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America's slump: Should the Fed do more, or less?

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While Janet Yellen, the economist President Obama tapped to run the Federal Reserve, was in the Senate last week promising to use Fed power to shore up the weak national economy, Charles Plosser, who represents the Philadelphia region in the Fed's national banking network, was across town at the Cato Institue warning there's not that many things she or any Fed boss can do to really make things better, and it will hurt, more than help, if she tries to do too much. Her testimony here, his speech here.

Yellen credited outgoing Fed President Ben Bernanke with using the Fed to prevent an outright world economic meltdown and promote the slow recovery, and endorsed his use of broad powers for broad policy goals. Highlights from Yellen's prepared remarks:

"Congress has entrusted the Federal Reserve with great responsibilities. Its decisions affect the well-being of every American and the strength and prosperity of our nation. That prosperity depends most, of course, on the productiveness and enterprise of the American people, but the Federal Reserve plays a role too, promoting conditions that foster maximum employment, low and stable inflation, and a safe and sound financial system.

"The past six years have been challenging... Government leaders confronted these challenges and successfully contained the crisis. Under the wise and skillful leadership of Chairman Bernanke, the Fed helped stabilize the financial system, arrest the steep fall in the economy, and restart growth. Today the economy is significantly stronger and continues to improve...

"But we have farther to go... Unemployment... is still too high," and, since inflation is low, "the Federal Reserve is using its monetary policy tools to promote a more robust recovery," which will "ultimately enable the Fed to reduce its monetary accommodation and reliance on unconventional policy tools such as asset purchases...

"I believe that supporting the recovery today is the surest path to returning to a more normal approach to monetary policy...

"The crisis revealed weaknesses in our financial system... I am committed to using the Fed's supervisory and regulatory role to reduce the threat of another financial crisis. I believe that

capital and liquidity rules and strong supervision are important tools for addressing the problem of financial institutions that are regarded as 'too big to fail'."

Plosser (speaking for himself, not the Fed, he noted) walked into a potentially more hostile forum -- the libertarian Cato Institute, where some scholars have endorsed Sen. Rand Paul's "End the Fed" campaign -- and defended the Fed, which turned 100 years old this year. But he also warned of practical curbs on the Fed's ability to fix real-world economic problems, and its vulnerability to abuse by ambitious and ill-informed politicians; and recommended formal limits that would stop many of the Bernanke-era Fed activities that Yellen broadly praised. Highlights from Plosser:

"First, limit the Fed’s monetary policy goals to a narrow mandate in which price stability is the [main] objective;
Second, limit the types of assets that the Fed can hold on its balance sheet to Treasury securities;
Third, limit the Fed’s discretion in monetary policymaking by requiring a systematic, rule-like approach;
And fourth, limit the boundaries of its lender-of-last-resort credit extension.

"These steps would yield a more limited central bank... help preserve the central bank’s independence, thereby improving the effectiveness of monetary policy, and.. make it easier for the public to hold the Fed accountable...

"As the Fed approaches its 100th anniversary, it is entirely appropriate to reflect on its history and its future... It might be improved...

"Central banks have been around for a long time, but they have clearly evolved as economies and governments have changed. Most countries today operate under a fiat money regime, in which a nation’s currency has value because the government says it does.

"Central banks usually are given the responsibility to protect and preserve the value or purchasing power of the currency. In the U.S., the Fed does so by buying or selling [Treasury debt and other financial] assets in order to manage the growth of money and credit...

"Governments establish their central banks with limits that constrain the actions of the central bank... Yet, in recent years, we have seen many of the explicit and implicit limits stretched.

"The Fed and many other central banks have taken extraordinary steps to address a global financial crisis and the ensuing recession. These steps have challenged the accepted boundaries of central banking... For example... after.. the Fed reduced its conventional policy tool, the federal funds rate, to near zero," it began buying mortgage bonds, and other assets for the first time, partly to bail out stricken companies like Bear Stearns and AIG.

"These asset purchases have led to the creation of trillions of dollars of reserves in the banking system and have greatly expanded the Fed’s balance sheet... Purchas(ing) non-Treasury assets amounted to a form of credit allocation, which targets specific industries, sectors, or firms," such as housing, or insurance, or auto production. "These credit policies cross the boundary from

monetary policy and venture into the realm of fiscal policy," which Plosser believes should be the role of the elected government, not the Fed.

"The goals and objectives for the Federal Reserve... have evolved over time. When the Fed was first established in 1913, the U.S. and the world were operating under a classical gold standard. Therefore, price stability was not among the stated goals in the original Federal Reserve Act." Instead, "the primary objective in the preamble was to provide an 'elastic currency"...

"The gold standard was a de facto rule that most people understood, and it allowed markets to function more efficiently because the price level was mostly stable.

"But, the international gold standard began to unravel and was abandoned during World War I. After the war, efforts to reestablish parity proved disruptive and costly in both economic and political terms [and] fell apart in the 1930s. As a result, most of the world now operates under a fiat money regime, which has made price stability an important priority for those central banks charged with ensuring the purchasing power of the currency.

"Congress established the current set of monetary policy goals in 1978. The amended Federal Reserve Act specifies the Fed “shall maintain long run growth [of the money suppy, to match] the economy's long run potential to increase production, so as to promote... maximum employment, stable prices, and moderate long-term interest rates.”... Many have interpreted these goals as a dual mandate with price stability and maximum employment as the focus.

"Let me point out that the instructions from Congress call for the FOMC to stress the “long run growth” of money and credit commensurate with the economy’s “long run potential.” There are many other things that Congress could have specified, but it chose not to do so.

"The act doesn’t talk about managing short-term credit allocation across sectors; it doesn’t mention inflating housing prices or other asset prices. It also doesn’t mention reducing short-term fluctuations in employment. Many discussions about the Fed’s mandate seem to forget the emphasis on the long run.

"The public, and perhaps even some within the Fed... seek policies that attempt to manage fluctuations in employment over the short run." But job policy is "problematic for the Fed. Most economists are dubious of the ability of monetary policy to predictably and precisely control employment in the short run, and there is a strong consensus that, in the long run, monetary policy cannot determine employment...

"As the FOMC noted in its statement on longer-run goals adopted in 2012, “the maximum level of employment is largely determined by nonmonetary factors that affect the structure and dynamics of the labor market.”

"In my view, focusing on short-run control of employment weakens the credibility and effectiveness of the Fed in achieving its price stability objective. We learned this lesson most dramatically during the 1970s... The economy paid the price in the form of a deep recession...

"Assigning unachievable goals to organizations is a recipe for failure... The public has come to expect too much from its central bank and too much from monetary policy, in particular... over the past 40 years, with the exception of the Paul Volcker era... We have assigned an ever-expanding role for monetary policy, and we expect our central bank to solve all manner of economic woes for which it is ill-suited to address...

"The so-called dual mandate has contributed to this expansionary view of the powers of monetary policy. Even though the 2012 statement of objectives acknowledged that it is inappropriate to set a fixed goal for employment and that maximum employment is influenced by many factors, the FOMC's recent policy statements have increasingly given the impression that it wants to achieve an employment goal as quickly as possible.

"I believe that the aggressive pursuit of broad and expansive objectives is quite risky and could have very undesirable repercussions down the road, including undermining the public's confidence in the institution, its legitimacy, and its independence... Assigning multiple objectives for the central bank opens the door to highly discretionary policies, which can be justified by shifting the focus or rationale for action from goal to goal.

"I have concluded that it would be appropriate to redefine the Fed's monetary policy goals to focus solely, or at least primarily, on price stability. I base this on two facts: Monetary policy has very limited ability to influence real variables, such as employment. And, in a regime with fiat currency, only the central bank can ensure price stability. Indeed, it is the one goal that the central bank can achieve over the longer run...

"Monetary policy and fiscal policy should have clear boundaries. Independence is what Congress can and should grant the Fed, but, in exchange for such independence, the central bank should be constrained from conducting fiscal policy... [But] the Fed has ventured into the realm of fiscal policy by its purchase programs of assets that target specific industries and individual firms." The Fed needs to buy"only U.S. government securities," not mortgage or troubled-company bonds, so the Fed will no longer pick what politicians say are key industries, distorting the economy.

The Fed also needs "simple, robust monetary policy rules" to "tie (its) hands," reducing the "instability or uncertainty" that comes when investors wonder what the Fed will do next. Congress should press the Fed to disclose its policies publicly and in advance; if it "chooses to deviate from the guidelines, it must then explain why and how it intends to return to its prescribed guidelines...

"Policymakers [including, presumably, Bernanke, and now Yellen] still desire to maintain discretion in setting monetary policy... [But] discretion is the antithesis of commitment and undermines the effectiveness of forward guidance. Given this tension, few should be surprised that the Fed has struggled...

"Simplify the goals. Constrain the tools. Make decisions more systematically. All three steps can lead to clearer communications and a better understanding on the part of the public. Creating a stronger policymaking framework will ultimately produce better economic outcomes...

"The Fed plays an important role as the lender of last resort, offering liquidity to solvent firms in times of extreme financial stress... The role of lender of last resort is not to prop up insolvent institutions. However, in some cases during the crisis, the Fed played a role in the resolution of particular insolvent firms that were deemed systemically important financial firms...

"The Dodd-Frank Act has limited some of the lending actions the Fed can take with individual firms under Section 13(3). Nonetheless, by taking these actions, the Fed has created expectations — perhaps unrealistic ones — about what the Fed can and should do to combat financial instability...

"It is unrealistic to expect the central bank to alleviate all systemic risk in financial markets. Expanding the Fed's regulatory responsibilities too broadly increases the chances that there will be short-run conflicts between its monetary policy goals and its supervisory and regulatory goals... If the set of institutions having regular access to the Fed's credit facilities is expanded too far, it will create moral hazard and distort the market mechanism for allocating credit. This can end up undermining the very financial stability that it is supposed to promote.

"Emergencies can and do arise," and the President's Treasury Department, not the Fed, should take the lead on dealing with them, Plosser added.

"Many observers think financial instability is endemic to the financial industry, and therefore, it must be controlled through regulation and oversight. However, financial instability can also be a consequence of governments and their policies... By rescuing firms or creating the expectation that creditors will be rescued, policymakers either implicitly or explicitly create moral hazard and excessive risking-taking by financial firms... It doesn't matter if the taxpayer or the private sector provides the funds. What matters is that creditors are protected, in part, if not entirely...

"The public has come to expect too much from its central bank. A more limited central bank... would help preserve the central bank's independence, thereby improving the effectiveness of monetary policy, and, at the same time, they would make it easier for the public to hold the Fed accountable for its policy decisions. These changes to the institution would strengthen the Fed for its next 100 years."