VANDERBILT Ave.
ASSET MANAGEMENT

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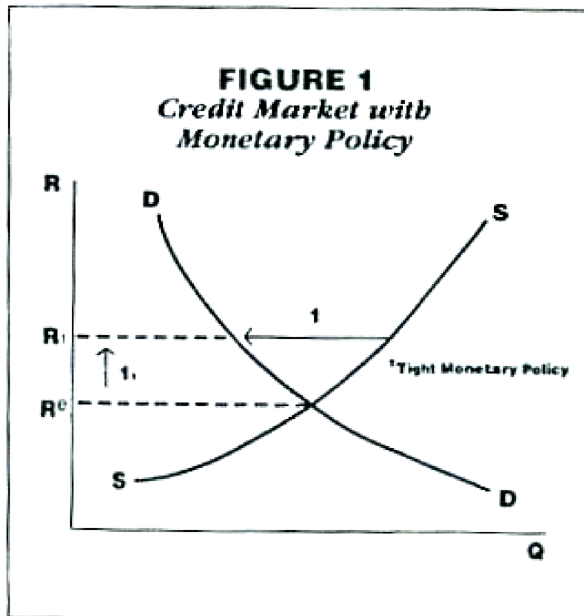
The Fed's New Policy

- Fed Chairman Greenspan offered a new paradigm for monetary policy. Tossing aside irrelevantly-behaved monetary aggregates. Greenspan now steers by the sextant of inflation-adjusted interest rates. We applaud this move.

- Real short rates are currently near zero, and must rise toward their **positive** "equilibrium" rate once growth improves.

The Fed Policy Guide

At the heart of the new credit market approach is the notion that the supply and demand for credit will determine the price of credit. **Private market forces influence credit demand and supply to determine an "equilibrium" short-term interest rate (R^e in Figure 1).** The actual level of short-term interest rate (R_1), however, is set by the central bank and will generally be different from the equilibrium rate determined solely by credit market forces. In this setting, **monetary policy is measured by the spread between the actual and equilibrium interest rates (R_1-R^e).** "Unchanged monetary policy" means that this spread does not change.



Quite apart from the direct implication for short rates. Greenspan's testimony was a tour de force on the theoretical foundations of the Fed's new strategy. Greenspan ended any pretense about the role of the M2 measure of the money stock in policy. The bank liability-based monetary

aggregates are unreliable indicators of liquidity in a word of increasing non-bank credit intermediation. But the Fed still needs a guidepost for policy, and Greenspan said that it has one: **Real interest rates relative to their equilibrium level.**

If real rates are above that level, the Fed is tight, with decelerating growth and disinflation the likely results. In contrast, if real rates are below their equilibrium level, the Fed is easy and accelerating growth and rising inflation are the probable outcomes. The implications for counter-cyclical Fed policy are clear. From a starting point of high real short rates, nominal short rates should be cut when growth cracks. Conversely, from a starting point of low or negative real short rates, nominal short rates should be hiked when growth prospects improve.

In this context, Mr. Greenspan explained that the stimulative power of the current real rate structure has been depressed by the "headwinds" of balance sheet restructuring and fiscal retrenchment. However, these headwinds are abating. Thus, the real growth and inflation outcomes associated with any given level of real short rates is set to increase. Accordingly, what currently is appropriately accommodative policy would in time represent excessively easy policy. The Fed will not stand pat to validate a passive shift to an inflationary policy stance. As growth improves, confirming the rehabilitated state of balance sheets, the Fed will nudge nominal short rates up, so as to lift real short rates closer to their equilibrium relationship to inflation, which is likely a positive spread of 50-150 basis points.

The economics community has been highly critical of this new guidepost for policy in the days since Mr. Greenspan first announced it. **We want to go on record in support of real short-term interest rates as an intermediate target for monetary policy.** The primary criticisms of the guidepost are that the equilibrium term structure of real rates is an ephemeral, unquantifiable, unstable concept. In one sense, this is true; real rates across the maturity spectrum oscillate cyclically around a non-constant secular trend. There is no one "perfect" equilibrium point. But perfection is not required for a monetary policy guide point to be useful.

Sound economic logic and common sense explicability are sufficient. In our view, real short rates pass those tests, particularly in the contrast between positive and negative real short rates:

- Perpetually-negative real short rates would imply and indefinitely-long positive arbitrage in favor of speculative investment in physical commodities with borrowed cash. In the event, inflation would not only rise, but tend to rise at an accelerating pace. This was the lesson of the late 1970s, an experience that Greenspan vowed this week that he would not repeat.

- Zero, not even negative, real short rates constitute a form of theft from the tax-paying holders of short-term Treasury debt. To wit, after taxes and after inflation, the purchasing power of the money they lend to the government declines. If maintained indefinitely, investors in Uncle Sam's short paper would revolt, lending their funds elsewhere, fueling the inflationary process.

We do not want to suggest that we are in danger of being overwhelmed by either of these developments. Nonetheless, they point up the risks of overstaying an excessively easy monetary policy stance, "getting behind the curve," as in the late 1970s. Mr. Greenspan plans to stay ahead of the curve. By introducing the concept of an equilibrium level of real short rates, which is higher than today's level, Mr. Greenspan establishes a defensible and understandable rationale for tightening once improvement in economic growth is clearly visible. M2 would never have done that. Thus, while the new guidepost for policy may have its flaws, it very much serves the interest of the Fed's anti-inflation secular bias. In the long-run the dollar denominated capital

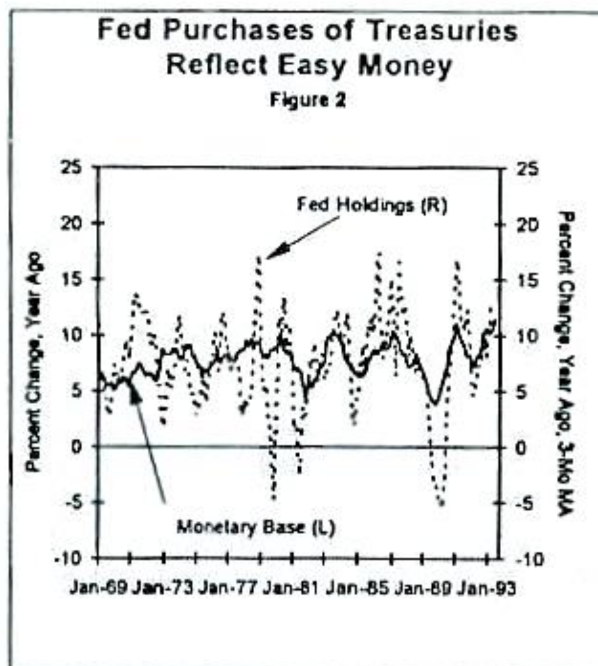
marketswill benefit from such a stance. In the interim, of course, the pain of tightening will have to be experienced first.

Is The Fed "Monetizing" The Federal Debt?

We have encountered this question a number of times in recent weeks. At the most basic level, our first response is yes: The Fed is buying interest-paying Treasury securities (its assets), paying for them with non-interest paying bank reserves and currency (its liabilities). The Fed's conversion of debt into money monetizes **the economy**. There is nothing nefarious about this. Rather, the money supply creation process is one in which the Fed accommodates banks' demand for reserves and the public's demand for currency while maintaining the purchasing power of these balances.

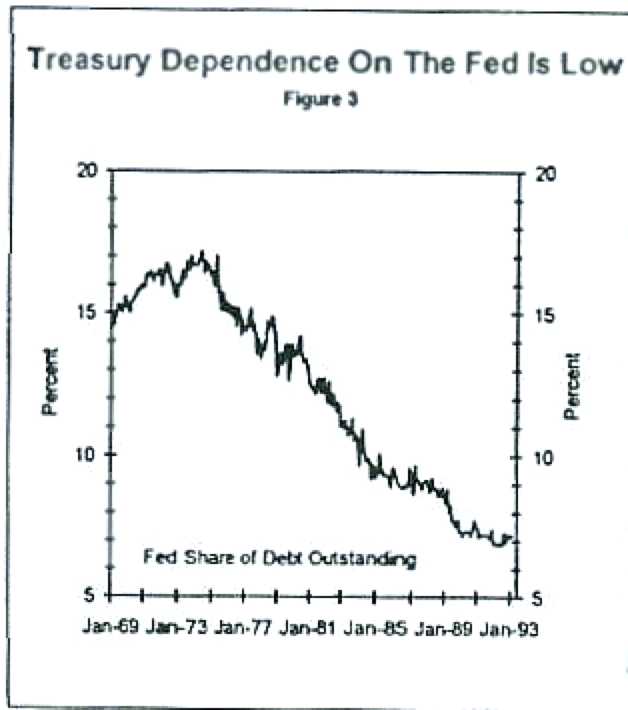
The "monetization question", however, is usually raised in the context of concerns over whether the Fed's stable-purchasing-power (zero inflation) objective is being compromised by the Treasury's need to float debt. Put differently, is the Fed holding short rates at artificially low levels to support the Treasury's need to float debt. Put differently, is the Fed holding short rates at artificially low levels to support the Treasury's borrowing, thereby sowing the seeds for rising inflation? Is the Fed being forced to purchase an ever-increasing share of Treasury issuance because the appetites of other investors are sated? If so, then the Fed is "monetizing" debt in the imprudent manner implicit in the question. With Mr. Greenspan announcing that the Fed's next move would be to tighten in pursuit of positive real short rates, any concerns about "monetization" should be put to rest.

In fact, the recent acceleration of the Fed's holdings of Treasury securities is simply a reflection of strong demand for bank reserves and particularly currency in circulation, which together comprise the monetary base (see Figure 2).



Some of the currency demand is presumably from abroad, where the physical dollar is increasingly used as a medium of exchange. In any event, as the Fed's liabilities have expanded in its recent easy money posture, so have its assets, particularly holdings of Treasury securities.

This policy, however, has entailed no imprudent accumulation of Treasury securities that would sow the seeds for future inflation. Indeed, the Fed's holding of Treasuries as a percent of the total stock of federal debt are small (see Figure 3).



Vanderbilt Research Team