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America Would Be Better Off Without Fed Monetary Policy

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Monetary policy is one of the cornerstones of American economic policy and the Federal Reserve is increasingly seen as one of America's bedrock institutions while the Fed chairman is often viewed as Washington's second-most powerful official. But, is this as it should be? Or is the Fed chairman in fact nothing more than a real-world Wizard of Oz? This article will first explain what present-day monetary policy is and is not and then explain why money doesn't count, as least as a major public policy concern. Interest rates, however, do count enormously, because properly setting interest rates in the commercial marketplace rather than in the political marketplace in which the Fed operates, is central to ensuring price stability and steady economic growth. The final portion of this article will describe how a truly market-based, Fed-free monetary policy can be implemented.

Contrary to most economic textbooks and popular mythology, monetary policy does not consist of the Fed controlling the money supply. The Fed readily admits as much. The Fed does not attempt such control because it decided long ago to be an interest rate signaller. Like all central planning agencies, the Fed understands that it can attempt to control the price of credit (interest rates) or the quantity of credit, but it cannot do both simultaneously. Because of the near impossibility of directly controlling the credit supply (credit, not money, is the real potential cause of inflation), the Fed, like most central banks in the industrialized world, has elected the far easier task of attempting to control, or at least influence, interest rates. However, even in this arena, the Fed is rapidly losing influence as the financial marketplace increasingly utilizes electronic technology to create credit markets and global capital flows over which central banker influence is rapidly diminishing. The markets, playing the role of Toto, are steadily pulling back the curtain to reveal what actually stands behind it.

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PULL-OUT LEADERSHIP DIRECTORY ENCLOSED

America Would Be Better Off Without Fed Monetary Policy

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Today, as a practical matter, monetary policy consists entirely of just one short-term interest rate signal, the so-called Federal Funds Rate Target (FFRT). The FFRT is the target interest rate that the Fed sets for the rate at which banks lend to one another, usually overnight, funds, or reserves, that they have on deposit at the Fed. The Fed's open-market operations (buying and selling Treasury securities) attempt, often not very successfully, to hold the actual Federal Funds rate in the vicinity of the FFRT. Open market operations also supply the banking system with reserves to meet its reserve requirement, which is the amount of reserves that banks and other depository institutions must hold in the form of currency or Fed deposits as a percentage of reservable deposits. These are deposits readily accessible by check or electronic funds transfer. Because the Fed is a rate signaller and not a quantity controller, it supplies banks with whatever reserves they need to meet their reserve requirement. This means that the reserve requirement exerts absolutely no control over the quantity of bank deposits, the other major component of the money supply besides currency. Instead, reserves are merely an expensive-to-administer tax on deposits.

Money (however defined) doesn't count for much in the U.S. economy today because all forms of money are merely those portions of the credit supply that also have the additional property of being convenient media of exchange. Hence, a checkable bank

deposit is a more convenient medium of exchange than a mortgage although a mortgage serves as a medium of exchange when it is assumed as part of a property purchase. Credit plays the much more crucial economic role of financing the ability to own assets in excess of one's own net worth or to mortgage future income with unsecured debt such as credit card balances or the federal government's debt. That is, while money may facilitate a transaction, just as do charges against unused lines of credit, credit permits the transaction to go forward in the first place if the buyer lacks sufficient assets beforehand to execute the transaction. Conceivably, a modern economy could operate without any money, with all payments charged against unused lines of credit, but it cannot operate without credit.

In a credit-based economy, which all but the most primitive are, inflation occurs when credit expands so rapidly as to over-stimulate demand for the then-existing supply of goods, assets, and services. This excessive demand boosts prices at an inflationary rate. By the same measure, if credit does not increase as fast as the supply of what is offered for sale, or if the quantity of credit contracts, then deflation can occur. Although rapid growth in the money supply may accompany inflation, it is not the transacting property of that money which is creating inflation, but rather the ability of the issuer of that money to finance purchases with it. This is why the government printing press is so often the cause of inflation. Fortunately, the federal government no longer pays its bills in currency, instead using checks or electronic funds transfers. Hence, the printing press long ago ceased to be a cause of inflation in the United States;

that is, U.S. inflation is no longer a monetary quantity phenomenon.

In recent decades, U.S. inflation has been a monetary price phenomenon because it has been caused by underpriced interest rates. As is true with any good or other service, the demand for credit varies inversely with interest rates. A nominal or stated interest rate is underpriced, that is, too low, if it does not fully compensate the lender for likely future inflation as well as providing her with a sufficient real or inflation-adjusted return on the credit she has provided after subtracting the other costs of supplying credit, such as credit losses. On the other hand, a nominal interest rate is too high if it overcompensates the lender for future inflation after accounting for all other costs.

Left to themselves, financial markets will set nominal interest rates which will produce non-inflationary credit growth: that is, stable prices and the steady economic growth which stable prices will stimulate. This is the case because in a large, competitive financial market, such as the United States has, the bargaining power of debtors and creditors is sufficiently balanced (the amount borrowed always equals the amount lent) to properly set all interest rates, from an overnight rate to 30-year mortgages. However, the Fed, in its increasingly desperate search for a role in the modern world, interferes in the interest pricing process by setting the FFRT. Although it cannot in fact enforce the FFRT on other interest rates through its open market operations, most participants in the financial markets still believe, like the Munchkins' belief in the power of the Wizard, that the Fed can enforce its will on at least other short-term interest rates.

The virulent inflation of the 1970s and early 1980s was caused by the Fed's then ability to signal all interest rates too low, which in turn caused an inflationary demand for all forms of credit, particularly long-term credit such as home mortgages. Over the last decade, though, the financial markets have asserted complete control over longer term interest rates. This control was especially evident in 1992 and 1993 when long-term rates stayed high even as the Fed snookered the financial markets into accepting excessively low and potentially inflationary short-term rates.

The Fed's continuing success in pegging the short end of the interest rate yield curve is harmful to the economy even as inflation continues its long, market-driven decline. This is the case because today inflationary and deflationary shocks (such as a jump in oil prices or a rise in unemployment) are not fully reflected in short-term interest rates, as they should be since most such shocks are relatively transitory in nature. Instead, these shocks are reflected in an exaggerated manner in longer term interest rates, which whipsaw those sectors of the economy, such as housing and capital goods manufacturing, that are most sensitive to interest rate fluctuations. In other words, instead of experiencing sufficient volatility in short-term rates, Fed monetary policy causes excessive volatility in longer term rates, which harms the economy.

Fortunately, the American economy can easily be freed from Fed monetary policy by simply abolishing the Fed's remaining monetary influences. Key is barring the Fed's interest rate signaling; specifically, the Fed's Federal Open Market Committee, which sets the FFRT, should be abolished. Other

needed changes include eliminating reserve requirements, bricking up the discount window through which the Fed lends to the banking system, shifting balances in the government's checking accounts to private banks, repealing currency's "legal tender" privilege (which increasingly is an anachronism), and shifting the management of the nation's currency supply to the Treasury Department. Stripping the Fed of its monetary functions will understandably raise questions about its future, but those questions should not stand in the way of freeing America from the last vestiges of the Fed's counterproductive influence over the economy.

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