The Dangers of the Fed Conducting Credit Policy

As president of the Richmond Fed, one of my greatest responsibilities and honors is serving on the Federal Open Market Committee (FOMC), the Fed's main policymaking body. The FOMC is composed of the Fed's Board of Governors, along with presidents of the other Reserve Banks. Together we work hard — and collegially — to achieve a consensus on policy decisions whenever possible. For example, regarding the broad direction monetary policy took throughout 2012, a year which covered my rotation as a voting Committee member, my colleagues and I have been in full agreement on the decision to leave interest rates near zero to support the sluggish economic recovery.

An inevitable byproduct of setting policy via committee, however, is that there will sometimes be disagreements about the correct course of action. In 2012, I found myself on the dissenting side for three reasons. First, I have objected to the language that the Committee included in its post-meeting press releases describing how long it expects to keep interest rates low. I believe such "forward guidance" could be misinterpreted in one of two ways: either that the Committee believes the economy is weaker than people had thought, or that the Committee has a diminished commitment to keeping inflation at 2 percent. Second, I disagreed with the Committee's choice in September to further increase the size of the Fed's balance sheet through asset purchases, because I judged that doing so was unlikely to stimulate the economy much without also raising inflation. Finally, I disagreed with the FOMC's chosen method of balance sheet expansion starting in its September meeting, namely, through the purchase of mortgage-backed securities (MBS) rather than the U.S. Treasury securities the Fed has traditionally restricted itself to buying.

Buying MBS in large quantities is intended to reduce borrowing rates for conforming home mortgages, and thereby provide support to that recovering market. However, it necessarily does so only by reducing rates for borrowers in other markets by less than would be the case if purchases were confined to U.S. Treasury securities. Therefore, by purchasing MBS, the Fed is attempting to tilt the flow of credit toward one particular economic sector. Markets generally are a better judge of creditworthiness than any central authority, I believe, so the Fed's actions risk distorting credit allocation and depriving some sectors of the credit they deserve.

If such purchases are to be made at all, they should be made with specific authorization from Congress. By purchasing MBS, the Fed conducts what is essentially fiscal policy without the checks and balances built into the normal appropriations process. The Fed has the ability to engage in credit allocation due to its operational independence — an important feature for protecting monetary policy decisions from short-run political pressures — which allows it to select the size as well as composition of its balance sheet. But by using that independence to favor specific sectors, the Fed opens itself up to criticism that could jeopardize that very independence in making the monetary policy decisions that are, in fact, central to its mandate.

One could conceivably justify redirecting credit flows if it appeared that unfettered credit markets were doing an ineffective job of meeting a particular sector's credit needs. In the case of mortgage finance, the opposite appears to be true. Housing finance historically has benefited from heavy subsidies, which arguably contributed to excessive household leverage during the boom. Many of those subsidies continue, and it's hard to see a case for adding to existing distortions.

The debate over which assets a central bank should purchase long predates my term on the FOMC. In fact, several important contributors to that literature have close ties to the Richmond Fed, including my predecessor, Al Broaddus, former research director Marvin Goodfriend, current Richmond Fed economist Robert Hetzel, and visiting scholar Robert King. While I certainly share the desire of my colleagues on the FOMC to support the economic recovery, my assessment, based on the arguments made by these and other scholars, is that the central bank's forays into credit policy fall outside its mandate, and that the long-term risks must be weighed carefully against whatever perceived short-term benefits may accrue from such actions.

To a large extent, the recent lack of unanimity on the FOMC reflects the unique challenges facing the economy in the aftermath of the very severe recession we have experienced — in particular, enduring economic weakness despite persistently low interest rates. That environment has required drawing policy analysis from the very frontier of economic research. Though we might occasionally come to different conclusions, I am confident that every member of the FOMC is united in pursuit of the Fed's prime objectives of 2 percent average inflation and maximum sustainable employment. **RF**

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