

Can We Trust the Fed?

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“In God We Trust” was first emblazoned on U.S. paper currency in 1957, and was steadily introduced to all U.S. paper currency by August of 1966.¹ How has this demonstrative, articulated trust in God underpinned the value of our currency? According to the BLS CPI inflation calculator², one dollar in 1947 had the same buying power as \$1.45 in 1966, which averages over those 20 years to an inflation rate of 1.9% per year. Subsequent to the full presence of trust in God on our paper currency, one dollar in 1967 now has the same buying power in 2014 of \$7.12, which averages over those 48 years to an inflation rate of 4.1% per year. Trust in God, sadly it seems, has led to an over two-fold increase in the rate of deterioration in the value of our currency. Trust in God alone has not preserved the value of our currency – so in the spirit that we “render unto Caesar that which is Caesar’s”³, trust in the Fed is likely more important to underpin the value of a dollar.

But can we trust the Fed? I would like to, but at this point I am not convinced. Let me begin with the positive – relative to other major central banks such as the Bank of Japan, the European Central Bank, and the People’s Bank of China, the Fed outperforms as a trusted and respected institution. The Fed is capable of bold action as a central bank in times of financial crisis, albeit not without mishaps. The Fed is also capable of conducting disciplined, constrained and systematic monetary policy in pursuit of its macroeconomic objectives while allowing modestly inclusive discourse and dissent on policy decisions. I take this view notwithstanding the fact that U.S. monetary policy has become more unconstrained and less principled and policy objectives have been shifting since at least 2008. Also, outperforming the industry standard as a central bank is a pretty low bar these days, as the other central banks I have listed (the Bank of England being an exception) are either institutionally incapable of bold central bank action or constrained yet inclusive monetary policy decisions.

The reason why it is difficult to trust the Fed, to my mind, then centers on the Fed’s shifting principles, changing macroeconomic policy objectives, and their unsystematic approach to implementing monetary policy. Key to this fluidity in the Fed’s thinking has been the changing nature of the interpretation of the dual mandate of maximum employment and price stability. Chairman Greenspan noted in May 24, 2001, “a central bank’s vigilance against inflation is more than a monetary policy cliché, it is, of course,

¹ <http://www.treasury.gov/about/education/Pages/in-god-we-trust.aspx>

² <http://www.bls.gov/cpi/cpicalc.htm>

³ Mark 22:21.

the way we fulfill our ultimate mandate to promote maximum sustainable growth.”⁴ On February 24, 2006, Chairman Bernanke struck a similar note about the primacy of price stability in the dual mandate:⁵

Price stability plays a dual role in monetary policy. Stable prices are desirable in themselves and thus are an important goal of monetary policy. But stable prices are also a prerequisite to the achievement of the Federal Reserve's other mandated objectives, high employment and moderate long-term interest rates. In particular, low and stable inflation and inflation expectations enhance both economic growth and economic stability.

Chairman Bernanke also notes in this same statement that, “Price stability plays a dual role in modern central banking: It is both an *end* and a *means* of monetary policy (emphasis in the original).”⁶ In other words, arriving at maximum employment required first passing through the door of price stability. Lexicographically, price stability was the first priority. Intellectually, price stability complemented maximum employment, but not the other way around. Price stability was a necessary condition for maximum employment.

Fast forward a few years, and these principles have shifted. We know this because in 2012 the Federal Reserve articulated its principles in print, announcing for example its operation definition of inflation as “the rate of 2 percent, as measured by the annual change in the price index for personal consumption expenditures, is most consistent over the longer run with the Federal Reserve's statutory mandate.”⁷ More strikingly, they moved away from the principle that price stability was necessarily a means to an end to achieve maximum employment. The document indicates that:⁸

In setting monetary policy, the Committee seeks to mitigate deviations of inflation from its longer-run goal and deviations of employment from the Committee's assessments of its maximum level. These objectives are generally complementary. However, under circumstances in which the Committee judges

⁴ Greenspan, Alan. “Economic Developments.” Remarks, May 24, 2001. As cited in Orphanides, Athanasios. “The Road to Price Stability,” FEDS Working paper #2006-05.

<http://www.federalreserve.gov/pubs/feds/2006/200605/200605pap.pdf>

⁵ Bernanke, Ben S. “The Benefits of Price Stability.”

<http://www.federalreserve.gov/newsevents/speech/bernanke20060224a.htm>

⁶ Bernanke, Ben S. “The Benefits of Price Stability.”

<http://www.federalreserve.gov/newsevents/speech/bernanke20060224a.htm>

⁷ <http://www.federalreserve.gov/newsevents/press/monetary/20120125c.htm>

⁸ <http://www.federalreserve.gov/newsevents/press/monetary/20120125c.htm>

that the objectives are not complementary, it follows a balanced approach in promoting them, taking into account the magnitude of the deviations and the potentially different time horizons over which employment and inflation are projected to return to levels judged consistent with its mandate.

The key terms that indicate the shift in principles of macroeconomic objectives are “not complementary”. In other words, compared to the Fed’s earlier understanding, compromises to achieving the price stability objective that may improve employment outcomes are now part of the Fed’s permanent lexicon. Manipulating short term trade-offs between price stability and employment are again, in a flashback to the Great Inflation, part of our monetary policy options. Price stability is no longer a necessary condition for maximum employment.

Obviously, shifting principles do not inspire trust or confidence. How does this play out in practice in our current economic environment? Currently, the 12 month growth of the PCE deflator is 1.5% as of the end of August. This is slightly below the Fed’s 2% inflation, price stability objective, but certainly not an indicator of a deflationary spiral or an outcome that is worthy of the current low inflation scaremongering.⁹ The employment picture has improved with further declines in the rate of unemployment to 5.9% in September 2014, but other indicators of employment (participation, part-time employment, etc ...) remain tender, and have shown to be outside the reach of the Fed’s ultra-accommodative monetary policy.

Given the employment and inflation picture, the Fed will remain accommodative even as it has recently ended the third round of quantitative easing. Indeed, the FOMC continues to indicate that:¹⁰

When the Committee decides to begin to remove policy accommodation, it will take a balanced approach consistent with its longer-run goals of maximum employment and inflation of 2 percent. The Committee currently anticipates that, even after employment and inflation are near mandate-consistent levels, economic conditions may, for some time, warrant keeping the target federal funds rate below levels the Committee views as normal in the longer run.

⁹ Interestingly, there is a disingenuous asymmetry between how oil prices enter the monetary policy conversation. For example, recent declines in oil prices are now interpreted as signs of weakness in world growth and contributing to deflation. However, rising oil prices which raise headline inflation numbers are typically dismissed as only temporary phenomenon. Is anyone fooled by this?

¹⁰ <http://www.federalreserve.gov/newsevents/press/monetary/20141029a.htm>

Taking into account the current stance of policy and the status of the economy, how can the Federal Reserve establish the trust that is needed to underpin our economic security? I have two recommendations. First, the Fed needs to better articulate, calibrate and prioritize the multiple risks we face in implementing policy in pursuit of the dual mandate. Indeed, while there is currently scaremongering about the risks of deflation, there is little historical or current evidence that policy needs to be further eased to meet this challenge. The Fed should say so. It should also reiterate that it only imprecisely measures slack in output and labor market activity. As such, they should articulate how this mis-measurement tempers the aggressiveness with which they will conduct policy as we return to more normal ranges of macroeconomic variation. I doubt they will make such a statement, but they should.

Finally, the Fed should articulate the risks inherent in its balance sheet that it has incurred as it pursued quantitative easing. Not only have asset purchases by the Fed raised both sides of its balance sheet by \$3 trillion, but the Fed's liabilities (balance reserves held by the Fed) are gross assets to the banking sector. If we learned anything from the Great Recession, it was that balance sheets matter, that the interconnectedness of balance sheets between institutions matter more, and that not talking about risks do not make those risks any less risky. And \$3 trillion dollars is an enormous amount of asset purchases. With a U.S. population of just over 300 million, this amounts to just under \$10,000 for every person in the U.S., or just under \$40,000 for a family of four. There is also significant management risk in the Fed rightsizing its balance sheet, albeit with new tools such as reverse repos and interest on reserves. Federal Reserve hubris should not be discounted here. If the Fed were as capable of handling all the responsibilities that it says it can, we would have avoided the Great Recession to begin with. Somehow, the Fed needs to find a thoughtful way to articulate the risks inherent in managing and unwinding its asset purchases, without creating additional volatility. This won't be easy, but the Fed should have a plan in mind since they have been purchasing these assets for six years!

Taken together, by ranking and articulating these more comprehensive risks, it should become clear to the Fed that the risks inherent in mis-measuring slack in labor and output markets combined with the risks associated with downsizing their balance sheet far outweighs the risk that inflation is too low.

My second recommendation to restore Trust in the Fed is a simple one – the Federal Reserve needs to recommit to the interpretation of the dual mandate that preceded the Great Recession. Simply put, it needs to prioritize that price stability is the primary purpose of the Federal Reserve, and that price stability provides the best environment

to foster maximum employment. Such a commitment would help to manage inflation concerns of all varieties, which will be particularly helpful as the Fed partly unwinds its balance sheet. Such a return to principles could help to foster the trust the Fed will need as we navigate the challenging road to normalcy before us.