

# The Need to Return to a Monetary Framework

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Comments prepared for the  
National Association of Business Economics Panel on

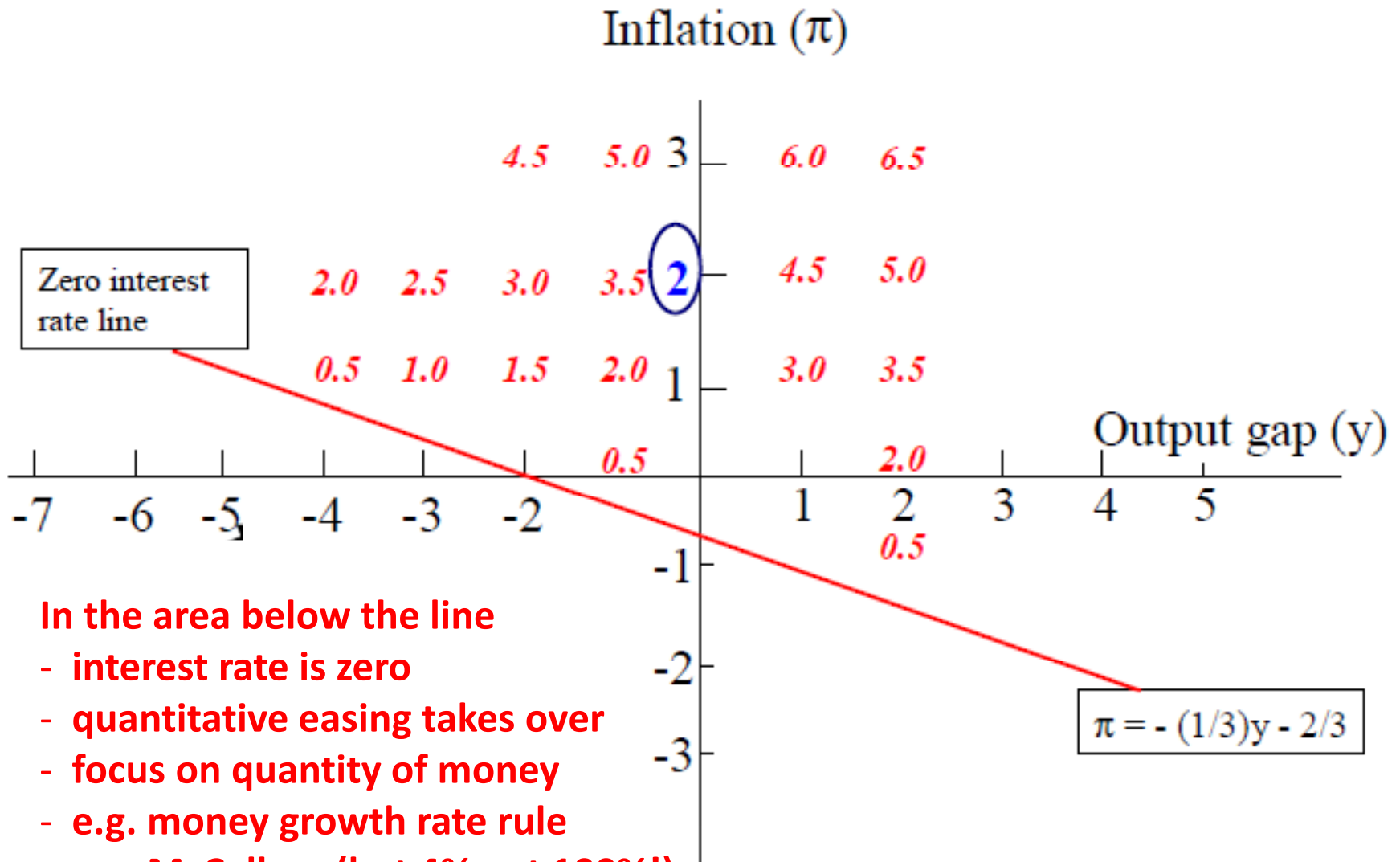
*Long-Run Economic Challenges:  
A Federal Reserve Perspective*

San Francisco  
January 3, 2009

# Why the Need?

- Empirical evidence shows that government actions and interventions caused, prolonged, worsened the crisis.
  - *Caused* it by deviating from historical precedents and principles for setting interest rates--worked well for 20 years.
  - *Prolonged* it by misdiagnosing the problems and responding inappropriately by focusing on liquidity rather than risk.
  - *Worsened* it by providing support for certain financial institutions and their creditors but not others in an *ad hoc* way
  - Details found at [www.JohnBTaylor.com](http://www.JohnBTaylor.com) “The Financial Crisis and Policy Response: An Empirical Analysis of What Went Wrong”
- But now is time to look forward, learn from the past:
  - Need to reinstate or establish a set of principles to prevent misguided actions and interventions .
  - A path back to principles should be part of current clean- up.

# A Conceptual Framework

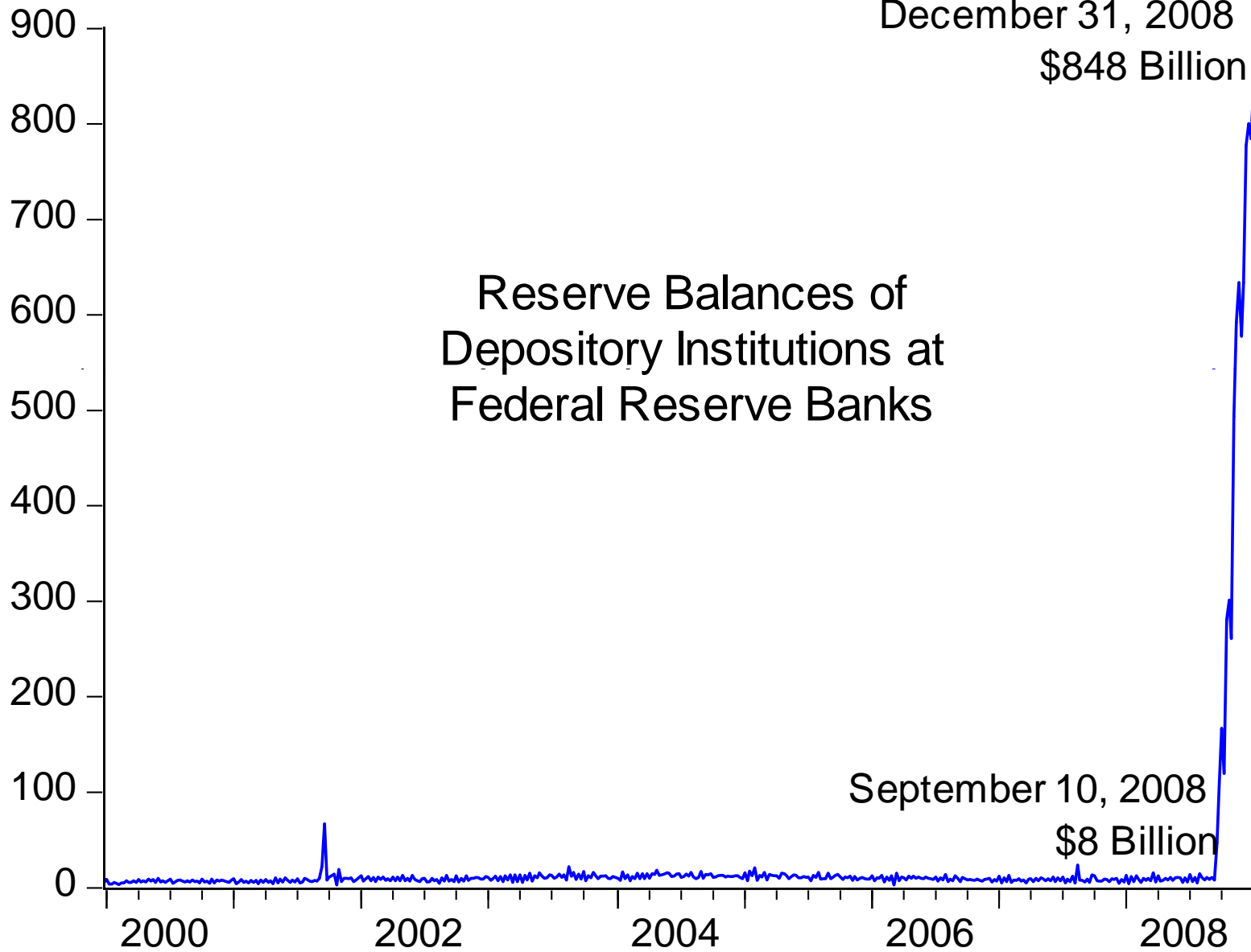


**In the area below the line**

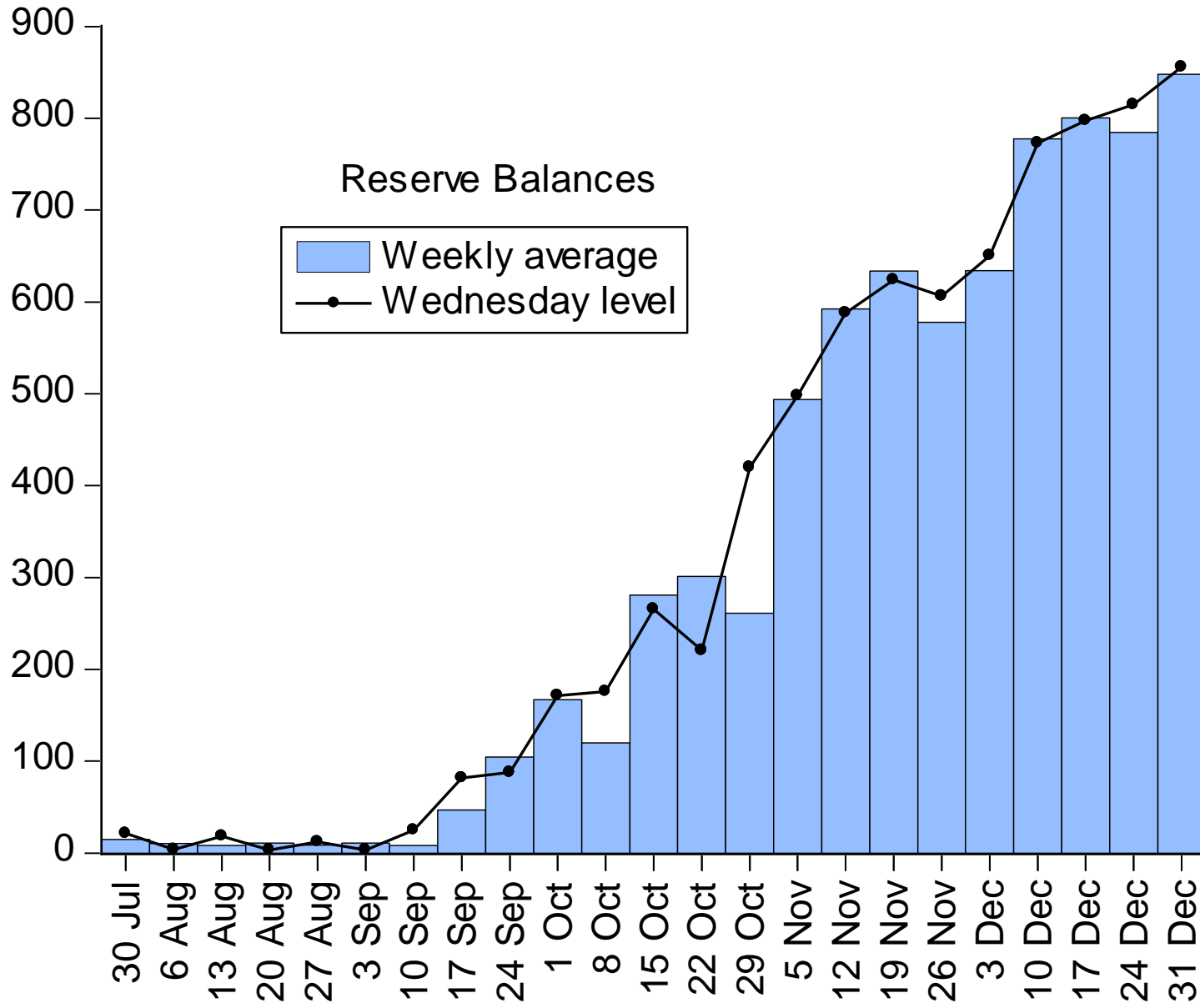
- interest rate is zero
- quantitative easing takes over
- focus on quantity of money
- e.g. money growth rate rule
- e.g. McCallum (but 4% not 100%)

**But take a look at the quantities now...**

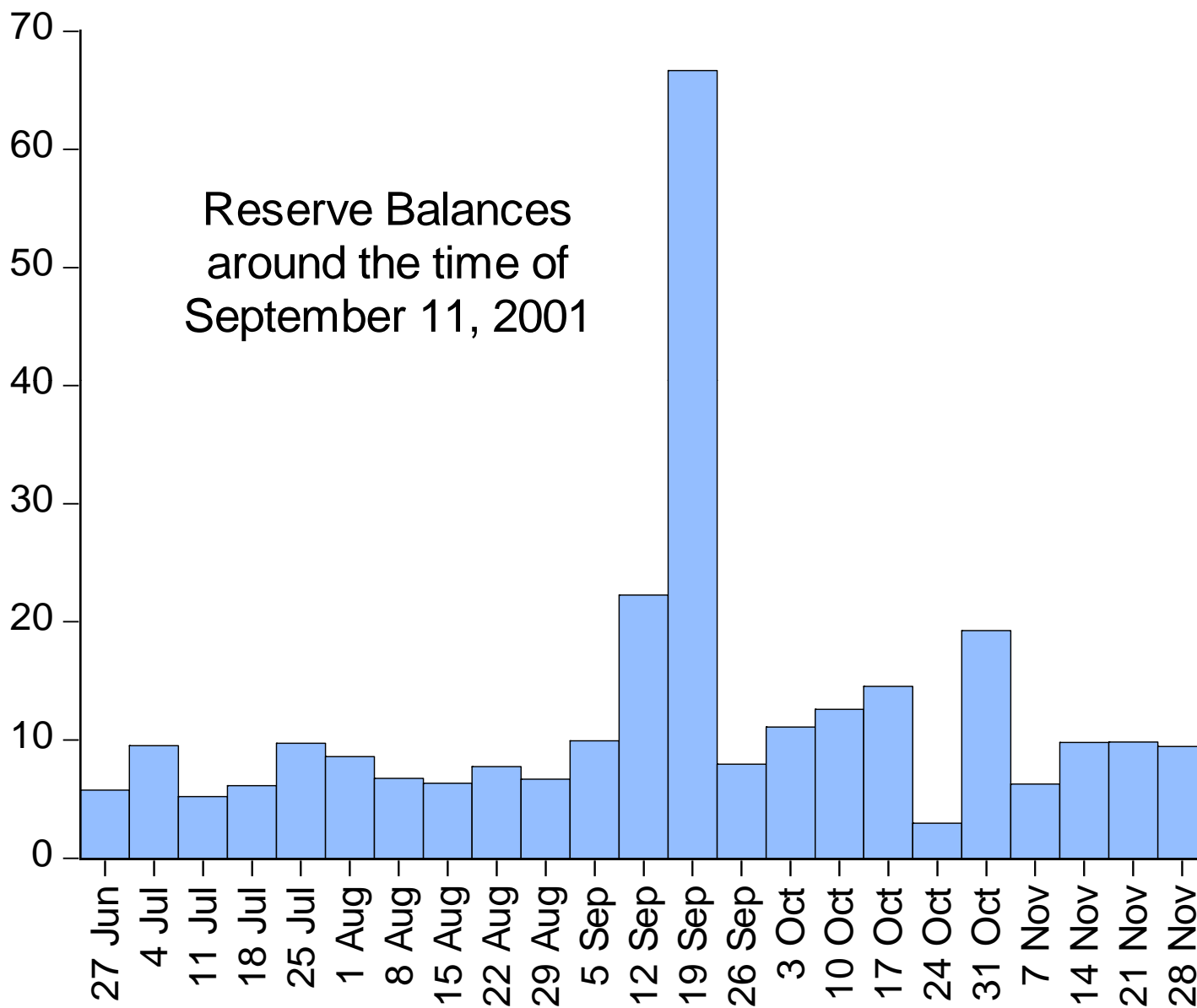
billions of dollars



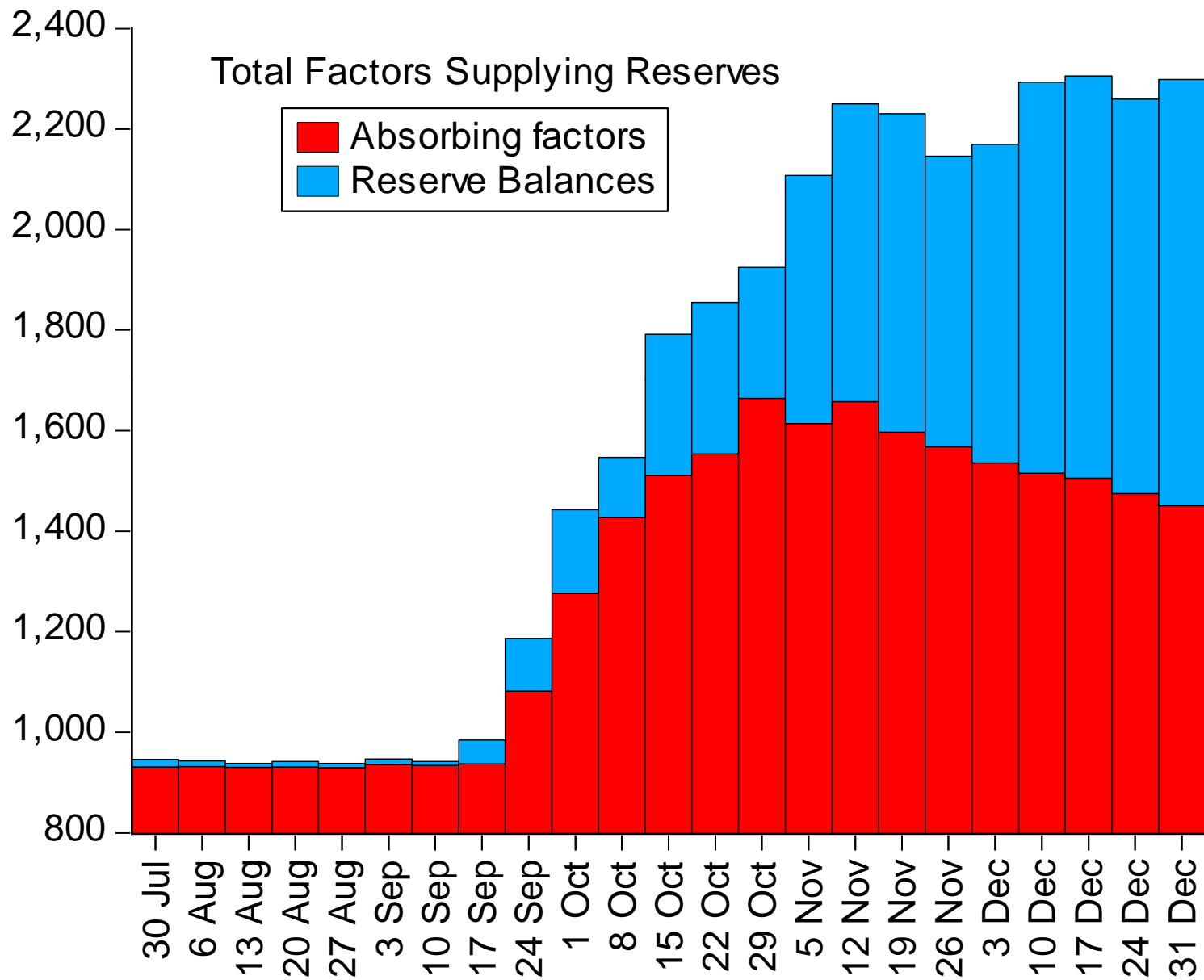
billions of dollars



billions of dollars



billions of dollars



# ***Major Factors Supplying Reserves***

- Securities (Treasury and Agency) held outright
- Repos
- Loans from the TAF
- Other Loans
  - Primary Credit Facility (discount window)
  - Primary Dealer Credit Facility
  - Asset Back Commercial Paper Money Market Mutual Fund Liquidity Facility
  - Loans to AIG
  - Term Asset-Backed Securities Loan Facility (credit card, student, auto)\*
- Private Portfolio holdings
  - Commercial Paper Funding Facility
  - Maiden Lane I (Bear Stearns)
  - Maiden Lane II (AIG)
  - Maiden Lane III (AIG)
  - Money Market Investor Funding Facility\*
  - Mortgage Backed Securities Purchase Program\*
- Other Federal Reserve Assets (**very large loans to foreign central banks**)

Note: Minimal change items are gold stock, SDRs, Treasury currency outstanding, seasonal and secondary discounts, float

# Not Simply Quantitative Easing

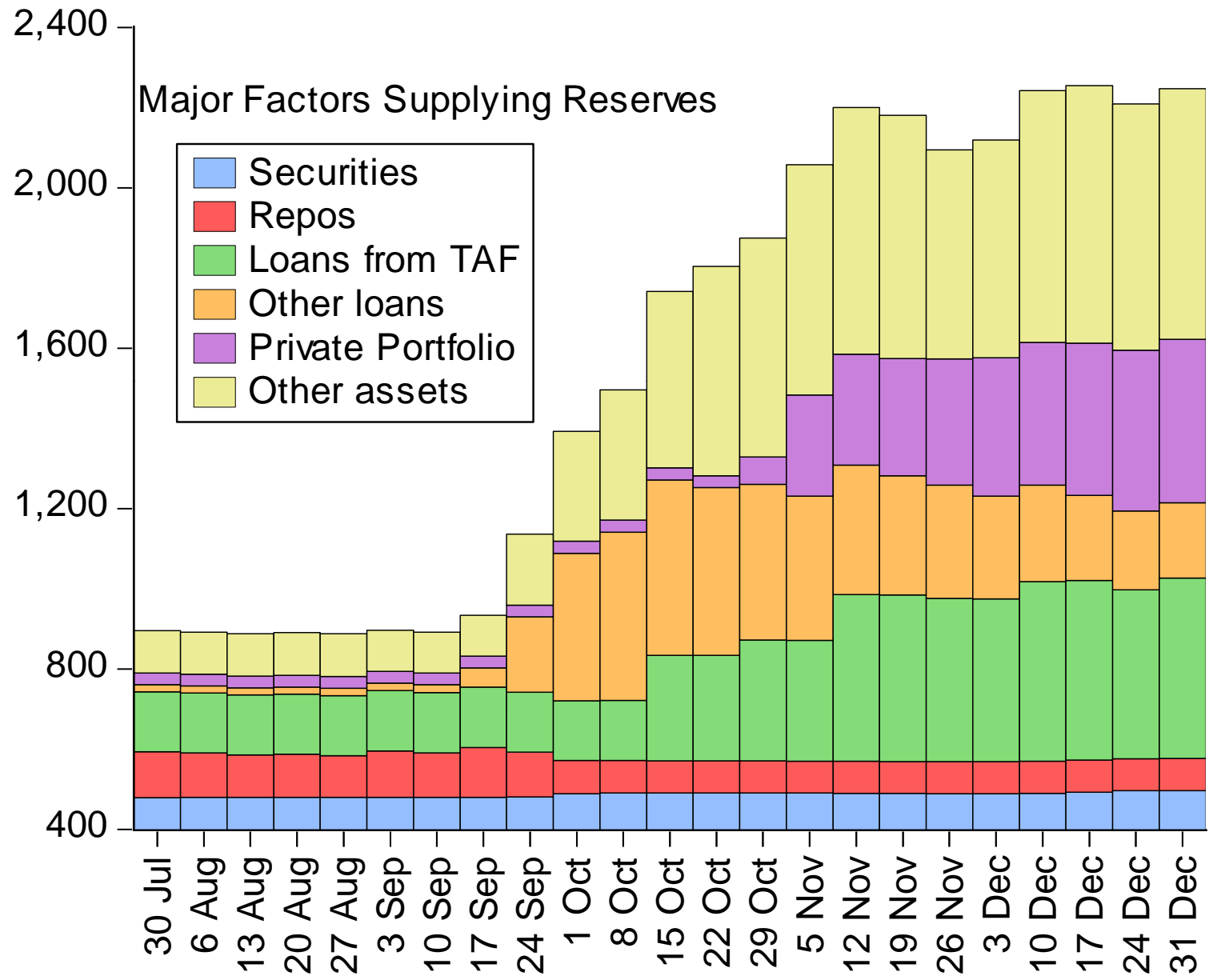
- ***How will purchases under the agency MBS program be financed?***

*Purchases will be financed through the creation of additional bank reserves -- From FAQ ,NY Fed, December 30, 2008.*

- Sounds like Industrial Policy
- Mondustrial Policy?

billions of dollars

### Major Factors Supplying Reserves



billions of dollars

700

600

500

400

300

200

100

0

# Other Federal Reserve Assets

2003

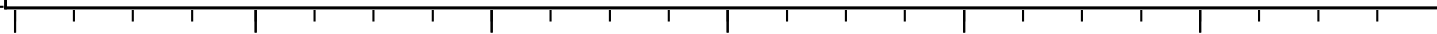
2004

2005

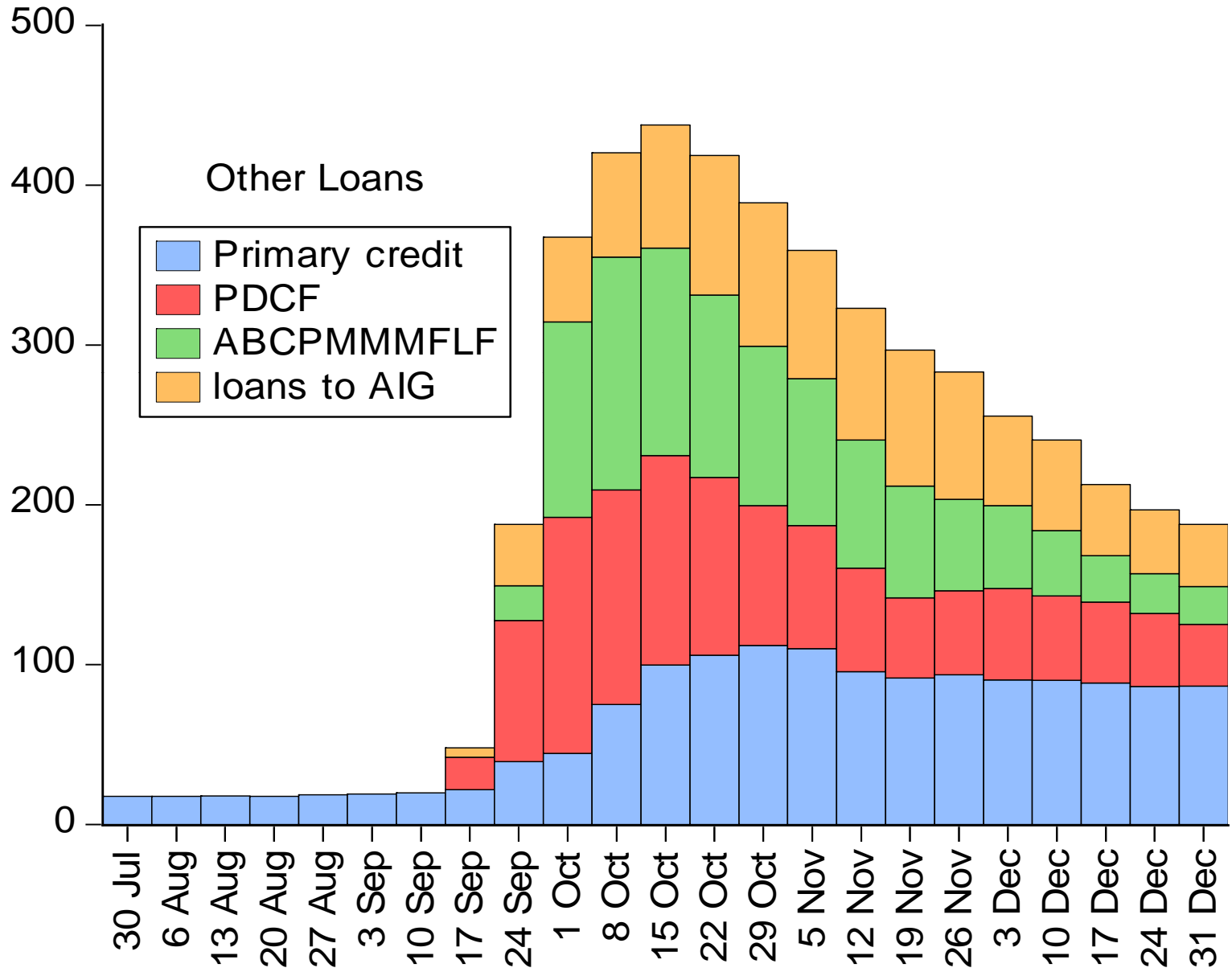
2006

2007

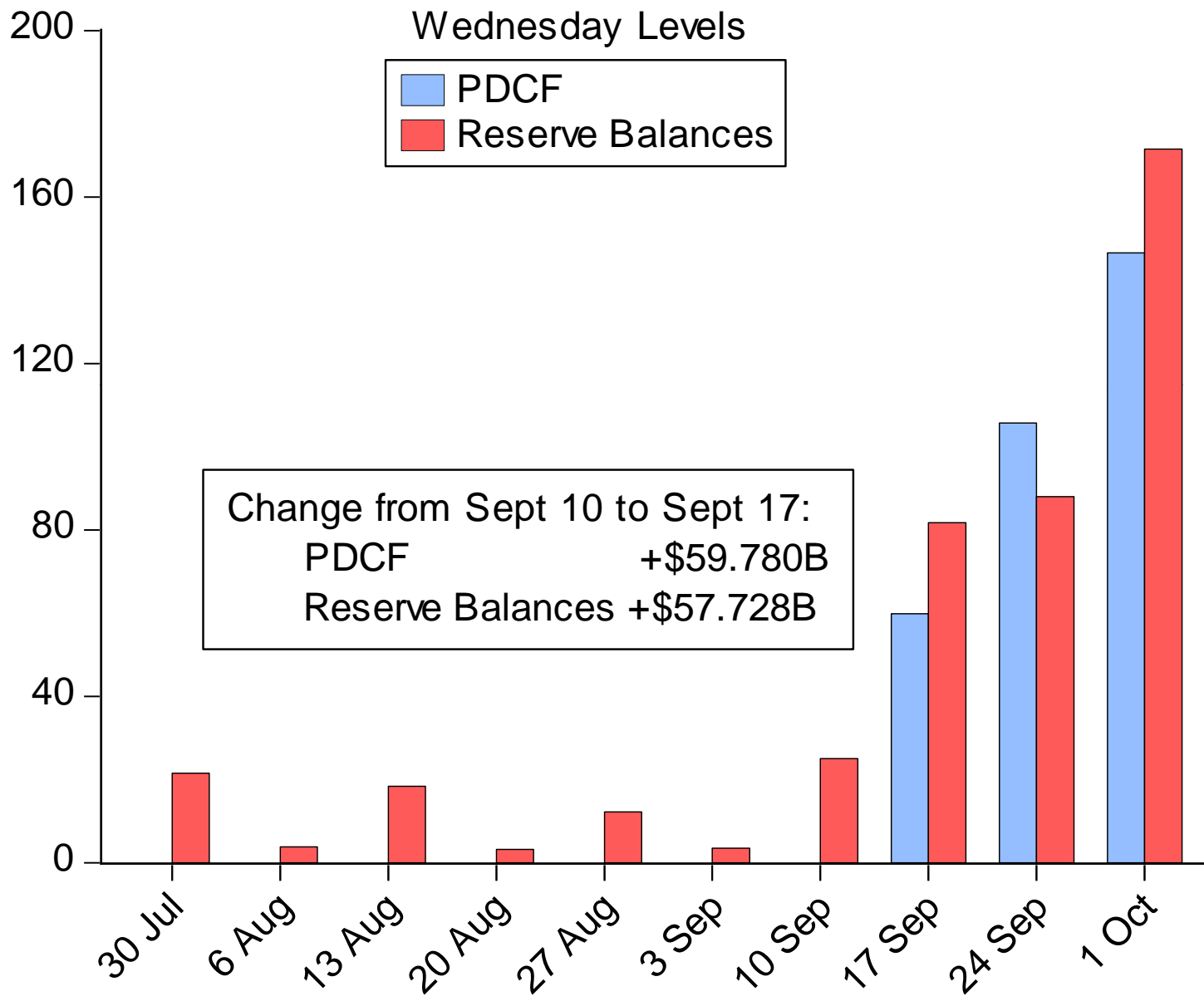
2008



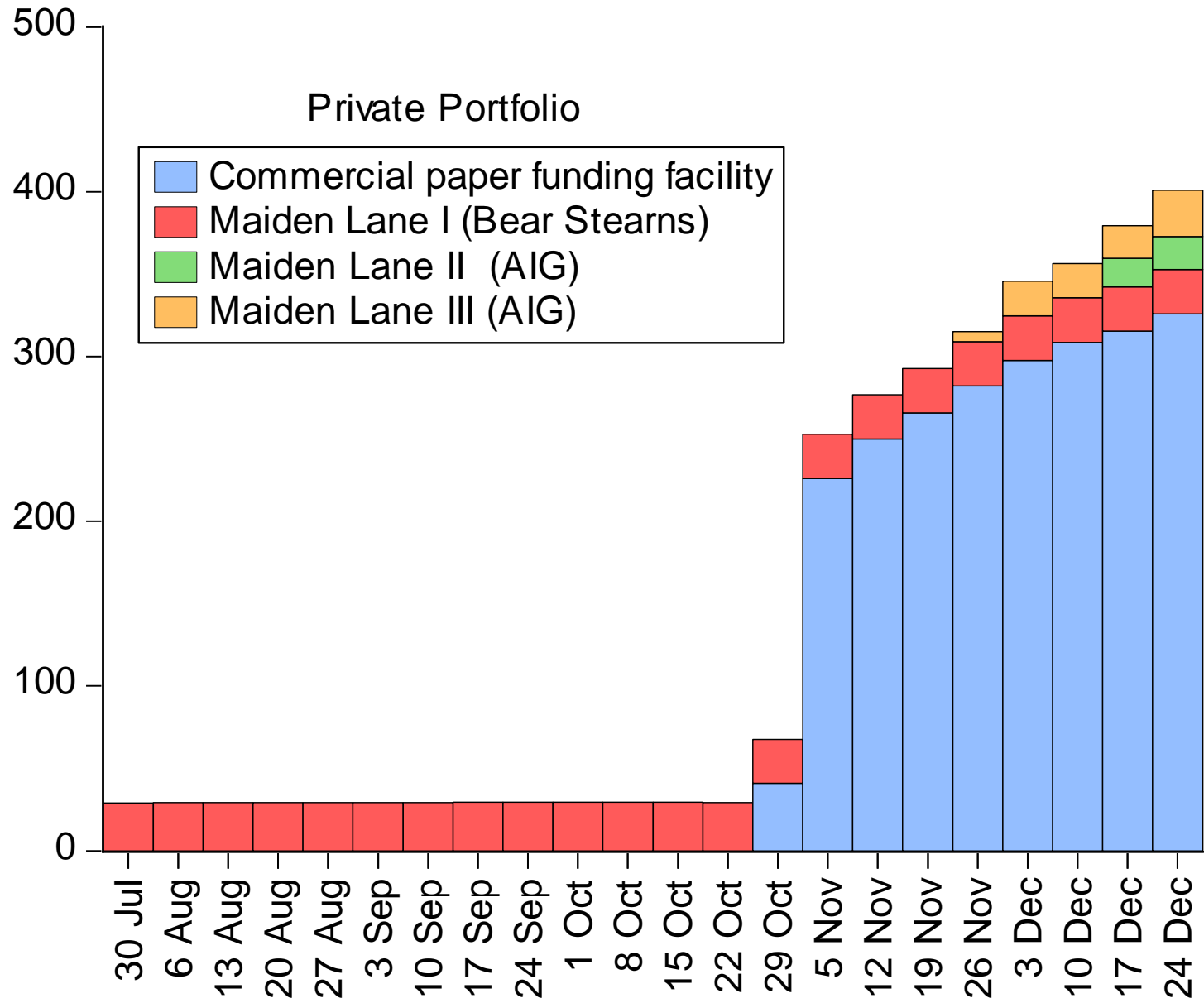
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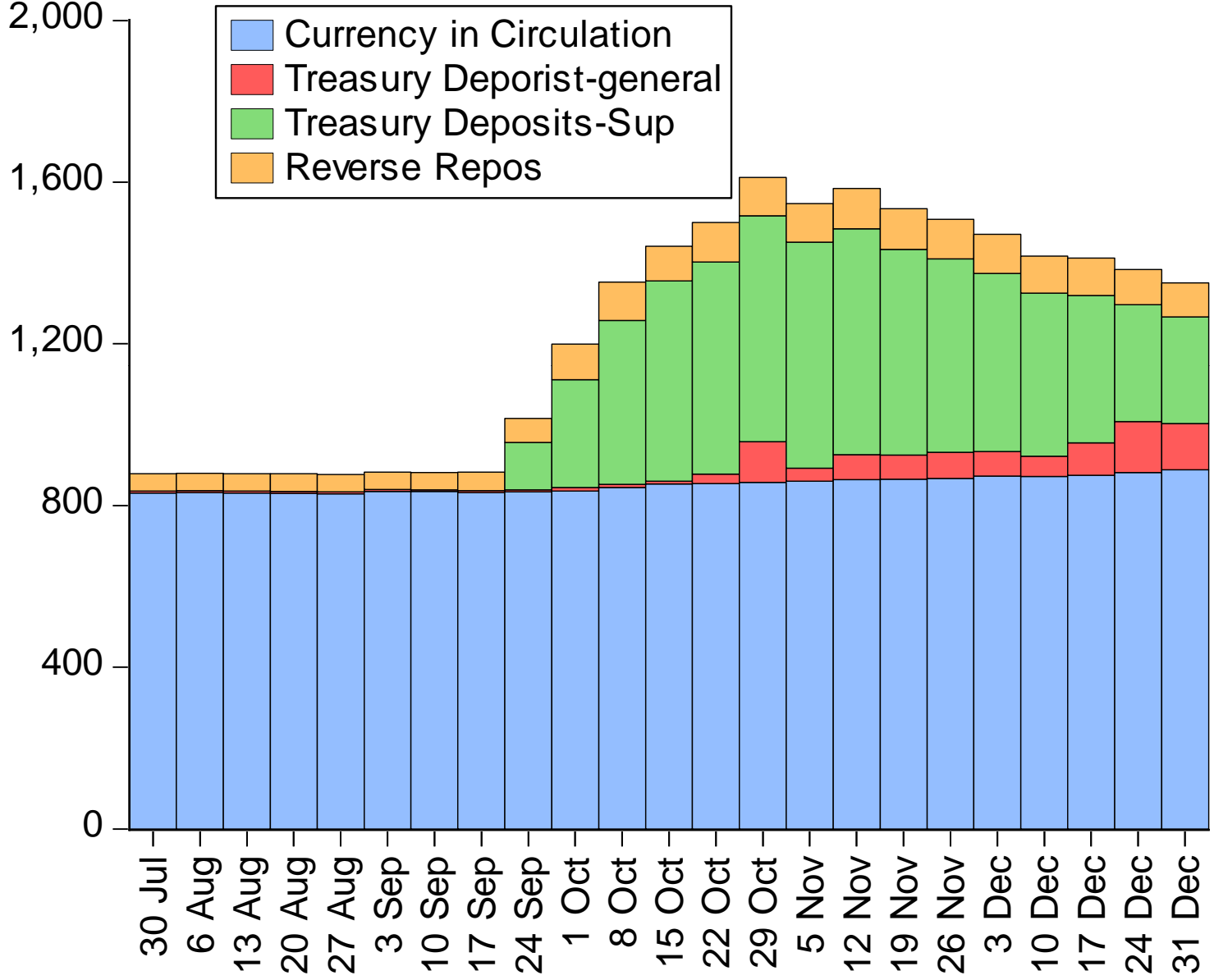


billions of dollars



billions of dollars

### Major factors absorbing reserves

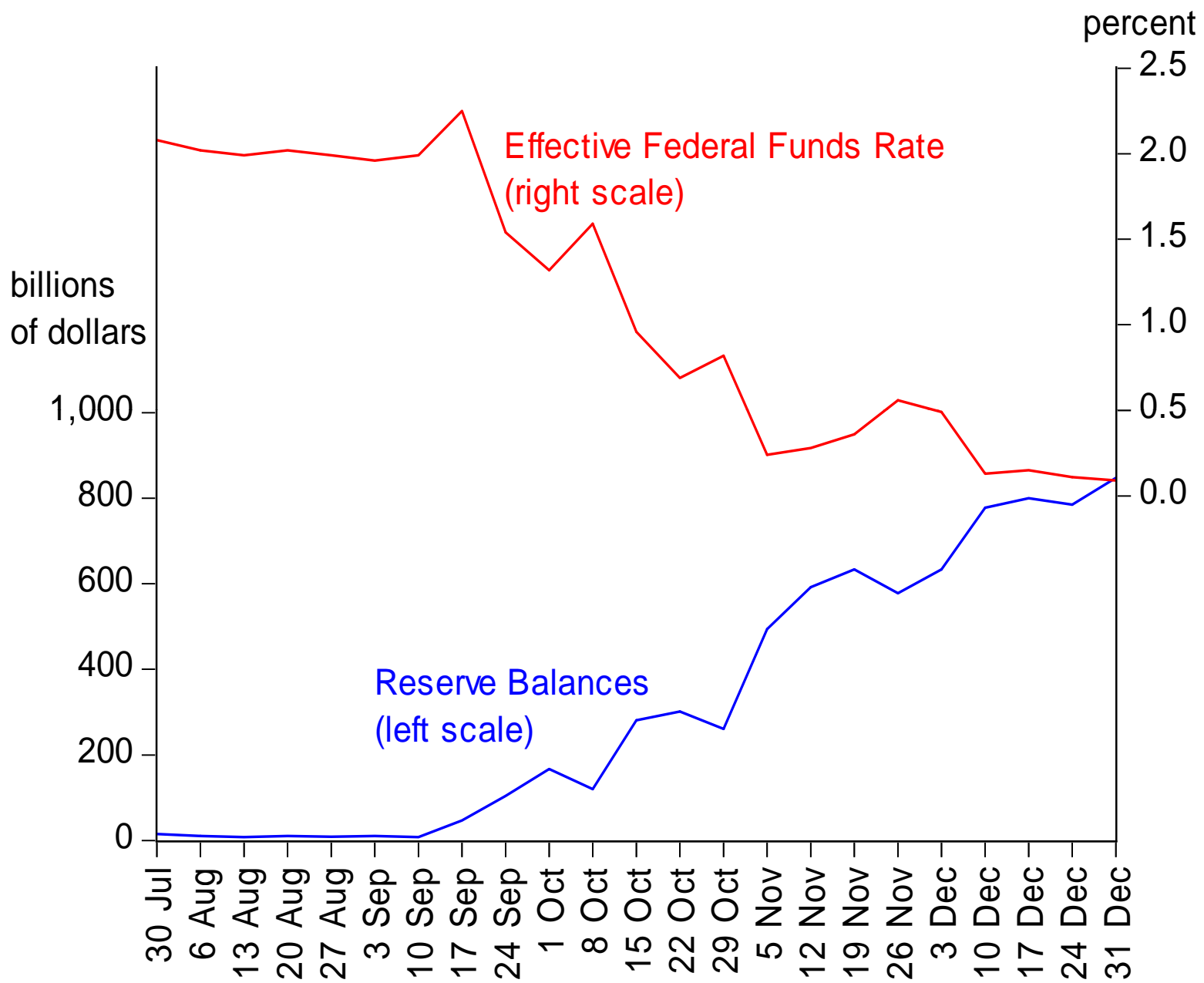


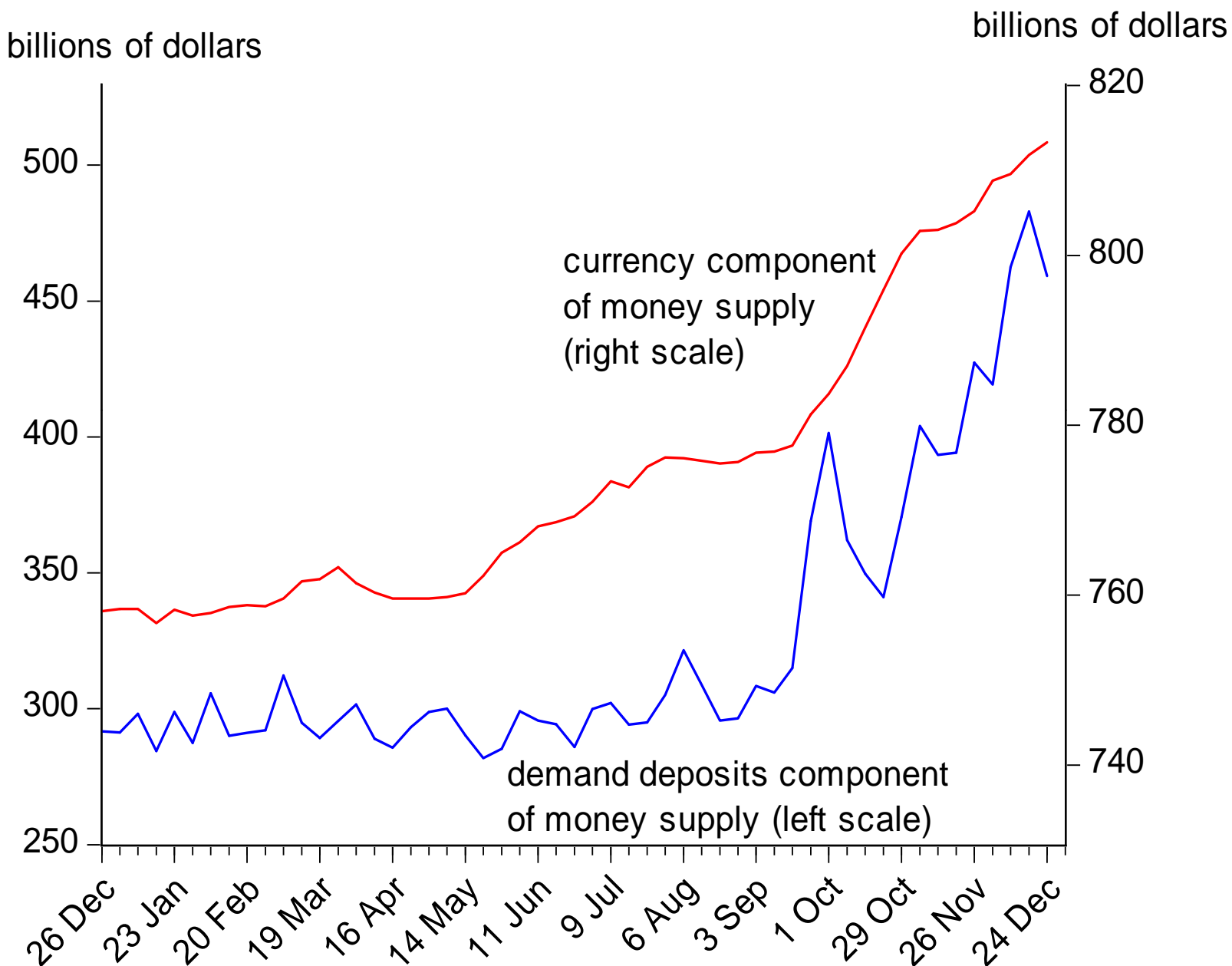
# Role of the Treasury

- Originally Treasury borrowed \$500B and deposited at Fed thereby absorbing reserves
  - Effectively Treasury is borrowing to finance purchases in certain sectors
- Supplemental accounts are being drawn down
  - If MBS program and TALF go to full amounts that will be equal to \$700 B.
- May require more Treasury borrowing or Fed borrowing itself to finance.

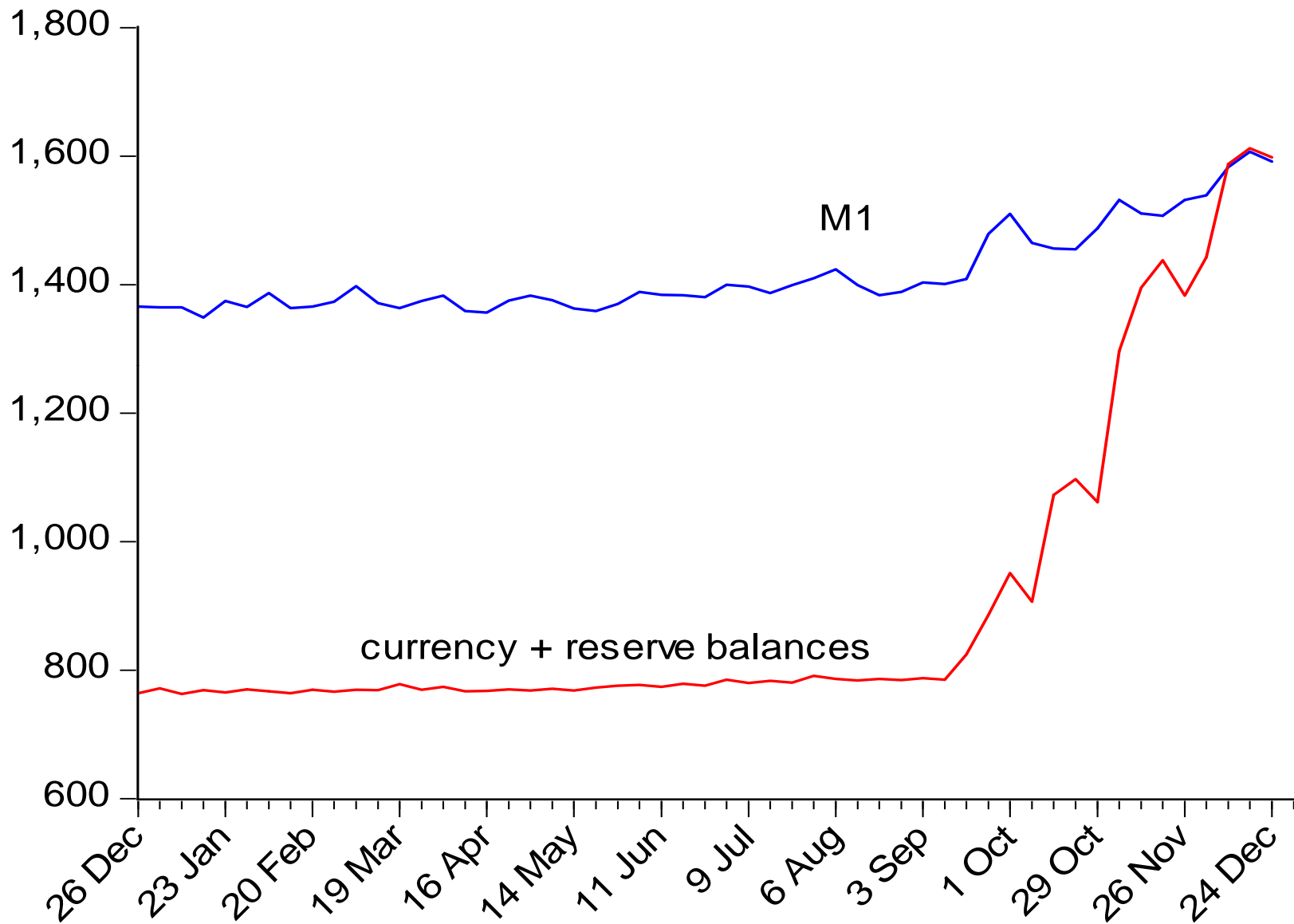
# Other views

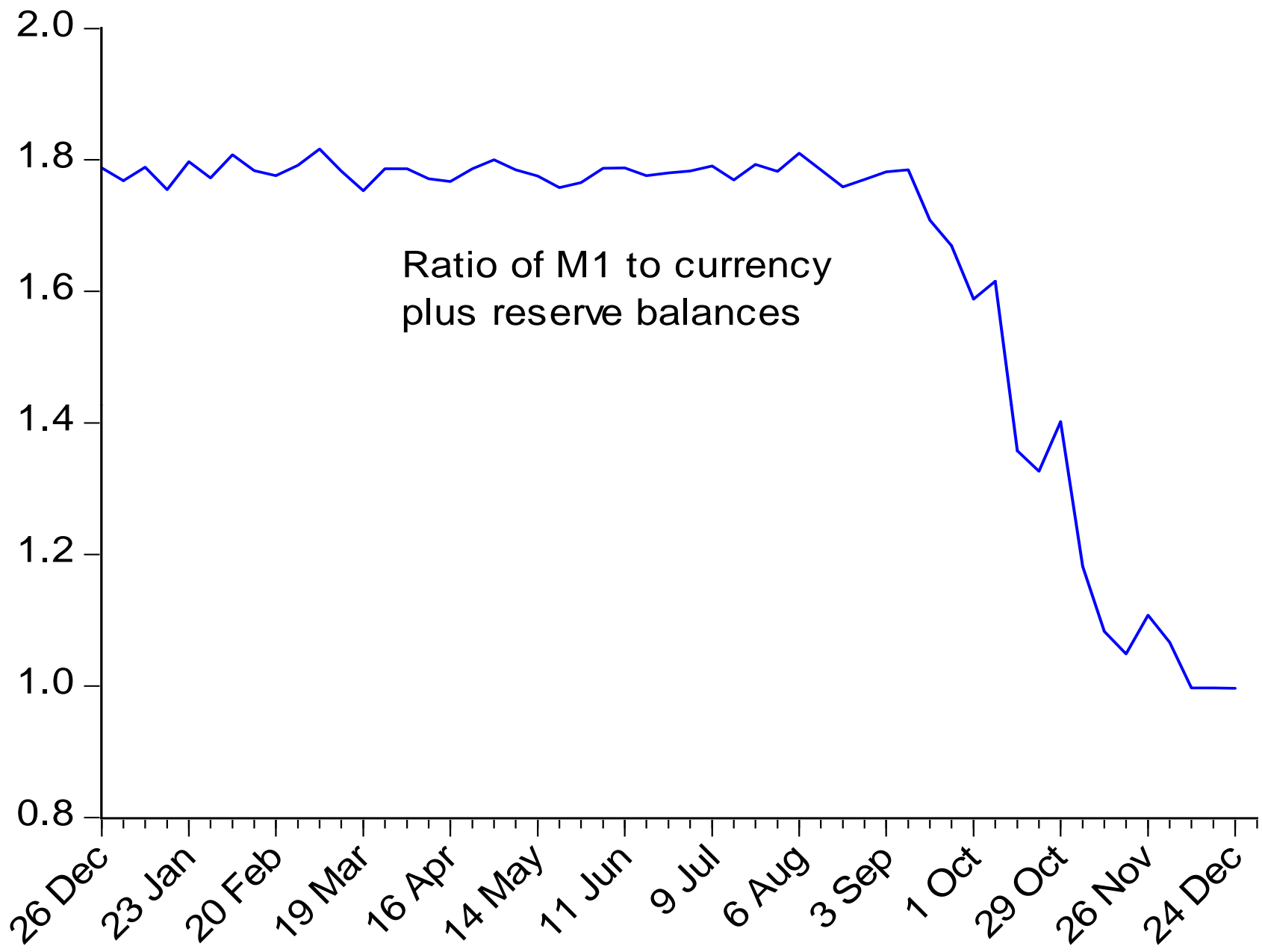
- Fed accommodated increased demand for reserves by banks, as in 9/11
  - Interest on reserves or flight to safety
  - Dates are off for interest on reserves story
  - And interest rates fell as reserves were increased
- Fed accommodated increased demand for monetary aggregates
  - True that both currency and demand deposits rose,
    - reflecting lower interest rates and flight from money market mutual funds,
  - But they rose much less than would have required the observed increase in reserve balances.
    - Money multiplier fell sharply





billions of dollars





Ratio of M1 to currency plus reserve balances

# Conclusions

- Get back to a monetary policy framework fast
  - Start by reducing the growth of the monetary base, then bring reserve balances down
  - Stipulate that goal is to exit from helping particular sectors: monetary policy, not industrial policy
  - Refrain from Fed borrowing or Treasury borrowing for Fed to finance loans to certain markets and sectors
- If not, then radical reforms are needed
  - Monetary independence?
  - Congressional oversight?
  - Role of district banks?
  - Section 13(3) “unusual and exigent circumstances” ?