Money news

AEI Looks at the Global Curse of the Fed

Tuesday, March 26, 2013 07:28 AM

By: Robert Feinberg

In the second and most provocative conference of the three events sponsored by the American Enterprise Institute (AEI) that have recently examined issues related to Federal Reserve policy in this, the 100th anniversary of the enactment of the enabling legislation, Brendan Brown, head of economic research at Mitsubishi UFJ Securities, presented his latest book, “The Global Curse of the Federal Reserve.” The book was originally published by Palgrave in 2011, but is now issued in a revised paperback edition.

Brown’s presentation was followed by comments from Mark Calabria, director of financial regulation studies at the Cato Institute, and Walker Todd of the American Institute for Economic Research, who was previously general counsel of the Federal Reserve Bank of Cleveland.

AEI’s Alex Pollock introduced the author, suggesting that the last four decades should have been a period of “central bank heaven,” because the Fed has been totally free of the shackles of the gold standard and fixed exchange rates, yet the period has witnessed what Pollock called “a constant stream of crises and panics, bubbles and shrivels, right up to the present.” He asked whether the combination of central banking and financial crises is merely a coincidence or whether the Fed is the primary cause of the financial crises, as the author contends.

Further, Pollock posed these questions:

1. Is it plausible that a committee of government officials and economists can so accurately forecast the future as to manage the behavior of an entire internationally integrated economy?

2. Does it make sense to have a national price-fixing committee for short-term, and now long-term, interest rates, and can such a committee operate successfully?

3. Does the modern central bank’s rock-solid commitment to permanent inflation, which it calls “price stability,” make sense?

To these questions, Brown responded no, no and no.

Brown credits Pollock as the inspiration for the book, because Pollock had suggested that the Fed could indeed be the font of the instability in financial markets.

In seeking to define the “global curse,” Brown first considers whether it is the progressive erosion in the value of the dollar, but he says it goes beyond inflation to encompass the waves of irrational exuberance followed by depression that have created so much economic destruction since the Fed began operating in 1914. These waves, described by economists in terms of asset price inflation and deflation, Brown blames on the Fed’s manipulation of interest rates.

This leads, in turn, to monetary disequilibrium that sends false signals to market participants and causing them to overestimate the rewards of investment and underestimate the risks. He traces the reference to waves of asset price inflation to a quote from John Stuart Mill, popularized by Milton Friedman, that most of the time money doesn’t matter, but when it gets out of control, when it becomes corrupt, it throws a monkey wrench into the machinery of the economy.

Brown calls the failure to emphasize the effects of monetary policy on asset prices a fault in the analysis by the monetarists, but he credited the Austrian economists for raising this issue. He ascribes Friedman’s reluctance to discuss asset prices to the difficulty of developing enough empirical evidence to support valid study, but Brown contends that this is not a sufficient reason to discount the importance of the relationship between Fed policy and asset price volatility.

Brown identifies three channels for this phenomenon: pegging short-term interest rates and giving forward guidance on long-term rates produces froth in assets markets, causing investors to embark on a desperate quest for yield, then creating fear over the threat of future inflation.

Brown briefly reviewed the history of monetary policy since the Fed was created and noted that asset price inflation did not start with the Fed, but that the waves have become worse under the Fed.

The last wave under the gold standard was in 1906 and 1907, following a surge in gold production in the 1890s, but at least there were some checks and balances, interest rates were freely determined and the price level fluctuated in both directions.

But as soon as the Fed opened, the gold standard and monetary framework collapsed. Friedman and Anna Schwartz describe the 1920s as high tide for the Fed, and they praise Benjamin Strong for his leadership as president of the Federal Reserve Bank of New York from 1914 until 1928.

Brown sees this as the breaking point between Friedman and the Austrians, who see that period as one of vast disequilibrium marked by a gap between U.S. and German interest rates that created a carry trade.

Brown calls for a policy of low interest rates during periods of technological progress that improve productivity, and he offers six recommendations as to how to cure the curse and set the stage for policy improvement under a new monetarist revolution:

1. Drop inflation targeting in favor of price stability over a very long run — 30 years.

2. Treat deflation phobia, a symptom of Federal Reserve Chairman Ben Bernanke’s leadership.

3. Cease all manipulation of long-term rates; break up the Bernanke bond manipulation.

4. Restore the monetary base as the pivot for policy and stop using payment of interest on excess reserves to subsidize banks.

5. Eliminate the Orwellian monetary history of the Great Depression.

6. Acknowledge the disease of asset price inflation spread through monetary disorder.

I found the discussion by Calabria easier to follow and more interesting than Brown's. While the book is only about 200 pages, Calabria found it very dense and said that even as an economist, he had only absorbed a third of it in several readings. He suggested this as a reason for buying the book, so that he could return to it repeatedly.

He praised the walkthrough of monetary history and the integration of the views of the Freidman, Austrian and Keynesian schools of monetary thought. Calabria performed a helpful service by identifying as the core recommendation the abandonment of the manipulation of short-term interest rates and replacing it with a low, steady increase in the monetary base.

He also suggested it is time to abandon the notion of the independence of the Fed and that anyone who believes in this probably has not stepped outside of academia in some time.

Todd focused on the task the Fed will confront whenever it decides to unwind its quantitative easing. He pointed out that the Fed had told its regional banks that this would entail a period of several years of above-average inflation, in the 5 to 6 percent range, but this estimate was made several years ago when the Fed's balance sheet was closer to $2 trillion rather than the $4 trillion it is slated to achieve. This is far different from the Fed's nice story line that inflation is nothing to worry about and deflation is the true enemy for the Fed to fight.

Todd lamented that due to a policy change by the Commodity Future Trading Commission and the Securities and Exchange Commission in the 2005-06 period, the balance in commodities trading has shifted from 70 percent real activity and 30 percent speculation to the reverse. He advocates strict administration of position limits and margin requirements as a check on excessive speculation and market manipulation.