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A Step Closer to a Free Market by the Fed

We have just heard from the newly appointed Federal Reserve Chairman, Kevin Warsh. He said that there would be changes in the Fed's message in his administration. Among these will be fewer projections.

With change, we might also have opportunity.

Some, like the British economist, journalist, businessman, and editor of 'The Economist', Walter Bagehot (1826-1877) who supported the Bank of England, England's central bank, thought that the purpose of a central bank should be that of a lender of last resort in an emergency, not a government economic central planner. [1]

In his earlier role at the Fed, Kevin Warsh supported Ben Bernanke's easing cuts of the Federal Funds Rate as an emergency measure but quit the Fed after he and the other governors voted for a second round of quantitative easing to buy bonds in November 2010.

Back then, Mr. Warsh didn't dissent at the FOMC meeting, or resign immediately, in order to show solidarity with the other Fed governors, but he thought that keeping rates low for longer than was necessary might be trading higher inflation at the risk of higher unemployment which would violate the Fed's mandate.

Some think new changes he may favor could include an end to the 'dot-plot', the individual inflation guesses of the 19 Fed governors that have increased media speculation about interest rates, but have added, in my opinion, little clarity.

Others think he may reduce the number of press conferences. There were fewer press conferences in the past, but their number increased under Chair Powell in an effort to eliminate the assumption that a FOMC meeting would only result in a rate change if there were a press conference scheduled afterward.

A major change that hasn't, to my knowledge, been suggested yet, would be to lower the IORB, the interest on reserve balances that the Fed pays to banks, for their deposits at the Fed currently at 3.65%. By reducing or eliminating this, the Fed could reduce the cost of this program to the government and theoretically to taxpayers, while enabling banks to put their excess funds at the Fed to potentially better use. [2]
By giving the banks less incentive to let their excess funds earn 3.65% at the Fed, the banks could return to their historical role of lending to their customers at whatever rates that they think is prudent and assume those risks at costs that are proportional to the interest they charge.

Although this could possibly increase the velocity of these funds in the banking system, which might contribute to increased inflation, I think that it could also help to further unwind the excessively low interest rates that were mandated by the Fed during the 'Great Recession' and let monetary policy get back to what might be considered normal, which could be an economic positive.

Federal Reserve Chair Warsh has quoted the monetarist economist Milton Friedman and has recently had high praise for former Fed Chair Alan Greenspan.

Friedman famously had said that "Inflation is always and everywhere a monetary phenomenon, in the sense that it is and can be produced only by a more rapid increase in the quantity of money that in output." [3]

Greenspan said that the acceptable rate for inflation was zero, or as he explained, the rate at which higher costs in the future should be so low that it would not alter the economic decisions of households or businesses and so could be ignored. [4]

Improving business conditions by incentivizing lending and reducing the worry about interest rates in the future would, in my opinion, be a positive outcome of the Fed's new focus. This may be what Chair Warsh is looking for.

It would be nice if he can find it.

Sincerely,

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1. Thomas M. Humphrey, 'Lender of Last Resort : The Concept in History', Federal Reserve Bank of Richmond, Economic Review, March/April 1989. http://www.richmondfed.org/-/media/richmondfedorg/publications/research/economic_review/1989/pdf/er750202.pdf
2. The Fed - Why does the Federal Reserve pay banks interest?, https;//www.federalreserve.gov/faqs/why-is-the-federal-reserve-paying-banks-interest.htm.
3. David R. Henderson, 'Inflation: True and False', defining ideas, Hoover Institution, May 20, 2021. https://www..hoover.org/research/inflation-true-and-false
4. 4. Robert H. Rasche and Daniel L. Thornton 'Greenspan's Unconventional View of the Long-Run Inflation/Output Trade-off', Economic Synopses, 2006, Number 1 https://fraser.stlouisfed.org/files/docs/publicationns/frbsl_economicsynopses_stls_20060101pdf

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