A Big Stick for the Fed

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The Fed’s September 21 FOMC statement makes great tea-leaf reading. The Fed is worried about deflation. Reading between the lines, the Fed might be powerless to stop it. We’re not there yet, but it could happen. Eventually inflation – stagflation – may well be the problem, and the Fed might be just as powerless.

Traditional policies to fight inflation or deflation can all run out of steam. Creative new policies can work, but they need to be put in place before they’re needed. The Fed needs a Big Stick, and it doesn’t have one.

If deflation looms, the Fed traditionally lowers interest rates. But rates are already close to zero, and can’t be lowered any more. The Fed could embark on more “quantitative easing,” buying more Treasury bills in exchange for money. But once interest rates are zero, Treasury bills and money are the same thing. If your doctor took away the red M&Ms and gave you green ones instead, it would not help your diet.

The Fed can buy more long-maturity treasuries. But now that short-term debt is the same as money, this action just rearranges the maturity of government debt in private hands. That doesn’t have a large effect on anything. Is the fundamental problem with the economy that the Treasury issued too much long-term debt and not enough short term debt, so the Fed needs to go undo that mistake? If anything, our government should be taking this moment of low long-term rates to restructure its debt towards long-term rather than short term debt. Then it would be immune from the sort of roll over difficulties that Greece just discovered.

The Fed can go back to buying private debt, such as commercial paper or mortgage-backed securities. It’s loath do to so – the Fed understands the political danger of allocating credit. But even this eventually runs out of steam. People don’t run out and spend money just because they sold government-guaranteed mortgage-backed securities in return for government securities.

The Fed is reduced to hoping that announcements will work; that merely saying “exceptionally low levels for the federal funds rate for an extended period” will prod people to push prices higher. Others such as the IMF’s chief economist Olivier Blanchard and several Fed governors have advocated that the Fed announce a higher inflation target. This is the WIN (“Whip Inflation Now”) strategy from the 1970s – tell them you want different rate of inflation and hope it happens. Speak loudly and hope they don’t notice you have no stick. But what do you do if it doesn’t happen? Make a bigger announcement?

Really, I take the announcement strategy as a sign of desperation. The Fed is reduced to hoping announcements will work, because it has run out of actions it can take. And every model we have says that raising expected inflation, which is what a higher target
does, results in more, not less unemployment. It is a "Phillips curve shift," a deliberate stagflation. Wanting to do that reveals either that one has forgotten the entire experience of the 1970s or, more likely, a breathtakingly desperate desire for inflation and no better (output-expanding) tool to create it.

Why not just drop money from helicopters, as Milton Friedman once suggested? The Fed can’t do that. Dropping money is a transfer payment. It’s a fiscal, not a monetary operation. The Fed can only buy assets, giving out one kind of government debt (money, reserves) and taking debt of equal value in return. It is restricted in this way for good reasons. If you think allocating credit is political, and threatens central bank independence, the writing of checks with newly created money is an order of magnitude more so.

The Fed needs something new. Here’s what I think works best. In every theory, governments easily cut off inflation or deflation by switching to a commodity standard. If the Fed commits to exchanging one dollar bill for a bushel of wheat, or an ounce of gold, those commodities cannot inflate or deflate. If the government is buying at a fixed price, you would never sell privately for less, and vice versa. In many theories, this “big stick” contingency plan helps to prevent inflation or deflation from breaking out in the first place.

But a commodity standard is impractical for a modern economy. If gold can double in value relative to other goods in the CPI, as it has done recently, then other goods can deflate to half their value if the government fixes the price of gold.

Instead, the Fed can target the thing it cares about – expected CPI inflation – rather than the price of gold. To do it, the Fed can target the spread between TIPS (Treasury Inflation Protected Securities) and regular Treasurys, or CPI futures prices. Here’s a simple example. Investors buy a CPI-linked security from the Fed for $10. If inflation comes out to the Fed’s target, they get their money back with interest, $10.10 at 1% interest. If inflation is 2 percent below target, the Fed pays $2 extra -- $12.10. This pumps new money into the economy, with no offsetting decline in government debt, just like the helicopter drop. If inflation is 2 percent above target, investors only get back $8.10 – the Fed sucks $2 out of the economy at the end of the year. If investors think inflation will be below the Fed’s target, they buy a lot of these securities, and the Fed will print up a lot of money, and vice versa.

One might object that these markets are small and undeveloped. I answer that is exactly why the Fed needs to start doing it now, so the markets are large and developed when the Fed really needs them. One might object that this is a pretty wild new proposal. I answer that we need such proposals if all conventional policies eventually run out of steam. And of course the details will be more complex than what I have outlined.

Will we get inflation or deflation? In the Fed’s view, inflation and deflation come from “slack,” “cost pressures” and “expectations.” They see a period of low inflation, returning
to normal when “slack” does so. They’re trying to talk up “expectations” a bit. Alas, historically the association between today’s “slack” and tomorrow’s inflation is very weak, and past efforts to talk expectations around have not been shining successes.

Monetarists look at the astounding rise in reserves, from about $10 billion in 2006 to $1 trillion now, and worry about hyperinflation. They forget that money and debt are the same thing at zero interest rates. People are happy to sit on money (“velocity is not constant”), and that the Fed can quickly unwind what it has done.

I look at a bigger picture. In every theory, inflation ultimately reflects supply and demand for government debt, including money. When people want to hold more government debt, they try to sell other stuff, and prices go down. When people want to dump government debt, they try to buy other things and prices rise. The Fed can change the maturity and liquidity of the government debt we hold. This can sometimes nudge inflation up or down, but it does not change the big picture.

With this perspective, I think we are still in the midst of a flight to quality that started with the financial crisis, eased a bit, and then returned with the European debt crisis. People want to hold US government debt for its short-term safety. Deflation can happen if that fear worsens, and there is not much the Fed can do.

When that fear recedes however, people will start consider our government’s ability to pay it off its debt. If we enter a period of slow growth, high and distorting taxes, and budget chaos, sooner or later the flight from US debt will begin and stagflation will follow. People will try to get rid of US debt in all its forms, and there will not be much the Fed can do to stop the subsequent inflation. Like all “bubbles,” and “crises” it will come rather unpredictably.

My CPI-targeting proposal, like a gold standard, is ultimately a way of communicating and enforcing the fiscal commitments needed to stop inflation or deflation in every theory. It takes tax revenue to buy back dollars when fighting inflation. Seeing the fiscal costs of defending the dollar will help force the Congress to address our chaotic fiscal policy before it spills into inflation that the Fed is powerless to control. Fiscal discipline, clearly communicated, is ultimately, is the Big Stick that controls inflation.

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