions become future reality. That helps to bring more stability. But more change is needed. Since the Bretton Woods system ended, the dollar has depreciated substantially, as much as 75 percent against the Swiss franc, the yen and some other currencies. The United States should agree on a common inflation target, zero to 2 percent, with the European Central Bank and the Bank of Japan. Any country that pegged its currency to one of the three would have a fixed exchange rate and low inflation. The three major currencies would gain exchange rate stability with those who peg.

All decisions would be voluntary. No meetings would be needed. Markets would monitor the commitment to low inflation. The dollar, the euro, and the yen would continue to float so as to adjust real exchange rates to productivity and other real events. Eventually the Chinese renminbi might join the agreement, if China allows its currency to float and abandons its exchange controls.

This arrangement would not work perfectly. It would provide low inflation and greater exchange rate stability. It would offer a public good to all countries that wish to take advantage. And it would depend on markets to enforce discipline.

One additional proposal is a rule, perhaps Bagehot's rule, as a lender-of-last resort rule combined with a capital requirement that enforces prudence by making stockholders and managers take the losses when credit market failures and mistakes occur.

Rational decision makers know that they must always answer three questions when choosing a strategy. Where are we? Where do we want to get? How do we get there most efficiently from where we are? In my study of Federal Reserve history, it is rare to find the Fed making rational plans. The present is no exception.

We can improve outcomes by ending unlimited discretion and insisting on great discipline and accountability for Federal Reserve actions.