Opening Remarks on the Limits to Monetary Policy and Fed Independence

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SOMC SHADOW OPEN MARKET COMMITTEE

Remarks for the Shadow Open Market Committee
Princeton Club, New York City, New York
September 27, 2019

E21 Manhattan Institute

ECONOMIC POLICIES FOR THE 21ST CENTURY

These are challenging times for the Fed and other central banks. Their credibility and effectiveness are being questioned and most important, the case for their political independence is under scrutiny, if not outright attack. I would like to think that these threats are entirely external in nature. But, unfortunately, I believe some of the challenge stems from self-inflicted wounds that have enabled these threats to grow and even flourish. While the Fed cannot always control the external political environment in which it exists, it can, and should, seek to avoid undermining its own credibility and the case for its independence.

To some extent, the problems stem from two related trends, both of which the Fed (and other central banks) have often contributed—mission creep, accompanied by elevated expectations of the capabilities of monetary policy, and, more recently, the extensive use of unconventional monetary policies that broke the traditional boundaries separating monetary policy from fiscal policy. Indeed, early on (see Plosser (2009,2010)) in began speaking frequently about the dangers of the Fed's unconventional policies and the risks they posed for the Fed's credibility and its political independence.

Political independence, of course, is widely viewed as an important pillar of sound monetary policy. The case for independence is largely an empirical one. History is replete with examples of undesirable outcomes when the monetary authorities become excessively politicized. While independence for the central bank is crucial, in a democracy it must be accompanied by constraints on the breadth and use of its authorities in order to ensure accountability.[1] Thus, institutional arrangements matter, including monetary policy strategies and operating regimes. The choice of such arrangements can act to support or undermine Fed independence.

These trends are not entirely new. For example, regarding mission creep and elevated expectations for monetary policy I often point to Milton Friedman's 1967 presidential address to the American Economics Association (see Friedman (1968)) where he said;

> *"We are in danger of assigning to monetary policy a larger role than it can perform, in danger of asking it to accomplish tasks that it cannot achieve, and, as a result, in danger of preventing it from making the contributions it is capable of making."*

This admonishment against mission creep and elevated expectations for monetary policy has become increasingly relevant, especially since the financial crisis and the ensuing recession. We have asked more and more of our central banks and, in my view, they have too eagerly accepted responsibility for economic outcomes that, in some cases, exceed their mandates and, in other cases, lay beyond their capabilities. For example, we often hear pronouncements that monetary policy should seek to address weakness in real wage growth, or low labor force participation rates, the challenges of income

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[1] In Plosser (2013). I delineated several institutional constraints on a central bank that I believed would support independence and accountability. I stressed (1) a narrow and achievable mandate to ensure accountability rather than wish list of economic goals and objectives; (2) limits on the types of assets the bank could hold on its balance sheet to prevent credit allocation; (3) the requirement that monetary policy specify a rule-like strategy for implementing monetary policy to improve transparency and predictability and to limit discretionary behavior that induces uncertainty and finally (4) systematic ex-ante policies when acting as a lender-of-last-resort.

inequality, climate change, or the prospects of future trade policy and the list continues to grow. Yet monetary policy has limited ability to influence these challenges even though monetary policy may have to react to the economic consequences. The extent that central bankers suggest monetary policy can or should seek address these concerns fosters a mistaken view of the power of monetary policy and central banks. This invites politicization and undermines central bank credibility when it fails to achieve the desired results.

It also does not come as surprise to me that the Fed's unconventional policies and its expansive views of the reach and influence of its policy tools (or its desire to expand its tool kit) over real economic outcomes have resulted in increased political pressure on the institution. Indeed, such actions amount to an open invitation to such pressure.

So, let me briefly highlight how policy choices by the Fed have undermined its own credibility and its case for independence. First let me say that to some extent, the Fed was under tremendous pressure to act during the financial crisis. It felt that it had no choice but to undertake many of these unconventional measures. Yet it was, in effect, placing big bets that the benefits would outweigh the costs. I think the jury is still out whether that assessment was the right one. Some of the extraordinary policies are now being viewed as less beneficial or effective than it was thought at the time.[2] And the accompanying costs or unintended consequences that these actions brought about are only now beginning to manifest themselves.

Unconventional policies adopted by the Fed centered on three inter-related dimensions – first, the use of what was referred to as Section 13(3) lending to rescue Bear Stearns and AIG; second, large scale asset purchase programs to allocate credit across firms, sectors, asset classes, and individuals; third, balance sheet expansion, or quantitative easing, to provide additional monetary accommodation when the policy rate reached the zero lower bound. Accompanied by the authority to pay interest on reserves, the large balance sheet has seen the Fed move to adopt a new operating regime - one where the large size of the balance sheet is no longer constrained by monetary policy.

Section 13(3) lending enabled the rescues of Bear Stearns and AIG. These creditor bailouts were overtly fiscal policy actions, placing tax-payer dollars at risk through the purchase of highly risky assets to support specific creditors of these failing firms. Such credit allocation decisions would normally be thought of as belonging to the fiscal authorities. These actions blurred the traditional boundary between monetary and fiscal policy. The ability of the Fed to conduct such fiscal actions did not go unnoticed. In December 2008, two Senators wrote Chairman Bernanke to request that the Fed help rescue GM and other automobile companies. After all, weren't these industrial giants as important to the economy as Bear Stearns and AIG? Bernanke said no to the request, but it proved not to be the last time Congress sought to use the Fed as a tool of fiscal policy. Indeed, Congress and the public reacted to these bailouts and in the Dodd-Frank legislation by placing limits on the types of lending the Fed could do under Section 13(3), while in the same bill it chose to fund a new agency (the Consumer Financial Protection Bureau) through the Fed. The irony of such action is striking, but foreshadowed and evolving trend toward the explicit use of the Fed's balance sheet to fund fiscal initiatives.[3]

[2] See Levin (2019) and references.

[3] The trend has continued. In 2015 the Congress passed a transportation bill that was partially funded from the Fed's balance sheet.

The large-scale asset purchase program also involved an important element of credit allocation. Each round involved a significant amount of MBS purchases. This was explicitly intended to provide special subsidies or support to the housing sector. Once again, such credit allocation policies are more appropriately thought of as fiscal policy. This effort to directly support housing through the purchase of MBS was a major departure from prior Fed practice. Prior to this episode the Fed had almost exclusively bought and sold Treasury securities in order to remain as neutral as possible vis a vis credit allocation. Moreover, it generally, although not always, sought to match its holdings of Treasuries to the maturity structure of the outstanding government debt to avoid influencing the market determined term structure.

Finally, the Fed has now adopted an operating regime for monetary policy commonly called a floor system. This system has several features, but from the standpoint of the current discussion, its key feature is that the Fed's balance sheet is no longer tied to monetary policy.[4] The primary instrument of monetary policy in a floor system is an administered rated, the interest paid on reserves (both excess and required). The balance sheet size is no longer constrained by monetary policy. The Fed has found this to be a desirable framework because it eliminates the need to shrink its balance sheet to conduct monetary policy. From the Fed's perspective, the large balance sheet also helps ensure massive amounts of liquidity in the banking system in the form of reserves. In effect, the Fed removes Treasury securities from the economy and substitutes bank reserves. One might reasonably ask why this is a desirable substitution and why it supports financial stability. Nevertheless, doing so does not impact monetary policy which is determined by the interest on reserves.

The risk of this operating regime is that the Fed's balance sheet becomes a new policy tool, independent of monetary policy. A balance sheet untethered to the conduct of monetary policy creates the opportunity and incentive for political actors to exploit the Fed's balance sheet to conduct off-budget fiscal policy and credit allocation. Such actions would undermine independence and further politicize the Federal Reserve.

Some may find these risks as fanciful but the reality is less benign. The Congress has already taken steps to find alternatives uses for the Fed's large balance and has opened the debate for further steps to do so. Active steps already taken include an effort by Congress in December 2008 to get the Fed to provide funds for the automobile companies that were on the verge of bankruptcy. But the requests did not end. As I have already mentioned, the Dodd-Frank legislation created the Consumer Finance Protection Bureau (CFPB) that was funded out of Federal Reserve earnings so as remove it from the budget process – a straight forward example of using the Fed for off-budget fiscal policy. In 2015, Congress passed a transportation bill which was partially funded from the Fed's balance sheet ($53 billion). Such intrusions are unlikely to end. Already there is discussion that the Fed must help "fund" new infrastructure spending and contribute to the Green New Deal. Imagine other initiatives that might involve rescues or bailouts of state or local governments. Support for this heavy reliance on the Fed's balance sheet is finding justification in the so-called MMT or Modern Monetary Theory.

Thus, through its expansionary views of the breadth of monetary policy's ability to influence the real economy, its unconventional monetary policy actions that have blurred the traditional boundaries between monetary and fiscal policy and its decision to adopt an operating regime in which the balance is unconstrained by monetary policy, the Fed is putting at risk its own independence and contributing to the incentives of others to further politicize its decision making process.

[4] See Plosser (2017) for a more a more detailed discussion.

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