

May 29, 2009

## A new accord?

As days go in the U.S. Treasury market, [Wednesday was a rough one](#). Bloomberg News described the day's developments as follows:

"The difference in yields between Treasury two- and 10-year notes widened to a record on concern surging sales of U.S. debt will overwhelm the Federal Reserve's efforts to keep borrowing costs low. ...

"The unprecedented government borrowing has created concern about a rise in consumer prices. Policy makers have expanded the Fed's balance sheet to \$2.2 trillion while excess reserves at U.S. banks have increased to \$896.3 billion.

" 'Inflation is in the headlight of many investors,' wrote Andrew Brenner, co-head of structured products and emerging markets in New York at MF Global Inc., in a note to clients today."

By cosmic coincidence, I was reading that story in Tokyo as I prepared to chair a session at [the Bank of Japan's 2009 International Conference on Financial System and Monetary Policy Implementation](#) in which Marvin Goodfriend (Carnegie-Mellon professor and former Richmond Fed policy adviser) presented his thinking on keeping the central bank's inflation objectives firmly in hand at a time of rapidly rising government debt and large increases in the Fed's balance sheet. Professor Goodfriend's case is laid out in a paper titled "[Central Banking in the Credit Turmoil: An Assessment of Federal Reserve Practice](#)" (which was also presented at [a conference devoted to research on the interactions between monetary and fiscal policy](#)—that is, government spending and tax—co-sponsored by Princeton University's Center for Economic Policy Studies and Indiana University's Center for Applied Economics and Policy Research). Goodfriend pulls no punches:

"The 1951 'Accord' between the United States Treasury and the Federal Reserve was one of the most dramatic events in U.S. financial history. The Accord ended an arrangement dating from World War II in which the Fed agreed to use its monetary policy powers to keep interest rates low to help finance the war effort. The Truman Treasury urged that the agreement be extended to keep interest rates low in order to hold down the cost of the huge Federal government debt accumulated during the war. Fed officials argued that keeping interest rates low would require inflationary money growth that would destabilize the economy and ultimately fail.

"The so-called Accord was only one paragraph, but it famously reasserted the principle of Fed independence so that monetary policy might serve exclusively to stabilize inflation and the macroeconomic activity. ...

"The enormous expansion of Fed lending today—in scale, in reach beyond depository institutions, and in acceptable collateral—demands an accord for Fed credit policy to supplement the accord on monetary policy. A credit accord should set guidelines for Fed credit policy so that pressure to misuse Fed credit policy for fiscal purposes does not undermine the Fed's independence and impair the central bank's power to stabilize financial markets, inflation, and macroeconomic activity."

Goodfriend's "new accord" amounts to asserting a set of principles that would reinforce price stability as the central goal of monetary policy, set the Fed down the road of extricating itself from the extraordinary credit market interventions of the past year-and-a-half, and join the central bank and Treasury in common cause toward the goal of doing everything possible to make sure that the Fed and Treasury don't go there again.

The paper was provocative, but it also raised a couple of fundamental questions. In particular, what is the degree of autonomous fiscal risk-taking appropriate to allocate to a central bank? If such powers are granted, how often and under what conditions ought those powers be exercised? And how far should the powers reach? If, as Goodfriend states, "the central bank's power to stabilize financial markets, inflation, and macroeconomic activity" requires [lender-of-last-resort](#) interventions—and hence pure credit policy interventions—what does that imply about the appropriate scope of monetary and regulatory authorities going forward? If the "shadow banking system" is the de facto banking system of the modern era—as Yale University's [Gary Gorton argued](#) in a paper presented at the Atlanta Fed's annual [Financial Markets Conference held earlier this month](#)—is the central bank's lender-of-last-resort function meaningful if narrowly construed (that is, if it fails to reach the shadow banking system)?

These, really, are first-order questions. On to the debate.

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