

A Monetary Policy for the Future¹

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A year ago on this same stage at another IMF conference, “Monetary Policy in the New Normal,” I argued that central banks should re-normalize monetary policy, not new-normalize it to some new normal as some had suggested. Today I want to elaborate on that theme, outline an implied monetary policy for the future and consider some objections that have been raised.

Let me begin with a mini history of monetary policy in the United States during the past 50 years. When I first started doing monetary economics in the late 1960s and 1970s, monetary policy was highly discretionary and interventionist. It went from boom to bust and back again, repeatedly falling behind the curve, and then over-reacting. The Fed had lofty goals but no consistent strategy. If you measure macroeconomic performance as I do by both price stability and output stability, the results were terrible. Unemployment and inflation both rose.

Then in the early 1980s policy changed. It became more focused, more systematic, more rules-based, and it stayed that way through the 1990s and into the start of this century. Using the same performance measures, the results were excellent. Inflation and unemployment both came down. We got the Great Moderation, or the NICE period (non-inflationary consistently expansionary) as Mervyn King put it. Researchers like John Judd and Glenn Rudebush at the San Francisco Fed and Richard Clarida, Mark Gertler and Jordi Gali showed that this improved performance was closely associated with more rules-based policy, which they defined as systematic changes in the instrument of policy—the federal funds rate—in response to developments in the economy.

Researchers found the same results in other countries. Stephen Cecchetti, Peter Hooper, Bruce Kasman, Kermit Schoenholtz, and Mark Watson showed that as policy became more rule-like in Germany, U.K., and Japan, economic performance improved.

Few complained about spillovers or beggar-thy-neighbor policies during the Great Moderation. The developed economies were effectively operating in what I call a nearly international cooperative equilibrium, another NICE to join Mervyn King’s. This was also a prediction of monetary theory which implied that if each country followed a good rules-based monetary policy then the international system would operate in a NICE way.

But then there was a setback. The Fed decided to hold the interest rate very low during 2003-2005, thereby deviating from the rules-based policy that worked well during the Great Moderation. You do not need policy rules to see the change: With the inflation rate around 2%, the federal funds rate was only 1% in 2003, compared with 5.5% in 1997 when the inflation rate was also about 2%. The results were not good. In my view this policy change brought on a search for yield, excesses in the housing market, and, along with a regulatory process which broke rules for safety and soundness, was a key factor in the financial crisis and the Great Recession.

¹ This is a written version of my opening remarks at a panel with Ben Bernanke and Gill Marcus on “Monetary Policy in the Future,” chaired by Jose Vinals. It was part of the IMF conference on “Rethinking Macro Policy III, Progress or Confusion?”

During the ensuing panic in the fall of 2008 the Fed did a good job of providing liquidity through loans to financial firms and swaps to foreign central banks. Reserve balances at the Fed expanded sharply due to these temporary liquidity provisions. They would have declined after the panic were it not for Fed's initiation of its unconventional monetary policy, the large scale purchases of securities now called Quantitative Easing. Regardless of what you think of the impact of QE, it was not rule-like or predictable, and my research shows that it was not effective. It did not deliver the economic growth that the Fed forecast and it did not lead to a good recovery. And yet another deviation from rules-based policy was the continuation of a near zero interest rate through the present, long after Great Moderation rules would have called for its end.

This deviation from rules-based monetary policy went beyond the United States, as first pointed out by researchers at the OECD, and is now obvious to any observer. Central banks followed each other down through extra low interest rates in 2003-2005 and more recently through quantitative easing. QE in the US was followed by QE in Japan and by QE in the Eurozone with exchange rates moving as expected in each case. Researchers at the BIS showed the deviation went beyond OECD and called it the Global Great Deviation. Rich Clarida commented that "QE begets QE!" Complaints about spillover and pleas for coordination grew. NICE ended in both senses of the word. World monetary policy now seems to have moved into a strategy-free zone.

This short history demonstrates that shifts toward and away from steady predictable monetary policy have made a great deal of difference for the performance of the economy, just as basic macroeconomic theory tells us. This history has now been corroborated by David Papell and his colleagues using modern statistical methods. Allan Meltzer found nearly the same thing in his more detailed monetary history of the Fed.

The implication of this experience is clear: monetary policy should re-normalize in the sense of transitioning to a predictable rule-like strategy for the instruments of policy. Of course, it is possible technically for the Fed to move to and stick to such a policy, but the long departures from rules-based policy show that it is difficult.

These departures suggest that some legislative backing might help. Such legislation could simply require the Fed to describe its strategy or rule for adjusting its policy instruments. It would be the Fed's job to choose the strategy and how to describe it. The Fed could change its strategy or deviate from it if circumstances called for a change, but the Fed would have to explain why.

There is precedent for such legislation. The Federal Reserve Act used to require the Fed to report ranges of the monetary and credit aggregates. The requirements were repealed in 2000. In many ways the proposed reform would simply replace them. It would provide responsible oversight without micro-managing. It would not chain the Fed to a mechanical rule. It would not threaten the Fed's independence. Indeed, it would give the more independence from the executive branch of government.

Now let me consider some of the objections to such a monetary policy whether it is backed by legislation or not.

Some argue that the historical evidence in favor of rules is simply correlation not causation. But this ignores the crucial timing of events: in each case, the changes in policy occurred before the changes in performance, clear evidence for causality. The decisions taken by Paul Volcker came before the Great Moderation. The decisions to keep interest rates very low in 2003-2005 came before the Great Recession. And there are clear causal mechanisms, such as the

search for yield, risk-taking, and the boom-bust in the housing market which were factors in the financial crisis.

Another point relates to the zero bound. Wasn't that the reason that the central banks had to deviate from rules in recent years? Well it was certainly not a reason in 2003-2005 and it is not a reason now, because the zero bound is not binding. It appears that there was a short period in 2009 when zero was clearly binding. But the zero bound is not a new thing in economics research. Policy rule design research took that into account long ago. The default was to move to a stable money growth regime not to massive asset purchases.

Some argue that a rules-based policy is not enough anymore and that we need more international coordination. I believe the current spillovers are largely due to these policy deviations and to unconventional monetary policy. We heard complaints about the spillovers during the stop-go monetary policy in the 1970s. But during the 1980s and 1990s and until recently there were few such complaints. The evidence and theory is that rules-based policy brings about NICE results in both senses of the word

Some argue that rules based policy for the instruments is not needed if you have goals for the inflation rate or other variables. They say that all you really need for effective policy making is a goal, such as an inflation target and an employment target. The rest of policymaking is doing whatever the policymakers think needs to be done with the policy instruments. You do not need to articulate or describe a strategy, a decision rule, or a contingency plan for the instruments. If you want to hold the interest rate well below the rule-based strategy that worked well during the Great Moderation, as the Fed did in 2003-2005, then it's ok as long as you can justify it at the moment in terms of the goal.

This approach has been called "constrained discretion" by Ben Bernanke, and it may be constraining discretion in some sense, but it is not inducing or encouraging a rule as a "rules versus discretion" dichotomy might suggest. Simply having a specific numerical goal or objective is not a rule for the instruments of policy; it is not a strategy; it ends up being all tactics. I think the evidence shows that relying solely on constrained discretion has not worked for monetary policy.

Some of the recent objections to a rules-based strategy sound like a revival of earlier debates. Larry Summers makes analogies with medicine saying he would "rather have a doctor who most of the time didn't tell me to take some stuff, and every once in a while said I needed to ingest some stuff into my body in response to the particular problem that I had. That would be a doctor who's [advice], believe me, would be less predictable."

So, much as the proponents of discretion in earlier rules versus discretion debates (such as Walter Heller and Milton Friedman), Summers argues in favor of relying on an all-knowing expert, a doctor who does not perceive the need for, and does not use, a set of guidelines.

But much of the progress in medicine over the years has been due to doctors using checklists. Experience shows that checklists are invaluable for preventing mistakes, getting good diagnoses and appropriate treatments. Of course doctors need to exercise judgement in implementing checklists, but if they start winging it or skipping steps the patients usually suffer. Checklist-free medicine is as bad as rules-free monetary policy.

Many say that macro-prudential policy of the countercyclical variety is an essential part of a monetary policy for the future. In my view it is more important to get required levels of capital and liquidity sufficiently high. We do not know enough about the impacts of cyclical movements in capital buffers to engage in fine tuning, and it puts the central bank in the middle of a very difficult political issue.

Some argue that we should have QE forever, leave the balance sheet bloated, and use interest on reserves or reverse repos to set the short term interest rate. But the distortions caused by these massive interventions and the impossibility of such policy being rule-like indicate that QE forever should not be part of a monetary policy for the future. The goal should be to get the balance sheet back to levels where the demand and supply of reserves determine the interest rate. Of course, interest rates on reserves and reverse repos could be used during a transition. And a corridor system would work if the market interest rate was in between the upper and lower bands and not hugging one or the other.

Should forward guidance be part of a monetary policy for the future? My answer is yes, but only if it is consistent with the rules-based strategy of the central bank, and then it is simply a way to be transparent. If forward guidance is used to make promises for the future that will not be appropriate in the future, then it is time-inconsistent and should not be part of monetary policy.

For all these reasons monetary policy in the future should be centered on a rule or strategy for the policy instruments designed to achieve stated goals with consistent forward guidance but without cyclical macro-prudential actions or quantitative easing.