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Fed Monetary Policy Can't Solve Our Economic Ills

By: William Poole - December 17, 2013

The final meeting of the year for the Federal Reserve's Open Market Committee will ideally result in the Fed finding a way out of its asset purchase, or Quantitative Easing (QE), program.

It's also time for the Fed to acknowledge that the slow economic growth over the past several years was caused by non-monetary policies beyond its control.

That means that Keynesians at the Fed and elsewhere need to accept this generalization: Whenever a country's growth is slow for a protracted period, the reason is always and everywhere poor government microeconomic policy.

For evidence, just look at the Soviet bloc countries, or China before 1979, or North Korea, or Castro's Cuba, or much of Africa, or Argentina. How much more do we need?

From Fed leadership, however, nary a peep about the non-monetary causes of slow growth.

Instead, the Fed has insisted on attempting a monetary-policy cure for a microeconomic problem, thereby creating a problem for itself and a future inflation risk for the rest of us.

The Fed is complicit in harmful fiscal and regulatory policies because monetary "stimulus" promises economic growth without the microeconomic policy reforms that really matter.

The Fed seems not to know how to exit from QE, which it has pursued in a futile effort to offset non-monetary head winds.

The Fed knows it must exit QE but also knows that the market will interpret an exit decision as an implicit announcement that higher policy rates (Fed funds and interest on bank reserves) may be just around the corner.

The Fed's concern is valid, but it's in this situation because of a hole it dug for itself through past policy announcements and hints of tapering asset purchases.

Below is my version of a draft Fed policy statement, with italics indicating the actual language from the policy statement that was issued after the October FOMC meeting. This draft statement, in my opinion, is a way out for the Fed.

In putting my proposal together, I've skipped most of the routine language in the typical FOMC statement:

Information received since the Federal Open Market Committee met in October generally suggests that economic activity has continued to expand at a moderate pace. Indicators of labor market conditions have sown further improvement, and the recent budget agreement should reduce uncertainty over fiscal policy. ... (L)onger-term inflation expectations have remained stable.

The Committee expects that, with appropriate policy, including fiscal and regulatory policies ... economic growth will pick up from its recent pace and the unemployment rate will gradually decline toward levels the Committee judges consistent with its dual mandate.

The Committee has concluded that further asset purchases for the system open market account are no longer necessary. Commercial banks have ample excess reserves; adding to those reserves will not promote economic growth but will raise longer-term risks. Consequently, the Committee is discontinuing its asset purchase program and will permit the open market portfolio to run off by not re-investing interest and principal on maturing issues.

The Committee sees the improvement in economic activity and labor market conditions over the past year as consistent with growing underlying strength in the broader economy. However, the Committee decided to await more evidence that progress will be sustained before adjusting its policy rates.

The Committee believes that employment growth and business fixed investment have been constrained by uncertainties over fiscal and regulatory policies.

Firms dependent on federal contracts are un- certain as to the future size of those contracts. Firms with potential investment spending that- might be disadvantaged by changes in the tax law are cautious about proceeding. Some firms have delayed increasing employment because they believe they could be adversely impacted by certain proposed regulations.

Monetary policy has gone as far as it can in creating conditions that partially offset these impediments to higher economic growth.

The Committee notes that conditions that create a low expected real rate of return on investment in plant and equipment require a correspondingly low rate of interest in financial markets. The Committee is therefore cognizant of the fact that increasing policy rates prematurely could risk a deflationary spiral.

The Committee will closely monitor incoming information on economic and financial developments in coming months, especially those relating to fiscal and regulatory policies and market responses to changes in those policies.

The Committee decided to keep the target range for the federal funds rate at 0 to 1/4% and currently anticipates that this exceptionally low range for the federal funds rate will be appropriate at least as long as the unemployment rate remains above 6-1/2%, inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee's 2% longer-run goal, and longer-term inflation expectations continue to be well anchored.

This approach — which changes nothing about monetary policy itself except QE — has several virtues, not the least of which is honesty about what has created slow growth in the U.S.

This route eliminates the implication that the end of QE might mean the beginning of rate increases. The recent budget agreement reduces near-term uncertainties over fiscal policy but the long-term fiscal and regulatory issues remain unresolved.

As long as these head winds depress growth prospects, the Fed can stay on hold. The Fed should explain that monetary policy cannot be a substitute for sound fiscal and microeconomic policies.

Can the Fed really believe otherwise?