What Should Central Bankers do?

There is a constant debate on the scope of the Federal Reserve’s power and debates surrounding their chosen policy framework are often connected. The Federal Reserve may be the most powerful financial institution in the world. They have supervisory power over many of the world’s largest banks and the ability to directly influence the money supply of the largest economy in the world. This influence spreads to markets and economies around the world. The decisions of how to influence the money supply are made by a committee of twelve people. The power given to this committee is enormous. The influence this committee has on the world economy begs the question, what should central bankers do?

This question echoes the writing of James Buchanan. I would like to see how the concepts spoken of by Buchanan and Hayek about knowledge and the economic problem can be applied to the Federal Reserve. Buchanan critiques economists for trying to find the solution to the economic problem of resource allocation. He suggests the idea an economic problem, as if there exists a single solution, should be done away with. The Federal Reserve has been given a problem to solve. They are mandated to maintain stable prices and maximize employment. This has come to be known as the dual mandate of the Fed. Given the existence of the Fed, one would hope there is a solution to this problem. The people who work at the Federal Reserve certainly strive to fulfill this mandate. The Federal Reserve may closely resemble the type of central planning institution critiqued by Hayek in his essay, “The Use of Knowledge in Society”. However, the concepts of these two economists can still be applied to the monetary policy of the Federal Reserve.

The information problem

The Federal Reserve relies on statistical aggregates of data and macroeconomic models to inform their policy decisions. There is an inherent information problem with monetary policy. There is no way 12 people, or 1,200 people can process the information necessary to correctly assess the movements of an economy influenced by the millions of decisions made by everyday people. As Hayek stated, the knowledge of the circumstances of time and place, held and acted upon by every individual in the world, make up an integral part of the how the economy keeps moving. “The continuous flow of goods and services is maintained by constant deliberate adjustments, by new dispositions made every day in the light of circumstances not known the day before, by B stepping in at once when A fails to deliver.” No modeling can account for these types of minute actions that sustain the economy.

There is another information problem on the other side of the equation. Because the Federal Reserve has so much power to influence the economy, there is an extremely high focus on the information that comes from Federal Reserve meetings. Not only are the press releases and minutes from the FOMC examined at the molecular level, every time a member of the FOMC says anything related to rates or markets the world is listening and markets move. This illustrates one of the inefficiencies of a single institution with this much influence on the economy. Financial markets are always starving for information on what the Fed is going to do. Members of the FOMC are reluctant to be candid in what they think because they know anything they say can have a huge impact on financial markets. Despite efforts to make FOMC meetings and expectations for future interest rates more transparent, there is still a lot of ambiguity in how the members of the FOMC decide to change rates and what the economic environment must be in order for them to make an unexpected change. This leads me to a discussion of a few different policy options.

Policy Frameworks

The current policy framework used by the federal reserve is inflation targeting. This policy stems directly from the federal reserve’s mandate to maintain stable prices. An inflation target is set, and the Federal Reserve consequently uses its toolkit to maintain inflation rates in the targeted range. Most central banks in developed countries have a target of around 2% inflation. The main reasoning for using inflation targeting is that, “Most macroeconomists agree that, in the long run, the inflation rate is the only macroeconomic variable that monetary policy can affect. (Bernanke,)” This is the base of the focus on inflation. There are many economists that agree that monetary policy has the most effect on inflation and price stability. The central bank can directly influence the money supply and can therefore directly influence price stability. It is a very easy connection to make. The toolkit of the federal reserve including the fed funds rate, interest on reserves and purchasing of government securities all directly influence the monetary base. The headline federal funds rate is a signal of how the federal reserve views the progression of inflation and other factors such as labor markets and, of course, inflation metrics.

Although inflation targeting provides a public signal of fed policy, it is still somewhat ambiguous how the FOMC arrives at decisions to change or maintain the federal funds rate and adjust other policy tools. In a recent press conference, Chairman Powell was asked what changes in certain metrics would lead the FOMC to change policy. The Chairman stated that they would continue to closely monitor inflation, labor markets and other factors. (look up exact quote). The flexibilty of this policy framework is both good and bad. It gives the Federal Reserve latitude to act in crisis situations but also leads to ambiguity in the decision-making process. The market has methods such as the dot plot and general predictions for what future policy will be. The federal reserve also attempts to paint a picture of plans for future rate changes. However, in the event of sudden changes, it is impossible for market participants to know what the federal reserve will do because there is no set framework for what will influence policy. Sudden changes in policy are very unpredictable.

Another approach is rules based monetary policy. In these types of policy methods, the headline rate or other mechanism for implementation, is pegged to a specific algorithm or metric to determine how monetary policy will change. The advantages are that the policy path is clear, and the only debate is what model to use. The disadvantage is that there is less freedom to implement abnormal policy in extenuating circumstances. Rules provide predictability and clarity in policy but also restrict the actions of the federal reserve in times of crisis.

Nominal GDP targeting is a type of rules-based policy that ties monetary policy to market expectations for nominal GDP. There is a nominal GDP futures market that acts as an information market for expectations of GDP. The Federal Reserve sets the target and is then the counterparty to the trades that happen. When