OPINION

The Dangers of an Interventionist Fed

By John B. Taylor

America has now had nearly a century of decision-making experience under the Federal Reserve Act, first passed in 1913. Thanks to careful empirical research by Milton Friedman, Anna Schwartz and Allan Meltzer, we have plenty of evidence that rules-based monetary policies work and unpredictable discretionary policies don't. Now is the time to act on that evidence.

A century of experience shows that rules lead to prosperity and discretion leads to trouble.

The Fed's mistake of slowing money growth at the onset of the Great Depression is well known. And from the mid-1960s through the '70s, the Fed intervened with discretionary go-stop changes in money growth that led to frequent recessions, high unemployment, low economic growth, and high inflation.

In contrast, through much of the 1980s and '90s and into the past decade the Fed ran a more predictable, rules-based policy with a clear price-stability goal. This eventually led to lower unemployment, lower interest rates, longer expansions, and stronger economic growth.

Unfortunately the Fed has returned to its discretionary, unpredictable ways, and the results are not good. Starting in 2003-05, it held interest rates too low for too long and thereby encouraged excessive risk-taking and the housing boom. It then overshot the needed increase in interest rates, which worsened the bust. Now, with inflation and the economy picking up, the Fed is again veering into "too low for too long" territory. Policy indicators suggest the need for higher interest rates, while the Fed signals a zero rate through 2014.

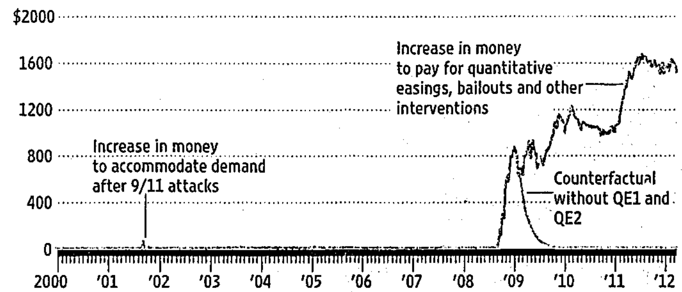
It is difficult to overstate the extraordinary nature of the recent interventions, even if you ignore actions during the 2008 panic, including the Bear Stearns and AIG bailouts, and consider only the subsequent two rounds of "quantitative easing" (QE1 and QE2)—the large-scale purchases of mortgage-backed securities and longer-term Treasurys.

The Fed's discretion is now virtually unlimited. To pay for mortgages and other large-scale securities purchases, all it has to do is credit banks with electronic deposits—called reserve balances or bank money. The result is the explosion of bank money (as shown in the nearby chart), which now dwarfs the Fed's emergency response to the 9/11 attacks.

Before the 2008 panic, reserve balances were about $10 billion. By the end of 2011 they were about $1,600 billion. If the Fed had stopped with the emergency responses of the 2008 panic, instead of embarking on QE1 and QE2, reserve balances would now be normal.

A Recipe for Inflation?

Bank money created by the Federal Reserve, in billions



Source: Federal Reserve Board H.4.1. release and author's calculations

This large expansion of bank money creates risks. If it is not undone, then the bank money will eventually pour out into the economy, causing inflation. If it is undone too quickly, banks may find it hard to adjust and pull back on loans.

The very existence of quantitative easing as a policy tool creates unpredictability, as traders speculate whether and when the Fed will intervene again. That the Fed can, if it chooses, intervene without limit in any credit market—not only mortgage-backed securities but also securities backed by automobile loans or student loans—creates more uncertainty and raises questions about why an independent agency of government should have such power.

The combination of the prolonged zero interest rate and the bloated supply of bank money is potentially lethal. The Fed has effectively replaced the entire interbank money market and large segments of other markets with itself—i.e., the Fed determines the interest rate by declaring what it will pay on bank deposits at the Fed without regard for the supply and demand for money. By replacing large decentralized markets with centralized control by a few government officials, the Fed is distorting incentives and interfering with price discovery with unintended consequences through out the economy.

For all these reasons, the Federal Reserve should move to a less interventionist and more rules-based policy of the kind that has worked in the past. With due deliberation, it should make plans to raise the interest rate and develop a credible strategy to reduce its outsized portfolio of Treasurys and mortgage-backed securities.

History shows that reform of the Federal Reserve Act is also needed to incentivize rules-based policy and prevent a return to excessive discretion. The Sound Dollar Act of 2012, a subject of hearings at the Joint Economic Committee this week, has a number of useful provisions. It removes the confusing dual mandate of "maximum employment" and "stable prices," which was put into the Federal Reserve Act during the interventionist wave of the 1970s. Instead it gives the Federal Reserve a single goal of "long-run price stability."

The term "long-run" clarifies that the goal does not require the Fed to overreact to the short-run ups and downs in inflation. The single goal wouldn't stop the Fed from providing liquidity when money markets freeze up, or serving as lender of last resort to banks during a panic, or reducing the interest rate in a recession.

Some worry that a focus on the goal of price stability would lead to more unemployment. History shows the opposite.

One reason the Fed kept its interest rate too low for too long in 2003-05 was concern that raising the interest rate would increase unemployment in the short run. However, an unintended effect was the great recession and very high unemployment. A single mandate would help the Fed avoid such mistakes. Since 2008, the Fed has explicitly cited the dual mandate to justify its extraordinary interventions, including quantitative easing. Removing the dual mandate will remove that excuse.

A single goal of long-run price stability should be supplemented with a requirement that the Fed establish and report its strategy for setting the interest rate or the money supply to achieve that goal. If the Fed deviates from its strategy, it should provide a written explanation and testify in Congress. To further limit discretion, restraints on the composition of the Federal Reserve's portfolio are also appropriate, as called for in the Sound Dollar Act.

Giving all Federal Reserve district bank presidents—not only the New York Fed president—voting rights at every Federal Open Market Committee meeting, as does the Sound Dollar Act, would ensure that the entire Federal Reserve system is involved in designing and implementing the strategy. It would offset any tendency for decisions to favor certain sectors or groups in the economy.

Such reforms would lead to a more predictable policy centered on maintaining the purchasing power of the dollar. They would provide an appropriate degree of oversight by the political authorities without interfering in the Fed's day-to-day operations.

Mr. Taylor is a professor of economics at Stanford and a senior fellow at the Hoover Institution. This op-ed is adapted from his testimony this week before the Joint Economic Committee, which drew on his book "First Principles: Five Keys to Restoring America's Prosperity." (W.W. Norton, 2012).