Hoover Economic Policy Meeting January 13 2014

Two years after a meeting held by the Economic Policy Group on " A Symposium on the Need for Reform of the Federal Reserve System", another meeting was held to discuss the current issues facing monetary policy and the U.S. economy five years after the end of the "Great Financial Crisis". The discussion covered a number of themes related to the Fed's unconventional monetary policy and its still not clarified exit strategy from QE3.

The first issue considered was the Taylor Rule. John Taylor presented a handout based on a Wall Street Journal article by Justin Lahart on December 20 2013. Taylor made two points. First that the federal funds rate that comes from the basic variant of his rule is 1.3% . This suggests that the current funds rate at close to zero is too low. Second that the Fed's balance sheet under QE3 is heading for the stratosphere , even accounting for tapering, with no end in sight.

The participants discussed whether the assumed equilibrium interest rate in the Taylor rule was too high at 2% with Bob Hall arguing that financial frictions and a reduced propensity to consume have lowered it. There was also discussion about Larry Summer's revived "Stagnation thesis". The consensus was that , like Alvin Hansen 75 years ago, Summer's focus was too short-run and pessimistic. Most agreed with Taylor's concern about the size and trajectory of the Fed's balance sheet under QE3.

A number of people expressed concern about the Fed's exit strategy and how it was planning to unwind its enormous balance sheet. Some proposed raising the interest rate paid on excess reserves and others favored raising reserve requirements.

The second issue discussed was whether significant inflation is on the horizon. Michael Bordo discussed work by Samuel Reynard of the Swiss National Bank which was based on a dynamic monetary model. He presented evidence that the current growth of broad money predicts a run up of U.S. inflation to 3 to 5% in the next 3 to 4 years. Reynard and others find parallels to the path of the current recovery with that of the last great financial crisis and depression 80 years ago . In this regard, Allan Meltzer pointed out that the Fed has always been slow to respond to inflation.

The ensuing discussion mentioned that there was no sign in the financial markets of any hint of inflation(although that was also the case 50 years ago, before the Great Inflation).

Third, George Shultz emphasized that because of ongoing paralysis in Congress and an Administration whose regulatory actions and executive orders has increased policy uncertainty, the Federal Reserve has been transformed from being a limited purpose organization to an all purpose organization with an unofficial mandate to cure all of the nation's economic ills with expansionary monetary policy.

Finally, Allan Meltzer argued that the reasons for this unusually slow recovery are: policy uncertainty, excessive debt and the anti-business stance of the current administration. This he posits has echoes to the second Roosevelt administration in the 1930s. Like Shultz he could not see how monetary policy could solve these problems.

Michael Bordo