

Special Feature B

Re-normalise, Don't New-normalise Monetary Policy

by John B. Taylor¹

Introduction

Now is a good time to take stock and consider where monetary policy should be going in the future. The actual practice of monetary policy in many countries in recent years—including the years leading up to and after the Global Financial Crisis (GFC)—has been dramatically different from policy in the years before. In some countries—the United States and several European countries in particular—this shift in policy was apparent before the crisis, and it showed up in a great deviation of policy interest rates from levels that would have been set in earlier periods under similar conditions. This shift continued after the crisis in what some researchers have called the Global Great Deviation², and it has been accompanied by many other unconventional monetary policy actions, including quantitative easing and Operation Twist, involving the large-scale

purchases of securities, as well as the increased use of capital controls and credit market interventions in emerging market economies.

There is now much discussion of the exit from unconventional policy, but the key question is where policy should be exiting to. Some are calling for a so-called new normal for monetary policy which would see the continuation of many of these interventions, and the IMF recently devoted a conference, “Monetary Policy in the New Normal”, to the idea.

In my view, central banks should re-normalise monetary policy rather than new-normalise it to some new normal. In this Special Feature, I explain this view by reviewing the actual practice of monetary policy and its impact in recent years.

Lessons from the Practice of Monetary Policy

I start by going back to the period before the recent GFC and illustrate important changes in monetary policy. It is useful to refer to the simple timeline in Chart 1, which shows the inflation rate and some representative monetary policy decisions in the United States.³ In the late 1960s, inflation was picking up, but monetary policy was falling behind the curve, as shown in Chart 1. With

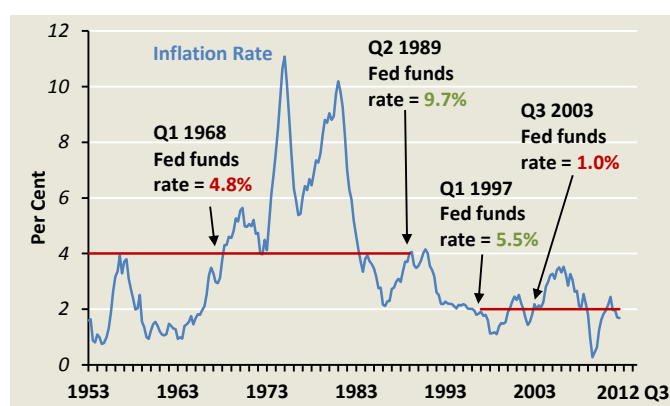
an inflation rate of 4%, policymakers held the Federal funds rate—the policy interest rate—just a bit over 4%, not high enough to contain the rising inflation. And so inflation rose and so eventually did unemployment. This was a highly discretionary and interventionist period, and the results were poor.

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² See Hofmann and Bogdanova (2012).

³ A more detailed analysis using policy rules or monetary response functions reveals these same changes.

Chart 1
United States Inflation Rates and Federal Funds Rates



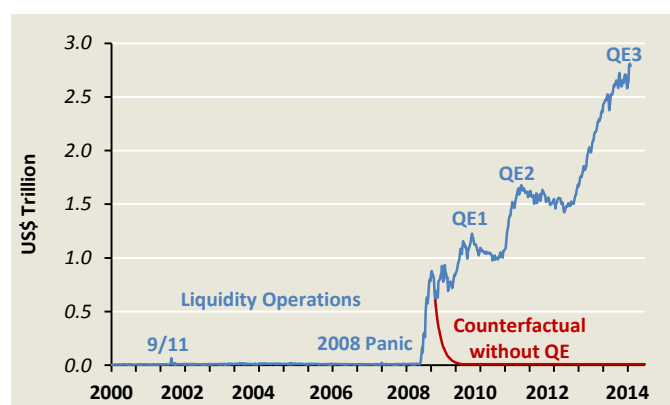
After more than a decade of this type of decision-making, policy changed (also illustrated in Chart 1). With an inflation rate of 4% in the late 1980s, the funds rate was nearly twice as high (9.7%) as it was in similar circumstances in the previous period. This new type of policy, which began when Paul Volcker was appointed Federal Reserve Chair in 1979, led to much better results. Both inflation and unemployment eventually fell. This policy continued through the 1990s and into the start of the new century: when the inflation rate was 2%, the interest rate was 5.5% in 1997. More generally, policy was systematic and rule-like.

But then there was a setback. The Federal Reserve started to hold its policy rate too low starting around 2003. In the timeline, the inflation rate was at 2%, while the funds rate

was only 1%. That was a deviation from the policy that had been working well in the 1980s and 1990s, and in retrospect was a precursor to the unconventional policy in the years ahead. The results were not good. In my view, this excessively low rate brought on a risk-taking search for yield, excesses in the housing market, and, along with a regulatory process which broke the rules for safety and soundness, was a key factor in the financial crisis and the deepness of the Great Recession.

During the panic in the fall of 2008, the Federal Reserve did a good job in its lender of last resort role by providing liquidity to the financial markets through loans and swaps to foreign central banks. Reserve balances expanded due to these temporary liquidity facilities as shown in Chart 2.

Chart 2
Federal Reserve Balances: Jan 2000 – Jul 2014



But then the Federal Reserve launched significantly into unconventional monetary policy—quantitative easing—as shown in Chart 2 by the massive increase in reserve balances due to QE1, QE2 and QE3. Regardless of what one thinks of the impact of these unconventional monetary policy actions, they were not rule-like

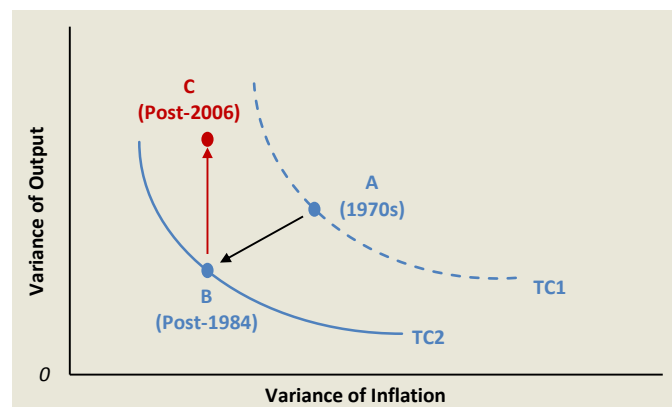
or predictable. My research shows that they were not effective, and may even have been counterproductive (Taylor, 2013b). Economic growth during the recovery from the Great Recession was much weaker than in earlier US recoveries from deep recessions.

Rules versus Discretion Again

Thus, shifts in monetary policy have made a great deal of difference for the performance of the economy. This view is corroborated by more formal statistical and historical classifications. Alex Nikolsko-Rzhevskyy, David Papell and Ruxandra Prodan (2014) ran monetary policy decisions through their statistical filters and detected rule-like policy from 1983 to 2002 and more discretionary policy in the periods before and after. Allan Meltzer (2012) used a historical methodology and found nearly the same thing. During the rules-based period, economic performance was so good that economists have dubbed it the Great Moderation, the Long Boom or simply NICE, for Non-Inflationary Consistently Expansionary, in the words of Mervyn King (2003).

The results can be summarised with the conventional macroeconomic stability trade-off curve used by Ben Bernanke ten years ago and shown in Figure 1. It shows the two objectives of monetary policy: price stability and output stability. Bernanke (2004) argued that the change in monetary policy was the reason for the shift from point A to point B, not simply some divine coincidence or a new normal. This is a view I agree with, and I have updated the figure to show the deterioration in performance since the end of the Great Moderation. I would argue that a change in the monetary policy approach is a big factor behind the movement to point C, not some devilish takeover of the divine coincidence or a new normal.

Figure 1
Macroeconomic Stability Trade-off Curve (TC)



Source: Bernanke (2004), updated to post-2006

It is important to note that changes in *de jure* central bank independence were not a factor in this policy change. As shown by Christopher Crowe and Ellen Meade (2007), the central bank law did not change much during this period. But it appears that *de facto* independence changed. Many agree that the Federal Reserve in the 1970s gave up a great deal of independence and that Paul Volcker took it back in the 1980s. Some now argue that with the unconventional actions in

recent years—such as buying mortgage-backed securities to help the housing market—the central bank has again begun to give up *de facto* independence.

The policy implication of this experience is clear: monetary policy should re-normalise or move back to the type of predictable rule-like policy that worked in the past.

Possible Objections and Sum-up

Of course there are objections to this conclusion. One focuses on the *zero bound* on the nominal interest rate. Wasn't that the reason that the central banks had to deviate from rules? Well, it was certainly not a reason in 2003–05 and it is not a reason now. By my calculations the short rate should be about 1.25% in the US now, so the zero bound is not binding. It appears that there was a short period in 2009 when zero was binding. But the zero bound is not a new thing in policy research. Policy rule design studies took that into account long ago. The default in the case of the zero bound was to move to a stable money growth regime, not to massive asset purchases. And David Reifschneider and John Williams (2000) proposed a rule-based way to deal with the problem back in the 1990s.

What about *monetary policy spillovers and international cooperation*? I believe the spillovers are largely due to these policy deviations and to unconventional monetary policy in particular. There were complaints about international spillovers during the stop-go monetary policy in the 1970s and of course during their necessary undoing under Volcker. But during the 1980s and 1990s and until recently there were few such complaints. Indeed it was a period of another NICE—a Near International Cooperative Equilibrium—to go along with Mervyn King's NICE during this period, much as models of international monetary theory predicted (Taylor, 2013c).

Should *forward guidance* be part of monetary policy in the future? Yes, but not in the

frequently changing and inconsistent way it has often been practiced during recent years. Forward guidance must be consistent with the policy rule or strategy of the central bank, and then it is simply a matter of being transparent about the strategy and a by-product of re-normalising. If it is purposely meant to promise for the future what will not be appropriate in the future, then it is time-inconsistent, and is not a good idea. Frequently changing forward guidance causes problems for monetary policy.

Some argue in favour of a policy of *QE forever* with reserve balances remaining high, allowing massive purchases and sales of securities on a regular basis. I think that the distortions caused by such massive interventions as well as the impossibility of making such a policy rule-like imply that such a new-normalised policy would be a huge mistake. It is best to have a goal of getting reserves back to levels where the demand and supply of reserves determine the interest rate. A corridor system for the interest rate would work if the market interest rate was in between the upper and lower bands and not hugging one or the other.

So, in conclusion, considering the actual practice of central banking in recent years and the problems with a so-called new normal policy, my recommendation is to declare that the goal is to return to a normal monetary policy, to describe the policy rule or strategy that would characterise that normal, and to lay out a transition strategy to get there.

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