Policy Debates at the FOMC: 1993-2002

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Introduction

- FOMC considers diverse points of view and absorbs new thinking over time
- Range perspectives is great strength of FOMC
- Committee discussions substantive and robust
- Case study of how—J. Alfred Broaddus, President of the Federal Reserve Bank of Richmond from 1993 to 2004—brought the Richmond Fed's perspective to the FOMC
- Account based on statements, presentations, debate preserved FOMC Transcripts

Introduction

- The Richmond Fed's perspective on the issues considered here illustrates a common principle:
- Fed (and other central bank) policies only have lasting effectiveness if the policies are credible to the public, i.e., the public is confident that the Fed's actions are free of political influence or manipulation and seek consistently to advance attainment of the Fed's central mandates--price stability and sustainable economic growth.

Transparency and Communication

- February 1994—FOMC historic decision to announce federal funds rate target without delay—took responsibility fully and publicly for short term interest rates

- Academics helped to prepare the way:

Goodfriend (1986)--Secrecy and Central Banking
Goodfriend (1991)--Interest Rates and Mon Pol
Taylor (1993)--Taylor Interest Rate Rule

Transparency and Communication

- Volcker and Greenspan Fed prepared the way:

Put in place strategy based on maintaining price stability within which Fed could talk productively and systematically about interest rate policy

Days of go-stop policy over—when interest rates lowered to stimulate employment and raised only when unemployment had to rise to stabilize inflation

Transparency and Communication

- Congressional Fed oversight prepared the way:

Late 1992, Henry Gonzales, House Banking Chair, began push for Fed transparency

---Fed discontinued MOD in 1976

---September 1993, Gonzales invited FOMC to testify —invitation asked about notes or records made at meetings

---Existence of nearly complete set of verbatim written transcripts of past FOMC meetings made public in Greenspan testimony

---Fed appeared in unfavorable light

Transparency and Communication

- February 1994, Greenspan asked that interest rate policy actions be made fully transparent as the Fed initiated preemptive interest rate policy against inflation
- Dramatic moment for those aware of longstanding reluctance of Fed to be clear about its interest rate policy actions, and for those who thought more Fed openness was necessary and beneficial

Transparency and Communication

- Greenspan presented his proposal as exceptional
- But there would be no turning back
- On February 2, 1995 the FOMC announced its intention to restart publication of its deliberative process as lightly edited transcripts of FOMC meetings released with a 5-year lag
- Equilibrium sustained without explicit Congressional agreement

Preemptive Policy in 1994

- February 1994, FOMC initiated interest rate actions to preempt rising inflation without a prior increase in inflation– for only second time in post-war FOMC history
- Volcker 1983-4 interest action held inflation at 4% without increasing unemployment
- Greenspan Fed allowed inflation to rise to 6% in late 1980s (FX agree, new leadership, ’87 crash)
- Modern monetary theory says real short interest rates must be allowed to fluctuate over the cycle to keep inflation well anchored

Preemptive Policy in 1994

- Magnitude, timing, communicating preemptive interest rate policy actions challenging in new transparent policy environment
- Greenspan concerned about market reaction asks 25 basis point initial action, subsequent caution
- Long bond rates moved up from 5.8% in Oct 1993 to peak at 8.2% early Nov 1994—"inflation scare"
- Short rates increased from 3% to 6%--without increase in unemployment

Preemptive Policy in 1994

- Broaddus, interested in acquiring credibility for low inflation, dissented for tighter policy in September 1994, Fed caught up with 75 bp action in Nov 1994
- Inflation expectations anchored, recovery extended
- Fed acquired credibility for low inflation---result of demonstrated commitment to achieve price stability after 1990-1 recession, in face of "jobless recovery," then acting preemptively against inflation, in the open against political and market skepticism
- Greenspan noted changes in the nature of the business cycle consistent with the acquisition of credibility for low inflation by the Fed; but didn't speak of credibility

Lending to Mexico: 1994-5

- March 1994, FOMC considered request by Mexico for a permanent increase in swap lines with the Fed and US Treasury
- Linked to recent passage of NAFTA and planned shift in Mexico to independent CB
- Decided to increase combined swap line to $3 billion each
- Request triggered lively debate in the FOMC

Lending to Mexico: 1994-5

- Broaddus framed the debate:

1951 Fed-Treasury Accord established that Fed must be independent within government to conduct *monetary policy* effectively

Independence under scrutiny by Congress

Fed must not take action that might abuse it

Mexican Swap line established in 1967 to support then fixed exchange rate

Fed agrees swap line no longer to be used to fix FX rate

Broaddus--any loan to Mexico in current circumstances would be a fiscal action of the US government

Fiscal actions—expenditures of the government—are supposed to be authorized by Congress

Fed should not be involved without explicit congressional authorization

Lending to Mexico: 1994-5

- Bill McDonough, President of the NY Fed, replied that the Fed should seek monetary stability beyond the American economy because of inter-linkages in world markets
- Greenspan acknowledged question is profound---whether the independent central bank should get involved in issues which are in many respects at the Treasury's lead

Lending to Mexico: 1994-5

- December 1994, the peso collapsed against the dollar
- January 1995, Congress refused to authorize $40 billion package of fiscal support for Mexico
- Administration asked Fed to participate in program with the Treasury's Exchange Stabilization Fund to provide financial support for Mexico
- Fed asked to raise from $3 to $20 billion willingness to "warehouse" German marks and Japanese yen for the ESF, and to show its support by increasing its swap line from the $4.5 billion voted in December to $6 billion in return for a "take out" by the ESF

Lending to Mexico: 1994-5

- Request precipitated spirited debate at the January 1995 FOMC meeting
- Tom Melzer, President of the St. Louis Fed, asked what ability do the Treasury or the ESF have to take the Fed out of an obligation if the funds are not appropriated by Congress?
- The program involved a take out by the ESF [ESF independent funding power for a take out]
- When the debate resumed the following day, Greenspan assured the Committee of the take out—that the Fed would not incur credit risk or market risk

Lending to Mexico: 1994-5

- Melzer concerned that Fed could be accused of subverting the will of the public…
- Greenspan responded that Republicans in Congress would support the Administration only if the Fed did so; he thought it irresponsible for Fed not to facilitate financial support for Mexico
- Broaddus saw the whole package as a fiscal action and not a monetary policy action saying "Congress did not have the will to take what I think we all agree was the appropriate action, so we are being left holding the bag. I guess I just see it as a raid on our independence, and I regret it."
- In the end, the ESF never warehoused FX with the Fed during the Mexican crisis; Mexico drew around $1.5 billion on its swap and repaid it by January 1996

Foreign Exchange Operations

- Fed recognizes Treasury's preeminence in FX operations and works closely with the Treasury in conducting interventions
- The Fed intervened in FX markets at the Treasury's request on a number of occasions during Broaddus's service as Rich Fed Pres
- The interventions precipitated lively debates
- The story is one of steadily diminished enthusiasm for FX intervention in the FOMC

Foreign Exchange Operations

- In mid-June 1994, the dollar declined precipitously; FX markets wondered whether the Fed could preempt rising inflation without a recession, and economic prospects improved in Germany and Japan
- At the Treasury's request the Fed and 16 central banks intervened on June 24th in a high profile effort to support the dollar
- The FX operation was widely reported in the world press as a failure

Foreign Exchange Operations

- Broaddus complained the Fed's involvement in such a conspicuously unsuccessful operation bound to raise questions in the public's mind about the Fed's effectiveness as an institution …urged that the Fed not get involved in FX ops unless there is general agreement in the Committee in a particular instance that it will back up the intervention with whatever monetary policy actions are necessary

Foreign Exchange Operations

- Greenspan replied that depends on whether markets are wholly efficient and do not run periodically into some significant abnormalities that an intervention could rebalance. He observed that the Fed had fended off recommended interventions which it thought were superfluous and potentially counterproductive. He thought that Fed withdrawal from FX ops would damage the Fed if it was perceived to be at loggerheads with the Treasury. However, he agreed with Broaddus's underlying philosophy on FX ops.

Foreign Exchange Operations

- November 1994, Broaddus dissented against renewing existing swap lines

"Because sterilized intervention cannot have sustained effects in the absence of conforming monetary policy actions, Fed participation in FX markets risks one of two undesirable outcomes. First, the independence of monetary policy is jeopardized if the System adjusts its policy actions to support short-term FX objectives set by the Treasury. Alternatively, the credibility of monetary policy is damaged if the System does not follow interventions with compatible policy actions, the interventions consequently fail to achieve their objectives, and the System is associated in the mind of the public with failed operations."

Foreign Exchange Operations

- The next major Fed FX intervention with the Treasury occurred on June 17, 1998 to strengthen the yen against the dollar after yen/dollar reached 146
- Broaddus disapproved saying …to prevent further yen depreciation…either the BOJ must pursue a tighter monetary policy or the Fed must pursue a more accommodative monetary policy or some combination of the two. The former risks an even deeper recession in Japan. The latter risks creating stronger inflationary pressure in the US economy at a time when rising inflation is already a risk. Indeed, a case could be made that we really need just the opposite, a more expansionary monetary policy in Japan and a less expansionary one in the US

Foreign Exchange Operations

- Greenspan responded…

…There was great reluctance at Treasury to intervene …and people now understood that Japan's effort to stabilize the yen in April [1998] demonstrated that [sterilized] intervention per se does not work.

…the only reason joint intervention in June 1998 worked was because it was perceived as a signal that either the Fed was going to ease or the Japanese were going to tighten monetary policy. Clearly, neither policy option was on the table.

- Nevertheless, Japan's reluctance to allow the yen to depreciate above 146 may have deprived QE actions of their credibility against deflation.

Foreign Exchange Operations

- The Fed decided to eliminate all of its standing swap lines when the euro came into existence in December 1999, except for lines with its NAFTA partners, Canada and Mexico
- Sterilized FX intervention had come to be seen as ineffective at best and counterproductive at worst given the paramount importance of domestic price stability as a priority of monetary policy
- Nevertheless, the Fed intervened again with Treasury on Sept 22, 2000 in conjunction with the G-7 monetary authorities to weaken the dollar against the euro, then trading below 90 cents/euro

Foreign Exchange Operations

- William Poole, President of the St. Louis Fed, expressed his disapproval of that intervention at the October meeting
- Greenspan responded "Between June of 1998 and today—or I should say last week—we probably had 20 or so different requests, at various levels, for intervention. We turned them all down. And indeed, in this latest case we were not happy with the notion of intervening. What occurred essentially was that the Treasury, feeling under very considerable pressure form the rest of the G-7, concluded that in the spirit of international comity we had very little choice but to accommodate the Europeans…"
- Greenspan acknowledged that the Federal Reserve had the choice of not participating, but he argued that a schism between the Fed and the Treasury should be avoided.

Inflation Targeting Debate

- January 1995, Greenspan asked FOMC to debate inflation targeting
- Broaddus presented “pro” and Governor Yellen presented “con”
- Broaddus—Committee should commit to long run price stability defined qualitatively such that expected inflation does not play a significant role in economic decision-making—definition of Volcker and Greenspan

Inflation Targeting Debate

- Broaddus—Justify short-term actions designed to stabilize output and employment against commitment to protect purchasing power of currency
- Yellen—Strongly opposed the adoption of formal multi-year inflation targets in which inflation rate should be the sole objective of policy with no weight given to stabilizing real variables (stronger proposal than Broaddus's)

Inflation Targeting Debate

- Yellen—Goals of price stability and output stability are often in harmony, but when the goals conflict and it comes to calling for tough trade-offs, to me, a wise and humane policy is occasionally to let inflation rise even when inflation is running above target.
- Yellen—A key argument in favor of inflation targeting—Al made this point—is that it would raise the FOMC's credibility and lower the sacrifice ratio…in my view that not achievable.

Inflation Targeting Debate

- Greenspan summed up the debate that day saying "now we understand why this Committee has had difficulty confronting this issue. It is because we are as split down the middle as we could possible get."
- The Committee resumed the IT debate at its July 2-3, 1996 meeting
- Broaddus and Yellen found common ground—to hold the line on current CPI inflation at 3%

Inflation Targeting Debate

- Cathy Minehan, President of the Boston Fed, suggested “hold the line where we are”
- The Fed had long favored the PCE over the CPI
- Governor Meyer asked about current PCE inflation,Greenspan answered it is 2%
- Meyer replied “we are there…maybe 2% inflation as measured by the PCE is where you want to be”

Inflation Targeting Debate

- Dramatic moment for those in room that favored an explicit long run inflation objective
- Committee had reached a working consensus for holding the line on inflation (CPI or PCE)
- But the discussion dissolved again into a debate about how low the Committee would ultimately want to go, and the meeting adjourned without any acknowledgement of the consensus that had been reached

Inflation Targeting Debate

- February 2-4, 1998, Broaddus pointed out that with CPI at 2% with an upward bias of around 1% Fed had reached effective price stability
- Public aware of and concerned with deflation
- The Fed should address deflation concerns as well as inflation concerns
- Fed should state explicit lower bound on CPI inflation, that calls for an upper bound, too

Inflation Targeting Debate

- Meyer added— "It is not just our ability to communicate to the public it is our own internal deliberations that are at stake here…The vague definition of price stability was adequate when inflation was 10%...but now I think there is a real question…There is an issue here."
- In effect, this revived the issue of Fed secrecy, not about deliberations, or actions, but about long run objectives

Asset Acquisition Policy

- January 2001, FOMC considered a variety of options for what assets it should acquire to implement monetary policy in place of Treasuries, should large federal budget surplus lead to a substantial paying down of govt debt
- Broaddus proposed that the Fed should ask for cooperation from the fiscal authorities so that the Fed could continue to pursue a "Treasuries only" asset acquisition policy

Asset Acquisition Policy

- Broaddus argued that “Treasuries only” has the virtue that neither the Fed nor the government as a whole has to acquire any private assets to conduct monetary policy
- Broaddus pointed out that all the alternatives involve the Fed in decisions about allocating credit in the economy
- Broaddus proposed that the Fed ask the fiscal authorities to continue indefinitely to issue debt for the Fed to buy

Asset Acquisition Policy

- Broaddus's defense of "Treasuries only" drew a clarifying question from Greenspan: What does a Treasury in surplus do with the Fed's payments for its debt?
- The answer arrived at in a spirited discussion is that if one of our goals is to minimize private assets acquired by the govt, then the govt should use net transfers from selling debt to the Fed to cut taxes or raise spending.

Monetary Policy at the Zero Bound

- January 2002, Greenspan asked for FOMC briefing on policy near the zero interest bound
- D. Reifschnieder, J. Williams, M. Goodfriend gave briefing
- I outlined how monetary policy—expanding bank reserves via the acquisition of Treasury securities—could stimulate economic activity at the zero interest bound

Monetary Policy at the Zero Bound

- Narrow liquidity satiated at the zero bound
- T-bills and bank reserves close substitutes
- But, broad liquidity services not exhausted
- Liquid financial assets earn near zero money return but evidently substantial "liquidity services yield"
- US public holds roughly $15 trillion in short-term liquid financial securities (deposits, T-bills, MMMFs, CP,…)

Monetary Policy at the Zero Bound

- Open market purchases of T-bills have little effect on broad liquidity at zero interest bound
- Must purchase longer term Treasuries with reserves to increase net broad liquidity
- Mechanics i) reduce marginal broad liquidity yield, induce portfolio rebalancing, raise asset prices, ii) raise net worth, facilitate credit flows, iii) lower interest on long term private debt, pay off bank loans, shift loans to others

Monetary Policy at the Zero Bound

- Two implementation problems hard to overcome—i) public must be confident that reserves will be expanded by as much and for as long as needed, the monetary authority must be prepared to overshoot by a wide margin the monetary policy actions needed ii) quantitative aggressiveness of monetary policy actions must be judged against the $15 trillion of broadly liquid financial assets

Monetary Policy at the Zero Bound

- Federal Reserve needs more fiscal support for monetary policy than usually granted by the fiscal authorities
- Fed exposed to capital losses on its long term Treasuries [No interest on reserves until 2008]
- Fiscal authorities should agree to recapitalize CB against capital losses to guarantee CB has resources to withdraw reserves from the economy against inflation

Monetary Policy at the Zero Bound

- Presentation stimulated following comments:

i) Concern about discontinuity and limited quantitative guidance for reserve creation

ii) What Japan's monetary policy at the zero bound taught (banking, FX, interest rate risk, support of fiscal authorities)

iii) Mechanism more likely works incrementally if all pieces in place, so fully credible

[Int. on Res. modifies details not substance]

Conclusion

- Account of FOMC deliberations makes clear Committee depends heavily on its Chairman:
  - i) Must encourage diversity of views
  - ii) Forge consensus for action from diversity
- In 1994, Chairman Greenspan led decisively to improve transparency and preempt inflation
- Chairman Greenspan encouraged unhurried consideration of problems less pressing—

Conclusion

---Inflation targeting in 1995-6, asset acquisition in 2001, monetary policy at the zero interest bound in 2002

- Chairman Greenspan's ambivalence on relations with the Treasury enriched debates on lending to Mexico, intervening in FX market
- Chairman Greenspan worked to end the Fed's intervention in FX markets
- Chairman Greenspan chose not to expedite the adoption of an inflation target

Conclusion

- Above all, Chairman Greenspan created a culture of equality in the Committee based upon a respect for economic analysis. Economic reasoning is a great equalizer. By encouraging debate in terms of economic reasoning, Chairman Greenspan enabled the Richmond Fed to maximize its contribution to the FOMC.