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Global Policy

Improving The Effectiveness Of Monetary Policy

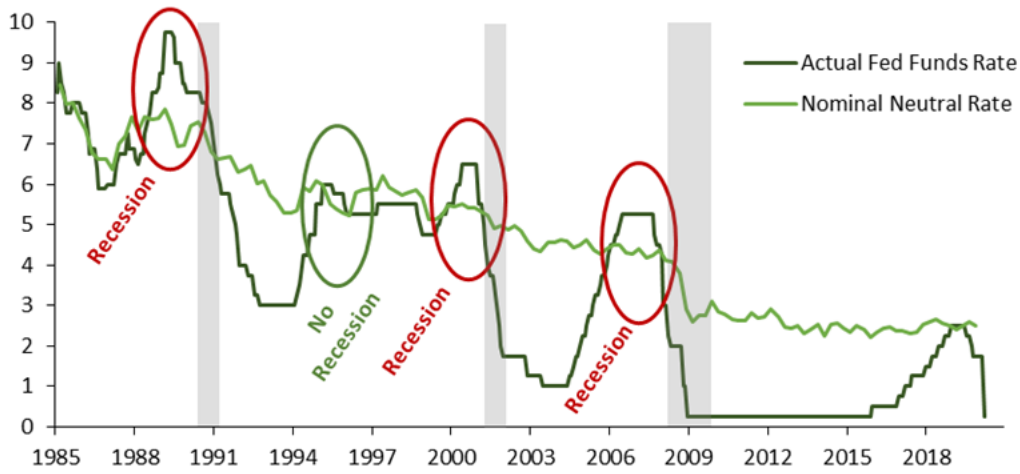
The Fed has done a lot in recent years to sustain the US economy. **There is no doubt that cutting rates, issuing forward guidance, embarking in large QE programs, and taking a variety of liquidity support measures helped the US economy emerge stronger from the financial crisis of 2008 and prevented the recovery from being more sluggish.** The same applies to the aftermath of the COVID-19 shock.

However, with interest rates that already very low and expected to stay very low, the power of monetary policy is now minimal. **Traditional tools, while helpful in preventing worse outcomes, cannot be expected to promote much better outcomes.** This essay outlines a different monetary policy strategy that, in conjunction with fiscal policy, can help the US economy mitigating and recovering faster from downturns. **The proposed strategy has the advantage that it could be implemented immediately – no legislative changes are needed. Even stronger variations would require tweaks to the Federal Reserve Act.**

1. The problem

The Fed has to contend with the problem that the nominal neutral rate (i.e., the level of the Federal funds rate above which the Fed begins restraining the economy) has declined because of a combination of structural factors and sliding inflation expectations. Raising rates above neutral is dangerous, as the chart below illustrates as it implies a high risk of recession. **Essentially, low and diminishing nominal neutral rates pin the federal funds rate, and therefore the whole yield curve, closer and closer to zero.**

The Federal Funds Rate, The Neutral Rate, And Recessions



Tightening policy above neutral is dangerous: Every time the Fed did it, a recession followed shortly thereafter. And with low inflation and a desire to bring it higher, there is no reason to go even close to neutral. Results: Low rates for a long time.

Sources: Cornerstone Macro and Holston-Laubach-Williams.

Simplifying a bit, central banks cut rates to induce households and businesses to spend and invest today instead of in the future. Conversely, when central banks tighten, they do so with the goal of pushing

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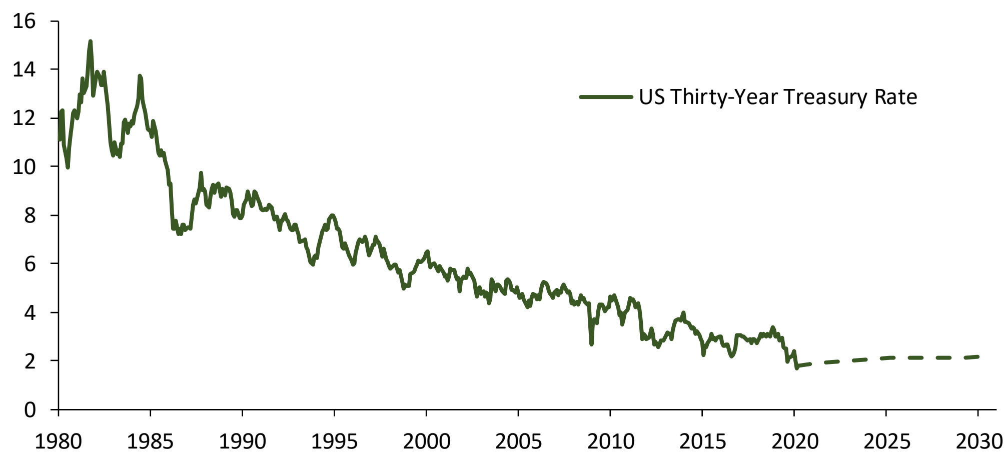
spending and investment into the future. **Traditional monetary policy, therefore, can be viewed as a way of shifting economic activity back and forth in time.**

The problem is that, when the whole term structure of interest rates is very low and expected to stay low, as it is today (chart below), traditional monetary policy loses effectiveness. The incentive to carry out the intertemporal substitution of growth is substantially diminished (at best) or non-existent (at worst) in those circumstances. To convince ourselves of that, all we need to do is look at the post-crisis world: There has been massive monetary easing (not just in the US but in many other countries as well), and yet inflation remains stubbornly under target and growth has been anemic outside of times of fiscal stimulus.

All the traditional instruments the Fed has at its disposal – rate cuts, forward guidance, QE, targeting of longer-term rates, even negative rates if the Fed chooses to go there, all do the same thing: They push rates that are already low even lower. That cannot be an effective policy for the reasons discussed above.

RATES ARE LOW AND EXPECTED TO STAY LOW

Treasury rates are at record low, and are expected to stay low based on any available indicator (forward rates (plotted), expected federal funds rate, etc. Traditional monetary policy is ineffective in these conditions.



Sources: Cornerstone Macro and Bloomberg. Future values based on current forward rates.

Something different is needed to restore the effectiveness of monetary policy. While the use of traditional tools can help preventing a bad situation from getting worse, **we cannot expect those tools to help much in fulfilling the Fed's mandates, namely, to promote maximum employment and keep inflation stable.**

2. THE SOLUTION

It is widely accepted that use of the Fed's balance sheet will be necessary to emerge from the next recession. In fact, the Fed very recently committed to buy an additional $700 billion of Treasury securities and MBS. **These purchases are the right thing to do to restore proper market functioning after the COVID-19 shock. However, they won't do much good to help the economy emerge from the coming likely recession.** Here is an alternative strategy to use the Fed's balance sheet to greater effect. The ideas here are based on work by Bartsch, Boivin, Fisher, and Hildebrand (here), Bernanke (here), and English, Erceg, and Lopez-Salido (here), among others.

a) **In lieu of QE, the Fed decides to make $X billion available for fiscal spending.** The Fed does this on its own initiative (i.e., independently and not in response to pressure from Congress or the Administration). **The amount is decided based on the same criteria that would have led to a decision to deploy similar amounts of QE, i.e., the expected impact on economic activity and inflation.**

b) **Congress decides how to spend the funds made available by the Fed. This maintains a separation between monetary and fiscal policies and leaves fund allocation decisions to elected officials.**

c) **The Treasury Department issues a perpetual bond with a par value of $X billion to fund the expenditures.** Treasury could issue a bond of any maturity to finance this expenditure. **A perpetuity is preferable because of the interaction with Fed policy** (see below).

d) **The Fed purchases the perpetuity.** The main idea, obviously, is that the Fed, rather than the public, finances the expenditure by buying the Treasury bond. **By buying a perpetuity, the Fed shows a strong, credible commitment to finance the fiscal expenditure forever.**

e) **Details of the arrangement between the Fed and the Treasury are codified into a new "accord."** It is a well-known and accepted fact that independent central banks produce better economic outcomes than central banks that are subject to the control of political authorities. **This step is important and necessary to preserve central bank independence.**

f) **The Fed commits to compensate for past inflation shortfalls.** This is key to making the strategy effective. **It is necessary to prevent doubts that in the future the Fed would offset easy fiscal policy with monetary restraint, thereby undermining the whole strategy.**

This sequence of steps is powerful and has the distinct advantage that it could be implemented today. No changes in the law are necessary – everything described above is already contemplated in existing authorities. Even stronger versions of the policy could be implemented with changes to the Federal Reserve Act (see below).

3. DISCUSSION POINTS

- **Creating money for QE vs. creating money for fiscal spending.** QE works predominantly by lowering term premiums and longer-term interest rates, and this is ineffective when rates are low and expected to stay low. Fiscal policy, instead, works the same regardless of the level of interest rates (or possibly even better when rates are low). Put differently, **new money deployed via fiscal policy is by definition spent and thus directly and immediately supports economic activity. Under appropriate fiscal policies, it can support economic activity for the long run.** New money deployed via QE cannot do that in a low-interest-rate environment for the reasons discussed in section 1.

- **The decision on the specific fiscal policies to be implemented must reside with Congress. This is obvious, but it's worth emphasizing for the avoidance of doubt.** The Fed is the only institution that has the ability to create money, and it should do that – independently and based on its assessment of economic need. But, in a democratic system, the decision on how to spend the money that is created belongs squarely to elected officials.

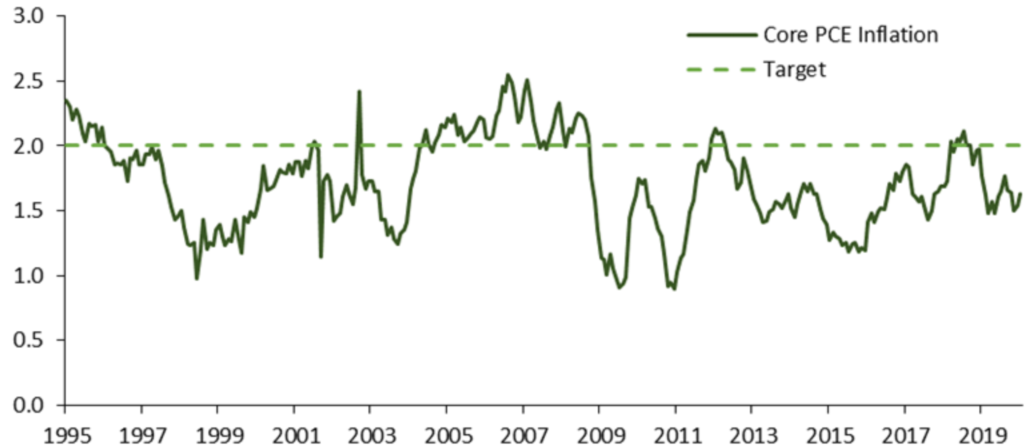
- **The three key ingredients of the strategy.** If the strategy is to produce beneficial effects, three things must be true.

  i. **The Fed's commitment to finance fiscal policy must be as credible as possible. The proposed strategy wouldn't be very effective if the public thought that the Fed may renege on its commitment in the future (for example, because of a change in personnel).** In that case, households and businesses would anticipate higher future taxes, would save more, and would thus negate or diminish the effect of the policy.

In principle, the Treasury could issue bonds of any maturity – it wouldn't make a difference as long as the Fed buys them, commits to hold them indefinitely (i.e., rolling them over at maturity), and such commitment is credible. **Financing the fiscal policy with a perpetuity that is bought by the Fed sends a strong signal that the Fed is committed to the strategy indefinitely.** In addition, at issuance, the Fed would be the only credible buyer of a perpetuity, and it would be price-insensitive, i.e., the perpetuity would be likely issued at a high price (and low rate). That would reduce the Fed's incentive to sell in the future.

ii. **The Fed's commitment not to offset an easy fiscal policy with tighter monetary policy must be as credible as possible.** This is why part f) of the strategy is crucial. **If the market suspects that the Fed will raise rates at some point in the future just because easier fiscal policy could "overheat" the economy, then market interest rates would raise today, and the benefits of the strategy would be undermined.** In addition, inflation would be lower under that scenario, which would keep real interest rates higher, increase the cost of the policy, and bring it closer to a traditional deficit-financed fiscal policy.

CORE INFLATION HAS BEEN SYSTEMATICALLY UNDER TARGET



Core PCE inflation has averaged 1.7% since 1995 – well below the ideal 2% target. The miss has been even more striking after the financial crisis. Since 2009, core PCE inflation has been at or above 2% only 11 months out of 133.

Sources: Cornerstone Macro and Bureau of Economic Analysis.

There are many possible ways to address this problem, but one is for the Fed to commit to a "make-up" strategy on inflation that compensates for past target misses. As shown above, the Fed has systematically missed the target to the downside. It seems likely that, at the conclusion of the ongoing policy review, the Fed will communicate its intention to make up for these misses in the future, i.e., to target a somewhat higher inflation for a time. **Communicating the desire for somewhat higher inflation would cement low rates expectations and boost the economy today. In addition, because somewhat higher inflation is compatible with a higher money stock, it would also reinforce the message that the Fed is committed to finance fiscal policy indefinitely.**

iii. **The Fed needs to remain independent.** Coordination between monetary and fiscal policy could raise doubts about the Fed's independence from the Administration. **Should those doubts take hold, term premiums would raise, leading to higher interest rates that would offset the benefits of the new strategy.**

To cement the notion of Fed independence, an "accord" between the Fed and Treasury should be entered into. **Such accord could be modeled, for example, after the 1951 Treasury-Fed Accord.** Although the circumstances and the premises of that accord were different from what we are talking about here, that accord laid the foundation for Fed independence, contributed to many decades of effective monetary policy, and kept term premiums low.

- **Now is the perfect time to implement this new strategy.** The coronavirus outbreak represents an unprecedented shock for the US and global economies. **Traditional Fed policies simply don't have the power to counter the economic impact and/or to promote a prompt recovery after the coronavirus shock is over.**

  A fiscal response is already in the works, but it will come at a time of already high deficits and debt. Recent reports suggest a total cost well in excess of $1 trillion. **If markets view the new debt issuance as unsustainable relative to future projected US growth and inflation, interest rates will raise and will undermine the effect of fiscal policy.** In addition, the Fed is already likely to credibly commit to keep interest rates low in the future by adopting an inflation make-up strategy. In short, the present circumstances offer the most favorable backdrop for an implementation of this strategy.

- **The strategy can be made stronger by changing the Federal Reserve Act.** There are two possible simple ways to make the proposed strategy even more effective. **Both involve dropping the constraint of Section 14(b)1 of the Federal Reserve Act that the Fed can buy securities "only in the open market."**

  If that provision is dropped, the Fed could agree to buy a perpetuity from the Treasury at par value, regardless of the interest paid by the perpetuity. In the limit, the Fed could agree to receive an interest of zero from the Treasury, which would make the perpetuity worthless in the open market. **This would cement the idea that the Fed would not sell the perpetuity in the future, as there would be no market for it.**

  In addition, by eliminating the requirement that the Fed purchases debt in the open market, the Treasury could issue a non-marketable security to the Fed. That security would not be available to the public, could not be sold in the open market even if the Fed wanted to, regardless of market value, and would not appear in the most-frequently used measures of debt-to-GDP. It would be the most transparent and credible form of debt monetization.

4. THREE ANTICIPATED OBJECTIONS

This proposal is obviously not uncontroversial. Three natural objections immediately come to mind.

- **This idea is inflationary. Yes it is, and it is a good thing.** Obviously, the Fed has had trouble reaching its inflation target for most of the post-financial crisis period. Low inflation contributes to push down adaptive expectations of future inflation. Consequently, it pushes the nominal neutral rate lower thus perpetuating the problem. **The proposed strategy makes it more likely that inflation will increase from a level that is too low to levels that have been acceptable in the past and that were associated with much better overall economic outcomes.** Inflation that is higher than today will also ensure that fiscal policy is truly financed by the central bank.

It's true that several past experiments with monetization have led to hyperinflation, but this strategy contemplates controlled, as opposed to unlimited, monetization. That's why the strategy insists on Fed independence and on the Fed deciding how much money to make available to fiscal authorities.

- **The Fed would lose at least part of its independence.** **That risk is real. But that's the whole point of having point e) in the proposed strategy** – it needs to be clear that central bank independence needs to be preserved. Sometimes, however, the impression is that central bank independence is treated as an end in itself. Instead, it should be a means towards an end, and the end is the best possible outcome for the US economy. **If well managed (via its codification in a new accord), the risk of giving up some independence is worth taking.**

- **There is no difference between Fed-financed expenditures and expenditures financed via Treasury bills.** It is true that this proposal would create reserves, which the Fed would have to remunerate at the interest rate on excess reserves (IOER). It is also true that the IOER is a floating rate and is close to a T-Bill rate. But one difference is that T-Bills would have to be bought by some investor over and over again, while the perpetuity is bought by the Fed only once. **Fed-financed fiscal policy removes both the uncertainty of whether there will be future buyers of T-Bills and the uncertainty of what price the Treasury might have to pay over and above the IOER, should investors demand a spread.**

  In addition, as the economy grows, demand for currency (dollar bills) increases as well, so over time a portion of the reserves created by the Fed to finance fiscal policy will be converted into currency. **While the Fed pays an interest on reserves, it pays no interest on currency, which leads to cost savings that grow over time.**

  In any case, **the key difference is that this proposal reduces or ideally eliminates the uncertainty on whether taxpayers would be subject to higher taxes in the future to finance current expenditures, therefore increasing the chances that the policy would lead to greater spending and investment.** This is obviously not true about a deficit-financed fiscal policy under any circumstances. The strategy as designed would also effectively pay for fiscal expansion via higher inflation.

5. Conclusion

This proposal would lead to a more effective monetary policy, would help raise inflation, inflation expectations, and the nominal neutral rate, thus generating more separation from actual interest rates and the zero bound. **Under an assumption of appropriate fiscal policies, the proposal could also promote a faster return to higher real neutral rates**, thus distancing the nominal neutral rate even more from zero. **Finally, the proposed strategy has the advantage that it could be implemented now under current Fed authorities, albeit even stronger versions would require changes to the Federal Reserve Act.** The risk is that the Fed would lose (or would be perceived as having lost) a piece of its independence. But the proposal contains a provision to manage this risk.