Unconventional Fed Policy Hasn't Paid Off

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The Fed's long experiment with unconventional monetary policy is starting to unwind. For the first time in seven years, the Federal Reserve's policy committee (the Federal Open Market Committee) departed from its zero interest rate policy and increased its benchmark rate by 25 basis points. The new target range for the federal funds rate is now 0.25 to 0.50 percent, up from the previous range of 0 to 0.25 percent.

That small rate move did not surprise financial markets, and the Fed reassured markets that any future rate increases would be gradual and depend on economic conditions. With moderate economic growth, an unemployment rate of 5 percent, and modest inflation, Fed Chair Janet Yellen agreed that the time was ripe for a "lift off" on the benchmark rate.

The committee provided forward guidance by stating that "the stance of monetary policy remains accommodative after this increase." The Fed will continue to reinvest principal payments from its large holdings of agency debt and agency mortgage-backed securities, and will rollover Treasury securities. Thus, the Fed's $4.5 trillion balance sheet will not shrink.

From looking at the size of the Fed's balance sheet that was pumped up by quantitative easing, as well as the corresponding massive increase in the monetary base (currency held by the public plus bank reserves) and suppressed interest rates, one would conclude that monetary policy has been "accommodative."

Yet, the truth is that during the last seven years, the rapid increase in the monetary base has not translated into robust growth in monetary aggregates or in nominal income. The so-called money multiplier has been historically low, and inflation as conventionally measured by the consumer price index has been weak. Meanwhile, real economic growth has been disappointing, with the weakest recovery since the Great Depression.

There is a strong case to be made that the Fed's unconventional policies have increased risk taking, created asset bubbles, misallocated credit, penalized savers, increased inequality and

discouraged private investment, thus slowing economic growth. Those costs were not mentioned in the committee's statement.

Instead, the Fed promised to increase inflation in 2016 and beyond to reach its 2 percent target, as if zero inflation or even mild deflation brought about by strong economic growth is bad. The Fed also added a "Monetary Policy Implementation" statement to its press release to explain how the benchmark rate would be increased. We learn that the Fed will rely on reverse repos to temporarily drain reserves from the banking system and also increase the interest it pays on reserves from 0.25 percent to 0.50 percent. The Fed has been paying out $6 billion per year on its total reserves of about $2.5 trillion, with a large share going to foreign banks. That amount could now double at a cost to the Treasury and taxpayers.

The committee's statement doesn't mention that paying interest on reserves, which began in October 2008, is counter-productive to the Fed's goal of getting high-powered money into the income stream. If banks get a risk-free return from holding reserves at the Fed, even if it is small, they will refrain from lending out their excess reserves in an era of uncertainty and onerous macro-prudential regulation.

So, while it is notable that the Fed is beginning to normalize interest rates, the real issue should be: Why hasn't the Fed's unconventional monetary policy worked to bring about robust growth? The monetary transmission mechanism has been broken by the Fed's own policy mistakes. The focus should be on letting markets set interest rates and on implementing a monetary rule that reduces uncertainty and increases freedom and responsibility by ending bailouts of insolvent institutions considered "too big to fail."

That's why we need to rethink monetary policy and to institute a Centennial Monetary Commission as recommended in the Fed Oversight Reform and Modernization Act, which recently passed the House. "Monetary policy," as Milton Friedman famously said, "is too important to be left to central bankers."

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