

## COMMENTARY

# Monetary Policy after the Crisis

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### Introduction

Lars Svensson has written a compact, well-reasoned assessment of monetary policy in light of the credit turmoil. His conclusions are well-organized and clear. I take advantage of Lars's craftsmanship to comment on the conclusions as he outlines them. To sharpen my commentary on Lars's views, I find it useful to distinguish "monetary policy narrowly defined" from "credit policy" and "interest on reserves policy." In the last part of my discussion, I illustrate briefly how the extra precision afforded by my classification is useful for assessing the different means by which a central bank makes its initiatives effective, and for setting the boundaries of independent central bank responsibilities. Given the limited space, I write in terms of the Federal Reserve, though it should be understood that the analysis is applicable more generally.

### Monetary Policy, Credit Policy, and Interest on Reserves Policy

Federal Reserve *monetary policy* narrowly defined consists of open market operations that expand or contract high-powered money (bank reserves plus currency) by buying or selling U.S. Treasury securities. Pure monetary policy is best appreciated this way: When the Fed's balance sheet is consolidated with the Federal government's balance sheet, the U.S. Treasuries disappear because they are liabilities of the Federal government. Only currency and bank reserves are left. So U.S. Treasuries acquired with currency or bank reserves is pure monetary policy.

Federal Reserve *credit policy* involves changing the composition of the Fed's asset portfolio between Treasury securities, on one hand, and credit to the private sector or non-Treasury entities on the other hand, holding the size of the Fed balance sheet fixed. A combination *credit and monetary policy* initiative would involve the use of newly created bank reserves to fund discount window lending or to purchase non-Treasury securities.

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**Author's note:** *My comment draws throughout on analysis developed and applied initially in Goodfriend (2011a).*

Pure credit policy by itself has little direct effect on the federal funds rate because it does not change aggregate bank reserves or interest paid on reserves. Fed credit policy works by interposing the government between private borrowers and lenders, and exploiting the government's creditworthiness to lower private borrowing costs and facilitate credit flows.

A good way to appreciate the difference between monetary policy and credit policy is this: Non-Treasury securities, e.g., loans or mortgage-backed securities, do not disappear on the consolidated Federal Reserve–federal government balance sheet. In effect, non-Treasury assets on the Fed's balance sheet represent private assets that have been acquired on behalf of the federal government.

*Interest on reserves policy* consists of varying the interest rate that the Fed pays on bank reserves, while holding monetary and credit policy fixed. The Fed began to pay interest on reserves in October 2008 to help put a floor under the federal funds rate. Interest on reserves works in that regard because depository institutions will not lend in the interbank market at interest below the rate they can earn on reserves held at the Fed.

## Commentary on Svensson's Conclusions

I summarize Lars's main conclusions below. To each, I attach one of two assessments: (1) agree wholeheartedly, or (2) agree with qualification. I don't disagree outright with any of Lars's conclusions. Broadly speaking, I share his view that greater clarity of central bank objectives and actions would be beneficial. I illustrate subsequently how the Fed can safeguard its independence and improve its operational effectiveness by distinguishing monetary policy narrowly defined from credit policy and interest on reserves policy.

**Conclusion 1:** "The crisis was not caused by interest rate policy but by other factors."

*I agree wholeheartedly.* The credit cycle was caused by a combination of other factors such as U.S. government subsidized housing finance, insufficient depository capital requirements, excessive use of liquidity, credit, and maturity transformation in money markets, inept regulation and supervision, global financial imbalances, and low global real interest rates (Goodfriend 2011c).

**Conclusion 2:** "Price stability is not enough to achieve financial stability, interest rate policy is not enough to achieve financial stability, and a separate financial stability policy is needed for financial stability."

*I agree with qualification.* The boundary for independent central bank responsibility for financial stability needs to be clarified and tightened with respect to credit policy initiatives.

**Conclusion 3:** “Flexible inflation targeting remains the best-practice monetary policy as before, during, and after the crisis. . . .”

*I agree with qualification.* I would not risk, tolerate, or target higher inflation in an attempt to stimulate economic activity at the zero bound on interest rate policy. Central bank stimulus at the zero bound works in only one of two ways. Monetary policy at the zero bound works by taking interest rate maturity risk onto the consolidated central bank–government balance sheet. Credit policy at the zero bound works by taking credit risk onto the consolidated central bank–government balance sheet. Either monetary or credit policy must be used at great scale to be effective, at potentially large financial risk to taxpayers. Hence, they should be utilized aggressively only if deflation becomes a clear and present danger (Goodfriend 2011b).

**Conclusion 4:** “It is important to conceptually distinguish financial stability policy from monetary policy and avoid conceptual and practical confusion between the two policies.”

*I agree with qualification.* Credit policy is both a financial stability policy and a fiscal policy, so the use of credit policy by an independent central bank must be tightly circumscribed.

**Conclusion 5:** “Monetary policy should be the last line of defense for financial stability policy, not the first.”

*I agree wholeheartedly.* In practice, there is no window of opportunity when interest rate policy can be used with a sufficient degree of confidence against perceived excessive asset price appreciation or excessive credit market expansion (Goodfriend 2003).

**Conclusion 6:** “Financial stability as an objective of monetary policy makes little sense, whereas financial stability, as an objective for the central bank, makes sense if the central bank gets control over financial stability instruments.”

*I agree with qualification.* Financial stability policy that involves expansive credit policy is fiscal policy, and so cannot be implemented effectively by an independent central bank without jeopardizing the central bank’s independence.

**Conclusion 7:** “I believe LSAPs conducted by the Federal Reserve have had substantial beneficial effects on the U.S. economy and that the objections that have been raised against them are not convincing.”

*I agree with qualification.* The Fed’s \$1 trillion injection of bank reserves into the economy in 2008–09 in exchange for non-Treasury securities such as mortgage-backed and agency securities delivered a powerful *combination monetary and credit policy* stimulus that protected against deflation. However,

the Fed should commit to a timetable or conditions by which it intends to remove such non-Treasury assets from its balance sheet in order to return to Treasuries only.

**Conclusion 8:** “I have long been in favor of the publication of a policy rate forecast on a regular basis based on practical experience [because] what matters . . . is not what the policy rate is during the one or few months until the next policy meeting, but what the longer interest rates are.”

*I agree with qualification.* The formal clarification of an inflation objective (as either a point target or target range) must come first. A published interest rate policy rate forecast can only reinforce the central bank's commitment to an explicit numerical inflation objective, the publication of interest rate policy intentions cannot substitute for it (Broaddus and Goodfriend 2004, pp. 13–15).

**Conclusion 9:** “Some observers suggest that . . . capital flows to other countries should be taken into account when, for instance, the Federal Reserve sets its monetary policy. I do not agree with that conclusion . . . if countries . . . choose to peg to the dollar, with capital flows, bubbles, and other negative effects, they are themselves responsible for those effects.”

*I agree wholeheartedly.* Monetary policy is most effective when a central bank lets its exchange rate float on the foreign exchange market so that it is free to focus entirely on domestic objectives such as price stability and full employment. This is no less true for emerging market economies than for developed economies.

## **Federal Reserve Independence and Credit Policy**

The presence of credit assets on the Fed's balance sheet should not be allowed to threaten the Fed's actual or perceived political independence and the credibility of its exit strategy from the zero interest bound. To preserve the Fed's independence, the Treasury and Congress should work to remove problematic credit assets from the Fed's balance sheet in exchange for Treasury securities, so the problematic credit assets can be monitored and managed elsewhere in the government. Then, there would be little need for Congress to scrutinize Fed actions beyond oversight hearings to hold the Fed accountable for stabilizing employment and inflation. And the Fed could manage interest rate policy independently as it has for decades.

## **Strengthening Interest on Reserves Policy**

The authority to pay interest on reserves is the most important tool enabling the Fed to raise the federal funds rate without first shrinking its balance sheet.

Depositories will not lend to each other below interest they receive at the Fed. However, large lenders in the federal funds market, such as government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac, and Federal Home Loan Banks (FHLBs), are legally ineligible to receive interest on balances they hold at the Fed. Depository institutions eligible to receive interest on reserves have an incentive to attract federal funds from the GSEs and the FHLBs, and to deposit those funds at the Fed. Yet, the federal funds rate has continued to fluctuate below the one-quarter percent interest the Fed has paid on reserves since the end of 2008. Thus, it is reasonable to worry that lending by the GSEs, the FHLBs, and others in the federal funds market could impair the power of interest on reserves to put a floor under the federal funds rate again when the Fed tries to exit the near-zero federal funds rate setting (Bech and Klee 2011).

The Fed should ask the Treasury and Congress to secure the interest on reserves floor for the federal funds rate by modifying regulations for the federal funds market to exclude all but depository institutions from lending in that market, or alternatively by allowing those institutions eligible to lend in the federal funds market to earn interest on balances at the Fed. So strengthened, interest on reserves would provide the Fed with a precise, flexible, and reliable means of raising the federal funds rate as the economy recovers, regardless of the size of the Fed's balance sheet.

## **Exiting the Zero Interest Bound with Monetary Policy Alone**

A major deficiency in relying on monetary policy narrowly defined to raise the federal funds rate is that the Fed would have to drain or immobilize hundreds of billions of dollars of reserves and return the stock of reserves to a level near to that prior to the credit turmoil in order to recreate a scarcity of reserves sufficient to raise the federal funds rate significantly. The problem is that large-scale operations would have to be undertaken in advance over a span of time to position monetary policy alone to raise the federal funds rate.

In lieu of selling assets, the Fed has proposed immobilizing reserves by arranging reverse repurchases or offering interest-earning time deposits. Either of these alternatives would also take time. Another problem with the Fed's use of such managed liabilities is that they involve credit policy. In particular, reverse repurchases are essentially a collateralized borrowing of funds using securities as collateral. Large-scale reverses expose the Fed to significant counterparty risk, which could complicate the Fed's management of financial markets in times of financial turmoil. In addition, the introduction and management of interest on term deposits, in particular, could destabilize the

interest elasticity of demand for bank reserves and complicate federal funds rate targeting with monetary policy.

The use of managed liabilities would jeopardize the Fed's independence by facilitating the perpetual use of credit policy borrowing by the Fed to fund asset acquisition. There is no reason for the Fed to issue managed liabilities if the regulation of the federal funds market is modified to secure the potential for interest on reserves to put a floor under the federal funds rate.

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