



U.S. monetary policy in disarray

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ABSTRACT

Monetary policy became more difficult to characterize during and after the mortgage foreclose and financial crises because of a shift to a new credit policy focused on private sector credit and that relies on traditional commercial banking strategies. The new credit policy broke the tight link that had existed between Fed credit and its effective monetary base, the monetary base that affects monetary aggregates. The Fed has adopted an exit strategy, but the discretionary powers that it followed remain in place as does a mistaken policy on the payment of interest on excess reserves.

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Monetary policy has become more difficult to characterize or follow since 2007. Before that time, matters were simpler, but still not simple. Earlier, there was a persistent debate about whether monetary policy was best characterized and understood as interest rate policy or by Federal Reserve (Fed) monetary actions to affect the growth rate of monetary aggregates. Since 2007, however, the Fed has been implementing policy actions aimed at the availability of Fed credit, especially private sector credit, as the key factor affecting the stability of financial markets, output, employment and prices. Monetary policy became credit policy in 2007 and has remained so since then. The tight link between Fed actions that change the money stock and those that affect the Fed's contribution to the stock of credit has been seriously degraded. At least for some time, there is no longer any simple measure produced by the Fed that can be taken as a benchmark for the Fed's actions to affect the economic expansion, the value of money (inflation), or financial stability.

The Fed has attempted to frame its response to the recession and financial crisis as largely following the analytical framework of Milton Friedman. For example, Nelson (2011, p. 2) cites Bernanke (2004, p. 2), who observes, "Friedman's monetary framework has

been so influential that, in its broad outlines at least, it has nearly become identical with modern monetary theory and practice." Nelson argues that "An underappreciated aspect of the policy response is its consistency on many dimensions with the framework for financial and monetary policy suggested by Milton Friedman's body of work." The argument and evidence in this article are strongly at odds with the Fed's view of its policy and Nelson's explanation of its consistency with the work of Milton Friedman. Nelson (2011) is characterized as a Fed view here, but this is not to argue that it was promoted or supported by research colleagues or Fed officials.¹

Section 1 discusses conventional interest rate policy and monetary base control as methods to influence aggregate demand. The Fed largely abandoned conventional interest rate policy in 2007 when it began to move the target federal funds rate to a rate below 25 basis points, or near zero. The Fed also prompted confusion over monetary actions by creating large excess reserves that blurred the

¹ Nelson is the Chief of the Monetary Studies Section, Division of Monetary Affairs, Board of Governors of the Federal Reserve System since 2009; he was a research official at the Federal Reserve Bank of St. Louis from 2003 to 2009, and was an economist and research advisor at the Bank of England from 1998 to 2003. Fed Research staff and officials exercise considerable independence in the subjects that they choose their analysis and conclusions at all three institutions. In particular, Nelson (2011) carries the explicit caveat: "The analysis and conclusions set forth are those of the author and do not represent the concurrence of other members of the research staff of the Board of Governors, or the Board of Governors."

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Fed's actions to influence monetary aggregates. Section 2 details the Fed's shift to credit policy, its shortcomings, and the breakdown in the link between Fed credit and the monetary base. Credit policy shifts the focus of Fed actions away from monetary policy and, instead, stresses a critical channel for direct placement of credit to distressed non-depository private financial firms and Government Sponsored Entities (GSEs) as the principal means for countering financial crises and recessions.² This section also provides an analysis of the payment of interest on reserves and the cost of subsidized excess reserve holding. Section 3 reviews recent claims by the Fed that their actions can be viewed as consistent with Milton Friedman's framework for monetary policy. Section 4 provides a summary and conclusions.

1. Conventional Fed policy to affect money and credit

One of the great monetary policy debates for 50 years or more has been whether monetary policy works by affecting the quantity of money that circulates in the economy or by interest rate policy, which for almost as many decades has been indicated by settings of the federal funds rate. At one level, this debate was not essential since setting a nominal interest rate or setting the monetary base could be analytically equivalent if implemented in an equivalent manner, but in practice this proved unachievable. Perhaps the greatest shortcoming of interest rate policy, at least as it has been carried out by the Fed, is that it does not focus on a real rate, the type of rate that might actually influence spending, output and employment and inflation. The broader, more fundamental issue is whether monetary policy might better be exercised by control of a monetary aggregate, such as the Fed's monetary base. Monetary targeting has not received much attention since 1982, when the Fed essentially abandoned targeting the monetary aggregate, M1, and later stopped paying lip service to the broader monetary aggregate M2. Instead, the Fed has ignored Congressional pressures for explicit monetary aggregate targets adopted in House concurrent Resolution 133 passed in 1975.

The old federal funds rate – monetary aggregates debate about the efficacy and instruments of monetary policy was quieted by the fundamental and prescient challenge of [Bernanke and Blinder \(1988, 1992\)](#) who rejected the usefulness of monetary measures as an indicator or instrument of policy and focused instead on the federal funds rate or credit spreads as part of a credit approach for a central bank to influence economic performance. [Taylor \(1993\)](#) provides the case for the eponymous rule explaining how the Fed could improve upon its ability to influence inflation, real GDP and the unemployment rate without reference to monetary aggregates. Once the federal funds rate was set at zero, however, the Fed resorted to direct credit measures to influence credit spreads and economic performance.³ [McCallum and Nelson \(2011\)](#) make a strong case for including money in the analysis of inflation in G-7 countries, as do [Belongia and Ireland \(2012\)](#) for the United States. Nonetheless, for many analysts, conventional policy became seemingly irrelevant to the Fed's leadership in 2007. It is useful to see how indicators of policy have evolved without direct policy reliance on them.

² The course of action is all the more striking in light of Chairman Bernanke's speech (2002) in honor of Friedman's ninetieth birthday, when he concluded "I would like to say to Milton and Anna (Schwartz): Regarding the Great Depression. You're right. We did it. We're very sorry. But thanks to you, we won't do it again."

³ [Belongia and Ireland \(2012\)](#) point out that [Bernanke and Blinder \(1992\)](#) led the charge in arguing against the use of a monetary aggregate in the conduct of monetary policy and that [Friedman and Kuttner \(1992\)](#) reinforce the instability of the money – GDP link after 1980, though [Leeper and Roush \(2003\)](#) reach the opposite result.

1.1. The federal funds rate as an indicator of recent policy

Federal funds rate changes and its level since 2008 indicate that the Fed has been extremely easy, or stimulative, because it was sharply reduced to, and has remained, near zero. The interest rates that matter for spending are real interest rates, the nominal interest rate less the expected rate of inflation. Using the personal consumption expenditure deflator over the past year to measure inflation expectations, the real federal funds rate in [Fig. 1](#) shows that the key rate sometimes moves in the opposite direction from the federal funds rate setting because of movements in expected inflation.

In particular, from July 2008 to July 2009 and again from December 2009 to November 2010, the real federal funds rate rose, and quite sharply.⁴ In the first instance, the Fed allowed its policy to become tighter, inadvertently deepening the recession and contributing to the financial crisis two months later and subsequently delaying and in the second instance weakening the recovery. The former increase is reminiscent of the sharp increase in the Fed's nominal and real discount rate in midst of the Great Depression in October 1931 that was kept in place until June 1933.⁵

1.2. The monetary base and the recent recession and recovery

Many analysts have long emphasized that the Fed should target the annual growth rate of a monetary aggregate in order to achieve macroeconomic objectives. For example, see [Andersen and Karnosky \(1977\)](#). Monetary aggregates measures, such as the narrow measure M1, have come into question for a variety of reasons, including the fact that much of a key component, currency, is held abroad and is therefore unlikely to affect domestic economic activity or prices. Sweep practices of depository institutions have also affected M1, but estimates of sweep balances can be incorporated.

Changes in one measure, the monetary base, reflect Federal Reserve actions that influence monetary aggregates. [Meltzer \(1987\)](#) and [McCallum \(1988, 2000\)](#) develop policy rules for the use of the monetary base to control GDP and inflation. The monetary base equals the assets of the Fed, netting out some uses of the monetary base that restrict the availability to support its two main uses: currency holdings of the public and reserve holdings of depository institutions. Increases in the growth rate of the monetary base are expected, with a lag, to boost the growth rate of broader monetary aggregates and, in turn to increase spending growth, and temporarily the growth rate of output and employment. Eventually, however, a more rapid increase in the monetary base and spending are expected to result only in a higher inflation rate.

In a simple model of the money supply process the monetary base is tightly tied to broader monetary aggregates via

⁴ If the real interest rate is constructed using the *ex ante* University of Michigan inflation expectations measures the surge in the real rate in these two periods is not as large. Recent swings in inflation associated with surges in energy prices and subsequent declines may not affect the University of Michigan expected inflation measure. However, both expected inflation measures are not immune to energy price swings before then and the PCE deflator is usually a better predictor of future inflation. The 10-year constant maturity TIPS yield shows four spikes in the real interest rate since the recession began: March 2008 to November 2008 (180 basis points), April 2009 to June 2009 (31 basis points), November 2009 to March 2010 (23 basis points), and October 2010 to February 2011 (71 basis points). The first period is the run-up to and worst part of the financial crisis during the recession, the second period is at the end of the recession and the third period matches the first four months of the surge shown in [Figure 1](#).

⁵ This is not to argue that the Fed's recent actions paralleled those during the Depression. In the early 1930s, the Fed allowed the money stock to decline some 25 percent causing rapid declines in spending, output and prices.

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