The Fed's Historic Move

Bob McTeer, 12.17.08, 06:40 PM EST

Unusual but not inflationary.

The Federal Open Market Committee's action on Dec. 16 was historic in its boldness and its willingness to go further into unchartered waters. In addition to reducing the target Fed Funds rate from 1% to a range between 0% and 0.25%, the FOMC promised to use open market operations and other measures to sustain the increased size of its balance sheet.

Among those measures, it said it would purchase agency debt and mortgage-backed securities to provide support to the mortgage and housing markets, and that early next year it would take measures to facilitate the extension of credit to households and small businesses. The FOMC also said it would study the potential benefits of purchasing longer-term Treasury securities.

The only action roughly comparable was the October 1979 decision to target the money supply directly and end the practice of targeting money indirectly by focusing on interest rates. In fact, the current decision is similar to the earlier one in that it leaves the Fed Funds rate more to the market, in order to hone in on other areas.

The difference is that the 1979 move targeted money and, by implication, bank reserves, on the liability side of the Fed's balance sheet. The current action seeks to target the asset side of the balance sheet. This is a major shift.

Several pundits have various objections to the Fed's move, all of which I believe to be overdone. Their main objection is that it will be inflationary--some argue inflation will balloon sooner rather than later. They cite the sharp increase in the size of the Fed's balance sheet and the recent expansion of bank reserves and money measures as prima facie evidence of looming inflation. Another objection is that the Fed's actions will weaken the dollar in foreign exchange markets, which has already begun.

My counterargument is that you don't go directly and immediately from reserve and money creation to rampant inflation. The sharp expansion of the monetary aggregates since the beginning of September was needed to offset the dramatic decline in velocity and the hoarding of reserves by the banking system.

Money has to be spent before it can create inflation and before it does that, it will provide a much-needed support to a rapidly declining economy. The British economist Sir Dennis Robertson made the famous and relevant distinction between "money sitting" and "money on the wing." U.S. money has been sitting.

Once aggregate demand picks up, the Fed will need to gradually reverse its actions. Much of that will happen automatically as loans are paid off and securities are sold back into the market. For now, deflation is more of a threat than inflation.

Fed critics are focused on the rapid increase in the size of the Fed's balance sheet, but, as I've written **here,** much of that expansion is benign. The critics assume implicitly that all the expansion on the asset side of the Fed's balance sheet is offset by monetary liabilities, which simply isn't true. Much of expansion is absorbed by non-monetary liabilities on the Fed's balance sheet.

Finally, I know many people believe the dollar should be strong and stronger under all circumstances, but there are times when an appreciating dollar does more harm than good. Now is one of those times.

The earlier depreciation of the dollar brought about a long-needed shrinkage of our trade deficit, which supported the economy. In several recent quarters, the shrinkage of the trade deficit contributed more than the total growth in real gross domestic product. That positive impact lessened considerably from the second to the third quarter.

With consumption declining and investment flat, net exports are the only private sector source of support for the economy. An appreciation in the dollar will change the impact of net exports from a positive to a negative. As I've said before, I'm for a strong dollar, but not just yet.

Bob McTeer is a distinguished fellow at the National Center for Policy Analysis and former president of the Federal Reserve Bank of Dallas.