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Federal Reserve Failures

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By Allan H. Meltzer

Recently, Stanford Professor John Taylor and I circulated a statement calling on Congress to require the Federal Reserve to choose and adopt a rule—a clearly stated way to make its decisions—that would permit anyone to know what they would do in the future. Our statement was signed by several Nobel Laureates with longstanding interest in and contributions to economic policy. A number of former Fed policymakers and senior staff signed the statement also. Earlier, the House of Representatives adopted the proposal. It could become law. I will forward a copy of the statement on request.

The future is of course obscure and, at times, subject to unpredictable changes. The proposed law permits the Fed to depart from its policy rule temporarily. And the proposed legislation does not impose a specific rule. The Fed chooses the rule it follows, but unlike the present, monetary policy is more disciplined and predictable.

The Federal Reserve has made many large errors in the past. Two well-known examples are the Great Depression of the 19305 and the Great inflation of the 1970s. Recently, the Fed contributed to the Great Recession in 2008 and following. Several recent errors are described here.

--The Fed made massive purchases of housing securities to bail out the industry that produced the crisis. Former Chairman Alan Greenspan had warned against and ended purchases of government backed mortgages. The Bernanke-Yellen Fed ignored that advice.

--Excessive attention paid to current data announcements and neglect of longer-term consequences. An example is the focus on monthly reports of employment growth. These numbers are subject to major revision. During the sluggish recovery after 2009, revised data the following month often reversed the direction of change. Markets responded because they expected the Fed to respond. The Fed was aware of the poor quality of the information but continued to rely on it because of the excessive attention it gives to current events.

--Overemphasis on current events and neglect of medium-term responses. I first noticed this problem more than 50 years ago in a 1964 report that the House Banking Committee requested me to prepare. The Fed is under pressure from market speculators and members of Congress to respond to current announcements. We do not have enough understanding of these short-term changes to use the data fruitfully to improve outcomes.

--Neglect, even dismissal, of data on money growth is one of the most costly results of the excessive focus on short-term data. Medium and longer-term data on money growth have correctly forecast inflation repeatedly. The Fed not only ignores these data, it paid interest on reserves to discourage banks from creating money. The current Fed ignores money growth and treats the response to policy as entirely given by the movement of interest rates. This is a huge error that is without support in past experience.

--From 1986 to about 2002, Chairman Greenspan mainly responded to a rule —the Taylor rule proposed by my Hoover colleague, John Taylor--that gave the best results over any sustained time period in the first 100 years of Fed policy. Inflation was low, recessions were brief and mild, and recoveries came promptly. This period is known as the Great Moderation. It shows how rule based policy improves outcomes.

—-As part of the excessive attention given to monthly and quarterly data, several Fed staffs produce forecasts of quarterly GDP, inflation and other variables. Their forecasts are no better than the best market forecasts. All are often subject to large errors. It is long past time when people should learn that ECONOMICS IS NOT THE SCIENCE THAT GIVES ACCURATE QUARTERLY FORECASTS. THERE IS NO SUCH SCIENCE. Economics is a very useful tool for showing the medium and longer term results of current and recent actions.

--In the current recovery the Fed's forecasts have repeatedly predicted a stronger recovery than occurred. Repeated errors of this kind should raise doubts about the Fed's model. Does it estimate the cost to the economy's growth of the huge increase in regulation, starting with Sarbanes-Oxley, Dodd—Frank, EPA rules and labor market changes? Almost certainly not.

--The Fed deserves praise for acting promptly and forcefully in 2008 to prevent a possible financial crisis. Its continued easy policy after 2009 were wrong, in my view. And l claim the Fed should have recognized their error. Almost all the reserves produced after 2009——trillions of dollars worth—sit idly on the balance sheets of domestic and foreign banks. The Fed claims that its policy gave us the increase in consumption that we have seen. But there is no sign of increased borrowing by middle and lower income consumers to finance their buying, so I am skeptical that Fed policy did much to improve outcomes for middle and lower income classes. Technology improvements and oil and natural gas drilling seem a more likely source of increased income and consumer spending. A recent study described by the National Bureau of Economic Research finds no evidence of consumers increasing borrowing to spend.

--The chief beneficiaries of Fed policy gained from the rise in the stock markets. Speculators and short-term traders became a vociferous opponent of ending the very big increase in stock prices. What they fail to understand is that unlike the stock market the economy benefits from the rise in stock prices only if the rise in asset prices stimulates new investment. New investment occurs if investors see the lower price of new, current capital as a substitute for purchasing existing assets. This did not happen. Spending for new capital never increased in this recovery. Instead, companies bought existing assets, removing competitors. Fed monetary policy did get some production of new houses through this channel. --The Fed's decision to maintain low interest rates permitted the Federal government to finance large budget deficits at the low rates. In all of its prior history, the Fed sacrificed its independence to finance the Federal budget only in wartime. This was a big mistake. It reveals a failure to understand the reasons for maintaining the independence of the Federal Reserve. The policy leaves a great uncertainty about the future. When interest rates rise, holders of government debt will experience large losses. Some of the losses will fall on inexperienced debt owners. These costs are in the future.

--Fed policy of keeping short-term interest rates at historically low values were supposed to encourage borrowing. That failed. One of the unfortunate side effects of low interest rates is that the Fed neglected the other side of the loan market—the lenders. Lenders could not find many profitable opportunities at the low rates that covered the risk on commercial loans. Also, they faced high costs of banking and financial regulation. Many small and medium-sized banks went out of business.

--The Fed has not announced a program for reducing the $2.5 trillion of excess reserves. One response is that by paying interest on reserves, the Fed can control their size. Perhaps that control will be accurate. But at what interest rate will it happen? And will that interest rate be the right rate for full employment with low inflation?

--Former Chairman Paul Volcker showed how the Fed could achieve good results by following a medium-term strategy and by controlling money growth. The Bernanke-Yellen Fed's major mistake was the decision to replace that successful policy with an alternative that is of much less benefit to the public.

The errors and poor judgments are not inevitable. Monetary policy can make a larger contribution to economic stability and performance. Congress and the public will get better, more consistent Fed actions, if the Fed follows a rule. The Senate should join the House by requiring the Fed to adopt a rule. And the Federal Reserve should end its fascination with interest rates and aim at medium-term targets for money and credit. The policy that worked so well for Paul Volcker is far better than the replacement they chose.