Opinion

Keeping Monetary Policy Constrained

BY JOHN A. WEINBERG

Some have proposed that the Fed follow a binding, explicit rule — a mathematical formula — to determine monetary policy. Such a prescription has even found its way into legislation introduced in Congress last year, with proponents arguing that it would enhance monetary policy transparency and accountability. Is this a good idea?

An early example of such a rule is one advanced by Milton Friedman in 1960, his "k-percent" rule, under which the Fed would choose a measure of the money supply and increase the money supply by a constant percentage every year. Several decades later, in 1993, Stanford University economist John Taylor proposed a somewhat more complex type of monetary policy rule, known as the Taylor rule. This type of rule more closely reflects the operations of modern central banks, which tend to conduct policy by setting a target for a short-term interest rate.

One purported benefit of adhering strictly to a rule is that it would make the Fed's actions more predictable, eliminating an unnecessary source of uncertainty in the economy and financial markets. Research has shown, for instance, that the uncertainty created by highly variable inflation can hurt the performance of the economy.

Committing to a fixed rule is also sometimes seen as a response to the so-called time consistency problem discussed by Edward Prescott and Finn Kydland, among others. A central bank might always perceive that a short-run gain in real economic activity can be had by producing a bit more inflation than the public expects. But acting on this temptation ultimately only leads to ever-higher inflation.

Yet when assessing the concept of a monetary policy rule, it is important to ask what we are comparing it to. During the 1960s and 1970s, Fed policy was indeed highly activist and discretionary. This period was marked by policymakers acting on a perceived trade-off between inflation and unemployment. The resulting economic performance was far from desirable, with volatile inflation that ratcheted up in each cycle.

For several decades now, as many observers have noted, the FOMC has instead operated as if it were pursuing an explicit inflation target. In this sense, the behavior of the Fed has already been broadly rule-like for some time, albeit with some exceptions. In fact, the Taylor rule began as an effort — a successful effort — to show that Fed monetary policy had been following a path described by that rule. Fed policy arguably continued to follow such a path until the 2007-2009 recession, when most Taylor-type rules began calling for negative interest rates.

In January 2012, the Fed's policy of constrained discretion again took a step in the direction of being rule-like. At that time, the Fed announced an explicit long-run inflation target of 2 percent. Since then, the Fed has continued to commit publicly to achieving this target and to addressing substantial departures from it with monetary action, if need be.

Why not take that final step, then, and adopt a formal rule such as Friedman's or Taylor's — and follow it strictly all the time?

I think the main answer is that while a monetary policy rule could be useful during normal times, we don't always live in normal times. In fact, if we think of "normal" as "average," then times are almost never normal. This might not matter if the economy's abnormal times always looked like its abnormal times of the past; in that case, we could write the rule to deal with them, too. As we know well from the financial crisis and its aftermath, however, this is not the case. As Leo Tolstoy wrote of unhappy families, each unhappy economic period is unhappy in its own way.

Thus, it is unlikely anyone could have constructed an autopilot prior to 2007 to steer the Fed through the ensuing recession and weak recovery. Nor is it plausible to think that monetary policy rules in existence today are necessarily sufficient to get us through the next crisis, whatever it may turn out to be. FOMC members will then need to draw upon lessons of history and theory and upon their own judgment.

Further, a formula like the Taylor rule embodies assumptions about underlying characteristics of the economy. Concepts like the potential rate of output growth or the natural rate of unemployment could affect one's view of what the exact rule is that the central bank should follow. These are theoretical concepts — they can have a precise meaning in an economic model but are not directly observable in the data. The process of discussing policy within the FOMC can in part revolve around the sorting out of different views about these "latent variables."

Monetary policy rules can serve a useful function within a regime of constrained discretion by helping the Fed communicate what it is doing and intends to do. But for the Fed to prescribe a policy rule for itself and to commit always to follow it, or for Congress to impose such a rule, could actually reduce rather than increase the Fed's credibility with markets — because market participants understand that a commitment never to vary from a monetary policy rule is a commitment that neither Congress nor the Fed could realistically keep. **EF**

John A. Weinberg is senior vice president and special advisor to the president at the Federal Reserve Bank of Richmond.