June 11, 2009

Price stability and the monetary base

Arthur Laffer, as several readers (and friends) have pointed out to me, is taking aim at the Fed:

> "… as bad as the fiscal picture is, panic-driven monetary policies portend to have even more dire consequences. We can expect rapidly rising prices and much, much higher interest rates over the next four or five years, and a concomitant deleterious impact on output and employment not unlike the late 1970s.
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> "About eight months ago, starting in early September 2008, the Bernanke Fed did an abrupt about-face and radically increased the monetary base—which is comprised of currency in circulation, member bank reserves held at the Fed, and vault cash—by a little less than $1 trillion. The Fed controls the monetary base 100% and does so by purchasing and selling assets in the open market. By such a radical move, the Fed signaled a 180-degree shift in its focus from an anti-inflation position to an anti-deflation position."

I have a few problems with that statement. To begin with, the notion that the Federal Reserve signaled a 180-degree shift in focus to move "from an anti-inflation position to an anti-deflation position" is about equivalent to saying that the temperature control system in your house has a fundamentally different objective when the heater kicks off in June and the air conditioning kicks on. The essence of an inflation objective—even an implicit one—is that a central bank will lean against price-level changes substantially below the desired rate, as well as changes substantially above the desired rate. You can certainly argue with the policymakers' forecasts and diagnoses of risks at any given time, but it serves the debate well to not muddle tactics (focusing on inflation or deflation as the economic weather requires) and objectives (the control of the inflation rate that is Mr. Laffer's true concern).

But that point is a quibble. The increase in the U.S. monetary base has indeed been something to behold, and the Laffer article gives a good explanation about why you might be worried about that:

> "Bank reserves are crucially important because they are the foundation upon which banks are able to expand their liabilities and thereby increase the quantity of money.
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> "Banks are required to hold a certain fraction of their liabilities—demand deposits and other checkable deposits—in reserves held at the Fed or in vault cash. Prior to the huge increase in bank reserves, banks had been constrained from expanding loans by their reserve positions. They weren't able to inject liquidity into the economy, which had been so desperately needed in response to the liquidity crisis that began in 2007 and continued into 2008. But since last September, all of that has changed. Banks now have huge amounts of excess reserves, enabling them to make lots of net new loans…
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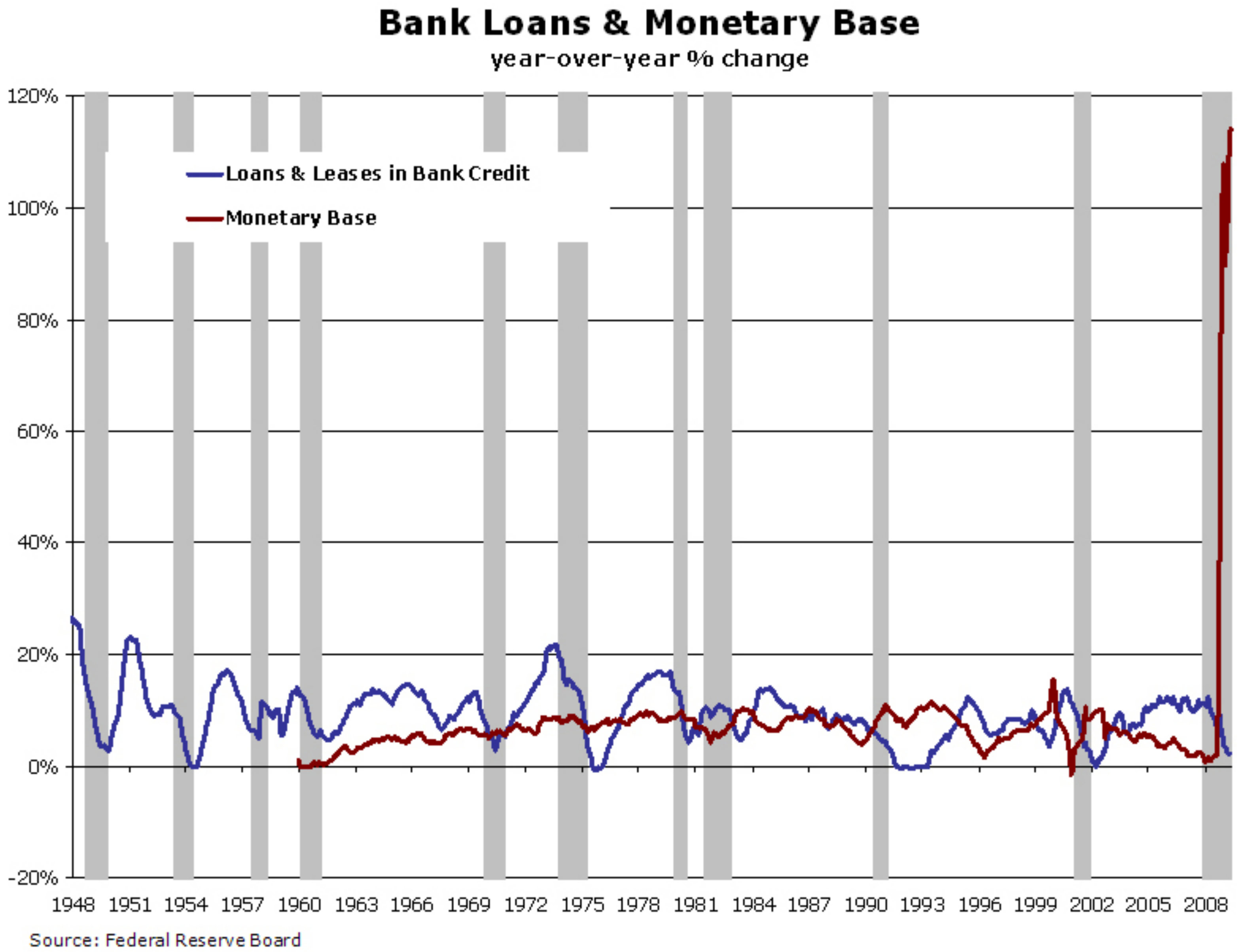
> "At present, banks are doing just what we would expect them to do. They are making new loans and increasing overall bank liabilities (i.e., money). The 12-month growth rate of M1 is now in the 15% range, and close to its highest level in the past half century."

OK, but in my opinion it is a bit of a stretch—so far, at least—to correlate monetary base growth with bank loan growth:



Let's call that more than a bit of a stretch.

The Laffer argument is in large part about what the future will bring. But we know that the payment of interest on bank reserves—which we have discussed in this forum many times (here and here, for example)—means a higher demand for reserves in the future than in the past. This change, of course, means that levels of the monetary base that would have seemed scary in the past will become the new normal. How big can the "new normal" be? That's a good question, and one I will continue to contemplate. But the assertion in the Laffer article that "a major contraction in monetary base" is required cannot be supported by either current evidence or simple economic theory.

There is, however, more. Whatever policy choices are required to deliver a noninflationary environment going forward, Mr. Laffer seems convinced that the central bank is not up to making them:

> "Alas, I doubt very much that the Fed will do what is necessary to guard against future inflation and higher interest rates. If the Fed were to reduce the monetary base by $1 trillion, it would need to sell a net $1 trillion in bonds. This would put the Fed in direct competition with Treasury's planned issuance of about $2 trillion worth of bonds over the coming 12 months. Failed auctions would become the norm and bond prices would tumble, reflecting a massive oversupply of government bonds."

On this I will just turn to my boss, Atlanta Fed President Dennis Lockhart, who addressed this very issue in a speech given today at the National Association of Securities Professionals Annual Pension and Financial Services Conference in Atlanta:

> "The concerns about our economic path are crystallized in doubts expressed in some quarters about the Federal Reserve's ability to fulfill its obligation to deliver low and stable inflation in the face of very large current and prospective federal deficits. In a word, the concerns are about monetization of the resulting federal debt.
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> "I do not dismiss these concerns out of hand. I also recognize that the task of pursuing the Fed's dual mandate of price stability and sustainable growth will be greatly complicated should deliberate and timely action to address our fiscal imbalances fail to materialize. But I have full confidence in the Federal Reserve's ability and resolve to meet its inflation objectives in whatever environment presents itself. Of the many risks the U.S. and global economies still confront, I firmly believe the Fed losing sight of its inflation objectives is not among them."

'Nuff said, for now.

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