A Steadier Course for Monetary Policy

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Testimony before the
Joint Economic Committee on
"The Fed at 100: Can Monetary Policy
Close the Growth Gap and Promote a Sound Dollar?"

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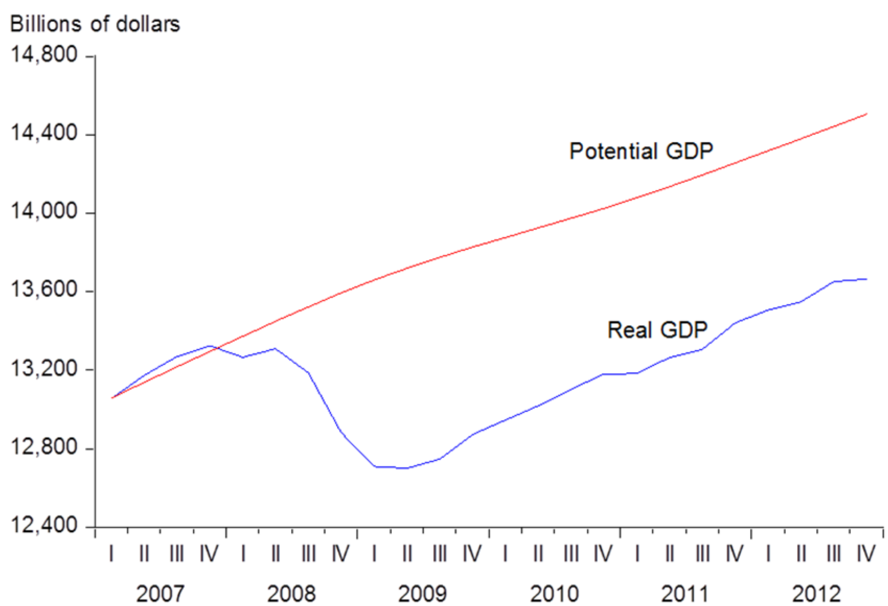
Chairman Brady, Vice Chair Klobuchar, other members of the Committee, thank you for the opportunity to testify. I will focus on the adverse impacts of the Federal Reserve's recent departure from a rules-based monetary policy and on the gains from a return to a steadier policy which would close the growth gap and maintain the purchasing power of the currency.

The Departure from a Rules-Based Monetary Policy Has Been Harmful to the Economy

The invitation to testify asked about "the Federal Reserve's departure from a rules-based policy." In my view such a departure has been the defining characteristic of monetary policy during the past decade in marked contrast to the steadier rules-based policy of the 1980s and 1990s. Monetary policy has consisted mainly of highly discretionary and unpredictable changes in the policy instruments in recent years, and, largely as a result, economic performance has not been good. We have had a deep recession and a very slow recovery, which have together created a huge growth gap—a main focus of this hearing. The persistent difference between potential GDP and real GDP illustrates the *growth gap*.



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The recent departure from rules-based policy began when the Fed decided during 2003-2005 to hold its target interest rate target well below the level implied by monetary rules that had characterized policy in the previous two decades of good performance. As I have argued previously,[2] this intervention led to a search for yield and excessive risk taking which exacerbated the housing boom, leading to the housing bust and the financial crisis which turned the recession into the great recession.

Once the financial crisis was evident in August 2007 the Fed continued with its unusual policy interventions. These measures did not prevent the crisis from getting worse; in my view some of them were harmful and an outright panic broke out in September 2008. One example is the Term Auction Facility announced in December 2007, which did not have the intended effect of reducing interbank interest rates in early 2008—as I testified to the House Committee on Financial Services[3] at the time—and probably drew attention away from risks in the banking system.

When the panic did strike in late September 2008, however, the Fed's liquidity support provided from October to December was helpful, especially in rebuilding confidence and stabilizing the money markets and the commercial paper market.

More problematic has been the continued departure from rules-based policy from 2009 through the present. Rather than simply letting the liquidity facilities draw down after the panic of 2008, the Fed started its unconventional quantitative easing program with large-scale purchases of Treasury and mortgage-backed securities. And when the recovery did not pick up as it expected, the Fed increased the massive asset purchases, which are now running at a pace of $85 billion per month. The Fed also repeatedly extended the zero interest rate policy, which now it says—as part of its forward guidance—will continue at least until the unemployment rate hits 6.5%.

Since 2009 I have argued in Congressional testimony[4] and elsewhere[5] that continuing these unprecedented discretionary interventions would create economic uncertainty and risk, which are detrimental to the economy. And indeed the interventions have been accompanied by disappointing outcomes as the Fed's growth forecasts, based on the policies, have consistently proved overly optimistic. After four years of disappointing results, it is hard to make a convincing case that the policies have been working.

From the start, these policies have created a two-sided risk of either continued economic drag or a future pick-up of inflation due in part to the uncertain impact of the eventual exit from the policies. Soft landings are always difficult for monetary policy and they are now more difficult than ever because it is hard to estimate the impact of selling the assets that the Fed has

[2] "Housing and Monetary Policy," in *Housing, Housing Finance, and Monetary Policy,* Federal Reserve Bank of Kansas City, September 2007, pp. 463-476.
[3] "Monetary Policy and the State of the Economy," Testimony before the Committee on Financial Services, U.S. House of Representatives, February 26, 2008.
[4] "Monetary Policy and the Recent Extraordinary Measures Taken by the Federal Reserve," Testimony before the, Committee on Financial Services, U.S. House of Representatives, February 26, 2009
[5] "Systemic Risk and the Role of Government," Dinner Keynote Speech, Conference on Financial Innovation and Crises, Federal Reserve Bank of Atlanta, Jekyll Island, Georgia, May 12, 2009

purchased. Moreover, raising interest rates at the same time will add to the difficulty, especially when the market has grown used to zero interest rates and government support for longer term bonds over many years.

A Gradual Exit from the Unprecedented Actions Would Be Helpful

For these reasons, the Fed should consider exiting from these policies sooner than is apparently its intent and the market's expectation. The longer the Fed's zero rate policy continues and the more its balance sheet grows, the more difficult the exit will be.

Of course, any exit strategy should be gradual and credible so as to mitigate any adverse effects on financial markets, or on residential investment and other components of spending. The exit strategy should also resolve any dynamic inconsistencies. Currently there is an inconsistency between the promise to hold the federal funds rate to zero until the unemployment rate hits 6.5 %—currently estimated by the Fed to occur in 2015—and the appropriate level of the rate that year. A variety of monetary policy rules suggest that the rate should be above zero in 2015 with the Fed's forecasts.

A return to a more rules-based policy will help remove the risks that are holding the economy back now.[6] A return to normal market-determined interest rates will reduce the incentive for pension funds and retirees to take on dangerous risks to boost their miniscule yield. It will reduce the incentive for banks to carry rather than write off bad loans. It will reduce the incentives for excessive federal borrowing and fiscal interventions. It will help restore the Fed's independence, which has been threatened by its excursions into fiscal and credit allocation policy and questioned by those who do not see why an independent agency of government should have such powers. And it will restore market signals and price incentives to money, bond, and other markets where the Fed's presence is repressing essential market mechanisms. Most important it will reduce harmful unpredictability due to deviations from steadier policy

Perhaps the best opportunity for the Fed to initiate an exit would be if and when economic growth rises above 2% for more than a quarter or two. Remarkably, economic growth has never even reached a four-quarter growth rate of 3% in this entire recovery. A credible exit could turn a couple of quarters of strong growth into a sustained recovery.

What rules-based monetary policy should the Federal Reserve follow to close the growth gap and maintain the purchasing power of the U.S. dollar?

This crucial question—raised in the invitation to appear here today—is best answered by examining American history. During the 1980s, the 1990s, and until recently, the Fed came closer to adhering to a rules-based policy than during any other comparable length period in its

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[6] These risks are discussed in my testimony "A Review of Recent Monetary Policy," before the Subcommittee on Monetary Policy and Trade, Committee on Financial Services, U.S. House of Representatives, March 5, 2013

100-year history.[7] The main instrument of policy during this period was the short-term interest rate—the federal funds rate—which was regularly adjusted by the Federal Open Market Committee according to developments in the real economy and changes in inflation, first with the aim of reducing inflation and then with the aim of maintaining a low and stable inflation rate. It was recognized that having a strategy for the instruments of policy was a good way to maintain price stability—the purchasing power of the currency—while at the same time stabilizing the real economy and keeping unemployment low.

In fact inflation and unemployment came down dramatically during this period, and the overall economy was so stable that economists have dubbed the period the Great Moderation. This Great Moderation ended with the 2007-2009 Great Recession and the 2009-ongoing Not-So-Great Recovery. The main lesson from both the successful and unsuccessful periods of American monetary history is that a rules-based policy, which adequately constrains discretion, works well. The provisions of the Sound Dollar Act reflect that lesson.

Monetary policy should focus on a clear strategy for the *instruments* of policy as well as the goal of that strategy. A goal or a target for inflation or nominal GDP is not enough if it is simply part of a "whatever-it-takes" approach to the instruments of policy. Such an approach can result in highly discretionary and unpredictable changes in policy instruments with unintended adverse consequences, as we have seen in recent years.

A successful rules-based policy must have a strategy for the instruments of monetary policy—either the federal funds rate, reserves, or something else that the Fed can reasonably control directly. The most straightforward way to make such a rule an integral part of monetary policy would be to reinstate the formal reporting requirement for the instruments of policy that was removed from the Federal Reserve Act in 2000. But rather than focus only on money growth as the requirement previously did, it would focus directly on a rule-like response of the short-term interest rate or some other appropriate instrument that the Fed can control.

This reform would constrain discretion by requiring that the Fed establish and report on a policy rule for the instrument. It would not require that the Fed choose any particular rule for the instrument, only that it establish some rule and report what the rule is. If the Fed deviated from its strategy, it would have to provide a written explanation and answer questions about its explanation. So while discretion would be constrained, it would not be eliminated. Congress would thereby exercise its constitutional authority without interfering in the day-to-day operations of monetary policy.

[7] See Allan H. Meltzer "Federal Reserve Policy in the Great Recession," *The Cato Journal*, Vol. 32, No. 2, 2012 and *A History of the Federal Reserve*, Volume 2, University of Chicago Press, Chicago, 2009.