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It Is Time to Rethink Central Banking

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On Wednesday the Fed raised its interest rate target by .75 percentage points, a clear signal that it is serious about fighting inflation. The above-normal tightening is also something of an admission that, until now, the Fed has been too timid.

Granted, there were good reasons for the Fed to be cautious. Tightening too much, too soon, might have backfired by aggravating supply shortages.

Still, as I (and others) pointed out then, by November 2021 both inflation and nominal gross domestic product (NGDP) had returned to their pre-pandemic trends and were still growing quickly. That growth suggested that a quarter point target rate increase in December or January would have been prudent, and that by delaying action further the Fed risked letting both actual and expected inflation worsen.

But the Fed waited until March to start raising its target rate.

The greatest danger posed by the Fed's delay was that it would eventually necessitate a much more aggressive tightening than would have otherwise been necessary, increasing the risk of triggering a recession. (As my colleague George Selgin likes to describe it: "Like a driver who fails to apply the brakes as soon as an obstruction comes into sight, the Fed must now 'slam the brakes' on money growth, thereby subjecting the U.S. economy to a correspondingly more severe case of whiplash.")

Although it's regrettable that Fed officials failed to act more quickly, what matters now is that they learn from their mistakes. And while several Biden administration and Fed officials have conceded that they messed up, a recent Wall Street Journal article suggests that they still don't get it. According to the article:

I suppose that a couple of years ago it may have made some sense to think that, because inflation tended to be below the Fed's goal after the 2008 crisis, the Fed could afford to maintain an easy policy stance without risking excessive inflation. But only a little.

The 2008 financial crisis and the COVID-19 shutdowns are completely different events in terms of both size, cause, and effect. And economic growth does not cause inflation. More importantly, though, the Fed (as most central banks) has spent decades *missing* its targets on inflation, interest rates, and broad monetary aggregates.

It tends to get reasonably close to its targets, but it does not have iron clad control over things like interest rates and inflation. (Inflation targeting central banks face all kinds of information problems, such as estimating the potential output of an economy (an unobservable variable), defining maximum employment (itself determined largely by nonmonetary factors), forecasting the productivity of the economy, and determining whether price-level changes are supply- or demand-driven.)

Regardless, the Fed admits that it can't explain the below average inflation after 2008. So, why in the world would the folks at the Fed be confident that they could control inflation with any degree of precision?

Incidentally, in a 2021 survey of economists from both the Euro area and the United States, less than one-third of respondents thought it was likely that central banks would hit their inflation targets over the next three years.

That result is perfectly understandable. What's frustrating, though, is that so many economists acknowledge the limitations that central bankers face but still insist on keeping the same basic policies in place.

I suppose many people take comfort in the idea that some group of experts can "steer" the economy with some degree of precision, but experience (and empirical evidence) doesn't back that notion up too well. On the other hand, history is full of examples of market-based monetary systems that, long before central banking, successfully created the money that people needed, when they needed it.

Naturally, these historical facts lead many people to favor shifting away from central bank managed money to a market-based system. I'm certainly not against such a move, but only if the shift can be done without destroying everything in the process, and that's much easier said than done.

The global economy depends largely on the U.S. dollar, a fiat national currency controlled by the U.S. government through the Fed. And the Fed controls much more than just the monetary base. It is more heavily involved in short-term credit markets–not just the Treasury market– than any other institution, and Congress has given it enormous discretion to carry out its required tasks. It is part of an incredibly oversized government.

To even shrink the Fed's role in money and finance is a herculean task that requires countless policy changes, many of which Congress will have to implement.

One way to start down the road to a market-based monetary system is to change the Fed's mandate so that it targets total nominal spending (commonly referred to as NGDP targeting) instead of prices and unemployment. Doing so will help alleviate the Fed's many (above-mentioned) information problems, thus improving its ability to conduct monetary policy.

While things would still be far from perfect, a nominal spending targeting regime would more closely mimic those market-based monetary systems that successfully supplied the amount of money that people needed, when they needed it.

I’ve previously referred to this feature as *monetary neutrality*, meaning that the Fed would constantly be trying to supply only the amount of money the economy needs to keep moving, no more and no less. It requires the central bank to be much less intrusive and it makes it easier for Congress to hold it accountable. Combined, these factors should minimize monetary disturbances and improve overall stability.

That increased stability should, in turn, make it much easier to build support for broader financial and fiscal reforms, including the development of private monetary alternatives.

Our time would be much better spent fleshing out this kind of system than fighting over who is most responsible for the current spike of inflation. Regardless of exactly where we place the blame, the federal government is responsible. And reducing federal policymakers’ discretion to tinker with the monetary system is the best way to truly fix the problem.

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