Operating Regimes and Fed Independence

Charles I. Plosser

These are challenging times for the Fed and other central banks. Their credibility and effectiveness are being questioned and, most importantly, the case for their political independence is under scrutiny, if not outright attack. It would be convenient to believe that these threats are entirely external in nature. But, unfortunately, I believe some of the challenge stems from self-inflicted wounds that have enabled these threats to grow and even flourish. While the Fed cannot always control the external political environment in which it exists, it can, and should, seek to avoid undermining its own credibility and the case for its independence.

To some extent, the problems stem from two related trends, both of which the Fed (and other central banks) have often contributed—mission creep, accompanied by elevated expectations of the capabilities of monetary policy, and, more recently, the extensive use of unconventional monetary policies that broke the traditional boundaries separating monetary policy from fiscal policy. Indeed, beginning in 2009 and 2010, I spoke frequently about the dangers of the Fed's unconventional policies and the risks they posed for the Fed's credibility and its political independence (see Plosser 2009, 2010).

Political independence, of course, is widely viewed as an important pillar of sound monetary policy. The case for independence is

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largely an empirical one. History is replete with examples of undesirable outcomes when the monetary authorities become excessively politicized. While independence for the central bank is crucial, in a democracy, it must be accompanied by constraints on the breadth and use of its powers in order to ensure accountability.[1] Thus, institutional arrangements and frameworks matter, including monetary policy strategies and operating regimes. The choice of such arrangements can act to support or undermine Fed independence.

Friedman's Admonishment

These trends are not entirely new. For example, regarding mission creep and elevated expectations for monetary policy, I often point to Milton Friedman's 1967 presidential address to the American Economic Association where he said: "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 contributions it is capable of making" (Friedman 1968: 5).

Friedman's warning was prescient. The 1970s saw an aggressive attempt by the Fed to influence and control the real economy, and unemployment more specifically, resulting in rising inflation rates that reached double digits. After Paul Volcker regained control of inflation in the early 1980s, monetary policymakers tended to exhibit more restraint toward the feasibility and effectiveness of stabilization policy, implicitly acknowledging Friedman's wisdom. Unfortunately, with the financial crisis and subsequent recession, the Fed seems to have returned to the mistaken hubris of the 1960s, albeit dressed up in fancier models and calls for financial stability.

Thus, Friedman's admonishment seems as relevant today as it was in 1967. We have asked more and more of our central banks and,

[1]In Plosser (2014), I delineated several institutional constraints on a central bank that I believed would support independence and accountability. I stressed (1) a narrow and achievable mandate to ensure accountability rather than a wish list of economic goals and objectives; (2) limits on the types of assets the bank could hold on its balance sheet to prevent credit allocation; (3) the requirement that monetary policy specify a rule-like strategy for implementing monetary policy to improve transparency and predictability and to limit discretionary behavior that introduces uncertainty; and, finally (4) systematic ex ante policies when acting as a lender of last resort.

in my view, they have too eagerly accepted responsibility for economic outcomes that, in some cases, exceed their mandates and, in other cases, lay beyond their capabilities. For example, we often hear pronouncements that monetary policy should seek to address weakness in real wage growth, or low labor force participation rates; the challenges of income inequality, climate change, or the prospects of future trade policy; and the list continues to grow. Yet monetary policy has limited ability to influence these challenges even though monetary policy may have to react to the economic consequences. The extent to which central bankers suggest monetary policy can or should seek to address these concerns fosters a mistaken view of the power of monetary policy and central banks. This broader scope for monetary policy invites politicization and undermines central bank credibility when it fails to achieve the desired results.

Unconventional Monetary Policy

The adoption of unconventional monetary policy that sought to expand the reach and effectiveness of the Fed's tools in order to influence and shape real economic outcomes sometimes broke the traditional boundaries that separated monetary from fiscal policy. One predictable consequence is increased political pressure on the Fed. Indeed, such actions amount to an open invitation to such pressure.

So, let me highlight in a little more detail how unconventional policy choices by the Fed have undermined its own credibility and its case for independence. First, let me say that to some extent, the Fed was under tremendous pressure to act during the financial crisis. It felt that it had no choice but to undertake many of these unconventional measures. Yet it was, in effect, placing big bets that the benefits would outweigh the costs. I think the jury is still out as to whether that assessment was the right one. Some of the extraordinary policies are now being viewed as less beneficial or effective than it was thought at the time (see, for example, Levin 2019), and the accompanying costs or unintended consequences that those actions brought about are only now beginning to manifest themselves.

Unconventional policies adopted by the Fed can be broken down into three interrelated buckets—first, the use of what was referred to as Section 13 (3) lending to rescue Bear Stearns and AIG; second, large-scale asset purchase programs to allocate credit across firms, sectors, and asset classes; and third, balance sheet expansion, or quantitative easing (QE), to provide additional monetary accommodation when the policy rate reached the zero lower bound. Accompanied by the authority gained in 2008 to pay interest on reserves, the large balance sheet has persuaded the Fed to adopt a new operating regime—one where the large size of the balance sheet is no longer constrained by monetary policy.

Section 13 (3) lending enabled the rescues of Bear Stearns and AIG. These creditor bailouts were overtly fiscal policy actions, placing taxpayer dollars at risk through the purchase of highly risky assets to support creditors of these failing firms. Such credit allocation decisions would normally be thought of as belonging to the fiscal authorities. These actions blurred the traditional boundary between monetary and fiscal policy.[2] The ability and willingness of the Fed to conduct such fiscal actions did not go unnoticed. In December 2008, two senators wrote Chairman Bernanke to request that the Fed help rescue GM and other automobile companies. After all, weren't these industrial giants as important to the economy as Bear Stearns and AIG? Bernanke said no to the request, but it proved a harbinger of things to come. Indeed, Congress and the public reacted to these bailouts and in the Dodd-Frank legislation Congress placed limits on the types of lending the Fed could do under Section 13 (3). Interestingly, in the same bill, Congress chose to fund a new agency (the Consumer Financial Protection Bureau or CFPB) through the Fed. The irony of such contrasting actions is striking but foreshadowed an evolving trend toward the explicit use of the Fed's balance sheet to fund fiscal initiatives.[3]

The large-scale asset purchase program also involved an important element of credit allocation. Each round involved significant purchases of mortgage-backed securities (MBS). This was explicitly intended to provide special support to the housing sector. Once again, such credit allocation policies are more appropriately thought

[2]While these rescues were sometimes explained as lender-of-last-resort actions, they did not follow the received wisdom passed down from Bagehot (1873), which was to lend freely at a penalty rate against good collateral in support of solvent firms—not failing firms.

[3]The trend has continued. In 2015, Congress passed a transportation bill that was partially funded from the Fed's balance sheet.

of as fiscal policy. This effort to directly support housing through the purchase of MBS was a major departure from prior Fed practice. Previously, the Fed had almost exclusively bought and sold Treasury securities in order to remain as neutral as possible vis-à-vis credit allocation. Moreover, it generally, although not always, sought to match its holdings of Treasuries to the maturity structure of the outstanding government debt to avoid influencing the market-determined term structure.

The New Operating Regime

Finally, the Fed has now adopted an operating regime for monetary policy commonly called a floor system. This system has several features, but a key element is that the Fed's balance sheet is no longer tied to monetary policy.[4] The primary instrument of monetary policy in a floor system is an administered rate, the interest paid on reserves (both excess and required). The balance sheet or the volume of reserves is not crucial to the setting of monetary policy as long as demand is satiated at the interest rate paid on reserves.

The rationale offered by the Fed for maintaining a large balance sheet, or as they refer to it, one with "ample reserves," has focused on (1) simplicity and improved efficiency in the control of short-term interest rates, including a reduced necessity of actively managing the supply of reserves through interventions, and (2) improvements in financial stability and the increase in demand for reserves induced, in part, by new regulations such as the LCR (liquidity coverage ratio). My view is that this new operating regime is not as simple or as beneficial as advertised and political economy concerns pose risks to the Fed's independence. More specifically, I argue that:

- Operational benefits are dubious;
- The role of the balance sheet in conducting monetary policy remains unclear;
- Important governance questions surrounding the operation of the system remain unresolved; and
- Political economy issues that put at risk Fed independence loom large for the institution.

So, let me briefly touch on each of these concerns.

[4]See Plosser (2017) for a more detailed discussion.

The Fed has argued that the new system is simple and successful. This conclusion is far from obvious. From my perspective, it looks like a jerry-rigged apparatus held together with belts and suspenders. The floor system has a lot of moving parts. As currently implemented,

- It specifies a target band for the federal funds (ff) rate determined by the FOMC;
- It requires the Board of Governors (BoG), not the FOMC, to set the interest on reserves (IOR);
- It has required the development of a reverse repo program (RRP) to support the lower end of the ff band, as the IOR has proved to be a leaky floor, and it still requires interventions using standard repos to manage the balance sheet to ensure the upper end of the ff is maintained;
- Moreover, the Fed is pursuing new regulations to prevent a private bank from competing with the RRP by forcing it to accept a lower IOR than other banks.

Another argument for the floor or ample reserves regime is that maintaining a buffer of highly liquid reserves enhances financial stability. What evidence is there to support such a claim? Is the balance sheet now a tool of financial stability rather than monetary policy?

The creation of reserves involves the Fed purchasing Treasury securities in the open market and creating bank reserves. Why does substituting reserves for Treasuries increase liquidity or financial stability? Both are highly liquid and qualify in meeting the LCR. Moreover, only banks can hold reserves while Treasuries can be held by a broader range of financial institutions and the public at large. How does the substitution of one highly safe and liquid asset held by the public for another, which can only be held by banks, improve stability? Of course, if the Fed chose to finance the reserve creation by purchasing more risky assets, the action comes with additional costs and risks born by the taxpayer and ultimately constitutes a form of fiscal policy or credit allocation by the central bank.

So, what about interest rate control? The Fed has argued that the floor system leads to better control of the short-term rate. Yet, the volatility of short-term rates during the precrisis regime never seemed to interfere with the implementation of monetary policy or the transmission of the funds rate target to other short-term rates. Interestingly, the old system worked well when total reserves were about $40 billion and fluctuated by relatively small amounts. Recent turmoil in the repo market has led many to conclude that the current system, with reserves of about $1.6 trillion (about 4,000 percent more reserves than precrisis), falls short of the amount necessary to stabilize short-term rates.

Granted the regulatory environment has changed. The LCR, for example, has increased the demand for reserves, and supervisory pressure seems to have biased banks into holding reserves rather than Treasuries. The Treasury has changed the way it manages its cash balances, relying more on deposits at the Fed than private banks, thus altering the need for reserves by the depository institutions. Changes in the way LCR is computed and shifts in government balances has resulted in more uncertainty and greater volatility in the demand for reserves than in the precrisis regime. This seems to have led to the Fed intervening in a massive way to absorb shocks. Ironically, this is exactly the sort of action the Fed had been hoping to avoid by adopting the floor system.

Another operational consequence of the expansion of reserves is that the interbank market for reserves, or fed funds market, has been largely eviscerated. The system is awash in reserves without much incentive for day-to-day trading. Without an efficiently operating funds market, reserves are not moving to where they are needed, trading volume is quite small, a few large banks hold the great majority of reserves, and, even on a day when reserves were seemingly scarce, such as during the repo turmoil in September 2019, reserves were not being traded and consequently not helping address the bottlenecks that were arising. Thus, the undermining of the funds market would appear to have had unintended consequences. The Fed seems to have become the de facto market-maker for reserves rather than the banks.

The Floor System and Monetary Policy

What does this new operating regime have to do with monetary policy? The Fed argued during the crisis and subsequently that expanding the balance sheet was essential to providing monetary accommodation. However, in building its case for continuing with an operating regime with a large balance sheet, the Fed has said little about the consequences of the continued large balance sheet for the stance of monetary policy. There are ways, I think, to answer this question. For example, the Fed might contend that the effects of balance expansion only occur at the effective zero bound, although they never made that claim even when they moved off the zero bound. Markets certainly don't seem to be of that opinion given their reaction to the shrinking of the balance sheet. Another answer might be that the effect of asset purchases was only through the acquisition of long-duration assets. Again, the Fed hasn't explicitly committed to such an interpretation, although it has suggested it will slowly move to a balance sheet composed predominantly of short-term Treasuries. Regardless, the Fed has not offered a view of how the size of the balance sheet and monetary policy are related, or not, under this new operating regime. It seems stuck in this never-never land where balance sheet policy matters for monetary policy at some times but not others.

Governance Issues

There are also important governance issues that need to be resolved under this new operating regime. According to the Federal Reserve Act, it is the BoG, not the FOMC, that sets the IOR. Thus, legally, the FOMC does not have the sole authority to conduct monetary policy under this new floor system. This new regime also raises the operational question as to how the Fed will decide the appropriate size of reserve balances. Once the demand for reserves is satiated, there would seem to be no limit on the volume of reserves. How will the Fed decide on the appropriate volume of reserves? Who has the authority to do so? Is there a limiting principle? If there is no limiting principle, how will the Fed resist efforts to expand its balance sheet for other purposes?

The Choice of Operating Systems and Central Bank Independence

This last question leads back to how the choice of operating regimes can impact the case for independence. In adopting a framework where a large volume of excess reserves becomes a standing feature of the operating regime, the Fed is opening the door to political interference and threats to its independence. Once the demand for reserves is satiated, there is no limit, in principle, to how big the balance sheet or volume of reserves can be. A large balance sheet unconstrained by monetary policy is ripe for abuse. Congress and an administration would be tempted to look to the balance sheet for their own purposes, including credit policy and off-budget fiscal policy.

Future confirmation hearings for Fed governors could take on an entirely new focus. Senators would likely be very interested to know how a prospective governor will view the asset side of the Fed's balance sheet. There could be questions regarding how the Fed should diversify its portfolio; there would likely be questions seeking support of the Fed in funding particular initiatives of Congress such as an infrastructure bill, maybe the Green New Deal, or support for failing state and local governments. As I have already mentioned, the off-budget funding of the CFPB in 2012 and the use of the Fed's balance sheet to fund a transportation bill in 2015 might be thought of as the early signs of such a trend.

Recently, we have heard a great deal about modern monetary theory (MMT). An implication of this "new" theory, which has not gone unnoticed by politicians, is that Congress can use the Fed's balance sheet to fund vast new spending initiatives, such as infrastructure, green investments, or social programs. Most economists find the logic of this strategy to fund large deficits troubling, if not outright nuts. But this growing appeal of MMT by some is exactly the sort of threat to independence that looms large. Yet, the Fed itself has contributed to this misguided use of its balance sheet through its unconventional policy choices, including QE, and now its new operating regime that untethers the balance sheet from monetary policy. Perhaps this threat will pass and we will muddle through somehow, but there is reason to be concerned as the price could prove quite high for Fed independence and the economy.

In summary, I think one of the biggest risks faced by the Fed, and perhaps other central banks as well, is the threat to independence. While some of the risk derives from external threats such as governments' unwillingness to accept accountability for failed or unsustainable fiscal policies, or to address much needed structural reforms, the position of many governments has been to rely on central banks to manage the fallout.

Conclusion

My concern in this article has been to point out how the Fed can, at times, be its own worst enemy. The Fed has frequently accepted greater responsibility for real economic outcomes even when monetary policy has limited ability to influence such outcomes. The hubris of a "whatever it takes" attitude can lead to failed policies and loss of credibility. Unconventional policies have blurred the traditional boundaries between monetary and fiscal policy, inviting political interference. Lastly, the choice of an operating regime that decouples the balance sheet from monetary policy is a choice that is also ripe for abuse and political interference.

On a more micro level, we have seen that the floor system, as currently implemented, is not as simple or efficient as advertised. Operationally, the unintended consequences on the functioning of the money markets have been problematic, and important issues of governance and the implication for the conduct of monetary policy have not been adequately addressed. I think it is time for the Fed to take a step back and reconsider its commitment to an "ample reserves" operating system and to take more seriously the current threats and how its own actions are undermining its credibility and the case for independence.

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