On Fiscally-Neutral Monetary Policy

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November 27th, 2018

Of many interesting things said during Cato's 36th Monetary Conference, one in particular tempted me to rush to the podium to give its author a big hug. The speaker, Joe Gagnon of the Peterson Institute, was calling into question the now-conventional wisdom that, to avoid interfering with the efficient allocation of credit or otherwise involving itself in matters best left to Congress, the Fed must stick to purchasing Treasury securities, and nothing else.

"It puzzles me," Joe said (at 00:31:36)

> why people think that the Fed should only allocate credit to the government. Why is that the obvious thing to do? …What seems to me more neutral would be [for the Fed and central banks generally to] hold the market basket of all assets, and then conduct their policy proportionately in all assets. That doesn't favor anybody or any sector — it's neutral. It seems like the natural way to go.

Think tank employees, and employees at different think tanks especially, aren't generally inclined to hug one another. But if one is, you can bet your boots its because the other fellow said something he'd have liked to have said himself.

In fact I've long been planning to write a post on the issue Joe raised, making an argument quite similar to his. I even started the project, present title and all, several months ago, only to shove it into my "drafts" folder, where it's been gathering dust ever since. Thanks to Joe, I'm finally inspired to finish what I started.

Treasuries Only

Central banks are, ideally, supposed to regulate the scale of nominal magnitudes — things like the price level, monetary aggregates, and nominal spending — without influencing relative prices or the allocation of scarce savings. In particular, their policy actions aren't suppose to be aimed at favoring particular security issuers or markets.

These notions suggest, for starters, that central banks should usually rely on open-market operations or other broad-based monetary operations. They're also generally taken to mean that, when central banks can't avoid extending "last resort" credit to particular firms, the firms so aided should be solvent and should pay market (that is, "normal" market) rates. They should, in other words, be the sort of firms private lenders themselves might assist were it not for information and transactions costs, or private credit-market disruptions, that keep them from doing so. A central bank that fails to meet these requirements is guilty of engaging in "credit policy," meaning actions that serve not just to regulate nominal magnitudes but to interfere with the efficient allocation of scarce resources among competing users.

But while the aforementioned conditions for steering-clear of credit policy may be necessary, they aren't sufficient, in part because whether a central bank avoids taking part in credit policy or not also depends on the assets it chooses to purchase on the open market.

So what sorts of central bank asset purchases are, and what sorts aren't, consistent with avoiding credit policy? The conventional wisdom here — and the view Joe Gagnon questions — consists of the "Treasuries only" doctrine. That doctrine's best-known exponent is Carnegie-Mellon economics professor (and as yet unconfirmed Federal Reserve Board of Governors nominee) Marvin Goodfriend, who happens to have shared his opinions on the topic at another Cato Institute event: the 2008 Symposium of the Shadow Open Market Committee.

According to Goodfriend, "Monetary policy refers to Federal Reserve policy actions that change the stock of high-powered money, i.e., currency plus bank reserves." In contrast, "[t]he Fed takes a credit policy action … by shifting the composition of its assets holding high-powered money fixed."

When the Fed substitutes an extension of credit for a Treasury security in its portfolio, the Fed can no longer return to the Treasury the interest it had received on the Treasury security that it held. In other words, when the Fed sells a Treasury security to make a loan, it's as if the Treasury issued new debt to finance the loan. Credit policy executed by the Fed is really debt financed fiscal policy. …

In effect, Fed credit policy works by interposing the United States Treasury between lenders and borrowers in order to improve credit flows. In doing so, however, the Fed essentially makes a fiscal policy decision to put taxpayer funds at risk. In the event of a default, if the collateral is unable to be sold at a price sufficient to restore the initial value of Treasury securities on the Fed's balance sheet that was used to fund the credit initiative, then the flow of Fed remittances to the Treasury will be smaller after the loan is unwound. The Treasury will have to make up that shortfall somehow, namely, by lowering expenditures, raising current taxes, or borrowing more and raising future taxes to finance increased interest on the debt.

Because the Fed is exempt from the appropriations process, Goodfriend argues, it "should avoid, to the fullest extent possible, taking actions that can properly be regarded as within the province of fiscal policy and the fiscal authorities." Doing that, in his view, boils down to having the Fed limit its portfolio holdings to Treasury securities. A "Treasuries only" policy, he says, "respects the integrity of fiscal policy fully" while helping "to preserve the Fed's independence" because it "leaves all the fiscal decisions to Congress and the Treasury and hence does not infringe on their fiscal policy prerogatives." In contrast

all financial securities other than Treasuries carry some credit risk and involve the Fed in potentially controversial disputes regarding credit allocation. When the Fed extends credit to private or other public entities, it is allocating credit to particular borrowers, and therefore taking a fiscal action and invading the territory of the fiscal authorities.

Fiscal Doublespeak

There is, to say the least, something fishy about the claim that, by sticking to buying Treasury securities, the Fed avoids "invading the territory of the fiscal authorities." The claim is admittedly true enough if one takes the term "invasion" literally to suggest a *hostile* incursion, meaning one that does harm to the parties encroached upon, in this case by chipping away at the Treasury's earnings. So far as Goodfriend is concerned, so long as the Treasury *benefits* from the Fed's operations, the Fed hasn't tread on fiscal turf at all. On the contrary: it might gobble-up all the Treasury (and guaranteed agency) securities it likes, without being guilty of "taking a fiscal action."

But Goodfriend's is, surely, an overly restrictive view. As I've argued elsewhere,

[w]hile confining the Fed to Treasury purchases may enhance its long-run contribution to government revenue, it cannot be said to minimize its fiscal footprint. On the contrary: It involves the Fed quite decidedly in the allocation of credit, albeit in a manner that favors the federal government over other parties.

There is, indeed, no older nor more frequently-recurring theme in the history of money than that concerning the tendency of governments, whether despotic or democratic, to treat monetary institutions over which they exercise some degree of control as official piggy banks, whether by debasing official coins or by pressuring fiat-money issuing central banks to finance their debts, even when doing so means allowing inflation to run wild.

Seen against this historical background, including plenty of recent experiences, the suggestion that central banks can best avoid entangling themselves in their governments' fiscal affairs by devoting their resources to buying government debt sounds like a bad joke. This isn't to say that Goodfriend is an apologist for inflationary finance, or for inflation itself. On the contrary: if he's anything he's an inflation hawk. But the fact remains that his understanding of what constitutes fiscally-neutral monetary policy leaves a lot be be desired.

Yet that hasn't stopped others who also dislike inflation and inflationary finance from embracing that same understanding. Consider this 2012 article by Charles Plosser, who was then President of the Philadelphia Fed. Plosser starts out by reiterating what we might call the old-time (as opposed to new-fangled) "fiscal-neutrality" religion. "It is widely understood," he says,

that governments can finance expenditures through taxation, debt — that is, future taxes — or printing money. In this sense, monetary and fiscal policy are intertwined through the government budget constraint. Nevertheless, there are good reasons to prefer an arrangement that provides a fair degree of separation between the functions and responsibilities of central banks and those of the fiscal authorities. For example, in a world of fiat currency, central banks are generally assigned the responsibility for establishing and maintaining the value or purchasing power of the nation’s monetary unit of account. Yet, that task can be undermined or completely subverted if fiscal authorities independently set their budgets in a manner that ultimately requires the central bank to finance government expenditures with significant amounts of seigniorage in lieu of tax revenues or debt. The ability of the central bank to maintain price stability can also be undermined when the central bank itself ventures into the realm of fiscal policy.

So far so good. But when it comes to saying how we should go about achieving the desired "separation between the functions and responsibilities of central banks and those of the fiscal authorities," Plosser offers us a textbook case of cognitive dissonance by serving-up

Goodfriend's "Treasuries only" elixir, in the shape of his own similar proposal for a new "accord" that would prevent the Fed from acquiring other sorts of assets. "I have long argued," Plosser says,

for a bright line between monetary policy and fiscal policy, for the independence of the central bank, and for the central bank to have clear and transparent objectives. I have also stressed the importance of a systematic approach to monetary policy that serves to limit discretionary actions by the central bank. Furthermore, I have proposed a new accord between the Treasury and the central bank that would severely limit, if not eliminate, the central bank’s ability to lend to private individuals and firms outside of the discount window mechanisms. I have noted that decisions to grant subsidies to particular market segments should rest with the fiscal authorities — in the U.S., this means Congress and the Treasury Department — and not with the central bank. Thus, the new accord would limit the Fed to an all-Treasuries portfolio, except for those assets held as collateral for traditional discount window operations.

Just how the accord in question would prevent the Fed from "financ[ing] government expenditures with significant amounts of seigniorage in lieu of tax revenues or debt" Plosser doesn't say. But the answer is simple enough: it wouldn't. It wouldn't prevent the Fed from employing its powers in a way that unduly favors not private-sector firms or markets, but the Federal government itself. Here again, the problem obviously isn't that Plosser doesn't mind inflationary finance. It's that he has embraced a flawed doctrine of what it means for the Fed to avoid "fiscal" operations as much as possible.

From "No Treasuries!" to "Treasuries Only"

Before we consider alternatives to the "Treasuries only" understanding of fiscally neutral monetary policy, let's take a quick detour into the Fed's early history, for the sake of illustrating just how far the newfound understanding of how to keep the Fed clear of fiscal policy veers from the orthodoxy that prevailed when the Fed was founded.

Although the original Federal Reserve Act allowed Fed banks to purchase U.S. government securities, it was understood that such purchases would be exceptional, and that the Fed's interest-earning assets would consist mainly of short-term commercial, agricultural, or industrial paper presented to it for rediscounting by its member banks. That understanding reflected the conventional wisdom, supported on one side by the "real bills" doctrine, according to which confining rediscounting to certain kinds of commercial paper would prevent inflation, and on the other by the view that central bank lending to the government was dangerous, because, as David Marshall explains, it could end up "tying the supply of credit to the spending whims of the government."

Paul Warburg, one of the Federal Reserve System's chief architects, expressed the prevailing attitudes at the time of the Fed's founding especially clearly and succinctly in his essay on "The Discount System in Europe," originally included among the publications of the National Monetary Commission and then republished in *Essays on Banking Reform in the United States* (1914, p. 154):

Notes issued against discounts mean elasticity based on the changing demands of commerce and trade of the nation, while notes based on government bonds mean constant expansion without contraction, inflation based on the requirements of the government without connection of any kind with the temporary needs of the toiling nation. Requirements of the government should be met by direct or indirect taxation or by the sale of government bonds to the people. But to use government bonds or other permanent investments as a basis for note issue is unscientific and dangerous.

Nor were such beliefs peculiar to the U.S. Because central bank purchases of government securities, even in the open market, were widely seen as equivalent to direct lending to governments, the belief that such purchases ought to be strictly limited was one held by most economists. As Ralph Hawtrey puts it in *The Art of Central Banking* (1933, p. 131),

the acquisition of Government securities by the central bank is regarded as opening the door to inflation. It is usual for the power of the central bank to lend to the Government to be carefully circumscribed, and the dividing line between lending direct and buying Government securities in the market may be rather a fine one.

In those days no less than today, Marshall reminds us, "it was thought that a well-run central bank should be free from political influence." But the fear then was that "extensive holdings of *government debt* might compromise central bank independence," and not that central bank purchases of commercial paper would do so.

That this early understanding was soon to be turned on its head must surely rank among the more fascinating developments in the history of modern monetary thought. The process began when, following the United States' entry into World War I, under pressure from Treasury Secretary William McAdoo (who was an *ex officio* member of the Federal Reserve Board), the Fed reluctantly started buying substantial quantities of Treasury securities at above-market prices.

At that time, as Kenneth Garbade reports (p. 3), the Directors of the Federal Reserve Bank of New York memorialized their misgivings, while expressing their conviction "that the normal services of the Bank as fiscal agent will best be rendered by assisting in distributing Government securities rather than by acting as a purchaser of them" and that their wartime action "should not be considered as establishing a precedent or a policy which will necessarily be followed in the future."

But the Great Depression was to dash any hope of such opinions being heeded. Instead, during it the collapse of the markets for bankers' acceptances and other sorts of commercial paper, the first appearance of short-term Treasury bills, and the fiscal exigencies of the New Deal, would collectively lead the Fed to shift to a Treasuries-only regime.[1]

It was while this shift was taking place, in the spring of 1933, that the Board of Governors granted the Fed banks permission to purchase up to $1 billion of government securities for the express purpose of helping the Treasury to market its debt. A second precedent was thus established for the Fed's agreement, during World War II, to formally commit itself to helping to finance the war by using open-market purchases to peg the interest rate on Treasury bills at a low level of just 3/8 percent. The Fed's substantial involvement in the market for Treasury securities thus ended up doing just what the Fed's founders feared it might do, to wit: transforming the Fed into a handmaiden of the U.S. Treasury.

The Fed's commitment to support the market for government bonds was still in effect when, during the Korean War, an increase in the CPI inflation rate to over 21 percent caused the Board of Governors, led by then-Chairman Thomas McCabe, to renounce it. Although that singular act of defiance cost McCabe his job, it also set the stage for the famous "Treasury Accord" by which the Fed was ultimately freed from any obligation to support the prices of government securities.

Ironically, it's from the 1951 Treasury Accord that Marvin Goodfriend draws inspiration for his own proposed "'Accord' for Federal Reserve Credit Policy," a chief element of which is a commitment to the "Treasuries only" doctrine that helped make the original Accord necessary in the first place.

A Better Approach

If a "fiscally neutral" Fed is neither a Fed that sticks to Treasuries only nor one that can direct credit willy-nilly to any firm or asset market it chooses, what is it?

Joe Gagnon's suggestion that the Fed "hold the market basket of all assets" has the distinct advantage of being intuitively appealing, jibing as it does with established notions of monetary neutrality in the broad sense. Unfortunately, that intuitive appeal is more than matched by the suggestion's unattractiveness as a practical policy. Who, for one thing, wants to see the Fed get into the business of buying *real* assets? And, stepping back down to planet earth, who really wants to see it taking a leaf from the central banks of Japan and Switzerland by loading-up on stocks, which make up a large share of all U.S. financial assets?

MIT's Deborah Lucas points the way toward a more pragmatic solution. "A central bank policy is fiscal," she proposes, "when it confers a net subsidy to a private entity, or when it has a direct effect on government spending or revenues." This definition, Lucas notes,

makes no special distinction between transactions involving Treasury securities and those involving private securities. If the Federal Reserve were to purchase a Treasury bond at an above-market price it would have a fiscal effect measured by the amount of the overpayment. However, if the Federal Reserve were to purchase a high-risk mortgage or corporate bond at a fair market price, there would be no fiscal effect because there is no subsidy. Relatedly, the assumption of credit risk is not in itself fiscal; along with other priced risks such as prepayment, interest rate and liquidity risk, it only gives rise to fiscal effects when the Federal Reserve transacts at non-market prices.

While Lucas's point seems perfectly reasonable, and has the merit of suggesting that central banks can avoid engaging in credit policy, including the shunting of savings toward the U.S. Treasury, without having to buy every asset under the sun, it still fails to add-up to a practical proposal. Instead it begs the question: just how is the Fed to avoid favoring the issuers of certain assets by buying them at above-market prices? How, in particular, can it do so while refusing to purchase certain kinds of financial assets at *any* price?

Flexible OMOs

As it happens, I think I have an answer to those questions. It consists of the plan I proposed in 2017 for "flexible" open-market operations, as published in the Heritage Foundation volume, *Prosperity Unleashed*. Although that proposal is aimed at reforming the Fed's procedures for supplying emergency credit to illiquid but solvent institutions, the "flexible open-market operations" (or "flexible OMOs") it calls for would also serve to make the Fed's operations fiscally neutral.

Flexible OMOs would do this for three reasons. First, they would have the Fed standing ready to purchase, in its routine open-market operations,[2] not just Treasury or agency securities but a much broader set of assets, consisting of all those marketable securities that can presently qualify as collateral for the Fed's discount-window loans. Second, they would be undertaken not with a score or so of "primary dealers" only, but with numerous counterparties, including all banks that might be eligible for discount window loans as well as all those counterparties presently taking part in the Fed's overnight reverse repurchase (ON-RRP) operations. Third, flexible OMOs would be undertaken using a version of Paul Klemperer's "product-mix" auction procedure specifically designed to prevent the Fed from favoring any particular securities or counterparties.

Although flexible OMOs would allow the Fed to purchase private securities, it would not allow it to arbitrarily steer credit toward particular private security issuers, holders, or markets. Instead it would allow counterparties possessing private securities, as well as those equipped with Treasuries, to bid for federal funds. Nor would its terms discriminate in favor of particular securities, except to the extent of giving proportionately larger haircuts to riskier ones, comparable to those that the Fed presently applies to different sorts of collateral in its discount-window lending.

While flexible OMOs are themselves fiscally neutral, they can only serve to keep a central bank employing them fiscally neutral if it relies upon them exclusively, rather than in combination with other lending operations. But the beauty of flexible OMOs is precisely that, apart from being fiscally neutral themselves, they allow a central bank that relies upon them in undertaking its ordinary monetary policy operations to dispense with other types of lending and with supplemental (ad-hoc or standing) lending facilities and programs. Instead, all counterparties that might otherwise be assisted through such supplemental programs would be eligible to take part in routine OMOs, using any collateral that might have secured for them a direct central-bank loan.

Done right, flexible OMOs serve to make a central bank's asset purchases neutral, not by having it purchase Treasury securities only, or by having it purchase the whole "market basket" of assets, but by having it purchase, especially during occasions of financial distress, the same basket of assets private-market financial firms might themselves be willing to purchase, or to treat as acceptable collateral, in ordinary times. Achieving fiscal neutrality thus goes hand-in-hand with having central banks efficiently fulfill their last-resort lending duties.

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[1] That the Banking Act of 1935 prohibited the Fed from purchasing securities directly from the Treasury, compelling it to buy them on the open-market only, did nothing to discourage or otherwise interfere with the shift in question. Nor did it serve to limit the Fed's ability to finance the government's deficits. Although some supporters of the measure may simply have failed to understand that the Fed could assist the Treasury just as effectively by buying its securities in the open market as it might by dealing directly with it, then Fed Chairman Marriner Eccles was almost certainly on to something in attributing it "to certain Government bond dealers who quite naturally had their eyes on business that might be lost to them if direct purchasing were permitted" (Garbade 2014, p. 7).

[2] My plan assumes that the Fed relies on regular open-market operations to achieve its operating target. That is, it assumes a "corridor" system of monetary control, rather than the "floor" system currently in place. Concerning why a corridor system should be preferred to a floor system see my recently-published book, *Floored!*

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