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U.S. monetary policy: A ship with a broken rudder

By George Selgin
May 22, 2015

"… our monetary system is still not functioning properly. If it were, the Federal Reserve's $4.5 trillion balance sheet would long ago have translated into healthy, if not inflationary, levels of spending."

-- George Selgin, director, Center for Monetary and Financial Alternatives at the Cato Institute

In light of some bad economic news, the Federal Open Market Committee's decision to continue its accommodative policy stance may come as relief to some. But it's no cause for celebration.

Indeed, it only underscores the fact that our monetary system is still not functioning properly. If it were, the Federal Reserve's $4.5 trillion balance sheet would long ago have translated into healthy, if not inflationary, levels of spending."

Although thousands of Fed watchers make their living by pretending otherwise, the truth is the science behind the FOMC's monetary policy decisions is decidedly humble. The ends that the committee is charged with achieving -- full employment and stable prices -- are dictated by the law of the land, while the statistics it relies on for guidance are mostly the stuff of headlines.

True, the FOMC also relies on confidential reports prepared by staff economists at either the Federal Reserve Board or the various regional Fed banks, but that information tends to be less influential than the latest statistical developments.

And while those statistics can sometimes send mixed signals, in the first quarter they seemed to cry out for continued monetary accommodation.

Although inflation crept up, the core PCE (personal consumption expenditures) price index is still well below the Fed's 2 percent target. Unemployment fell some more, but so did labor force participation, which is lower than it's been since the '70s. Every other pertinent statistic -- dollar exchange rates, real output and nominal spending, among them -- pointed to an economy still struggling to climb out of a recession.

Why are the Fed's trillions still not cutting it?

One culprit is the persistence of extraordinary bank holdings of excess cash reserves, the counterpart of which has been a correspondingly minuscule ratio of bank lending to bank deposits. The Fed itself contributes to this problem by paying interest on excess reserves. Although the policy might make sense under other circumstances, today it makes none.

Instead of easing the way for the Fed to begin shrinking its bloated balance sheet, this misguided policy stands in the way of that healthy step by artificially boosting the demand for bank reserves.

In short, if the FOMC is finding it difficult to "normalize" monetary policy, as it has promised to do, that's partly because the board of governors, which sets the interest rate on bank reserves, is blocking the way.

To be sure, sound monetary policy is partly a matter of having the FOMC make sound decisions. But that, as I've suggested, is the easy part. The hard part is seeing to it that the monetary system works the way it's supposed to. Unless that's done, the FOMC might as well be manning the helm of a ship with a broken rudder.

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