# The Fed´s monetary policy has become dysfunctional

Tim Duy is a well known "Fed Watcher". As such what he writes does not necessarily reflect his views but what he sees as the Fed´s view. In "Fed intent on raising rates even if the economy sours", we read:

> A combination of weak labor force growth, solid employment growth, a lower unemployment rate, and firmer wage gains will tend to support the Fed's view that the ***labor market needs to cool substantially to prevent inflationary pressures from building***. Regardless of the estimate of the neutral interest rate, central bankers probably won't think policy is restrictive ***until they see a pullback in the pace of activity.***

That´s absurd! It is not unemployment or growth that "controls" inflation, but monetary policy. However, if the Fed believes that monetary policy is interest rate policy, monetary policy will control inflation through its effects on growth and unemployment. That´s a recipe for disaster!

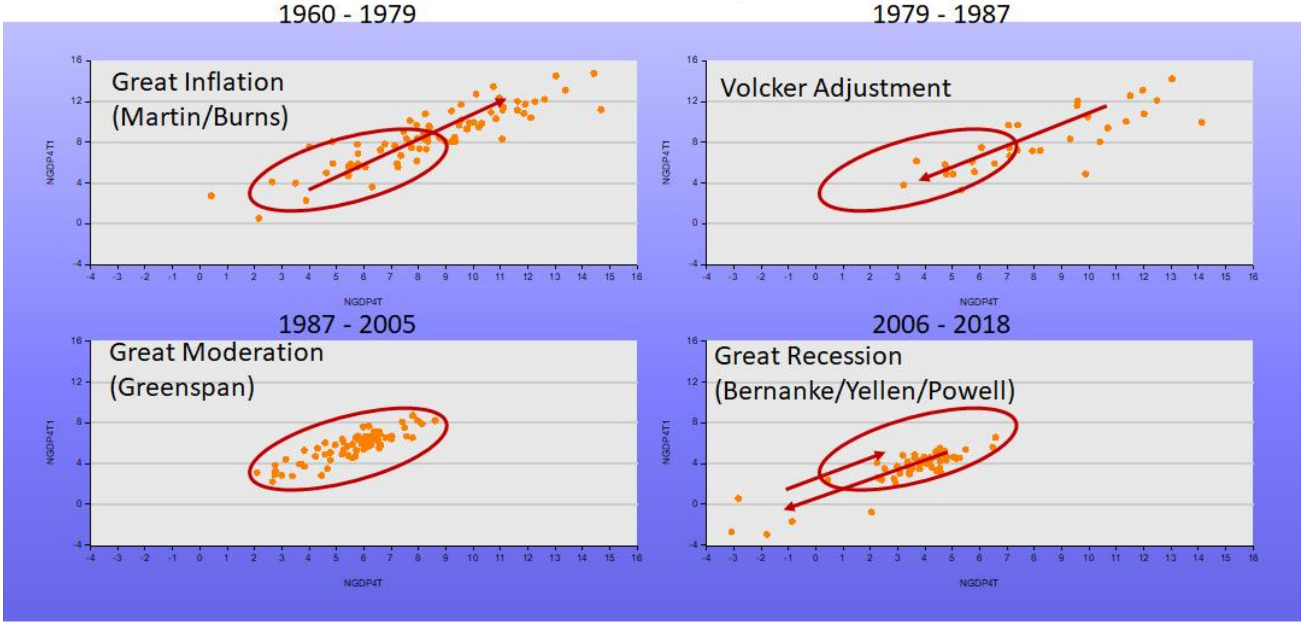
If instead, you define the stance of monetary policy by the behavior of nominal spending (NGDP) growth, you will find that if the Fed strives to keep nominal spending growth stable, i.e. if the Fed obtains nominal stability, both inflation and real growth will be stable.

The dispersion charts below illustrate. For different periods the charts depict the dispersion of NGDP growth, real GDP growth & inflation (PCE Core).

The "Standard" is the "Great Moderation". During those years, nominal spending (NGDP) growth dispersion (volatility) was "narrowly circumscribed". Real growth and inflation dispersion during those years reflected that stability, just as the "Great Inflation" reflected the increasing dispersion of NGDP growth in an "upward" direction, and the "Great Recession" reflected the increase in nominal spending growth dispersion in a "downward" direction.

NGDP Growth Dispersion

1960 - 1979 | 1979 - 1987




RGDP Growth Dispersion

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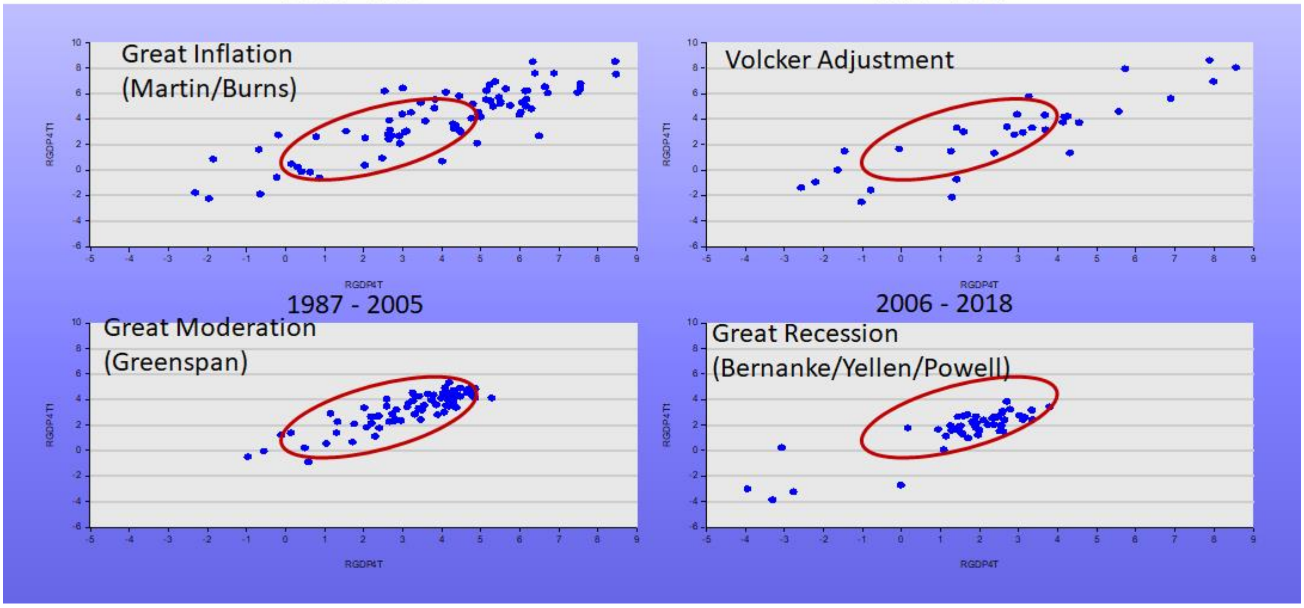
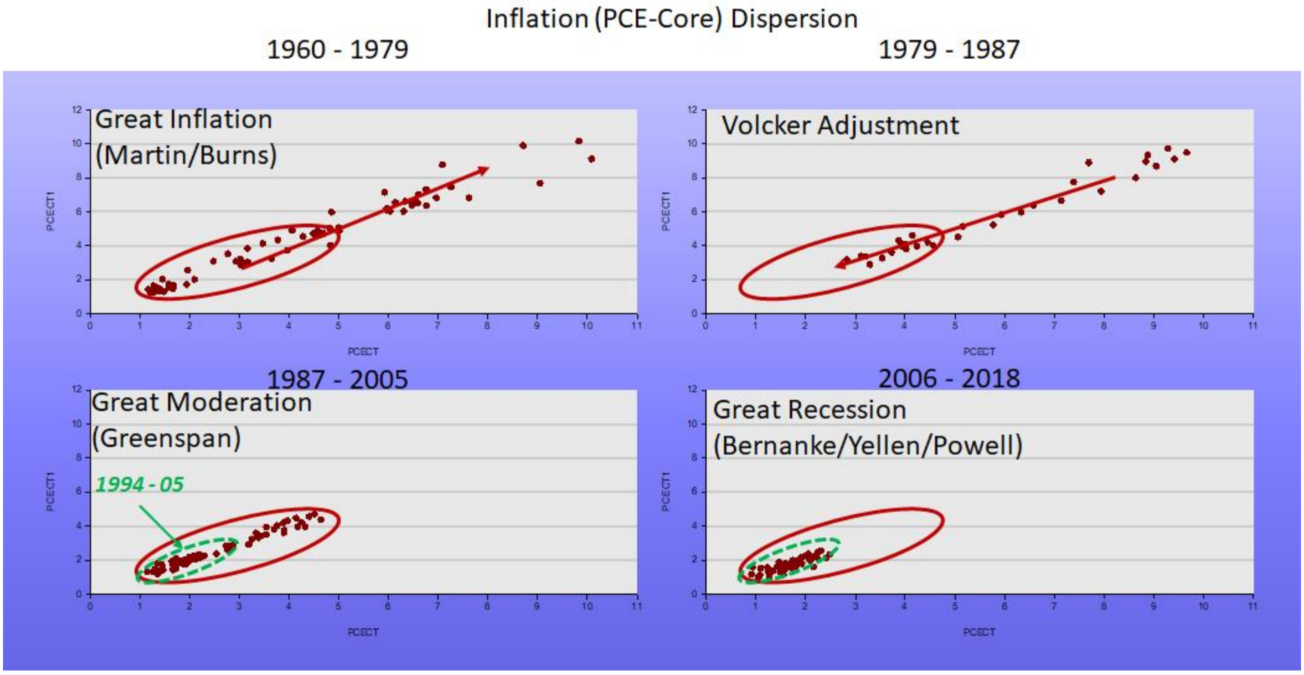
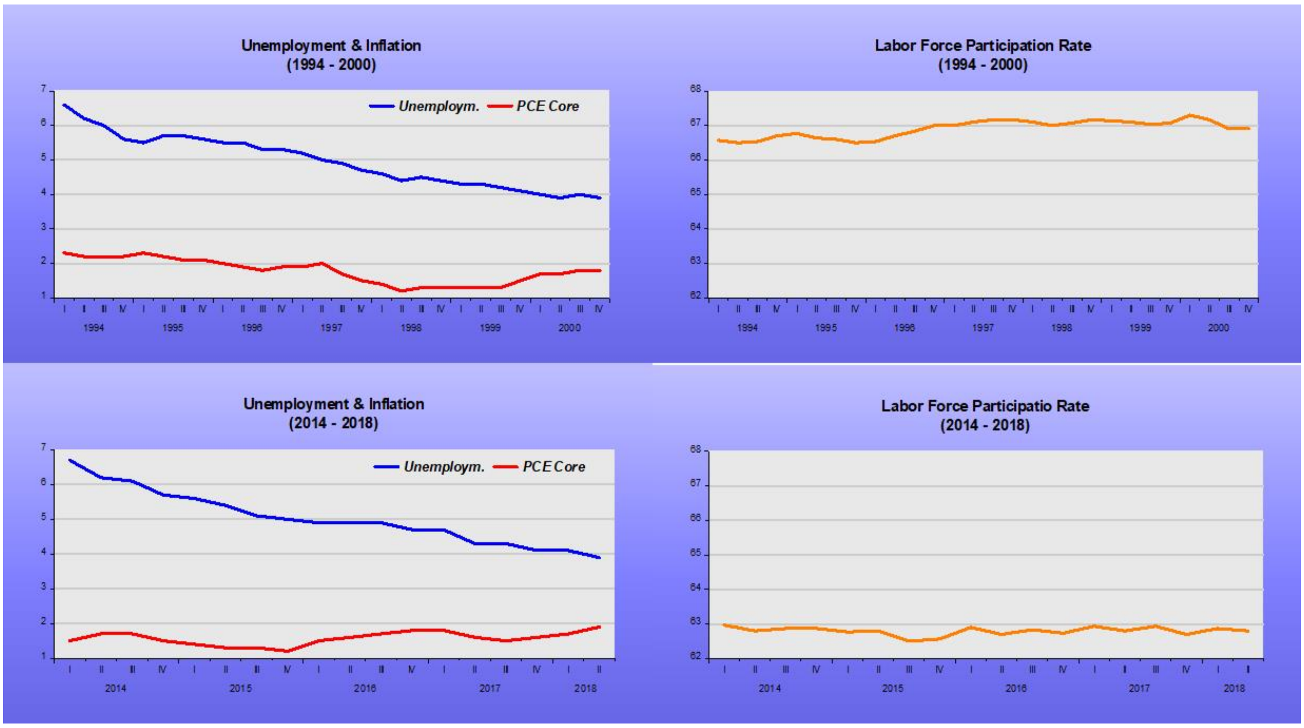


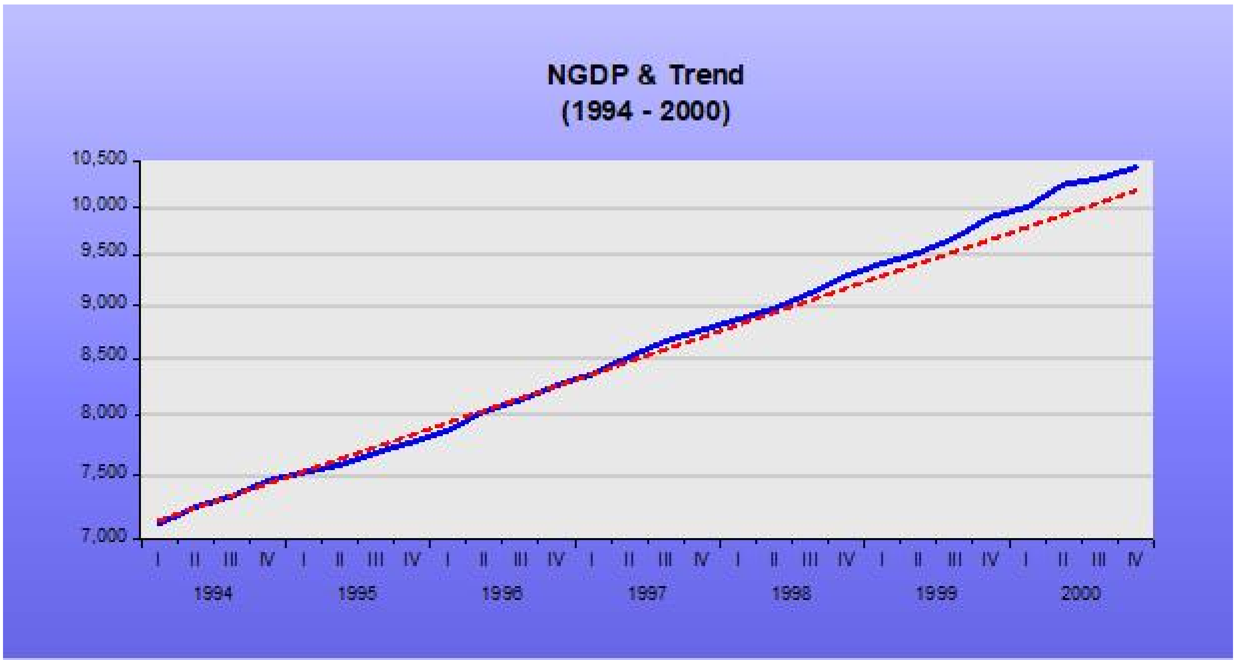


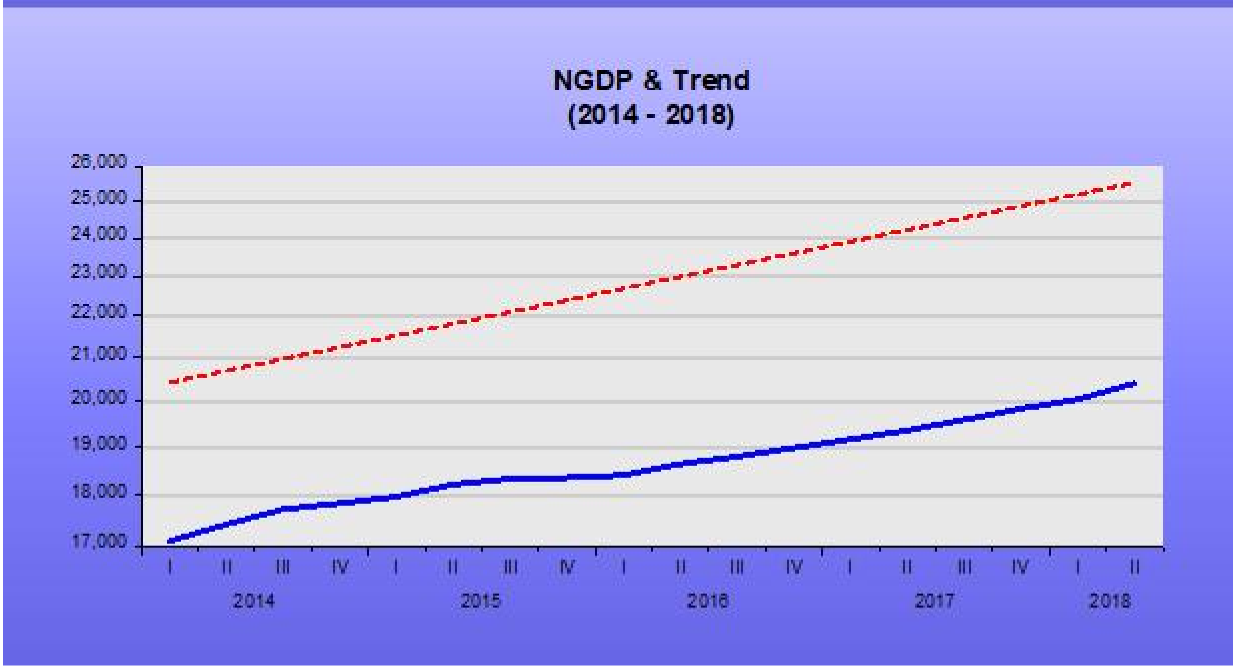

There is one caveat. The level of nominal spending (relative to trend) must be considered. For example, the charts below show that without additional information, it would be hard to distinguish the last few years from the second half of the 1990s. The behavior of inflation and unemployment is very similar in both periods.

If, however, you were shown data for the employment-population ratio or the labor force participation rate in the two periods, you would be able to “guess” which is which.

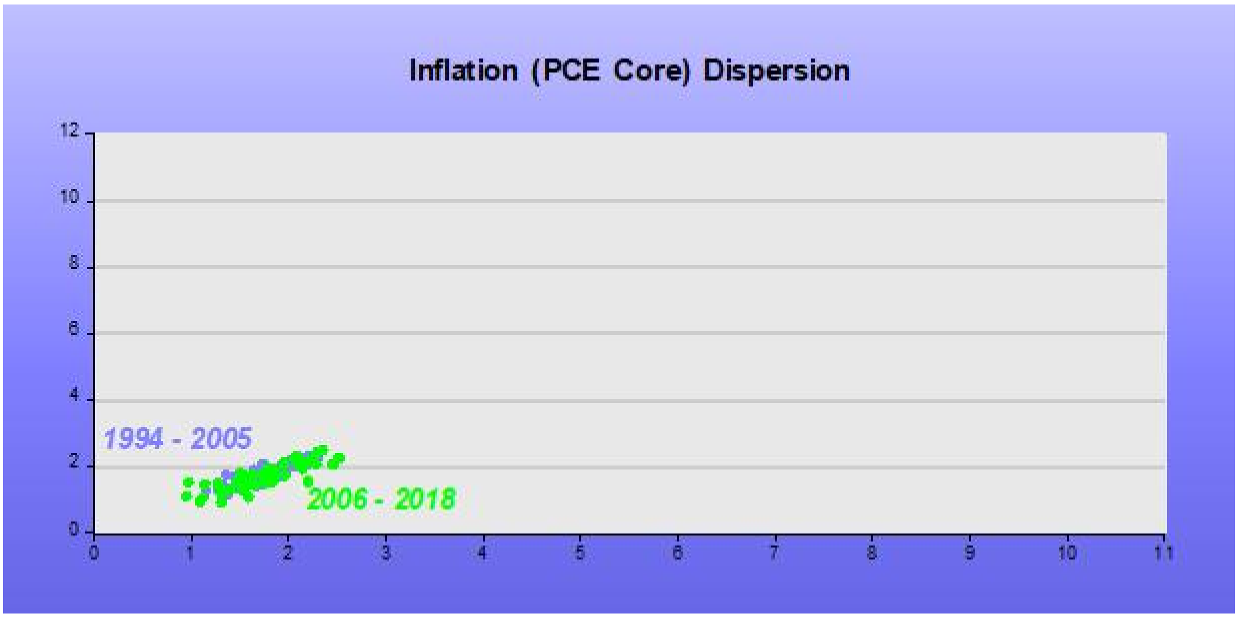



The next charts show that the level of nominal spending relative to (the same) trend is markedly different in the two periods. I believe that goes a long way in explaining why the labor force participation is so much lower at present. The “deniers” will say that mostly reflects demographic factors!




The next chart allows me to argue that targeting inflation is not the first best way of conducting monetary policy. Note that inflation in 1994 -05 and 2006 – 18 is the “same”. After “escaping” from the “stability circle” in 2008 -09, nominal spending growth was brought back inside the circle.  That means nominal spending growth has stabilized.




With that, inflation remains low & stable, just as it was before. However, since the Fed has kept the economy depressed (a much lower level of nominal spending), we are missing on many goodies that would be available if instead of inflation, the Fed targeted the **level path** of spending (just as it de facto did during the Great Moderation).