Reforming the Fed

By

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The Federal Reserve has announced its intention to review in 2019 "how to best pursue the Fed's statutory mandate" of maximum employment and price stability. Suggestions have been made that that the Fed pursue a price level target, or an average of inflation rates over a multi year period, or nominal income targeting. These suggestions all reflect an underlying preoccupation. How might a new target framework generate expectations of higher inflation, leading in turn to more spending and more resilience to future economic downturns? In short, how can future monetary easing be made more effective?

These suggestions are doomed to failure. They all rest on the assumption that expectations can be magically raised by a Fed statement of intent, even when circumstances (say high unemployment) point expectations in the opposite direction. Moreover, they ignore the fact that other instruments of monetary policy will be increasingly constrained, which must cast further doubt on the Fed's capacity to deliver on its promises. Finally, when the next recession does call for monetary easing, the global "headwinds" of accumulated debt will prove immensely resistant to the Fed's best efforts. In short, we are in a place where we do not wish to be.

The Fed's mandate needs a much broader Congressional review. Near term price stability has been vastly oversold as a vehicle for achieving overall economic stability. More specifically, the case for avoiding price declines caused by productivity increases has never been adequately made. Indeed, monetary easing in recent decades, to resist inflation coming in below target levels, might have contributed materially to many of our current problems. Debt levels have risen as has wealth inequality. Resource misallocations and zombie companies have reduced productivity growth. Low intermediation margins and the search for yield have fostered financial instability.

At the very least, the Fed should be pursuing price stability over a much longer time period than hitherto. Given how little we know about the welfare effects of moderate inflation or deflation, or about the capacity of central banks to influence domestic prices, why have central banks responded so aggressively to decimal point deviations from announced targets. Similarly, the Fed should be given a mandate for financial market stability, defined quite broadly as avoiding "boom" conditions in credit markets that set the stage for subsequent "busts" and financial stress. This restraining influence would be the very opposite of the Fed "puts" that we have seen in recent years. Such expectations, together with Fed communication practices that raise Sharpe ratios, have encouraged leveraged speculation rather than reducing it as intended.

What remains unexplored is how to respond to the next recession, assuming that monetary policy is no longer fit for that purpose. I suggest reliance on a combination of sustainable fiscal policy (near term stimulus and longer term debt brakes) and significant private sector debt restructuring. None of this would be pleasant, but making Wall Street pay a price, at last, for having made bad loans would certainly find favor on Main Street.