The Conduct of Monetary Policy

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The Federal Reserve's independence is essential to the conduct of monetary policy. But while the Fed is independent within government, it is not independent of government. The grant of authority to the Fed comes from Congress, to which the Fed is ultimately accountable. In my view, the Fed was granted significant powers by Congress, but those powers were not unlimited. The grant of authority was constrained. So by my measure, the Fed is a powerful institution, but a bounded one.

The limits on the Fed in the conduct of monetary policy—that is, limits in the grant of government powers and in the efficacy of its actions to facilitate economic growth—are too often forgotten in Washington. We should acknowledge and understand these limits, not seek to manage or circumvent them.

Many leading econometric models used by central bankers, and promoted in the academy, suggest that the more the Fed pushes down long-term interest rates, the more that policy actions can be deployed to grow GDP, thereby maximizing employment and minimizing the output gap. The law of diminishing returns, however, applies to financial markets and the real economy, and some leading models are unable to account sufficiently for this nonlinearity.

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In these remarks, allow me to highlight a few key themes to help guide the discussion on the limits of monetary policy, applicable both at home and abroad.

The Fed's Credibility

Acknowledging the limits of monetary policy elevates, rather than relegates, the authority of the central bank. Fed officials should do their level best to burnish the most important asset they possess, which cannot be found anywhere on the Fed's audited financial statements. This value resides principally in the Fed's institutional credibility. Consider this credibility a goodwill item of sorts, and it is far more potent than the value of Treasury and related assets owned by the Fed. This credibility of the central bank wasn't granted by statute; it was earned. And each generation of Fed policymakers is rightly asked, however implicitly, to leave the institution with more credibility than was inherited. In the framework I find most persuasive, the Fed's credibility allows it to act powerfully when warranted and stand aside in other times, when the benefits are overwhelmed by the risks.

Situational Awareness and the Value of Humility

Central banking demands situational awareness. Monetary policy can be considerably more powerful at certain moments, while sorely lacking efficacy in others. Monetary policy aggressiveness can be demanded in certain circumstances; the utmost modesty is required in others.

As a result, policymakers must assess the regime in which they find themselves. For example, if you go back to the depths of the financial crisis in 2008 and 2009, you may reasonably conclude that a panic was under way—perhaps akin to the panic of 1907 that gave birth to the Federal Reserve. That conclusion might well give the Fed a greater right, even obligation, to act aggressively. Monetary policy is a powerful tool to address financial panics—that is, among other things, to infuse liquidity to get bid-ask spreads to narrow and markets to clear.

As we emerged from the financial panic, many commentators praised the world's leading central banks for their efforts in helping markets to function once again. On the rare occasion of financial panics, a central bank may well be able to pull the proverbial rabbit out of the hat.

Nevertheless, we should push strongly against the view that central bank heroics in times of panic can be replicated in more benign periods. Monetary policy may be considerably more limited in scope and efficacy when markets are functioning, interest rates are at the zero lower-bound, prices are stable, and economic growth remains modest.

Consider a regime where an economy is growing well below its long-run potential—say at about 1.5 to 2.0 percent—and inflation, at least as measured by government statistics, is broadly consistent with price stability. One would be hard pressed to call that economic backdrop a panic. Now, politicians might be panicked as they approach an election. Unemployment would still be too high, job creation still anemic, but that may not be the kind of panic where central banks can be—or should be disposed to be—exceptionally aggressive.

Situational awareness has another important dimension. Central bankers must evaluate their policies in the context of other macroeconomic policies of the government. Monetary policy does not affect the economy in isolation. Central bankers may well consider whether their actions are crowding in good policy or crowding it out (see Warsh 2011). There should be a healthy dynamism with other economic policies being undertaken by the rest of official Washington, including regulatory, trade, and fiscal policies.

Let's imagine two divergent macroeconomic regimes. First, consider a policy regime where Congress and the administration are making good progress defeasing outstanding liabilities and reducing indebtedness. Budget deficits are falling and long-term entitlement expenditures are on the path to sustainability. In that case, a central bank—even at the zero lower-bound—might not be able to do much more to achieve potential GDP solely through balance sheet actions. But, it might well be less subject to critique. There could be fewer rightful questions of debt monetization or threats of fiscal dominance. There would be no case that the central bank was crowding out other policies—if, in fact, other policymakers were stepping up to the plate.

But then imagine a regime where liabilities are growing every day, and as deadlines come and go central banks are repeatedly asked to come to the economy's rescue in lieu of pro-growth policies from other parts of the government. This situation does not require much of an imagination because it may approximate the environment in which we find ourselves. That's situational awareness. And it is critical in fairly evaluating the merits of central bank action.

Communication Policy

Central bankers—when their tools appear limited by the zero lower-bound—often resort to a range of other tools. Communication policy is often cited as one such tool employed by central bankers to help establish financial conditions more to their liking. And surely, the economic literature affirms the benefits of so-called open-mouth operations to help influence investor expectations and affect market conditions. But I do not consider communications as a separate policy instrument. Market participants and business people are more interested in something other than what central bankers say; they look to what central bankers actually do. Given the frequency and power of actions by most central banks over the last several years, central bankers have revealed their true preferences by virtue of their actions over time. Communications policy, hence, is most effective when it is consistent with actual behavior.

The Dual Mandate

Central banks with a dual mandate—price stability and maximum sustainable employment—confront different limits with respect to each objective. On the price stability front, the central bank maintains the dominant role in establishing, burnishing, and achieving its price stability objective. Milton Freidman was correct: Central banks can, over the medium term, work to achieve a price stability objective. If you look at the other side of the Federal Reserve's mandate—the employment mandate—the central bank has an important role to play, of course. You won't hear me walking back from this responsibility. But labor markets are influenced in certain regimes, like those in which we find ourselves, by policies and practices far outside the remit of the Federal Reserve, far outside the remit of a powerful but narrow central bank. If fiscal policy, trade policy, and regulatory policy are having a materially negative effect on labor markets and potential GDP, the Fed is not well situated to compensate for those failings. Moreover, it runs grave risks if it overpromises and underdelivers.

Conclusion

The limits of monetary policy are real. Central bankers, including at the Fed, are especially wise to acknowledge those limits. And their policy objectives must take account of the environment in which they are operating. At the end of the day, they should try to crowd in other actors, rather than crowd them out. Our citizens deserve nothing less.

Reference

Warsh, K. (2011) "Our 'Financial Repression' Trap." *Wall Street Journal* (6 December).