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A Monetary Mind at the Treasury

Dec 4, 2020 | **JOHN B. TAYLOR**

STANFORD – No US secretary of the treasury will have spoken out so often and with as much authority about monetary policy as Janet Yellen once she is sworn into that position. The only other former Federal Reserve chair to become treasury secretary was G. William Miller in 1979, and he had spent only one year at the Fed. Yellen, by contrast, previously served for two decades there – through good times and bad – with stints as staff economist, governor, president of the San Francisco District, vice chair, and chair.

Such experienced leadership at the top of the treasury department will matter greatly for monetary-policy rules and strategy in the months and years to come. In anticipating what Yellen might do, there is a long history to consider. In 1996, when she was a Fed governor, she spoke about policy rules in a speech entitled "Monetary Policy: Goals and Strategies." Holding up the Taylor Rule as an exemplar, she said that it "has appealing properties as a *normative* description of how policy *ought* to be conducted."

Listing some of these properties, Yellen noted that the Taylor Rule has a "long-run inflation target," and that it entails "a strategy for handling tradeoffs … taken in the context of a systematic long-run strategy." It has been shown "to deliver remarkably good performance in the face of a wide variety of shocks," and it can "help the Federal Reserve communicate to the public the rationale behind policy moves."

Some 16 years later, as a Fed vice chair, Yellen said that a good "benchmark rule should conform to the so-called Taylor principle, which states that, other things being equal, a central bank should respond to a persistent increase in inflation by raising nominal short-term interest rates by more than the increase in inflation." She then added her own rules-based feature, arguing that "it is essential that policy rules incorporate a sufficiently strong response to resource slack … to help bring the economy back toward full employment expeditiously."

Then, in 2017, Yellen, as Fed chair, stated that the Taylor Rule "embodies key principles of good monetary policy," and went on to explain the differences between what it prescribes and the Fed's actual policies. She indicated that a strict mathematical formula could be supplemented by easy-to-understand formulations such as, "When the economy is weak… we encourage spending and investing by pushing short-term interest rates lower … when the economy is threatening to push inflation too high down the road, we increase interest rates."

Throughout 2017, Yellen and the Federal Open Market Committee (FOMC, the Fed's rate-setting body) had been pushing actual monetary policy in a more strategic direction, dialing the benchmark federal funds rate toward a normal level and unwinding the Fed's asset holdings. And that July, Yellen issued a new *Monetary Policy Report* that included, for the first time ever, a section on "Monetary Policy Rules and Their Role in the Federal Reserve's Policy Process." Noting that the same "key principles of good monetary policy" are incorporated into other policy rules, the report recognized the value of the Taylor Rule and four variations on it.
This emphasis on rules and strategies continued under Yellen's successor, Fed Chair Jerome Powell. In a 2018 *Monetary Policy Report*, there were sections elaborating on the 2017 report, with Powell stating in Congressional testimony that,

"In evaluating the stance of monetary policy, the FOMC routinely consults monetary policy rules. … I find these rule prescriptions helpful. … I would like to note that this *Monetary Policy Report* provides further discussion of monetary policy rules and their role in the Federal Reserve's policy process."

Then, in March 2018, the Fed launched a new website on "Monetary Policy Principles and Practice," which included a section on "Policy Rules and How Policymakers Use Them."

But the COVID-19 crisis has changed all this. After six consecutive *Monetary Policy Reports* that echoed the fundamental changes made in July 2017, the July 2020 Report had absolutely nothing to say about policy rules. While the Fed's emergency actions in March and April were both necessary and effective in opening financial markets, that period has since passed, and there is now hope for rapid deployment of vaccines and a return to more normal economic conditions.

We do not yet know what the future holds for monetary policy, but many commentators have been calling for a return to what David Papell and Ruxandra Prodan of the University of Houston call "policy rule forward guidance." Fortunately, the minutes of the November 2020 FOMC meeting offered hints of a possible move in this direction, with "Many participants [judging] that the Committee might want to enhance its guidance for asset purchases fairly soon."

In any case, the Fed will maintain its independence going forward. But with views from different parts of the new administration and Congress influencing future appointments and legislation, and with another pandemic spending package in the offing, it would help to have a more rules-based monetary policy in place at the Fed. This would greatly simplify negotiations and improve the design of fiscal policy more generally. Likewise, having a treasury secretary who supports the move to a clear, predictable, systematic, rules-based monetary strategy will be most welcome.

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