Joint Economic Committee
Republicans
Representative Kevin Brady
Vice Chairman

UNITED STATES MONETARY POLICY GOING FOWARD

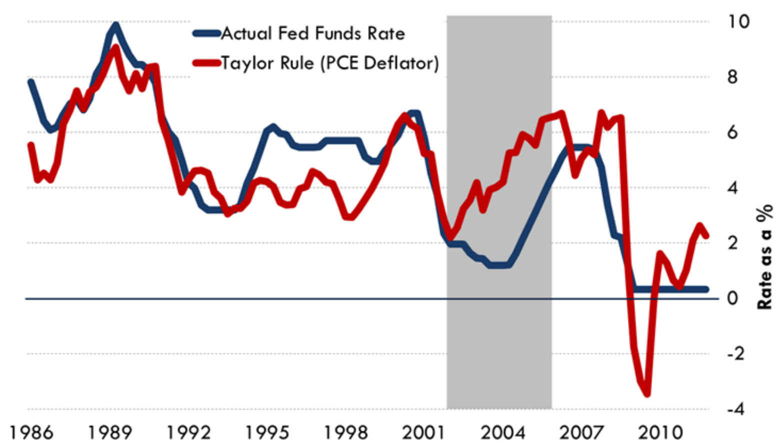
A Single Mandate for Price Stability Implemented by a Rules-Based, Inflation-Targeting Policy Maximizes Growth and Job Creation

March 2, 2012

EXECUTIVE SUMMARY

In recent years, the Federal Reserve has shifted away from well-established norms for monetary policy. These policy deviations—which include holding interest rates too low for too long from 2002 to 2005 (Figure 1) and intervening into the market during and after the financial crisis of 2008 (Figure 2 on reverse) —have harmed the U.S. economy. The Federal Reserve's actions contributed to the inflation of an unsustainable housing bubble; a global financial crisis; and increased market uncertainty, which has inhibited a robust recovery. Avoiding these policy deviations would have likely mitigated the economic harm and caused fewer Americans to lose their jobs.

Figure 1. Actual Federal Funds Rate vs. the Rate Prescribed by Taylor Rule, using PCE Deflator since 1986



*Shaded region represents the 2002 to 2005 policy deviations

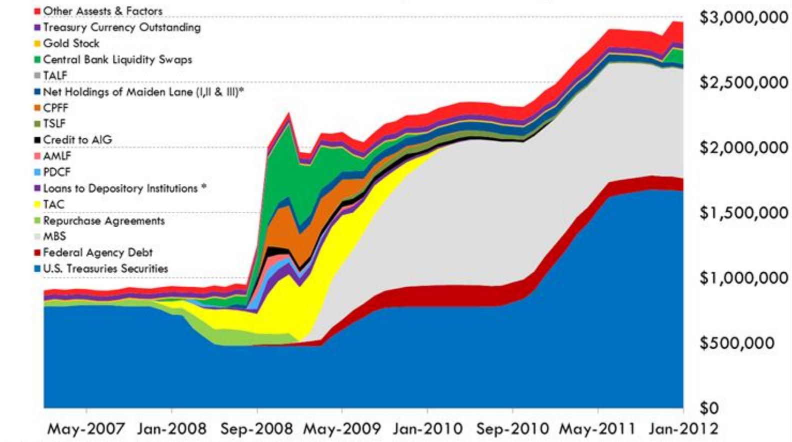
Soure: Federal Reserve Board

In the period from 2002 to 2005, the Federal Reserve held interest rates too low for too long. This policy deviation contributed to the housing bubble.

This era of monetary policy experimentation should end; history has demonstrated what works and what doesn't. During the 1970's, the Federal Reserve produced destructive stagflation—the combination of high unemployment and high inflation—by pursuing a "go-stop" monetary policy oscillating between a focus on inflation and a focus on employment.

The Federal Reserve's balance sheet has over tripled since the financial crisis. Its policy stance risks harmful price inflation going forward.

Figure 2. Massive Expansion of the Federal Reserve Balance Sheet since 2006 (millions $)



*Net Holdings include Maiden Lane I (Jul. '08), II(Dec. '08 and III(Nov. '08);
*Include Primary, Secondary and Seasonal Loans to Depository Institutions

Source: Federal Reserve Board

Conversely, during the period from 1983 to 2000—known by economists as the "Great Moderation"—the Federal Reserve implemented a rules-based monetary policy that focused on containing inflation. The predictability of monetary policy in that era allowed businesses to confidently engage in long-term planning and investment. As a result, our economy flourished. Two robust economic expansions occurred—the November 1982 to July 1990 economic expansion, which lasted 31 quarters, and the March 1991 to March 2001 expansion, which lasted 40 quarters. Not surprisingly, the unemployment rate trended down over the same period.

In order to ensure a prosperous America in the 21st century, the Federal Reserve should implement a rules-based, inflation-targeting monetary policy going forward in order to promote long-term price stability, economic growth and job creation.

In order to ensure a prosperous America in the 21st century, the Federal Reserve should refocus its efforts on what works. It should implement a rules-based, inflation-targeting monetary policy going forward in order to promote long-term price stability, economic growth and job creation. This study provides four policy recommendations to achieve rules-based policies going forward:

1. Create a single mandate for the Federal Reserve to maintain long-term price stability;

2. Require the Federal Reserve to monitor asset prices for signs of incipient asset price bubbles;

3. Restrict open market operations to U.S. Treasuries, repurchase agreements, and reverse repurchase agreements during normal times; and

4. Require the Federal Reserve to clearly articulate a lender-of-last-resort policy.