Cato Handbook for Policymakers

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35. The Limits of Monetary Policy

Congress should

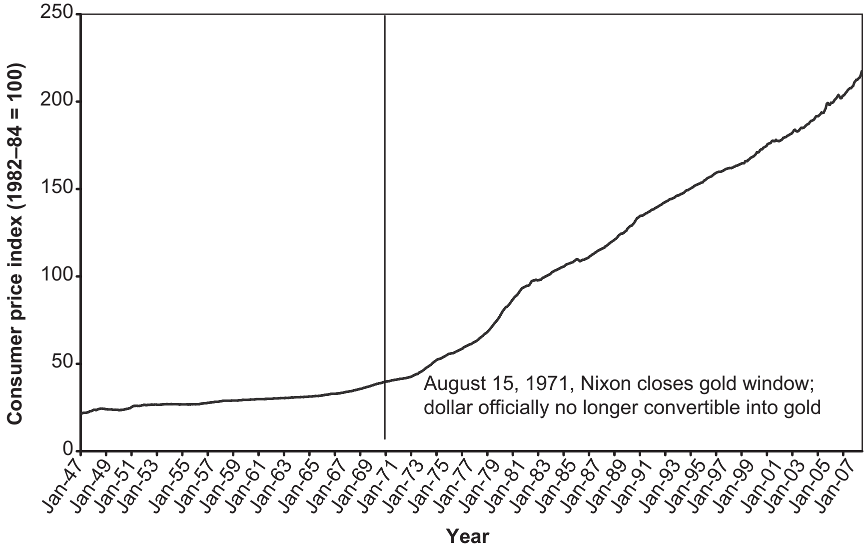
- amend the Federal Reserve Act to make long-run price stability the primary goal of monetary policy;
- recognize that the Federal Reserve cannot fine-tune the real economy but can achieve long-run price stability by its control over the monetary base (currency held by the public plus bank reserves);
- hold the Fed accountable for safeguarding the purchasing power of the dollar;
- abolish the Exchange Stabilization Fund—the Fed's role is to stabilize the domestic price level, not to peg the foreign exchange value of the dollar; and
- repeal the tax on privately issued bank notes and allow digital currency and other substitutes for Federal Reserve notes to emerge, so that free-market forces can help shape the future of monetary institutions.

Today, the United States is on a pure fiat money standard with a discretionary central bank: the dollar has no defined value in terms of a commodity or basket of commodities; there is no convertibility principle operating; and there is no monetary rule to ensure long-run price stability. Consequently, the price level has drifted upward without a solid anchor (Figure 35.1).

James Madison, the chief architect of the Constitution, recognized that convertibility is a more certain way to protect the value of money than reliance on a central bank—even if that central bank were tied to a quantity rule. In 1820, he wrote:

> It cannot be doubted that a paper currency, rigidly limited in its quantity to purposes absolutely necessary, may be made equal and even superior

Figure 35.1
U.S. Price Level in a Pure Fiat Money Regime



SOURCE: Bureau of Labor Statistics.

> in value to specie. But experience does not favor a reliance on such experiments. Whenever the paper has not been convertible into specie, and its quantity has depended on the policy of Government, a depreciation has been produced by an undue increase, or an apprehension of it.

It is ironic that today most policymakers consider the gold standard a relic and any shift away from a pure fiat money regime ‘‘an experiment.’’ But policymakers should take Madison’s concern about irredeemable paper money seriously and think about monetary rules that could help anchor the future purchasing power of the dollar.

The challenge for Congress is to set the framework for stable money and to recognize that sound money is a prerequisite for financial stability and the efficient operation of a free-market price system. Policymakers should be aware of the limits of monetary policy: the Fed may be able to create money out of thin air but it cannot, by so doing, create goods and services or full employment. Indeed, the opposite is true: inflation distorts price and profit signals and increases uncertainty. As such, there is more likely to be a negative rather than a positive relation between inflation and economic growth (Figure 35.2).

Figure 35.2
Inflation Harms Growth

SOURCES: U.S. Department of Commerce: Bureau of Economic Analysis; U.S. Department of Labor: Bureau of Labor Statistics.

Ending the Fed's Dual Mandate

History has shown that monetary stability—money growth consistent with a stable and predictable value of money—is an important determinant of economic stability. Safeguarding the long-run purchasing power of money is also essential for the future of private property and a free society. In the United States, persistent inflation has eroded the value of money and distorted relative prices, making production and investment decisions more uncertain.

In the early 1970s, wage-price controls were imposed—ostensibly aimed at reducing inflationary expectations. Those controls only repressed inflation as money growth accelerated. When the controls were lifted, the excess supply of money became evident. Meanwhile, the controls reduced economic freedom and increased government discretion, thus undermining the rule of law.

Today, we face a growing budget deficit, trillions of dollars of unfunded liabilities, and a mounting federal debt in the wake of the subprime crisis. The danger is that global investors will downgrade U.S. sovereign debt, and that as foreigners buy less of it, the Fed will buy more. Inflation will then reduce the real burden of the debt but only at the cost of slower economic growth and a loss of credibility. We will not become another Zimbabwe, but there will be an increased threat of wage-price controls and a loss of economic freedom. That is why it is essential that the Fed pursue a policy of long-run price stability.

Current law specifies no single objective for monetary policy, which leads to uncertainty. William Poole, former president of the Federal Reserve Bank of St. Louis and a proponent of long-run price stability (that is, zero expected inflation), has pointed to the market disruption caused by the lack of a clear monetary rule to guide Fed policy:

> The fact that markets so often respond to comments and speeches by Fed officials indicates that the markets today are not evaluating monetary policy in the context of a well-articulated and well-understood monetary rule. The problem is a deep and difficult one.

Congress should face that problem by amending Section 2A of the Federal Reserve Act, making long-run price stability the primary aim of monetary policy. If the Fed were held accountable for achieving zero expected inflation, the inflation component of nominal interest rates would vanish and rates would fall to their ''natural'' level. Increased certainty about the future value of the dollar would also have a beneficial effect on investment and would attract foreign capital, thus promoting output and employment. There would be no need to list ''maximum employment'' and ''moderate long-term interest rates'' as separate goals of monetary policy.

The amended Section 2A would read: ''The Board of Governors of the Federal Reserve System and the Federal Open Market Committee shall maintain long-run growth of the monetary and credit aggregates so as to maintain long-run price stability.'' That amendment would not preclude the Fed from acting as a lender of last resort in a liquidity crisis, but it would require a reversion to noninflationary growth of money and credit—and thus ground the public's expectations with regard to the future value of the dollar.

Ending the Fed's dual mandate to achieve both full employment and price stability would recognize the limits of monetary policy and help depoliticize the policymaking process. Rather than having to weigh the short-run tradeoffs between the two goals (lower unemployment at the cost of higher inflation), the Fed could focus on what it can achieve—long-run price stability. The exact monetary rule the Fed adopted to achieve that objective is less important than making policymakers accountable for sound money.

The Price Stability Act of 2008, introduced by Rep. Paul Ryan (R-WI), would be a good template for legislation introduced in the 111th Congress. It would require the Fed to ''establish an explicit numerical definition of the term 'price stability'; and maintain a monetary policy that effectively promotes long-term price stability.'' But the proposed legislation has no teeth: there is nothing in it to penalize the Fed for failing to achieve the stated goal.

Making the Fed Accountable

The Fed's function is not to set interest rates or to target the rate of unemployment or real growth. The Fed cannot control relative prices, employment, or output; it can only directly control the monetary base and thereby affect money growth, nominal income, and the average level of money prices. In the very short run, the Fed can affect output and employment, as well as real interest rates, but it cannot do so in the long run.

Targeting the federal funds rate to achieve the Fed's dual mandate of full employment and price stability assumes that the Fed can correctly forecast the state of the economy. But Fed forecasts are far from perfect, and if the Fed holds the target rate below the market rate by expanding the monetary base, inflation will increase and the Fed will have to put on the brakes.

The self-regulating nature of the classical gold standard is a far cry from today's activist monetary policy. In the choice of monetary rules, the Fed should aim at those that minimize the need for forecasting, such as Carnegie-Mellon economist Bennett McCallum's nominal final demand rule or the variant of that rule proposed by William Niskanen in this *Handbook* (Chapter 36). An even simpler rule is to freeze the monetary base and let private firms supply currency in response to market demand, as proposed by Milton Friedman.

The Fed cannot attain more than one policy target, and it has only one policy instrument. The surest target is long-run price stability, and the only instrument the Fed has direct control over is the monetary base. With a McCallum-type feedback rule, the Fed would adjust the growth of the monetary base to keep nominal gross domestic product (or domestic final sales) on a smooth noninflationary growth path. With an inflation target, the Fed would adjust the monetary base so that the growth rate of the price level was approximately zero in the long run. There would be some rises and falls in the price level due to supply-side shocks, either positive or negative, but expected inflation would remain close to zero (in the 0–2 percent range) over time.

Congress need not dictate the exact rule for the Fed to follow in its pursuit of long-run price stability, but Congress should hold the Fed accountable for achieving that goal—and not require the Fed to respond to supply shocks that would lead to one-time increases or decreases in the price level.

The public's trust and confidence in the future purchasing power of the dollar can be permanently increased by a legal mandate directing the Fed to adopt a monetary rule to achieve long-run price stability. According to Poole:

> The logic, and the evidence, both suggest that the appropriate goal for monetary policy should be price stability, that is, a long-run inflation rate of approximately zero. . . . A central bank's single most important job is preserving the value of the nation's money. Monetary policy has succeeded if the public can reasonably trust that a dollar will buy tomorrow what it will buy today. . . . I am confident that our economy's long-run performance would be enhanced by a monetary policy that aims at, achieves, and maintains a zero rate of inflation.

That institutional change—from a fully discretionary monetary authority to one bound by law to a single target—not only would bolster the Fed's reputation but would enhance the efficiency of the price system and allow individuals to better plan for the future. People's property rights would be more secure as a result.

For a law making price stability the sole aim of monetary policy to be effective, the Fed must be held accountable for failure to meet that target. Consequently, the law must clearly state the price-stability target while letting the Fed choose how best to achieve it. Transparency will make it easier for Congress and the public to monitor the Fed's behavior and to effectively reward or penalize it.

The New Zealand inflation-targeting law is instructive. The Reserve Bank Act of 1989 states that the sole objective of monetary policy is price stability. A target range is set for inflation, as measured by the consumer price index, which the governor of the Reserve Bank must achieve within a specified time horizon, with exceptions made for supply shocks. The governor is required to sign a contract, the Policy Targets Agreement, with the finance minister, in which the governor agrees to a target range for inflation set by the finance minister, the period for achieving it, and the penalty of dismissal for failing to meet the target. That arrangement has served New Zealand well in achieving a low rate of inflation while letting its currency float on the foreign exchange market. Unlike countries with pegged exchange rates and no monetary rule, New Zealand sailed through the Asian financial crisis quite smoothly.

Congress should draw on New Zealand's experience to create a credible monetary law that holds the chairman of the Fed accountable for achieving long-run price stability.

Recognizing the Limits of Monetary Policy

The Fed cannot permanently increase the rate of economic growth or permanently lower the rate of unemployment by increasing money growth, nor can it permanently lower real interest rates. But it can throw the economy off track by policy errors—that is, by creating either too much or too little money to maintain stable expectations about the long-run value of the currency. The most grievous error of discretionary monetary policy, as Milton Friedman and Anna Schwartz have shown in *A Monetary History of the United States*, was the Fed's failure to prevent the money supply from shrinking by one-third between 1929 and 1933, which turned a sharp but otherwise ordinary recession into the Great Depression.

Economics, like medicine, is not an exact science. The guiding principle of economic policy should be the great physician Galen's (A.D. 160) admonition to ''first do no harm.'' Instead of pursuing in vain an activist monetary policy designed to fine-tune the economy and achieve all good things—full employment, economic growth, and price stability—Fed policy ought to be aimed at what it can actually achieve.

Congress must contemplate three questions in its oversight of monetary policy: (1) What can the Fed do? (2) What can't it do? and (3) What should it do?

What Can the Fed Do?

The Fed can

- control the monetary base through open market operations, reserve requirements, and the discount rate;
- provide liquidity quickly to shore up public confidence in banks during a financial crisis;
- influence the level and growth rate of nominal variables, in particular, monetary aggregates, nominal income, and the price level;

- control inflation and prevent monetary instability in the long run;
- influence expectations about future inflation and nominal interest rates.

What Can't the Fed Do?

The Fed cannot

- target real variables so as to permanently reduce the rate of unemployment or increase economic growth;
- determine real interest rates;
- peg the nominal exchange rate and at the same time pursue an independent monetary policy aimed at stabilizing the price level, without imposing capital controls;
- fine-tune the economy;
- make accurate macroeconomic forecasts.

What Should the Fed Do?

The Fed should

- keep the growth of nominal GDP (or domestic final sales) on a stable, noninflationary path so that expected inflation is close to zero by controlling the monetary base;
- let market forces determine the dollar's relative price, that is, its foreign-exchange value, which would be more stable in a rules-based monetary regime;
- use forward-looking prices (such as the price of gold, financial assets, and the exchange rate) to help guide monetary policy;
- follow Bagehot's rule during a liquidity crisis and lend only on good collateral at a penalty rate.

Abolishing the Exchange Stabilization Fund

If the Fed is to retain its independence and be held accountable for maintaining the domestic purchasing power of the dollar, it cannot also manage the external value of the dollar, in the absence of capital controls. The dollar should be free to float, capital should be free to move, and the Fed should use its power to control money and credit growth to ensure long-run price stability. Thus, Congress should abolish the Exchange Stabilization Fund, which was created in 1934 by the Gold Reserve Act.

The ESF has been used by the Treasury to try to ''stabilize'' the external value of the dollar, but without success. It has also been used to make dollar loans to support the currencies of less developed countries. It is time to get rid of this relic of the New Deal, as long recommended by Anna Schwartz.

By abolishing the ESF, Congress would give a clear signal that it supports exchange-rate and capital freedom, and that the primary function of the Fed is to ensure that the future value of the dollar is secure.

Welcoming the Evolution of Alternatives to Government Fiat Money

While Congress should hold the Fed responsible for maintaining the value of money, in terms of its domestic purchasing power, Congress should also welcome the emergence of alternatives to government fiat money, such as digital cash. Monetary institutions should be allowed to evolve as new technology and information become available.

The growth of electronic commerce will increase the demand for new methods of payment, methods that economize on paper currency. As consumers' trust in electronic cash grows, the demand for the Fed's base money may *decrease*. That would actually make the implementation of a monetary rule easier because the Fed need not worry about complications arising from changes in the ratio of currency to deposits, according to monetary economist George Selgin. Indeed, Milton Friedman's simple rule of zero growth of the monetary base may work quite well in the information age, and it may be a step toward private competing currencies, as advocated by F. A. Hayek.

A concrete measure to promote greater monetary choice would be for Congress to repeal the 1 percent tax on bank-issued notes that is still on the books (U.S. Code, Title 12, Section 541), as suggested by economist Kurt Schuler.

Conclusion

Monetary disturbances have been either a major cause of or a key accentuating factor in business fluctuations. Maintaining a money of stable value through institutional reform would be socially beneficial.

It is time for Congress to recognize the limits of activist monetary policy and to focus on long-run price stability as the Fed's primary objective.

Monetary policy should not depend on any one individual or a Federal Open Market Committee of 12 politically appointed people. It should depend on rules that limit discretion and hold the Fed chairman accountable for failing to achieve money of stable value. Financial markets will then show less anxiety upon the release of every Open Market Committee statement.

The major thrust of this chapter has been to call on Congress to make the Fed accountable for maintaining the long-run value of the currency. But Congress should not limit its vision to a monetary system dominated by a government-run central bank, even if that institution is limited by a monetary rule.

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