Retirement Income
JOURNAL

The Fed at a Crossroads

By Paul Volcker *Wed, Jun 12, 2013*

Addressing The Economic Club of New York on May 29, the former Fed chairman said that "the Federal Reserve, with assets of $3.5 trillion and growing, is… acting as the world's largest financial intermediator."

I first entered the System as a neophyte economist in 1949. Then, as now, the Federal Reserve was committed to maintaining a pattern of very low interest rates, ranging from close to zero at the short end to 2½ percent or less for Treasury bonds. If you feel a bit impatient about the situation now, quite understandably so, recall that the earlier episode lasted 15 years.

The initial steps taken in the midst of the 1930's continuing depression were at the Fed's initiative. The pattern was held through World War II in explicit agreement with the Treasury. Then it persisted right in the face of double-digit inflation after the war, increasingly under the duress imposed by the Treasury and Presidential pressure.

The growing restiveness of the Federal Reserve was reflected in testimony by Mariner Eccles in 1948: "Under the circumstances that now exist, the Federal Reserve System is the greatest potential agent of inflation that man could contrive."

That was pretty strong language by a sitting Fed governor and a long-serving Board Chairman. But it was then a fact that there were many doubts about whether the formal legal status of the central bank could or should be sustained against Treasury and Presidential importuning. At the time, the influential Hoover Commission on government reorganization itself expressed strong doubts. At any rate, over time calls for freeing the market met strong resistance.

Treasury debt had ballooned in the War, exceeding 100% of GDP, so there was concern about an intolerable impact on the budget if interest rates rose strongly. Ending Federal Reserve support might lead to panicky and speculative reactions, and declines in bond prices would drain bank capital. Main line economists, and the Fed itself, worried that a sudden rise in interest rates could put the economy back in recession.

All of that resonates today, some 60 years later, even if few now take the extreme view of the first report of the then new Council of Economic Advisors: "Low interest rates at all times and under all conditions, even during inflation" would be desirable to promote investment and economic progress. Not exactly a robust defense of the Federal Reserve and independent monetary policy.

Eventually, the Federal Reserve did get restless, and finally in 1951 rejected overt Presidential pressure to continue the ceiling on long-term Treasury rates. In the event, the ending of the "peg" was not dramatic. Interest rates did rise over time, but long bonds, with markets habituated for years to a low interest rate, remained at moderate levels. Monetary policy, free to act against incipient inflationary tendencies, contributed to 15 years of stability in prices, accompanied by strong economic growth and high employment. The recessions were short and mild.

No doubt, the challenge of orderly withdrawal from today's broader regime of "quantitative easing" is far more complicated. The still-growing size and composition of the Fed's balance sheet implies the need for, at the least, an extended period of "disengagement." Moreover, the extraordinary commitment of Federal Reserve resources, alongside other instruments of government intervention, is now dominating the largest sector of our capital markets, that for residential mortgages. Indeed, it is not an exaggeration to note that the Federal Reserve, with assets of $3.5 trillion and growing, is, in effect, acting as the world's largest financial intermediator, acquiring long-term obligations and financing short-term, aided and abetted by its unique privilege to create its own liabilities.

Beneficial effects of the actual and potential monetization of public and private debt, the essence of the QE program, appear limited and diminishing over time. The old "pushing on a string" analogy is relevant. The risks of encouraging speculative distortions and the inflationary potential of the current approach plainly deserve attention. All of this has given rise to debate within the Federal Reserve itself. In that debate, I trust sight is not lost of the merits—economically and politically—of an ultimate return to a more orthodox central banking approach.

I do not doubt the ability and understanding of Chairman Bernanke and his colleagues. They have a considerable range of tools and instruments available to them to manage the transition, including the novel approach of paying interest on excess reserves, potentially sterilizing their monetary impact. What is at issue—what is always at issue—is a matter of good judgment, leadership, and institutional backbone. A willingness to act with conviction in the face of predictable political opposition and substantive debate is, as always, a requisite part of a central bank's DNA.

Those are not qualities that can be learned from text books. Abstract economic modeling and the endless regressions of econometricians will be of little help. The new approach of "behavioral" economics itself is recognition of the limitations of mathematical approaches, but that new "science" is in its infancy.

A reading of history may be more relevant. Here and elsewhere, the temptation has been strong to wait and see before acting to remove stimulus and then moving toward restraint. Too often, the result is to be too late—to fail to appreciate growing imbalances and inflationary pressures before they are well ingrained.

There is something else beyond the necessary mechanics and timely action that is at stake. The credibility of the Federal Reserve, its commitment to maintain price stability, and its ability to stand up against pressing partisan political pressures is critical. Independence can't just be a slogan. Nor does the language of the Federal Reserve Act itself assure protection, as was demonstrated in the period after World War II. Then, the law and its protections seemed clear, but it was the Treasury that for a long time called the tune.

In the last analysis, independence rests on perceptions of high competence, of unquestioned integrity, of broad experience, of non-conflicted judgment and the will to act. Clear lines of accountability to the Congress and the public will need to be honored.

Moreover, maintenance of independence in a democratic society ultimately depends on something beyond those institutional qualities. The Federal Reserve—any central bank—should not be asked to do too much, to undertake responsibilities that it cannot possibly meet with the appropriately limited powers provided.