Do the Emperors wear clothes?

Dr Woody Brock | SED | 27 October 2016

1. Ignorance Masquerading as "Expertise"

> Between 1890 and 1905, one of the most challenging problems confronting the high priests of physics was that of the true nature of the "heavenly Ether" that had to exist in order for light to be able to be seen. Eminent physicists had diverse and divergent views about the Ether, and its relation to the then-murky concept of the photon. No one questioned its existence, because the models of the day made clear that this substance had to exist.
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> Consider the shock then, when in 1905, Albert Einstein showed that the Ether cannot exist at all, as its existence was incompatible with the constancy of the speed of light. Of course, Einstein was only able to arrive at this conclusion because he had thought deeper and better than the professional consensus, and in the process transformed the concepts of space and time into the single concept of "space-time."
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> A similar shock occurred some sixty years earlier when James C. Maxwell showed that the electric and magnetic force manifestations of matter were not distinct as was assumed, but were rather differing manifestations of a single phenomenon, namely electro-magnetism. Many supposed experts once again turned out not to know what they were talking about.
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> Suppose by 2025 it has become clear both from experience and from advances in economic theory that the G-7's monetary policies of the 2008-2018 period were fundamentally misconceived, and ended up causing great damage to the real economies of the West. The consensus would certainly be shocked by this outcome. So would most experts. We would not be, and in this PROFILE we explain why this is likely to be the case.

Curing secular stagnation has been and still is the principal goal of economic policy makers throughout the G-7. For reasons discussed below, it came to be believed during the past decade that innovative and extremely easy monetary policy on its own would restore a suitable level of economic growth and inflation. The policies that were adopted during today's ongoing seven-year recovery were driven by this belief. Regrettably, this belief is incorrect both in theory and in practice, as is seen below. It is also a belief that self-styled experts should have been wary of from the start.

As a personal aside, while I am knowledgeable about monetary policy, I do not consider myself an "expert" on this subject at all. But this short coming is pretty standard whenever I decide to address any complex problem. As a result, I have over the years turned to genuine experts for help in deepening my own understanding of the issue at hand. It has been my good fortune to have been able to identify and have access to such experts.

My frustration today is that, when it comes to monetary policy – much less "recovery policy" – those supposed experts who enjoy the bully pulpits of academia and the Op-Ed pages turn out to be emperors wearing no clothes. To put it bluntly, I have not been able to find a genuine expert on monetary theory – by which I mean a person who can explain from convincing first principles *WHY* current policies have failed to generate the economic recovery that had been widely expected.

Perhaps the worst offenders in this regard are the central bankers themselves, officials now sanctified with near-celebrity status. Their disagreements, their failed efforts to justify their policies, and their refusal to change the course of policy over the past seven years constitute a modern Tower of Babel. Their ignorance of their own ignorance is as significant as their ignorance.

For example, note their inability to explain exactly how *at a causal level* massive purchases of bonds (and now perhaps equities) were going to revive growth on Main Street, as opposed merely to boost asset prices on Wall Street. And how could central bankers have forgotten that their mandate is to generate satisfactory levels of employment and inflation on Main Street where most citizens reside? In their embarrassing and ongoing attempts "not to upset the markets" by keeping interest rates very low, central bankers have put the concerns of investors over those of savers, retirees, and employees whom they should be serving.[1]

To be sure, central bankers assured us that trillions of QE dollars would provide "liquidity" and thus benefit Main Street. But that assurance wasn't worth much when, upon closer inspection, the noun "liquidity" turned out to have no meaning in this context since QE dollars never reached Main Street. [Recall the fate of the "Ether."]

We were also assured that massive bond purchases would drive bond yields lower, causing investment spending to surge, and thus boosting prospects on Main Street. Really? Didn't Yale's James Tobin (the first and greatest Nobel laureate in financial economics) show us 50 years ago that central bank bond purchases need not impact bond yields at all? In this regard, consider that government bond yields fell the most in Germany where not only was there no QE, but where it is verboten even to speak of QE.

Part 2 below discusses the theoretically correct way in which the nations of the West could and should have generated meaningful recoveries starting in 2010. The theory involved is utterly fundamental in the pantheon of economics, but was ignored by policy makers most everywhere, especially by central bankers. Part 3 below offers a broadside indictment of central bankers and their abject lack of professionalism. Four dimensions of their improper behavior are identified. This section focuses less on their policy mistakes than it does on their highly problematic ethics. Finally, Part 4 is a Q & A which identifies the actual as opposed to intended consequences of the monetary policies of the G-7. That is, it clarifies many of the myths and half-truths that circulate about the efficacy of monetary policy.

2. Macro-Controllability and Optimal Economic Policy – A Brief Review

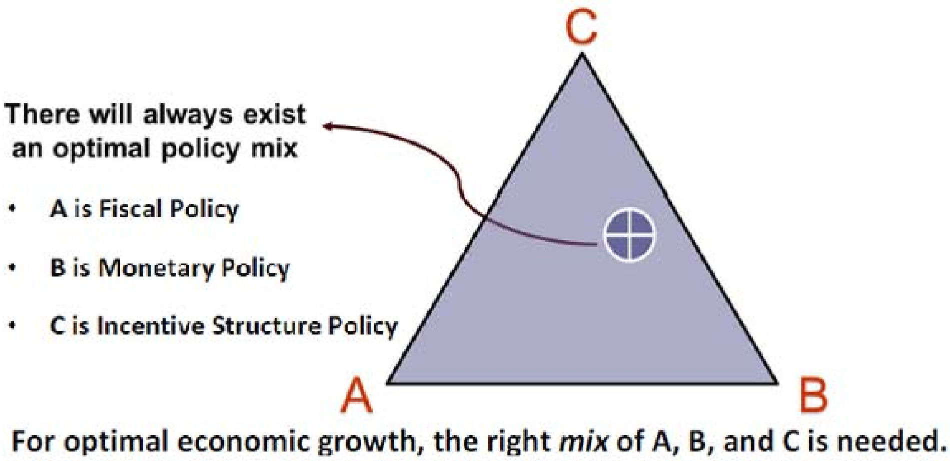
Let's start off reviewing what good economic theory tells us about achieving a good economic recovery after a shock such as the global financial crisis. We have repeatedly reminded readers of the Fundamental Theorem of macroeconomics, namely the "controllability" theorem introduced by Jan Tinbergen back in the late 1950s, and fully formalised by Kenneth Arrow and Mordecai Kurz in 1970. [Tinbergen would be the recipient of the first Nobel Prize in economics ever awarded.]

The basic idea is simple and intuitive:

> If a nation has n goals (say, the three goals of full employment, strong long-run growth, and stable inflation), then it is necessary to have at least n independent policy levers. Only if this is the case can an economic policy be adopted that will optimally restore and maintain stable growth.

This is the story told in Figure 1. Here, the three policy drivers we propose are fiscal policy, monetary policy, and incentive structure policy. The last of these is often called "regulatory policy" or else "structural reforms".

Figure 1: A Lack of macro-controllability – or why monetary policy was never going to work on its own



Source: Strategic Economic Decisions, Inc

What then does proper economic theory tell us about how to achieve economic recovery?

First, it is necessary to clearly identify specific policy goals, goals that are mutually compatible.

Second, proper theory instructs us to identify a suitable number of quite different policies that are mutually independent in the sense that changes in any one policy (e.g. lower interest rates) are fully compatible with and independent of changes in other policies (e.g. reduced fiscal stimulus and increased deregulation of small businesses).

Third, there must be a "joint optimisation" over these three policy domains. That is, it must be determined which particular mix of monetary, fiscal, and regulatory policies is optimal for achieving the triad of goals.[2]

Fourth, these policies must be implemented. All of them, jointly.

The crucial point here is that there is no such thing as "optimal monetary policy." The concept is vacuous, and monetary policies deemed optimal will usually prove ineffectual if not dangerous, as in the case today. For there is only one optimal policy – the triad of policies jointly determined in step 3. There will be one monetary, one fiscal, and one regulatory policy, the <u>triad</u> of which will optimise the performance of the economy.

Despite the critical importance of this most fundamental of all results, virtually no economic pundit or central banker seems to have been aware of its existence during the past decade. Instead, a sloppy consensus was somehow reached in that "it is up to the Fed to do what is needed to restore optimal growth." To be sure, there are some who have pointed out that "monetary policy alone is not sufficient." But to state this is a far cry from invoking controllability, and demanding that its precepts be implemented.

Given the disappointing results of monetary-only policies over seven years, we increasingly read that "central banks have run out of ammunition" or that "extremely easy monetary policy has failed to achieve what it promised 0 not only in the US but in Europe and Japan."

What you SHOULD be reading after seven years of disappointing policies is this: "As we should all have known from the start, monetary policy on its own should never have been expected to restore rigorous growth."

2.1 The Abe exception in Japan

There was one policy maker who did appreciate this point, and who emphasised it for four years - Prime Minister Abe of Japan, a politician, not a monetary policy maker. His "three arrows of recovery" strategy not only recognised that monetary policy must be augmented by fiscal and deregulatory policies, but he uniquely recognised that the latter were far more important to Japan (a land of corrupt cartels) than were monetary and fiscal policies. Regrettably, Japanese politics prevented his achieving the structural reforms that were so sorely needed. Largely because of this reality, his policies failed. But what matters to us here was the deafening silence by "Japanese officials" in backing him up in his quest for structural reforms, especially by his monetary policy experts.

2.2 The truth about actual fiscal policy in the US, Europe, and Japan

Critics of our position here would probably argue that, in the case of the US, the Obama administration did not ignore fiscal policy as we may have implied in our discussion of controllability. The truth is complicated. For sure, there was significant fiscal stimulus during the two years of recession that ended in 2010. The federal fiscal deficit soared from less than $400 billion in the last year of the Bush administration, to some $1.4 trillion in 2010.

However, what is at issue here is the magnitude of fiscal stimulus that was needed to achieve a vigorous recovery starting at the end of 2010. During this period, fiscal policy tightened very significantly as the government deficit fell from some $1.4 trillion back to under $500 billon. This represents a “fiscal drag” on growth (and hence on the recovery) of a magnitude not experienced in seven decades. It is also why the author in his book *American Gridlock* so strongly advocated the introduction of a "Marshall Plan" of infrastructure investment in high-rate- of-return projects. Financing these would give rise to "good" fiscal deficits that are repaid many times over through their positive impact on both short-term employment and on longer-term productivity gains.

Suppose monetary policy been complemented by a high level of infrastructure investment (the need for which has now finally been recognised both by the left and right), and by long overdue structural reforms. Then (i) today's destructive zero-rates-forever monetary policies would have been obviated, and (ii) the recovery would have been vigorous. The math needed to see this is not demanding.

In Europe, the analogy to fiscal policy drag in the US was dubbed "austerity." In Japan, the analogy was Abe's unfortunate boost in the consumption tax.

3. The unprofessionalism of monetary policy makers – four manifestations

In our view, today's new elite of central bankers are personally culpable for creating serious future problems worldwide via their policies of the past seven years. On Judgement Day, they will rank alongside those bankers whose follies impaired the financial system.

In this section, we offer what is essentially a moral critique of this group as people who in our view have seriously abused their very position as civil servants. Thereafter, in Section 4, we offer a policy critique of the policies of central bankers, and attempt to clarify certain myths and half-truths about these policies.

3.1 Flaw #1 – Ignoring the demands of controllability

Given monetary policy makers' Main Street mandate of controlling goods (not asset) prices and employment, why did central bankers almost everywhere remain silent upon the issue of controllability introduced just above?

They acted as if monetary policy could go a long way on its own to restore growth, notwithstanding the fact that they should have known from elementary graduate economics that monetary policy cannot in general be effective on its own. They, or their spokesperson, should have shouted from the rooftops that, given the particular headwinds confronting the 2010-2015 recovery, monetary policy must be complemented by (1) fiscal stimulus, and by (2) a good dose of deregulation. Consider what happened in the case of the US. Central bankers remained silent as fiscal drag exploded. As for deregulation, central bankers were silent as hundreds of pages were added to the Federal Register as the Obama administration piled on so many regulations that, among other things, more small businesses closed than opened in 2014.

To be sure, Ben Bernanke and others in the US randomly pointed out that "we at the Fed cannot do everything on our own." But this protest was muted, whereas it should have been vigorous given the importance of macro-controllability. The authorities should have known this, and given their mandate, should have vigorously asserted: "It is almost pointless for us to rely on rock-bottom interest rate levels and asset purchases to get this recovery moving."

The result of ignoring the demands of controllability was by far the worst recovery on record. We predicted that this would be the case as far back as 2011.

3.2 Flaw #2 – Failure to disclose critical policy tradeoffs

Central bankers have remained mum on the painful tradeoffs that had to be made in implementing a zero-interest-rate world. Given its Main Street mandate, where were the central banks' cost/benefit analyses weighing the gain/pain tradeoffs of the benefits to Wall Street versus the pain to Main Street from a zero-rates-forever policy? It is only now that we are reading about the pending disaster confronting insurance companies and pension funds – and it is not from monetary policy makers that we are learning about this crisis, but from the companies impacted. Exactly what disaster is this?

It is the prospective inability of many life insurance companies and pension funds to meet their promises to pay well over 130 million beneficiaries the annuities, life insurance settlements, and pensions being counted on by average citizens. Indeed, executives and fund managers are now belatedly pointing out that the Fed's zero-rate- forever policies are killing their ability to earn the returns needed to remain liquid.

Is the retiree issue too small a problem to bother with, compared to the need to prop up banks? No. The reverse is true. Consider that the net worth of US households is now $89 trillion, according to a recent Fed release. The share of peoples' wealth in bank deposits and other bank investments is a small fraction of the share held by insurers and pension funds.

Contrast with Viagra: Listen to any of the new drug advertisements that are now aired so frequently on TV. After hearing of the benefits of such-and-such a drug, we are warned of "the following six side-effects: vomiting, muscle ache, etc." The law requires the promulgation of such tradeoffs. Why should central banks not have been held to comparable standards in pointing out the side-effects of their policies? Their failure to do so constitutes an amoral lack of professionalism in the extreme.

3.3 Flaw #3 – Failure to disclose conflicts of interest

A third criticism of central bankers lies in their deliberate obfuscation of those whose interests they serve. We must "follow the money" here and ask which players' interests have been best served by monetary policy. The workers on Main Street, or present and future retirees, or the banks the Fed regulates?

History will show that the principal beneficiaries of the Fed's policies will have been the banks and the markets. With regard to the banks, keep in mind that the Fed is owned by the banks that are members of the Federal Reserve System. In this vein, two speakers at the recent August 2016 Jackson Hole Fed Conference stated that, with long term rates being as low as they have been due to negligible inflation, the Fed has been obliged to keep short rates very low. For in order to remain profitable, banks need a positively sloped yield curve. [Try making sense of this concept in a negative-interest-rate world!].

Fed Chairman Volcker knew all this during the 1980-1981 crisis, but he put the long-term interest of the real economy ahead of the interests of the banks and the markets.

We detect a serious conflict of interest here. The most elementary cost/benefit analysis would show that the accumulating losses of retirees and insurance beneficiaries on Main Street swamp the benefits reaped by banks from a zero-interest-rates-forever monetary policy. The conflict of interest here should have been fully disclosed given that the Fed's Humphrey-Hawkins mandate is the health of Main Street.

Even if central bankers complained that they did not have all the policy tools needed to repair the economy, they surely should have broadcast the need for other branches of government to deal with the interests of current and future retirees. Yet we cannot recall a single Fed policy-maker commenting on this conflict of interest. Had there existed other powerful regulators responsible for the health of insurance companies and pension funds, we could blame them and not the Fed for not speaking out. But there are none.

Did anyone muzzle central bankers so that they could not speak the truth in this regard? No. They chose to do so, reflecting either gross ignorance or else faulty ethics on their part.

A Utilitarian Critique: Our comments thus far can be elevated to a moral philosophical level by recalling that, for over two centuries, government policy makers have been assumed to adhere to the moral Utilitarian Rule of selecting policies so as to maximise the Greatest Good for those citizens whose interests they arbitrate. Have monetary policy makers done so? No.

3.4 Flaw #4 - Failure to admit mistakes, to learn, and to change course

Our final complaint is the abject failure of central bankers to admit after the fact that the low-rate and QE policies they have stuck with have proven far more ineffectual than they had expected them to be. This objection is totally independent of their failure to acknowledge the adverse tradeoffs and conflicts of interest implicit in the policies they adopted. Indeed, until just recently, despite the failure of policies to date, central bankers worldwide have merely promised "to do more of the same." In this regard, the European bank announced the possibility of extending QE to acquiring equities.

In late September 2016, however, the attitude of central bankers began to change notably. The new refrain seems to be "there is little if anything more than monetary policy can do" - a refrain being heard four years later than it should have been heard.

But, even now as these emperors disrobe themselves, they persevere in failing to state what was and still is truly needed to boost growth - structural reforms, in particular.

This fourth critique leads us to our concluding remarks in which we assess the inadequacy of such tools as monetary policy makers did use.

4. The Expected versus Actual Impact of Specific Monetary Policies

The tool-kit of today's monetary authorities consists of:

1. Changing short-term rates;
2. Changing long-term rates via "market signaling" policies and announcement effects;
3. Buying/selling assets in order to alter long-rates directly as opposed to indirectly as in (2); and,
4. Printing money in ways transcending asset purchases.

We note that policy 3 was never in effect before 2010. In the case of policy 4, the very concept of genuine money printing was verboten until quite recently. But this is finally changing and we shall soon witness various forms of money printing having little to do with asset purchases.

CLARIFYING FOUR MYTHS AND HALF-TRUTHS IN A Q&A FORMAT

First, the impact of changing the Fed funds rate

Q: As for the Fed funds rate tool, how powerful is it in impacting the economy?

A: The efficacy of the funds rate depends upon the country in which rates are changed, upon the particular circumstances at hand (e.g. the causes of recession), and upon the magnitude of the interest rate change.

Q: Why does the country matter here? What difference could that make?

A: Consider Australia. Mortgage rates and many other rates on loans are priced off of short-term rates. Thus when the Reserve Bank increases the rate on overnight funds, the impact on the size of mortgage payments is immediate. This being true, the central bank has great power to impact consumer spending and thus the economy right away. Conversely, in the US, loans are largely priced on longer-term rates over which the Fed has little control (see below). So the differing monetary systems of different nations do indeed matter.

Q: What do you mean by stating that the effectiveness of traditional monetary policy "depends upon the circumstances?"

A: Consider the extent to which the lethargic US recovery has reflected a failure of both residential and corporate investment spending to rebound given an extremely low funds rate. With a little forethought, the authorities should have expected this. To begin with, the shock to homeowners across the US from the greatest recorded loss in housing wealth in memory would not wear off quickly. That is, rock-bottom mortgage rates should not have been expected to kick-start residential investment to the extent it did traditionally. In the case of corporate investment, the pessimism attending the housing and financial shock predictably made CEOs reluctant to invest long term.

Perhaps more important is the fact that the very nature of "capital investment" has changed given (i) the dramatic fall in the price of capital goods; and, (ii) the shift from bricks and mortar investment into R&D and patent-filing expenditures. The first development means that "investment spending" measured in dollar terms (Price times Quantity of investments) has fallen as P kept dropping. The second development played a role in depressing quantity Q because the national income accounts do not recognise much R&D spending as "investment." The point here is that, given these new developments, authorities should not have expected the dollar value of "investment" to have been strong regardless of very low interest rates.

Q: What about the issue of the "magnitude" of a change in the Fed funds rate?

A: At the simplest level, magnitude matters for obvious reasons. Thus, when we hear how effective Paul Volcker's policies were, it is often forgotten how enormous the rise in rates was. When rate hikes are much more modest, their impact is predictably less. In this regard, the Bernanke-Yellen rate cuts have not been nearly as great as the Volcker increases. Also they have pretty well followed inflation downward. Thus, the reduction in real rates has been slight.

Q: Isn't this why Lawrence Summers has recommended more aggressive easing, aiming to drive the real interest rate down to its "equilibrium" negative value.

A: Yes. It is.

Q: Do you agree with Summers?

A: Not at all. Summers seeks lower real rates to stimulate today's lack of investment spending. In our view, for the reasons cited above, investment spending has proven and should have proven insensitive to interest rate cuts. What is needed is fiscal policy in the form of infrastructure investment, not additional monetary easing. Summers himself now agrees that the time has come for fiscal easing and for hefty infrastructure spending. Yet, he also sticks to his Wicksellian view that a lower "natural" rate of interest is needed. What troubles us is not as much that this will not work, but that Summers never mentions the tradeoff costs cited above that would result from further easing.

Second, the Fed's ability to impact long-term rates prior to the advent of QE

Q: How effective were traditional Fed policies in changing long-term yields?

A: Traditionally, the only way in which the Fed could impact (not alter) the level of long-term rates was to influence "market expectations", primarily about future inflation. For example, the Fed could cite reduced inventories and rising wages as indications of a tightening economy that merited tighter monetary policy. In doing so, the Fed would be sending a message to the bond market that inflation would rise, causing bondholders to demand a higher inflation premium. This would, of course, drive bond yields upwards.

Q: Did the Fed often use this tool effectively prior to 2008?

A: Fairly often. But it is hard to distinguish between autonomous bond yield increases given prospective increases in inflation obvious to the markets, versus policy-driven increases due to tighter monetary policy. In principle, bond holders would always seek protection against higher inflation regardless of the course of monetary policy, for inflationary prospects are the true drivers of the bond market.

Third, the Impact of QE on bond prices

Q: Was the introduction of QE an effort to manage longer-term yields more directly?

A: Yes. The basic idea is simple. By actually purchasing assets (bonds), and thus increasing the demand for such assets, the price of bonds would rise and the yields would fall. As a result, the economic recovery would be stimulated. On the surface, this logic seems irrefutable as it is based upon the Law of Supply and Demand, along with the assumption that lower yields would stimulate investment and recovery. We have already cast doubt upon this second assumption.

Q: But what about your first point - the ability of Fed purchases to actually lower bond yields?

A: Here is the rub. Anyone familiar with the work of the late Nobel laureate James Tobin of Yale University will recall that the Law of Supply and Demand does not work in asset markets the way it does in goods markets on Main Street. The reason why lies in the "stock-versus-flow" distinction.

Q: Doesn't this refer to the fact that, in asset markets, the magnitude of increased demand for, say, bonds (e.g., by QE) on an annual basis is small compared to the total size of bond-holdings (the stock of wealth) that the public can buy or sell at will, depending upon market sentiment?

A: Yes. This "stock" you speak of consists of all outstanding past issuances of the asset in question, a number that will generally be much greater than any annual "flow" addition to/subtraction from this stock.

Q: You have stressed this point often in the past. But how does it apply to the specific impact of QE on driving bond yields lower?

A: Suppose that the public back in 2010 had interpreted QE as a "monetization" of debt that would cause future inflation. [Recall what happened in the gold market when QE was announced.] Then bondholders would have responded by demanding and getting a higher inflation premium. This will drive up yields, even though the intention of the Fed in buying bonds had been to lower them. But back in 2010 and in subsequent years, the bond market watched inflation keep decelerating both in the US and elsewhere. This development on top of the European banking crises caused a flight by nervous investors into safe government bonds, thus driving down yields.

Q: Are you suggesting that this shift in market sentiment alone could have driven down bond yields, without any Fed bond buying at all?

A: Yes. For example, German bond yields fell the most of all with no assist from QE. Investors from all over the Eurozone, witnessing the distress in the South of Europe, fled into this uniquely safe asset. In the US, when the Fed ceased making purchases, bond yields actually declined a bit, notwithstanding the panic of June 2014 when the mere hint of a "tapering" of Fed purchases send bond prices sharply downward. Market confusion during this important period reflected confusing and often contradictory statements from supposed monetary experts, and from Fed officials as well.

Fourth, the prospective impact of proper money printing

Q: We are beginning to hear more and more about "helicopter money" created out of thin air by the Fed. Will such money create liquidity, and if it does, will inflation necessarily be the result? Also, will the creation of such money stimulate the recovery, other things being equal?

A: We discussed this point in our August **PROFILE**, "A Novel Microeconomic Perspective on Economic Growth." There are three main points to keep in mind.

First, the main purpose of such money creation is to boost aggregate demand, or more formally, to shift the economy's demand curve for goods and services outward. But this will only happen if the money that is created ends up in the hands of consumers who will spend the proportion of it (usually 94%) that is not saved. What went wrong with QE is that the Fed created (printed) $3.3 trillion of new bank reserves - the way it paid banks with reserves for the bonds it bought from them. Had consumers followed up by borrowing (and then spending) one or two trillion dollars from the banks made possible by this easing of credit availability, then the demand curve would have shifted outward. For what is borrowed is spent. But shell-shocked consumers chose not to borrow and spend, so no net new bank reserves were transformed into true liquidity on Main Street. Additionally, the savings rate soared during the recovery.

Second, with the right amount of increase in demand, any inflation target whatsoever can be achieved, given the movement of the supply curve. The current G-7 inflation target is and should be 2%. No government has been able to achieve this level in recent years, and no money printing proper has been used. But it soon will be and should be used to achieve positive inflation given the disaster of falling prices and wages for households with debt to service out of income. Alternatively, the Marshall Plan for infrastructure investment could go into effect, and it would equivalently drive the demand curve outward. Interestingly, Clinton, Trump and Summers are now supporting precisely this large-scale infrastructure project, if six years late.

Third, money can be printed in many different ways. QE would have achieved it via the means described above had consumers wished to borrow and spend, but they did not. Or, the Treasury could mail all taxpayers a $3500 annual check using funds created electronically within its bank account by the Federal Reserve Bank.[3] This most genuine kind of money printing would not raise the government deficit as it would not be deficit-financed as, say, the Kennedy tax cuts were. Or, finally, the Treasury could deficit-finance such annual payments to taxpayers. It could do so by issuing new Treasury securities in the amount needed to fund the $3500 checks to taxpayers each year, and selling these bonds to the public. But to offset this, bonds of the same amount would subsequently be bought in from the secondary market by the Fed each year. The result would be that publicly held debt would never grow due to this form of money creation.[4]

Fourth, the financial markets must be convinced that money printing, whatever its form, would not result in hyper-inflation as many investors might fear. The Treasury and the Fed jointly would have to make crystal clear to the markets that, just as they can drive the aggregate demand curve outward to generate some inflation, they can equally reverse their operations and thus drive the curve leftward to reduce inflation. There is an analogy between the demand-curve management we are recommending here and the way the Fed has for 80 years shifted the supply curve of bank reserves that it controls backwards and forward to maintain the Fed funds rate target set by the Fed Board of Governors. The funds target in this instance would be analogous to the new inflation rate target.

We stress that, if and when money printing is put into practice, it will be within the purview of the Treasury and the Fed jointly, not simply the Fed. And the Treasury will call the shots. New legislation will most probably be needed.

ENDNOTES

1. The contrast between the Volcker and the Yellen Fed is instructive in this regard. In 1980, soaring inflation was the principal problem confronting Main Street, with the CPI reaching 14.2% in 1981. Fed Chairman Volcker succeeded in breaking the grip of inflation by jacking the Fed funds rate to over 20%, the markets be damned.

2. This can be achieved recursively via dynamic programming, as Arrow and Kurz established in great detail.

3. The new offsetting asset of the Fed could be a loan to the Treasury in the form of a perpetual zero-coupon Note.

4. Would interest expense to the Treasury soar due to the creation of these new T-securities, especially if interest rates rise? No. For the Treasury could have the Fed remit to it (the Treasury) all coupon interest payments it receives from the Treasury. The only interest expense that would rise would be the cost of servicing publicly held debt which is now down to about two thirds of the total Federal debt. Ever more QE could drive this share downward.

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