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RESEARCH SUMMARY

AN INTRODUCTION TO US MONETARY POLICY

Monetary policy is critical for policymakers to understand because their mistakes can cause enormous suffering. On one hand, not creating enough money to satisfy public demand can lead to massive deflation, such as the kind that turned a recession in the early 1930s into the Great Depression. On the other hand, creating more money than the public demands can lead to serious inflation, like the inflation the United States experienced in the 1970s and early 1980s.

In a study for the Mercatus Center at George Mason University, Senior Affiliated Scholar Steven Horwitz examines the history and evolution of the Federal Reserve System (Fed), as well as the tools it uses. The study also considers alternatives to the current discretionary monetary regime and evaluates their potential for providing a stable monetary framework.

To read the entire study and learn more about its author, see "An Introduction to US Monetary Policy."

BACKGROUND

Financial panics in the 1800s gave rise to a narrative that a lack of regulation led banks to engage in behavior that harmed customers and caused recessions. This view is incorrect: it was onerous state regulations that made small, underdiversified banks prone to failure in the face of an economic downturn. Even though this was a misperception, Congress passed the Federal Reserve Act of 1913, which created a "decentralized central bank" consisting of 12 districts and a weak oversight board. Over time, the Fed has evolved to play a critical role in managing the US money supply and acting as a lender of last resort to financial institutions.

The Fed can create money directly by authorizing the Treasury to print Federal Reserve notes, but this is rare. Rather, the Fed has long relied on three conventional tools to direct monetary policy:

- The **reserve ratio**, or the percentage of cash and deposits that the Fed's commercial member banks must keep on hand.

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- The **discount rate**, or the interest rate that the Fed charges member banks that borrow reserves.

- **Open market operations**, or the Fed's buying or selling of government bonds as a way to increase or decrease the quantity of banks' reserves. When banks have more reserves, they can create more loans and expand the money supply. When their reserves decrease, they cannot create as many loans, and the money supply contracts. The Federal Open Market Committee oversees open market operations by buying and selling government bonds to a group of authorized securities dealers.

During the 2008 financial crisis, the Fed exercised powers that it had not used previously. As it injected capital into failing banks, it paid interest on excess reserves in order to offset any resulting inflation. The Fed also began a program of "quantitative easing." Quantitative easing is a form of expansionary open market operation in which the Fed buys financial assets on a significantly larger scale than it does during standard open market operations. As part of its QE strategies between 2008 and 2014, the Fed purchased long-term financial assets rather than short-term government bonds.

MONETARY EQUILIBRIUM AND DISEQUILIBRIUM

Monetary equilibrium occurs when the quantity of money equals what the public demands at the current price level. Monetary disequilibrium, therefore, occurs in when there is too little money (deflation) or too much money (inflation). Since a central planner cannot have all the knowledge necessary to know exactly how much money the public demands, a central bank must take its best guess. When it guesses incorrectly, monetary disequilibrium results.

- *Deflation*. When a central bank produces an insufficient supply of money, much of the population will have insufficient money to acquire the goods and services they desire, and economic activity will contract. Producers will have to cut prices and wages to a level where consumers are willing to spend again. The problem will eventually work itself out, but not without economic pain, including, potentially, high unemployment. This was essentially what happened during the Great Depression when the Fed failed to prevent a collapse in the money supply.

- *Inflation*. When too much money is produced, people will have cash balances greater than they desire, which they will then spend, causing prices to rise. Savers, who have funds in accounts not paying market rates of interest, will be harmed. Because inflation measures are based on the prior year's price increase, those living on fixed incomes will not see adjustments in their benefits until after prices have risen.

Inflation leads to the misallocation of resources. This misallocation becomes especially problematic when it creates new capital goods that otherwise would not have been created. When it becomes clear that there was no true demand for such goods, the boom for goods results in a bust, and the reallocation of resources that follows can be costly. One example of this process is the recent housing boom and bust.

ALTERNATIVES TO CENTRAL BANK DISCRETION

Despite the Federal Reserve Act's aim to achieve financial stability, the worst instances of inflation, deflation, and bank failures in US history have all occurred since the Fed's creation.

Given the Fed's failures, it is worth considering four alternative rules the Fed could follow in place of its current practice of discretionary policy:

- *Make money redeemable in a commodity such as gold.* A commodity standard constrains a central bank's ability to expand the money supply and create inflation. People could redeem notes in gold if the Fed inflated the currency. Historically, however, central banks have reneged on the promise to allow redemption during times of crisis such as war and depression, when governments could not raise funds except through inflation.

- *Impose a price-level or inflation-rate target.* The Fed has a dual mandate to target both inflation and unemployment. Given the strong arguments that unemployment is not affected by monetary policy except in the short run and that expansionary policy will create inflation, a popular alternative to current policy is to require the Fed to focus only on stabilizing inflation, or the price level. A limitation of this policy is that it could prevent prices from falling owing to desirable increases in productivity.

- *Close the central bank and allow private banks to issue their own currencies.* This option would allow individual banks to produce currency in a competitive process of "free banking." Banks would have an incentive to supply notes as needed to meet customers' demand for money. However, it is unlikely political actors would support a system that removes power from their hands and constrains their ability to deficit-spend.

- *Impose nominal GDP (NGDP) targeting.* The Fed could target either the absolute level or the growth rate of NGDP, which is the total volume of spending, unadjusted for inflation. NGDP targeting is superior to price-level targeting because it takes into account changes in real growth. It is also probably more politically feasible than free banking, but it is unclear whether the monetary authority could successfully implement this policy and resist the temptation to deviate from the target for political reasons.

CONCLUSION

History shows that a failure to understand monetary policy can lead to immense economic pain and suffering. The United States cannot afford to continue the mistakes that have led to the deflation of the Great Depression, the inflation of the 1970s and 1980s, and the recent housing boom and bust. Policymakers must consider which available policy alternatives best promote a sound currency and sustainable economic growth.