Monetary Policy: Friend or Foe?

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Abstract

The financial crisis of 2007-2009 was severe around the world. Unprecedented expansionary monetary policies were adopted in response by the US Federal Reserve and most other central banks. We may be approaching the point where these monetary policies are causing more harm than good.

1. Introduction

The financial crisis of 2007-2009 was severe around the world. Unprecedented expansionary monetary policies were adopted in response by the US Federal Reserve and most other central banks. Now, more than eight years after the financial crash, monetary policy still is extremely expansionary, and short term interest rates are still near zero. In Europe and Japan some key interest rates and bond yields are negative. In spite of the unprecedented loose monetary policy, economic growth remains slow, and US unemployment was very slow to recover to the 5% level. Bank margins and profits are depressed by the low interest rate structure, and credit worthy borrowers is very cautious about borrowing to invest. Insurance companies and pension funds are struggling to earn a return needed to fund their future liabilities by holding more risky assets. Debt has increased enough to be a drag on economic growth. We may be approaching the point where these monetary policies are causing more harm than good.

These same ills are present in the European Union and in Japan. In 2012 Mario Draghi, president of the European Central Bank, quelled markets by promising to do "whatever it takes" to restore economic growth. Since then aggressive quantitative easing and negative interest rates in 2016 have not boosted growth, and deflation is more likely.

Japan presents the same example, with a record of intermittent recession since 1990. The Bank of Japan (BOJ) implemented massive quantitative easing in 2013 but fell into recession in 2014. Now the BOJ has adopted negative interest rates to increase money supply. However, a planned increase in their consumption tax, a dual track labor market, and heavy regulation show that more fiscal policy reforms are needed.

It may be time to restore more normal interest rates and monetary policy. (Thornton, 2015). Only effective fiscal policy in concert with effective monetary policy can fully restore economic growth and prosperity.

2. Economic Policy Tools

In the event of recession, inflation, or financial crisis, there are specific policy tools that can be deployed. Monetary policy deals with the money supply, credit, and stability of the financial system. It is controlled by the Federal Reserve as the central bank, and the primary policy tools are short term interest rates and the large scale purchase or sale of US government bonds ("open market operations"). Additional monetary policy tools are bank regulations, capital requirements, "forward guidance" of future policy changes, interest paid (or charged) on commercial bank excess reserves, and public statements intended to influence bank behavior. Under the Dodd-Frank Act, the Fed participates in the designation of certain large financial institutions as "systemically important", and it supervises stress tests to determine if the selected institutions have adopted the proper mix of risk management strategies and equity capital to survive a financial crisis. In most cases monetary policy tools affect the broad economy and cannot target specific firms or segments of society. Monetary policy can be adopted quickly by the Federal Reserve Board of Governors and the Open Market Committee. The Federal Reserve Act of 1913, as amended, assigns the Fed the rather limited dual mandate of achieving “low inflation and maximum employment”.

Fiscal policy also provides tools to deal with recession, inflation and financial crisis. The primary fiscal policy tools are taxes, government spending, and regulatory policy. These tools are controlled by Congress, with strong influence by the executive branch. Regulation by the executive branch and the independent agencies constitute fiscal policy directed at specific objectives, such as deposit insurance, environmental quality, or consumer protection. Some fiscal policy tools can target specific objectives, such as taxes on tobacco or subsidies for solar panels. Fiscal policy changes must go through the legislative process, so they can take time to formulate and implement. The decision makers of fiscal policy are elected representatives who have multiple goals and priorities in addition to economic outcomes.

3. Seeds of the Sub-Prime Mortgage Crisis

Since the 1960s politicians have seen opportunity in tilting housing policy toward low and moderate income and minority buyers. Congress passed the Community Reinvestment Act in 1977 to encourage banks to make more loans in low-income areas. In 1994 the Clinton administration required that at least 30 per cent of home mortgages purchased by Fannie Mae and Freddie Mac be for loans made to families with income below the local median. In 1996 the target was increased to 42 per cent. By 2005 the target was 52%. To achieve these targets, loan underwriting standards, such as down payment requirements, were relaxed by Fannie Mae and Freddie Mac. In 2004 no-document loans were accepted (liar’s loans). After the crisis passed, it became clear that mortgages meeting the traditional underwriting standards never had significant default problems, and the mortgages written to lower standards became the “sub-prime” source of the financial crisis.

4. Economic Policy in the 21st Century

At the beginning of the 21st century, the US economy was strong, and it was in the later stages of the “internet boom” of 1991-2001. A recession followed during March-November of 2001, and the Fed adopted expansionary monetary policy, bringing short term interest rates down to 1%, a forty-year low. Expansionary fiscal policy also was adopted, including tax cuts and targeted rebates. Despite these initiatives, the unemployment rate was slow to recover, leading some pundits to criticize the “jobless recovery”. Possibly in response to that criticism, the Fed continued the low interest rates until June of 2004. Now, in hindsight, some fault the Fed for keeping rates “too low for too long”.

During the late 1990s the US stock markets boomed. The federal government ran four years of budget surpluses. The Dow Jones Index increased 35% per year for four years, and residential real estate prices also increased considerably in many local markets. These trends sparked speculation among the public, and a desire among politicians to encourage homeownership. When short term interest rates dropped to 1% in 2001, it suddenly became feasible to structure adjustable rate mortgages with monthly payments lower than rent in many markets. Fannie Mae and Freddie Mac already were relaxing mortgage underwriting standards, and they were buying the majority of all home mortgages made in the US. As it turned out, many of these home mortgages were made not to owner-occupants but to speculators or even sham buyers. These factors created a perfect storm that encouraged speculative home purchases and led to a steady rise in home prices. The rise in home prices reinforced the speculative urge for buyers to buy and for developers to develop. (Acharya, 2011).

In June 2004, the Fed started a gradual process of increasing short term interest rates by 0.25% at each of the next 17 meetings of the Open Market Committee. This brought short term rates to 5.25% in July 2006. As short term interest rates increased, the interest rates and (adjustable) monthly payments on the multitude of home mortgages made during 2001-2006 began to rise. In 2007 we started to see gradual increases mortgage delinquency rates. By that time almost all US home mortgages were in mortgage pools that were collateral for mortgage-backed securities (MBS). These MBS, mostly issued and guaranteed by Fannie Mae or Freddie Mac, were held by investors and financial institutions around the world, and they were not obligations of the US government. By 2008 foreclosures increased and the credit quality of MBS came into question. MBS investors began selling, and MBS prices plunged. Fannie Mae and Freddie Mac were obligated honor their guarantee and replace foreclosed mortgages with sound loans. Losses at Fannie Mae and Freddie Mac mounted, and on September 8, 2008 the federal government assumed the debts of Fannie Mae and Freddie Mac and placed quasi-government agencies in conservatorship. On September 15, 2008 the subprime mortgage panic had spread to the broader financial community and investment banker Lehman Brothers filed for bankruptcy. The financial world was shocked when the Fed and Treasury did not act to bail out Lehman, as they had done for investment banker Bear Stearns in March 2008.

The rather sudden spread of the mortgage crisis to the broader world economy surprised many, including the Federal Reserve and most other policy makers. Suddenly in October 2008 the Fed adopted unprecedented expansionary policy, bringing short term interest rates down to near zero, where they remained until December 2016. Collectively these developments led to the extraordinary monetary policy that has persisted for eight years.

5. Quantitative Easing (QE)

Traditional Keynesian theory sees investment as the linking mechanism between monetary policy and the real economy. In a recession, low interest rates are thought to lead to increased demand for investment and capital. This increase in investment adds to aggregate demand and GDP, creating jobs and curtailing the recession. In keeping with this theory, the Fed lowered short term interest rates to near-zero in October 2008, and they still expect rates to remain very low for at least the next two years.

In spite of this very accommodative monetary policy, economic growth remains weak, and this recovery is the slowest in modern times. Inflation is well below the US target of 2 per cent, and it is dangerously close to deflationary territory, especially in Europe and Japan. As The Economist reported:" Faith in monetary policy is wavering". (Economist, February 29, 2015, page 9). However, it may be that increased investment is spurred not by low interest rates, but by the prospect of rising interest rates. That might explain why firms are in no rush to invest now. The extended period of weak investment has led to low growth of labor productivity, which in turn has led to slow growth in wages.

In November 2008, the Fed balance sheet showed assets of $490 billion. Due to "large scale asset purchases" (LSAP) or Quantitative Easing (QE) policy since then, the Fed balance sheet has reached $4.3 trillion in assets. This translates into more than a 750% increase in the Fed balance sheet. Current policy is to offset maturing issues by buying more bonds. This and other policy moves created the most accommodative US monetary policy in the 100-year history of the Fed.

The financial crisis had its roots in the massive issuance of sub-prime and Alt-A mortgages since 2000. (These were mortgages not meeting the traditional standards for down payment and other underwriting measures). Most of these mortgages were bought by Fannie Mae or Freddie Mac, which set mortgage underwriting standards. However, the sub-prime mortgage problem was not widely noticed until 2007 when mortgage delinquency rates (and later foreclosures) started to rise. By 2007 some mortgage investors were trying to liquidate their positions, causing mortgage-backed securities (MBS) prices to fall. On August 9, 2007, French bank BNP Paribus suspended redemption for some of its investment funds. This event set the stage for massive contagion throughout the world financial markets.

Within one week the Fed cut the discount rate by 50 basis points, and within a month it also cut the federal funds rate target by 50 basis points. The Fed created several emergency lending facilities to allow financial firms, such as commercial paper dealers and broker-dealers, access to Fed borrowing. In March 2008 Bear Stearns almost failed and was bailed out, and in September 2008 Lehman Brothers failed – without a bailout. By then the Fed had loaned $300 billion to stabilize the financial system. Soon after Lehman Brothers failed, credit markets froze as banks could not determine which of their counterparties were solvent. Within days (on the second try) the Treasury Secretary and Fed Chair managed to get Congress to provide $787 billion for the Troubled Asset Relief Program (TARP), that soon was used to pump massive amounts of cash into the banking system to increase liquidity (by purchasing preferred stock from banks). It is noteworthy that the federal government taking an equity position in public companies causes severe concern within the investment community. This topic will be considered in a future paper.

However, the Fed "sterilized" this lending by selling an equal amount of bonds from its portfolio, so as to avoid increasing the monetary base or the money supply. This policy avoided causing inflation, but also it reallocated credit to major financial firms and away from smaller business firms. This sterilization held down the monetary base, or total credit in the economy. (This same sterilization policy was adopted in early 1930, when it allowed total credit to fall, promoting the Great Depression.)Soon the Fed was no longer able to continue sterilization, the monetary base increased, and liquidity was increased throughout the banking system. The actual federal funds rate dropped as low as 33 basis points, well below the then target of 1.5%. Interest rate targeting had become meaningless. This was the beginning of Quantitative Easing (QE). The theory underlying QE is murky at best and bogus at worst. Ben Bernanke is quoted as saying: "The problem with QE is that it works in practice, but it doesn't work in theory". However, the evidence that QE worked is mixed. (Bernanke, 2014)

The minutes of Fed meetings during that time reveal that there was considerable debate as to whether QE would work and how it should be implemented. Nevertheless, QE was adopted in three phases: QE1ran from Nov 2008 through March 2010. QE2 ran Nov 2010 through June 2011. Operation Twist followed during September 2011 through December 2012. Then QE3 ran January 2013 through October 2014. The Fed bought longer term Treasury bonds (short term and longer term) and MBS while selling short term paper (Operation Twist). The idea was to bid up bond prices to push yields lower and flatten the yield curve. This was thought to drive investors out of these bonds into other assets that provided a higher yield. If successful that would spur economic growth and employment by increasing spending on housing, common stock, and other assets. (Thornton, 2015). QE was seen as needed when central bank policy interest rates reach the "zero lower bound" and traditional monetary policies are not effective. There is debate among scholars as to whether QE has a valid theoretical foundation. (Williamson, 2015).

6. Results of Quantitative Easing

Often there are unintended consequences of fiscal or monetary policy. The current extremely loose monetary policy has lasted since 2008 and is unprecedented; the adverse effects could be more damaging to the economy than is generally known. The Fed has bought enough Treasuries and MBS to build its assets to $4.3 trillion. This bid the asset prices up and their yields down. Predictably some investors shifted to riskier assets in search of yield. Higher risk assets are not appropriate for all investors, especially in the event of an adverse scenario.

Pension funds and insurance companies must earn a return to fund their future obligations, and they also are affected by Fed actions. If these non-depository financials shift to riskier assets and events turn against them, they risk losses that could jeopardize their customers or clients. Currently many public and private US pension funds are seriously underfunded, and excessive risk-taking could exacerbate that problem. Many public pension funds continue to promise benefits assuming a 6% or more annual return on their investment portfolio.

Low rates on safe assets penalize savers and fail to encourage saving. Of major concern, about half of people in the US reaching age 65 have essentially no financial assets to fund their retirement. Policy that would encourage rather than discourage saving is needed.

The Fed expects interest rates to remain low for "an extended time". This policy signals firms to postpone investment, because the low rates will be available into the future. Low rates drive higher income savers into riskier assets with higher yields, while lower income households often cannot accept the risk or have few assets. Thus the low yields transfer income from the poor to the rich, not an ideal monetary policy. Monetary policy that targets assistance to specific firms or sectors is a re-allocation of credit. To the extent such effects become widespread and well known, public distrust of the central bank and disrespect for its independence could arise.

Current policy has led banks to hold a record high amount of excess reserves. This is partly for safety (liquidity) and partly for lack of investment demand. These reserves could be loaned out, and if that were to happen in large amounts, inflation would result. The FED has acknowledged that risk, and they plan to use their new policy tool of paying interest on excess reserves when needed. That is, if bank lending becomes excessive, paying a higher rate on excess reserves would encourage banks in general to hold more excess reserves and make relatively fewer loans. However, the threshold rate may differ by bank, and the supply and demand mix may differ by market. It is not clear that the FED could fully manage bank lending by the (new) blunt instrument of interest on excess reserves. In addition, if the FED were to pay banks billions of dollars annually to "not lend", public support of the independence of the central bank could be in question. The unintended consequences could be significant.

7. Rules-based Monetary Policy

John B. Taylor has developed a pragmatic guide for the FED to set short term interest rates based on the inflation rate and the GDP gap. This "Taylor rule" suggests that interest rates were too low during the 1970s (leading to massive inflation), about right in the 1980s, and too low after the 2001 recession (leading to the subprime mortgage boom and bust.) The Taylor rule suggests current interest rates are too low as well. (Taylor, 2013). Some members of Congress have proposed writing such a rule into law. Ben Bernanke, recently retired as Chairman of the Fed, opposes that initiative as an incursion on the independence of the Fed. (Bernanke, 2015, pages 571-572).

8. Discussion

Capitalism is a dynamic system that provides incentives for productivity growth in the presence of free enterprise and private property rights. That productivity growth provides for rising, although unequal, incomes. Flexible exchange rates help to rebalance economies and keep production consistent with incomes. Monetary and fiscal policies must be coordinated and balanced to achieve long term goals. Excessive and extended reliance on monetary policy, especially negative interest rates, imposes rising costs on society and diminishing marginal benefits. As with all manmade structures, monetary and fiscal policy must be continually revised and reformed to meet the changing needs of the real world. This is the best way to create wealth.

9. Recommendations

It is very important that the Fed gradually lift interest rates to more normal levels, especially while the economy is performing well. Monetary policy based more closely on the Taylor Rule and less on discretion would more likely yield better economic results over the longer term.

Fiscal policy needs to play a more active role in managing the economy. Tax reform designed to lower rates, reduce exemptions, and broaden the tax base would contribute to economic growth. Fiscal issues such as Social Security, Medicare, Medicaid, and healthcare reform need to be managed to control long term costs and performance of these programs.

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