A New Fed-Treasury Accord

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The Fed has lowered its regular policy rate to zero. What should it do now?

In formulating its future policy, the Fed needs to be cognizant of two principles. First, it should avoid conducting fiscal policy by proxy. Second, its policy should be consistent with low and stable inflation in the long run.

With these two principles in mind, I propose a coordinated Fed and Treasury response to the current economic crisis that involves large-scale Fed purchases of inflation-indexed Treasury bonds (a.k.a. TIPS).

Current Policy

In addition to having brought the fed funds target rate down to between zero and ¼ percent, recent U.S. monetary policy has and will continue to involve the expansion of the Fed's balance sheet (http://www.federalreserve.gov/releases/h41/Current/). On the asset side, there has been a phenomenal increase in the Fed's holdings of private debt via an alphabet soup of new lending facilities, especially in the fourth quarter of 2008. On the liabilities side, the Fed has issued new reserves and borrowed new Treasury securities to help finance its purchases of private debt.

By providing reserves in exchange for short-term private debt, the Fed is playing its role as lender of last resort (although some have argued that it is quickly becoming the lender of first resort). This policy serves to help mitigate the liquidity crisis and prevent a collapse of the financial system along the lines of what happened in the Great Depression.

However, by selling Treasuries to finance purchases of private debt, the Fed is implicitly conducting a form of fiscal policy by proxy. In particular, the new lending facilities inevitably favor some borrowers over others. As a practical matter, I might personally be more comfortable with the judgment of certain central bankers than some politicians about which firms and industries to "bail out". But, as a principle, the Fed should keep out of the business of credit allocation and fiscal policy more generally. Such distributional policy should be left to the fiscal authorities.

Also, current Fed policy only avoids making things worse than they already are. It buys time for other policies to be put in place, but it does not stimulate or "reflate" the economy on its own, especially if everyone in the financial system assumes the Fed will remove excess reserves the moment that the liquidity crisis has passed. The limits of current policy are clearly illustrated by the recent slide of the economy into a deeper recession and the corresponding fall in inflation, including core inflation, despite the massive expansion of the Fed's balance sheet.

My Proposal
So how can the Fed reflate the economy without conducting fiscal policy by proxy? The simple answer is that it should provide Treasury with a large quantity of funds to conduct its own policy. Of course, an obvious concern with running the printing presses to provide funding for fiscal stimulus is that it would be highly inflationary in the long run. Thus, the Fed also needs the ability to reverse the monetary expansion in case this policy is too successful.

I propose that the Fed purchase a large quantity of inflation-indexed bonds from Treasury. This provides Treasury with cheap financing for its spending, while leaving the Fed with a clear exit strategy in the event of high inflation.

This proposal takes it as a given that, if done on a large enough scale, an increase in government spending and/or tax credits will have some impact on aggregate demand. Some economists might argue that households and firms would merely save in anticipation of higher future taxes. However, there is little evidence that such "Ricardian equivalence" holds in the real world, especially during a time of recession.

It should also be noted that, in some sense, this proposal is not too different to what the Fed seems to be considering. In particular, the latest policy statement mentions that the Fed is "evaluating the potential benefits of purchasing longer-term Treasury securities" (see http://www.federalreserve.gov/newsevents/press/monetary/20081216b.htm). My main point is that, in doing so, the Fed should consider purchases of real bonds instead of nominal bonds in order to make its exit strategy politically and economically feasible.

Why real instead of nominal?
There are a few reasons why the Fed should purchase real bonds instead of nominal bonds.

First and foremost, in the event of inflation rising above an acceptable level, the Fed could easily sell the inflation-indexed bonds it acquired from the Treasury to the private sector in order to remove excess cash and reserves from the economy and thereby raise short-term interest rates. In making this point, I want to be clear that I do not really doubt the Fed's ability to raise short-term interest rates even if it had purchased nominal bonds. But with rising inflation, the Fed would face a clear mismatch between its assets (increasingly worthless nominal bonds) and liabilities (a fixed amount of cash and reserves). In such a setting, the only way for the Fed to restore its balance sheet in the long run without going cap-in-hand to Treasury would be to drive inflation back to very low levels or even negative territory. This presumably involves the Fed raising short-term interest rates to even higher levels than it would have to with real bonds, thus pushing the economy back into recession in the shorter term.

At the same time, there is always a danger with nominal bonds that the Fed will face political pressure not to raise interest rates in response to high inflation. Besides objecting to a policy-

induced recession, some politicians might wonder whether the Fed should be allowed to restore its balance sheet at the cost of increasing the real liabilities faced by Treasury.

By contrast, with a large quantity of real bonds outstanding, most politicians would be less eager for inflation to continue and would be more supportive of Fed efforts to bring it under control. In part this is because even the most spendthrift politician does not like inflation for its own sake. Also, real bonds are indexed to the Consumer Price Index, which overstates true inflation, with the bias increasing with the level of inflation. Thus, the real liability that Treasury faces would actually increase with higher inflation. Meanwhile, with real bonds, the Fed should be content to target two or three percent inflation instead of a lower rate that would have been necessary to restore its balance sheet given nominal bonds. This is because the real bonds would retain their value, keeping the Fed's balance sheet sound in the face of inflation.

The political economy point here is that Treasury and the Fed tend to think of their balance sheets independently. And, given this, it makes some sense for Treasury to match its real assets (tax revenues) with real liabilities (indexed bonds), while it makes a lot of sense for the Fed to take on the risk of matching real assets (indexed bonds) with nominal liabilities (cash and reserves). Unwanted inflation improves the Fed's balance sheet, but this is countered by the Fed's policy goal of keeping inflation under control. By contrast, if Treasury is trying to match real assets with nominal liabilities, it is harder to see what would constrain it from pressuring for higher inflation in the long run. Presumably this is one of the reasons why we have a somewhat independent monetary authority in the first place.

"Zero-Percent Financing plus a Cash Rebate"
An obvious question one might have about this proposal is what is in it for Treasury. Why would Treasury issue inflation-indexed bonds when it can currently issue nominal bonds for extremely low interest rates, all the while hoping that the real value of its liabilities will be inflated away at some point in the future? This is where the Fed needs to strike a bargain with Treasury. It should offer funds at even lower interest rates than the market is currently providing. What would this mean if long-term interest rates were to go near zero in a liquidity trap? It means that the Fed should offer Treasury "zero-percent financing plus a cash rebate". For example, they could lend Treasury $110 in return for the promise to be paid back $100 plus an inflation adjustment.

Why on earth would the Fed do this? If it sounds like I am proposing that the Fed willingly give away some of its net worth to Treasury, that is because I am. However, this is exactly what the Fed already does and would be doing if it purchased nominal bonds with the hopes of reflating the economy. The only difference is timing. With real bonds, this transfer of net worth would be done up front in exchange for the Treasury issuing real bonds instead of nominal bonds (i.e., in return for promising not to give the Fed a difficult time when it has to raise interest rates to reign in inflation in the future).

Also, this proposal is consistent with what some recent academic papers by Gauti Eggertsson and Olivier Jeanne and Lars Svensson imply should be done to get the economy out of a liquidity trap. In particular, for a central bank to credibly commit to some positive inflation, it should buy

real assets with printed money and then issue a "dividend" to the fiscal authority to make sure the central bank's balance sheet is only positive if inflation turns out to be above a target level for a period of time. For example, the central bank could print money to purchase foreign reserves as part of a crawling peg depreciation of the domestic currency. The depreciation would directly cause inflation by increasing the price of import goods (i.e., it would work even if Ricardian equivalence holds). The more general point is that the general commitment to some inflation can be achieved by purchases of any real assets such as real estate or indexed bonds, providing a strong incentive for the central bank to avoid deflation in order to keep its balance sheet sound and keep its independence.

So why not purchase foreign reserves or real estate instead of real bonds? The exchange rate solution was formally proposed by Lars Svensson to solve Japan's deflation in the 1990s. However, Japan was unique in suffering deflation at the time. The current economic crisis is global and an exchange rate solution would look a lot like a "beggar thy neighbor" policy that, in any event, is the jurisdiction of Treasury, not the Fed. As for real estate, that would also really just be fiscal policy by proxy. If that is what the democratically-elected fiscal authorities choose to spend their cash rebate from the Fed on, so be it. But the Fed really should not be choosing or be seen to choose which markets or industries to favor. By purchasing bonds, the Fed leaves this decision-making up to the fiscal authorities, where it belongs, for better or for worse.

Conclusion

I have proposed a coordinated policy for the Fed and Treasury to stimulate and reflate the U.S. economy in the short run that credibly commits to low, but positive inflation in the long run. The policy involves the Fed purchasing inflation-indexed bonds at potentially negative interest rates from Treasury. The Fed's balance sheet would take an immediate hit, but no more so than the longer-term hit that it would take if the Fed purchased nominal bonds that lose their value when inflation returns. Treasury gets its funds to stimulate the economy at bargain rates. But the real bonds mitigate future political pressure on the Fed not to respond should inflation get out of hand.

References

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