The Scope and Responsibilities of Monetary Policy

GIC 2011 Global Conference Series:
Monetary Policy and Central Banking in the Post-Crisis Environment

The Central Bank of Chile
Santiago, Chile

January 17, 2011

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Introduction

I am delighted to speak before the Global Interdependence Center's event today, and I especially want to thank Governor José De Gregorio and the Central Bank of Chile for hosting today's conference. I have been trying to repay a visit that Governor De Gregorio made to the Philadelphia Fed for a GIC conference in 2008. And I am glad that our schedules finally made possible my first visit to this beautiful country.

As the title of the conference today suggests, Governor De Gregorio and I share some unique challenges in conducting monetary policy in a new world, a post-crisis world. Yet I believe some old lessons still apply. I would like to begin with a quote that some of you may recognize.

> *"…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 contribution that it is capable of making."*

Milton Friedman spoke these words in his presidential address before the 80th meeting of the American Economic Association in 1967.[1] Although that was over 40 years ago, I believe Friedman's caution is one well worth remembering, especially in this world where central banks have taken extraordinary actions in response to a financial crisis and severe recession. I believe the time has come for policymakers and the public to step back from our focus on short-term fluctuations in economic conditions and to think more broadly about what monetary policy can and should do.

[1] Milton Friedman, "The Role of Monetary Policy," *American Economic Review*, 58:1 (March 1968), pp. 1-17.

It may help to put Friedman's words into context. His remarks were directed at an economics profession that had gravitated toward believing that there was a stable and exploitable trade-off between inflation and unemployment – otherwise known as the Phillips curve. According to this view, policymakers should pick a point on the Phillips curve that balances the nation's desire for low unemployment and low inflation. Friedman argued that this was a false trade-off and the experience in the U.S. in the decade that followed his remarks, often referred to as the Great Inflation, was a painful demonstration of Friedman's valuable insight. In particular, that episode illustrated starkly that there was no stable relationship between inflation and unemployment. We learned the dangers inherent in monetary policies that take low inflation for granted in a world of high unemployment or perceived large output gaps. Our experiences clearly showed that efforts to manage or stabilize the real economy in the short term were beyond the scope of monetary policy, and if policymakers made aggressive attempts to do so, it would undermine the one contribution monetary policy could and should make to economic stability – price stability.

Of course, monetary theory has advanced in the past three decades with more sophisticated models and empirical methods to test the validity of these models. However, the proper scope of monetary policy remains an important issue today. In response to the global financial crisis, central banks have been asked to use monetary policy and other central bank functions to deal with an increasing array of economic challenges. These challenges include high unemployment, asset booms and busts, and credit allocations that fall more properly under the purview of fiscal policy. I believe we have come to expect too much from monetary policy. Indeed, broadening its scope can actually diminish its effectiveness. When monetary policy over-reaches and fails to deliver desired, but unattainable, outcomes, its credibility is undermined. That makes it more difficult to deliver on the goal it is actually capable of meeting. Moreover, when the central bank is asked to implement policies more appropriately assigned to fiscal authorities, the independence of monetary policy from the political process is put at risk, which also undercuts the effectiveness of monetary policy.

In my remarks today, I want to discuss the appropriate scope of monetary policy in dealing with real economic fluctuations, asset-price swings, and credit allocation. In doing so, I want to reinforce Friedman's caution that we should be careful not to expect too much of monetary policy. I believe that if we recognize the limits to what monetary policy <u>can</u> do effectively, we will be better able to understand what monetary policy <u>should</u> do.

Before continuing, I should note that these are my views and not necessarily those of the Federal Reserve Board or my colleagues on the Federal Open Market Committee.

Monetary Policy and Real Economic Fluctuations

The U.S. Congress has established the broad objectives for monetary policy as promoting "effectively the goals of maximum employment, stable prices and moderate long-term interest rates." This has typically been characterized as the "dual mandate," since if prices are stable and the economy is operating at full employment, long-term nominal interest rates will generally be moderate.

Most economists now understand that in the long run, monetary policy determines only the level of prices and not the unemployment rate or other real variables.[2] In this sense, it is monetary policy that has ultimate responsibility for the purchasing power of a nation's fiat currency. Employment depends on many other more important factors, such as demographics, productivity, tax policy, and labor laws. Nevertheless, monetary policy can sometimes temporarily stimulate real economic activity in the short run, albeit with considerable uncertainty as to the timing and magnitude, what economists call the "long and variable lag." Any boost to the real economy from stimulative monetary policy will eventually fade away as prices rise and the purchasing power of money erodes in response to the policy. Even the temporary benefit can be mitigated, or completely negated, if inflation expectations rise in reaction to the monetary accommodation.

Nonetheless, the notion persists that activist monetary policy can help stabilize the macroeconomy against a wide array of shocks, such as a sharp rise in the price of oil or a sharp drop in the price of housing. In my view, monetary policy's ability to neutralize the real economic consequences of such shocks is actually quite limited. Successfully implementing such an economic stabilization policy requires predicting the state of the economy more than a year in advance and anticipating the nature, timing, and likely impact of future shocks. The truth is that economists simply do not possess the knowledge to make such forecasts with the degree of precision that would be needed to offset the economic shocks. Attempts to stabilize the economy will, more likely than not, end up providing

[2] There are some extreme cases. If the monetary authority engineers a hyperinflation, it is likely to have deleterious effects on output and employment.

stimulus when none is needed, or vice versa. It also risks distorting price signals and thus resource allocations, adding to instability. So asking monetary policy to do what it cannot do with aggressive attempts at stabilization can actually increase economic instability rather than reduce it.

Therefore, in most cases the effects of shocks to the economy simply have to play out over time as markets adjust to a new equilibrium. Monetary policy is likely to have little ability to hasten that adjustment. In fact, policy actions could actually make things worse over time. For example, monetary policy cannot retrain a workforce or help reallocate jobs to lower unemployment. It cannot help keep gasoline prices at low levels when the price of crude oil rises to high levels. And monetary policy cannot reverse the sharp decline in house prices when the economy has significantly over-invested in housing. In all of these cases, monetary policy cannot eliminate the need for households or businesses to make the necessary real adjustments when such shocks occur.

Let me be clear that this does not mean that monetary policy should be unresponsive to changes in broad economic conditions. Monetary policymakers should set their policy instrument – the federal funds rate in the U.S. – consistent with controlling inflation over the intermediate term. So the target federal funds rate will vary with economic conditions. But the goal in changing the funds rate target is to maintain low and stable inflation. This will foster the conditions that enable households and businesses to make the necessary adjustments to return the economy to its sustainable growth path. Monetary policy itself does not determine this path, nor should it attempt to do so.

For example, if an adverse productivity shock results in a substantial reduction in the outlook for economic growth, then real interest rates tend to fall. As long as inflation is at an acceptable level, the appropriate monetary policy is to reduce the federal funds rate to facilitate the adjustment to lower real interest rates. Failure to do so could result in a misallocation of resources, a steadily declining rate of inflation, and perhaps even deflation.

Conversely, when the outlook for economic growth is revised upward, real market interest rates will tend to rise. Provided that inflation is at an acceptable level, appropriate policy would be to raise the federal funds rate. Failure to do so would result in a misallocation of resources and, in this case, a rising inflation rate.

In both cases, changes in the federal funds target are responding to economic conditions in order to keep inflation low and stable and doing so in a systematic manner. Monetary policy is <u>not</u> trading off more inflation for less unemployment or vice versa. As I have already argued, the empirical and theoretical case for such a trade-off is tenuous at best. And the data to support the view that central banks can favorably exploit such a potential trade-off are even more dubious.

So what should monetary policy do? To strengthen the central bank's commitment to price stability, I have long advocated that the Federal Reserve adopt and clearly communicate an explicit numerical inflation objective and publicly commit to achieving that objective over some specified time period through a systematic approach to policy. It is one of the messages of economic research over the last 40 years that policy is best conducted in a rule-like manner. This helps the public and the markets understand and better predict how policy will evolve as economic conditions change. This reduces volatility and promotes transparency and more effective communication.

An inflation objective coupled with a rule-like approach to policy decisions would make the central bank's commitment more credible and policy more effective in achieving its goals. Indeed, the Federal Reserve is one of the few central banks among the major industrialized countries that have not made such a public commitment. I believe it is time we did. Such a commitment will help the public form its expectations about monetary policy, which would enhance macroeconomic stability.

Monetary Policy and Asset Prices

Let me now turn to the role of monetary policy in the evolution of asset prices. Some argue that monetary policy can be a source of distorted asset prices. That can be a problem, but it usually occurs when policy deviates from the sort of systematic policy rules that a price level or inflation target would suggest. Thus, a systematic approach to achieving price stability would help monetary policymakers avoid exacerbating the effects of asset-price swings on the economy. Putting aside monetary-policy-induced asset-price swings, I think it is fair to say that the broad view among many monetary policymakers is that asset prices should not be a direct focus of monetary policy. They generally accept the idea that various forms of prudential regulation or supervision are better suited to address such challenges, should it be called for, than monetary policy. Yet the housing boom, its subsequent collapse, and the financial crisis that followed have caused some to rethink this position concerning the scope of monetary policy.

No one takes issue with the view that asset prices are important in assessing the outlook for the economy and inflation. Movements in asset prices can provide useful information about the current and future state of the economy. Even when a central bank is operating under an inflation target, asset prices are informative. Put another way, judgments about the inflationary stance of monetary policy should be informed by a wide array of market signals, including asset-price movements.[3] So while asset prices may be relevant in the normal course of monetary policymaking, the presumption is that such prices are responding efficiently and correctly to the underlying state of the economy, including the stance of monetary or fiscal policy. The bottom line of this view is that monetary policy should not seek to actively burst perceived asset bubbles.

Other people, especially in light of the recent financial crisis, advocate an active role for monetary policy to restrain asset-price booms. They tend to believe that asset prices are not always tied to market fundamentals. They worry that when asset values rise above their fundamental value for extended periods – that is, when a so-called bubble forms – the result will be an over-investment in the over-valued asset. When the market corrects such a misalignment – as it always does – the resulting reallocation of resources may depress economic activity in that sector and possibly the overall economy. Such boom-bust cycles are, by definition, inefficient and disruptive. So, the argument goes, policy should endeavor to prevent or temper such patterns.

This argument for monetary policy to respond directly to a perceived mispricing of specific assets is controversial. It requires that policymakers know when an asset is over-priced relative to market fundamentals, which is no easy task. For example, equity values might appear high relative to current profits, but if market participants expect profit growth to rise in the future, then high equity values may be justified.

Another challenge in addressing asset-price bubbles is that contrary to most of the models used to justify intervention, there are many assets, not just one. And these assets have different characteristics. For example, equities are very different from real estate. Misalignments or bubble-like behavior may

[3] Research does offer some support for the predictive value of various asset-price movements for the future path of inflation; however, the evidence varies considerably across types of assets and, in my view, is not overwhelmingly supportive.

appear in one asset class and not others and may vary even among a specific asset class. But monetary policy is a blunt instrument. How would policymakers have gone about pricking a bubble in technology stocks in 1998 and 1999 without wreaking havoc on investments in other asset classes? After all, while the NASDAQ grew at an annual rate of 81 percent in 1999, the NYSE composite index grew just 11 percent. What damage would have been done to other stocks and other asset classes had monetary policy aggressively raised rates to dampen the tech boom. During the housing boom, some parts of the U.S. housing market were experiencing rapid price appreciation while others were not. How do you use monetary policy to burst a bubble in Las Vegas real estate, where house prices were appreciating at a 45 percent annual rate by the end of 2004, without damaging the Detroit market, where prices were increasing at less than a 3 percent annual rate?

Because monetary policy is such a blunt instrument, asking monetary policy to do what it cannot do, such as seeking to deliberately influence the evolution of asset prices, risks creating more instability, not less. Moreover, the moral hazard created by the belief that the central bank would intervene if prices of a certain class of assets became "misaligned" might, in fact, cause more inefficient pricing and more instability, not less.

Monetary Policy and Credit Allocation

Finally, let me address another issue that has loomed large during the crisis and where great caution is required going forward – the role of monetary policy in credit allocation. At various times during the crisis, the Federal Reserve and many other central banks around the world intervened in various markets to facilitate intermediation. In many cases, these efforts were targeted to specific sectors of the economy, to specific types of firms, or in some cases, to specific firms.

Most of these efforts were justified on the grounds that central banks should act as "lender of last resort" in order to preserve financial stability. The specific criteria for undertaking these actions could not help but be somewhat arbitrary as policymakers had little experience with such a crisis, and little theory to guide them beyond Walter Bagehot's dictum from the 1873 classic *Lombard Street* to limit systemic risk by "lending freely at a penalty rate against good collateral."[4] In general, these actions,

[4] Walter Bagehot, *Lombard Street: A Description of the Money Market* (New York: E.P. Dutton and Company, 1921). [Orig.pub. 1873]

especially in the U.S., involved extensive use of the central bank's balance sheet and likely went far beyond what Bagehot would have imagined.

Even when it is appropriate for a central bank to function as a lender of last resort, it should follow a rule-like or systematic approach. This suggests announcing in advance the criteria that will be used to lend and who will be eligible to participate. Economic and financial stability would be best served by establishing such guidelines in advance and committing to following them in a crisis. That commitment is hard to deliver on, but institutional constraints can help tie the hands of policymakers in ways that limit their discretion. Most central banks, including the Fed, have not developed such systematic plans and thus behaved in a highly discretionary manner that generated moral hazard and volatility.

My purpose here is not to critique the myriad programs that were put in place or the varying degrees of moral hazard they created but to make a more general point – one that I have made before: that these actions, for the most part, are better thought of as forms of fiscal policy, not monetary policy, because they involved allocating credit and putting taxpayer dollars at risk. Moreover, asking monetary policy to do something that it should not do – engage in fiscal policy – can be detrimental to the economy by undermining monetary policy's effectiveness at maintaining its ultimate responsibility: price stability.

A body of empirical research indicates that when central banks have a degree of independence in conducting monetary policy, more desirable economic outcomes usually result. But such independence can be threatened when a central bank ventures into conducting fiscal policy, which, in the U.S., rightly belongs with Congress and the Executive branch of government. Having crossed the Rubicon into fiscal policy and engaged in actions to use its balance sheet to support specific markets and firms, the Fed, I believe, is likely to come under pressure in the future to use its powers as a substitute for other fiscal decisions. This is a dangerous precedent, and we should seek means to prevent such future actions.[5]

I have long argued for a clear bright line to restore the boundaries between monetary and fiscal policy, leaving the latter to Congress and not the central bank. For example, I have advocated the elimination of Section 13(3) of the Federal Reserve Act, which allowed the Fed to lend directly to "corporations,

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[5] See Charles I. Plosser, "Credible Commitments and Monetary Policy After the Crisis," speech at the Swiss National Bank Monetary Policy Conference, Zurich, Switzerland, September 24, 2010.

partnerships and individuals" under "unusual and exigent circumstances." The Dodd-Frank Wall Street Reform and Consumer Protection Act sets limits on the Fed's use of Section 13(3), allowing the Board, in consultation with the Treasury, to provide liquidity to the financial system, but not to aid a failing financial firm or company.[6] But I think more is needed. I have suggested that the System Open Market Account (SOMA) portfolio, which is used to implement monetary policy in the U.S., be restricted to short-term U.S. government securities. Before the financial crisis, U.S. Treasury securities constituted 91 percent of the Fed's balance-sheet assets. Given that the Fed now holds some $1.1 trillion in agency mortgage-backed securities (MBS) and agency debt securities intended to support the housing sector, that number is 42 percent today. The sheer magnitude of the mortgage-related securities demonstrates the degree to which monetary policy has engaged in supporting a particular sector of the economy through its allocation of credit. It also points to the potential challenges the Fed faces as we remove our direct support of the housing sector.

Decisions to grant subsidies to specific industries or firms must rest with Congress, not the central bank. That is why I have advocated that the Fed and Treasury reach an agreement whereby the Treasury exchanges Treasury securities with the non-Treasury assets on the Fed's balance sheet. This would transfer funding for the credit programs to the Treasury, thereby ensuring that policies that place taxpayer funds at risk are under the oversight of the fiscal authority, where they belong. And it would help ensure that monetary policy remains independent from fiscal policy and political pressure.

Conclusion

Although it has been over 40 years since Milton Friedman cautioned against asking too much of monetary policy, his insights remain particularly relevant today. I too am concerned that we are in the process of assigning to monetary policy goals that it cannot hope to achieve. Monetary policy is not going to be able to speed up the adjustments in labor markets or prevent asset bubbles, and attempts to do so may create more instability, not less. Nor should monetary policy be asked to perform credit allocation in support of particular sectors or firms. Expecting too much of monetary policy will

[6] See Charles I. Plosser, "The Federal Reserve System: Balancing Independence and Accountability," speech at the World Affairs Council of Philadelphia, February 17, 2010.

undermine its ability to achieve the one thing that it is well-designed to do: ensuring long-term price stability. It is by achieving this goal that monetary policy is best able to support full employment and sustainable growth over the longer term, which benefits all in society.