

WHY THE FED'S MONETARY POLICY HAS BEEN A FAILURE

R. David Ranson

Passing its 100th birthday, the Federal Reserve is receiving unprecedented scrutiny. We (the public) are living through the consequences of its attempts to bolster the U.S. economy through exceptionally low interest rates and the conversion of great quantities of debt to money. Although these efforts are ongoing, we are disappointed. Even with the help of strenuous actions on the fiscal side, economic and credit-market recovery from the recession of 2008–09 was notoriously slow. It took 15 quarters for U.S. real GDP to pass its pre-recession high in the fourth quarter of 2007, compared to only 7 quarters following the deep recession of 1981–82. On a per capita basis, there was an even starker contrast between the two recoveries. Moreover, the Fed remains a suspect in the genesis of the financial crisis that precipitated the Great Recession. The ultimate test of its role as overseer and regulator of the commercial banking system met with a very poor result.

Questions concerning the Fed's record can be asked at two levels: (1) Has the economic outcome been poor because the Fed made too many errors of judgment? Or (2) were its policies based on erroneous beliefs about how the economy works? If either is true, with or without mistakes, perhaps the Fed's efforts were

Cato Journal, Vol. 34, No. 2 (Spring/Summer 2014). Copyright © Cato Institute. All rights reserved.

R. David Ranson is President and Director of Research at Wainwright Economics.

inherently ineffective. My view that monetary policy might even have contributed to economic stagnation comes from several concerns:

- Fed thinking about the credit market is at odds not only with Adam Smith's Invisible Hand, or its modern reformulation by Hayek in terms of market price signals, but with standard microeconomics.
- Expectations that current monetary policy tools will have the desired effects on credit volume and economic growth lack straightforward empirical verification in the long sweep of U.S. history.
- As a creation of the banking industry, the Fed long ago became its designated protector. It is motivated to give priority to prolonging the life and maintaining the profitability of existing financial institutions even where that might conflict with competition and general economic health.
- In decisions relating to inflation and unemployment, the Fed overrelies on "headline" statistics of public debate that have been politicized and tend to obscure more than they reveal.

I address these considerations in turn.

Fed Policy versus Free-Market Thinking

The U.S. economy is broadly capitalist and competitive, and Americans have a respect for the invisible guiding hand of market forces. To place a central bank in a governing role at the hub of the monetary system represents an opposite philosophy. In no other major sector is the general level of prices pegged and re-pegged by federal authority. It's the antithesis of free-market thinking to imagine that the Fed has unique or superior knowledge to impose an interest-rate structure that will better allocate credit.

Banks claim unique status in the economy. Politicians see them as a fragile credit-allocation mechanism without which the economy could barely even function, but which require government assistance and supervision. In no other industry is there general acceptance of need for a supplier or demander of last resort.

Even in a credit crunch like the one that hit in 2007, it's unclear what the Fed's injections of funds did to help. They were designed to ease the stress felt by banks caught with assets for which there was

no demand at acceptable prices. But the economic collapse came anyway.

Despite the common usage of the ambiguous word “liquidity,” making cash plentiful is not the same as making markets liquid. A liquid market is one in which there are plenty of willing buyers and sellers and the volume of transactions is sufficient to allow each investor to trade without materially affecting the price. An illiquid market is one in which buyers and sellers are temporarily holding back from normal trading and prices are pushed around by individual transactions.

A “liquidity crisis” is something else again: a situation in which financial firms are scrambling to find enough cash to conduct their operations without incurring losses that threaten their solvency. In one sense, the market paralysis of 2007–08 can be analyzed as an information problem. Financial markets were illiquid because their participants had become highly uncertain about the value of many of the assets that they would normally be trading. Neither injections of funds nor interest-rate cuts could dispel the confusion. Indeed Treasury and Fed actions and inactions added an extra layer of uncertainty.

As experience has since confirmed, not even a zero rate stimulates the broad use of credit in the economy. From the viewpoint of microeconomics that should not be surprising. To expect otherwise could only make sense if borrowers are assumed to drive the credit market while lenders and savers are passive. What policymakers cannot grasp, apparently, are the elementary economics of a market that is not permitted to clear.

From early times, maximum prices imposed by law have famously led to hoarding, shortages, and smuggling. Symmetrically, minimum prices have led to underutilization and spoilage. Fixing the lawful price of any commodity, product, or service leads to either one wasteful disequilibrium or the other. A rate close to zero for short-term credit incapacitates the market-price mechanism and hurts the economy by forcing markets to allocate capital arbitrarily or politically.

The economic effects of Fed interest-rate control differ from those of a legally mandated zero interest rate. The Fed constantly intervenes in the wholesale securities markets to buy or sell whatever amounts are sufficient to peg the rate near zero, allowing borrowers and lenders to respond as they please. The question is not simply one of shortage or glut, but of a misallocation of the country's resources.

The gasoline market in Mexico could be a parallel. Government-owned oilfields produce petroleum that reaches the public in the form of fuel at an artificially low price. Microeconomics dictates that Mexicans overconsume gasoline as a result, leading to waste in their energy and energy-using industries. Similarly, the Fed's zero interest-rate policy misprices credit, causing industries throughout the economy to misallocate it. In either case, the economy's productivity is degraded.

Artificially low interest rates permit borrowers who should not be borrowing to get funds from lenders who shouldn't be lending to them. They crowd out some potential borrowers and lenders who could have produced credit for more productive purposes. Common language calls this situation "cheap money." The marginal cost of borrowing is cheap for the lucky recipients, of course, but not for the economy as a whole.

Because the capacity of the economy to create credit is finite, credit needs to be allowed to flow to the most productive uses that markets can discern. A distortion of market interest rates imposes unseen costs on the nation generally.

Empirical Verification that Monetary Policy Works

There is a dearth of historical evidence that Fed tools have had the economic effects that are now so widely expected. The simple empirical facts about the way monetary policy actions have been correlated with the economy receive surprisingly little public attention (see Ranson 2013 for highlights of the empirical evidence outlined here).

Monetary policy can be quantified in two basic ways: quantity and price. The Fed's effort can be expressed by the volume of money that is created or which is added to its assets or the liabilities side of the banks' balance sheets. Or it can be measured in terms of the changes it induces in the price structure for credit.

On the price side, a decline in the Fed's target short-term interest rate is widely believed to boost the economy. But historical correlations over long periods of time tell a different story. Allowing for leads and lags, both increases and declines in interest rates have led ultimately to lower output. And whereas active use of monetary policy is supposed to stabilize the economy's performance, ups and downs in short-term rates are associated historically with growth that is not only slower but more volatile.

On the quantity side, an increase in the monetary base or in bank reserves is widely presumed to lead to a better economy. But historical correlations between the growth rates of the monetary base and the economy are inverse. Proponents of quantitative easing can interpret this as reverse causation, that is, from the economy to policy. But the corresponding correlation of monetary base growth with a variety of inflation indicators is positive. To make sense of that, the direction of causation must go from policy to the economy. Whatever the correct dispositions of chickens and eggs, the evidence falls far short of providing clear validation for the Fed's current policies.

Needless to say, the econometric literature on monetary policy goes far beyond the analysis of simple correlations. Its practitioners (including the Fed's own staff) advocate "structural modeling" and some occasionally dismiss simple correlations as inconclusive. I have multiple responses to this objection.

First, throughout the observational sciences, all correlations are inconclusive by their nature—and not just for chicken-and-egg reasons. How can the complex be easier to interpret than the simple? The more intricate the evidence, the more scope there will be for doubt and dispute.

Second, structural models are an intensely disputable basis on which to justify policy. Different researchers have different prior beliefs that lead them to formulate different structures and draw different conclusions from the same evidence. The Fed's own "dynamic stochastic general equilibrium" models are a case in point of the built-in assumption that the economy is predictable and monetary policy is effective.

Third, simple correlations come to us from direct observation unbiased by any assumed structure. Other observational sciences cite them routinely and take them seriously—as do economists too, when it suits them.

Fourth, structural modeling is a field to which only a select body of professional economists has access. The broadest possible public needs to know the simple empirical facts, and should share the task of recognizing and interpreting them.

Politicization of Monetary Policy

The Fed is a political enterprise. Realists must question whether central banks have the objectivity to adhere to principle in times of

crisis or economic malaise. The doctrine of “regulatory capture” supports casual impressions that the Fed is always mindful of the health and profitability of the commercial banks that are its clientele. It is as likely as not to be swept up in a financial panic. Supportive actions get high priority. Under criticism Fed leaders have resisted this suspicion, but one instance may illustrate why it should not be dismissed.

In 2007, as signs of a banking crisis began to increase, the Fed started cutting interest rates. In November outgoing St. Louis Fed president William Poole told the Cato Institute that “the Fed never bails out any party—even banks—with capital or any sort of guarantee. . . . Whenever the Fed steps in to deal with financial instability its intent is to stabilize the overall economy, not just one segment of it, such as Wall Street.” Poole (2007) supported his point with stock-market evidence: “I reviewed all stock market declines of at least 10 percent going back to 1950, along with actions by the Federal Open Market Committee over the same span. The data prove that the FOMC has not lowered interest rates in systematic fashion at the time of stock market declines.” Poole was right about the general stock market. But in the process of taking another look at the evidence, I used a more specific index of bank stocks to detect the existence of a threat to bank profitability and solvency. By that measure, the banking industry got into most trouble in 1990–91 and 2000. Following both of those periods large Fed rate cuts took place. From more systematic tests I found a consistent relationship between bank stock prices and Fed interest-rate policy (Ranson 2008).

Fed interest-rate cuts, whether or not they are needed or efficacious for the economy, have enabled banks to work their way out of threats to their collective balance sheets. By cutting rates the Fed steepens the yield curve and widens the spread between the rate at which depository institutions lend and the rate at which they borrow. If rates are pushed below the levels at which they would stand if the Fed did not intervene, that’s an implicit subsidy.

Tyranny of the Status Quo

Over time, political philosophies influence what economic statistics are used and how they are interpreted, adding to a kind of tyranny of convention in economic diagnosis. And in tracking the economy, the Fed is obliged to follow convention like any

government agency. But distortions can arise where measures of economic performance have been designed by government for the benefit of government. They are capable of obfuscating policy failure and holding back its recognition.

The Fed is unwise to evaluate the progress or success of its monetary policy based on uncritical use of statistics that receive the overwhelming but superficial attention of the media. Headline statistics for the labor market, for example, have given the impression that progress is being made because the number of workers defined as “unemployed” has declined relative to the so-called labor force. Early in the recovery, Fed statements identified an unemployment rate of 7 percent as a sign that the economy would have advanced to the point that it might back off.

Transcending arbitrary definitions of the labor force and the number of unemployed, harder numbers point to a very different judgment. In more than four years, the ratio of employment to population of working age has barely even begun to recover from its collapse in the recession. Several measures of this ratio all dropped by about one fifth during 2007–09, but the slow speed of their improvement since the bottom suggests that it will take a further decade or two to reapproach prerecession levels.

The central headline statistic on the basis of which the Fed makes decisions and judges its success is the rate of inflation. The annual change in the official consumer price index is presently so low that policymakers can use it to argue that the inflationary effect of what the Fed has done can be disregarded. Or even that the specter of “deflation” still looms, thus appearing to require increased doses of the same policies.

Whether we have a historically high or historically low inflation rate is less clear than is widely realized, and in light of the low-inflation assumption in Fed thinking deserves much more scrutiny.

It's imperative to begin by recognizing that inflation is an ill-defined concept. There exists no single inflation rate that everyone could accept as authoritative. As the Austrian-American economist Gottfried Haberler warned more than 80 years ago, “The relative position and change of different groups of prices are not revealed, but are hidden and submerged in a general index” (Haberler 1928: 444). Inflation varies from one group of people to another, one place to another and one economic activity to another. The inflation rate

for goods, especially technological goods, is very different from the inflation rate for services.

All in all, what is glibly called *the* rate of inflation is a fiction and can be actualized only as some kind of average price increase in an astronomical number of consumer products and services. One definition of inflation may produce estimates that are much higher than those from another. Beyond that, the headline consumer price index, along with the personal consumption deflator and other derivatives, slips by major conceptual difficulties. The CPI consists mainly of large numbers of price quotations that barely change at all from month to month. That's not because markets aren't changing, but rather because of greater reliance on posted prices than actual transactions. Except for well-defined commodities, personal observation suggests that the nature and features of consumption goods are changing all the time. Few price changes can be measured without ambiguity.

Most important, the consumer price index is overhauled and redefined periodically in the political arena. Against good practice in statistics, the official history of the cost of living is a cobbling together of a series of different indices, each of which had temporary official status at one time. Different iterations give amazingly different estimates of inflation (see Williams 2012). Addressing such objections points toward an inflation rate that is much more fluid than the official one—and historically above average. By placing such an ambiguous index at the center of its deliberations the Fed may have misled both itself and the public.

Conclusion

The Fed's decisions are hampered by the need to preserve banks that are "too big to fail" and by flawed methods of evaluating the labor market or the cost of living in public discourse. But there are reasons to fear that, even if all obstacles could be corrected, there is something inherently ineffective about the Fed's current monetary policies. The assumption that they have stimulated or bolstered the economic recovery is based much more on doctrine than on evidence.

When a policy is unsuccessful, policymakers should rethink it and try something different. But that is unrealistic here. Opponents of existing policy argue that it has failed because it is wrong. Supporters counter that it needs more time to work, or has been deployed on an insufficient scale.

In adversarial politics the broad direction of economic policy has become a philosophical choice. The two sides are separated by a fence that divides advocates of “big government” from “small government,” egalitarians from libertarians, and so forth. This impasse is the result of politics and will have to be resolved by politics. Only the electorate can change the broad direction of unsuccessful policy, because its authors will not.

References

- Haberler, G. (1928) “A New Index Number and Its Meaning.” *Quarterly Journal of Economics* 42 (3): 434–49.
- Poole, W. (2007) “Bailing Out the Markets Is Not a Goal of Fed Policy.” Address to the Cato Institute, Washington, D.C. (30 November).
- Ranson, R. D. (2008) “Just Who Is the Fed Watching Out For?” H. C. Wainwright & Co. Economics (15 May).
- _____ (2013) “Would the U.S. Be Better Off without Monetary Policy?” H. C. Wainwright & Co. Economics (11 November).
- Williams, J. (2012) “Commentary.” American Business Analytics & Research, Commentary No. 482 (15 November).