

# **Monetary Policy 1.0**

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It was only just a few years ago that monetary policy experts had universally converged on a small set of central bank principles, Monetary Policy 1.0. These simple principles were based firmly on a central bank's credibility and the trust the central bank inspired in businesses, households and financial market. First, monetary policymakers embraced a rules based, inflation targeting approach to setting the federal funds rate that implied **very low rates of inflation**, and **limited counter-cyclical stabilization**. Second, there was near unanimity of opinion that **central banks should be independent** from other branches of government in choosing appropriate policies, even if central banks should not independently choose the goals for monetary policy. Both these positions have been long held by the Shadow Open Market Committee.

The current beta version of monetary policy, a response to the extraordinary challenges of the current financial crisis, has been a large deviation from Monetary Policy 1.0. Granted, policymakers had to make difficult decisions in real-time, and arm-chair economists may be no better at real-time policy than arm chair quarterbacks are at playing football on the field. However, some prominent economic policymakers now openly question some of the principles of Monetary Policy 1.0, and in turn wish to make a new, more fashionable Monetary Policy 2.0. We should all be concerned at this turn of events.

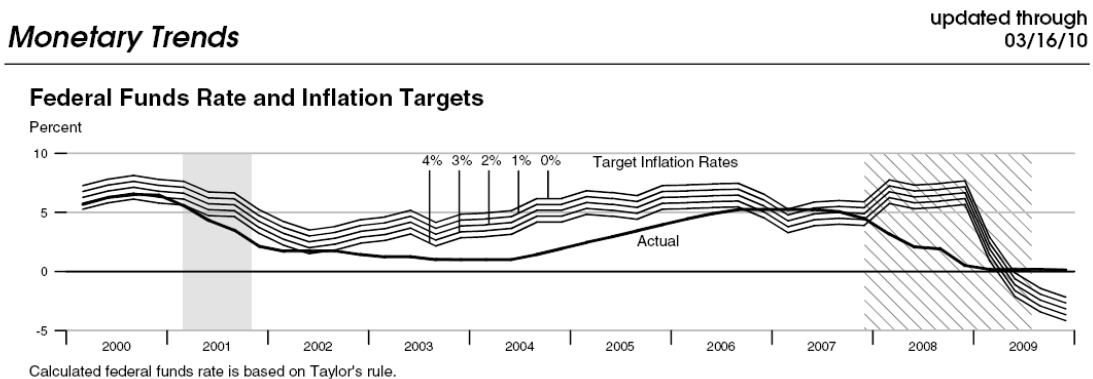
### **I. Long Run Inflation and Stabilization**

Let's start with whether Monetary Policy 1.0's *sine qua non* that a commitment to a long term low inflation, of say 2% or somewhat less, still remains desirable? According to Monetary Policy 2.0, the answer is no. The rationale for this new perspective is based on the view that low average inflation by central banks kept short term interest rates low, which limited central bank's abilities to generate negative real interest rates to combat the contractionary affects of the financial crisis. Indeed, in a recent co-authored piece, the IMF's Chief Economist, Olivier Blanchard [2010], states that "*Higher average inflation, and thus higher nominal interest rates to start with, would have made it possible to cut*

*interest rates more, thereby probably reducing the drop in output and the deterioration of fiscal positions.”* In stating this, he echoes the sentiments of John Williams [2009], Executive Vice President and Research Director of the San Francisco Federal Reserve, who argues for the possibility of considering an average inflation rate of 2% to 4% *“to avoid the zero lower bound [for the federal funds rate] causing sizable costs in terms of macroeconomic stabilization even in a much more adverse macroeconomic climate.”*

Presumably, these policy economists would have preferred that we entered the current financial crisis with a higher average rate of inflation as the consequence of a more expansionary monetary policy. This perspective is, of course, very concerning as it goes against the implication of the standard “Taylor rule” measure for calibrating monetary policy which has been used to argue that a likely contributing factor to our recent financial crisis was the Federal Reserve’s easy monetary policy – see Taylor [2010]. For example, the Federal Reserve Bank of St. Louis publishes a graph (Figure 1) of the level of the federal funds rate implied by the Taylor rule for alternative levels of long run inflation. As Figure 1 indicates, from the middle of 2002 through the middle of 2006, the federal funds rate was set by the FOMC below where policy had historically been even with a 4% inflation target level. This repeats itself again starting for at least a full year starting in January of 2008.

Figure 1: Taylor Rule Calculations for the Federal Funds Rate Path Under Alternative Long Run Inflation Objectives (Federal Reserve Bank of St. Louis, Monetary Trends)



Federal Reserve Chairman Ben Bernanke [2010], however, has recently provided evidence that policy was not too aggressive during the early to mid part of the last

decade, particularly as this relates to the issue of whether such a policy error by the FOMC contributed to the financial crisis.<sup>1</sup> Indeed, he demonstrates that by using real-time measures of output gaps and inflation forecasts, this more sophisticated version of the Taylor rule more closely tracks the actual federal funds rate.

That being said, in John Taylor's [2010] response to Chairman Bernanke's paper [2010], he notes that "*These technical arguments are important, but one should not lose sight of the forest through the trees. You do not have to rely on the Taylor rule to see that monetary policy was too loose. The real interest rate during this period was persistently less than zero, thereby subsidizing borrowers.*" Indeed, the SOMC [2004] at its meeting in May of 2004, made a similar declaration on the stance of monetary policy: "*With strong economic growth and the expansion on sound footing, the Fed must now begin the process of raising interest rates. Nobody knows the level of the federal funds rate consistent with a "neutral" monetary policy (one that generates sufficient growth in money while maintaining price stability) ... But that neutral real rate is clearly not negative.*" For the post-war U.S., extended periods where the real federal funds rate remains negative during an economic expansion have preceded both the Great Inflation and now the Great Recession. That's not a great track record.

Moreover, adopting a more inflationary monetary policy to achieve a 4% long run rate of inflation has other major negative consequences. First, there's no evidence that higher inflation generates better economic growth or lower unemployment—in fact, just the opposite is true. Second, a higher (4%) inflation target is inconsistent with the Federal Reserve's dual mandate as established by Congress that the Federal Reserve pursue price stability. Third, shifting to a 4% inflation target would push up nominal bond yields, with the associated economic costs for funding private sector activity and in managing the U.S.'s public debt.

Taken together, there appears to be an emerging dividing line between Monetary Policy 1.0 and 2.0. The latter suggests that we may need higher long run levels of inflation

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<sup>1</sup> Former Federal Reserve Chairman Alan Greenspan [2010] takes a similar position to current Chairman Bernanke.

consistent with more accommodative monetary policy so we can run more aggressive counter-cyclical policies in case large negative economic and financial shocks hit. By contrast, the former would suggest that we need to implement less aggressive counter-cyclical monetary policies and adopt a low long run average level of inflation so that we don't create the conditions where adverse economic and financial shocks become larger in magnitude. All in all, Monetary Policy 1.0 seems the stronger position by far.

## II. Central Bank Independence

The differences between Monetary Policy 1.0 and 2.0 are likely to be much less dramatic on the topic of Central Bank independence, although we will not know for sure for some time. The reason is that the policy response chosen to counteract the financial crisis required that the Federal Reserve, the executive and legislative branches of government, and the private sector to closely coordinate. At this point, as the major initial affects of the financial crisis begin to subside, it is difficult to determine *prima facie* whether the Federal Reserve remains master of its domain.

Only with time will we learn if the monetary policy consensus 2.0 has changed adversely for the Federal Reserve's independence. There are a few areas that we should look to for clues to the new consensus, particularly in the area of the politicization or regulatory capture of the Federal Reserve. Moreover, there are areas where the Federal Reserve could take action in order to establish and demonstrate its independence, which would in turn enhance its credibility.

The first clue to watch for to monitor the Federal Reserve's independence is in the choice of assets that the Federal Reserve chooses to hold on its portfolio, and how quickly it goes about selling off its holdings of non-traditional assets. The financial crisis has led the Federal Reserve to hold a host of non-standard private and semi-private (GSE instruments) assets, which have exposed the Federal Reserve's balance sheet to questions on politicization and regulatory capture. That being said, as a response to the crisis, the ownership of these assets has allowed the Federal Reserve to provide liquidity to markets

that were under siege and where public confidence had severely eroded. However, the time is soon approaching for the Federal Reserve to start unwinding its positions in these assets, and return to a “Treasuries only” policy – see Goodfriend [2010]. The Federal Reserve can sell private sector assets back to the private sector, and it can sell GSE securities to either the private sector or to the Treasury (the latter since Fannie Mae and Freddie Mac have now been nationalized and should, according to the CBO [2010], be part of the overall Federal Budget). Such a set of policies, as articulated in Goodfriend [2010], will limit politicizing the Federal Reserve’s role and help to enhance its independence and credibility.

The second area of concern for the Federal Reserve’s independence will be its ability to resist the temptation and pressure to monetize the outstanding public debt. Certainly, as public debt continues to mount, there will be short-run pressures by the legislative and executive branches for the Fed to exchange some of the government debt for money creation. History has not been kind to the economies of nations that pursue this temptation. To safeguard its independence, the Federal Reserve could simply announce that it will implement its responsibility to fulfill its dual mandate to create price stability and maximize employment by adopting a specific low long run inflation objective. Indeed, the FOMC could announce this policy interpretation as soon as possible, in order to minimize the inflation uncertainty inherent in an economy where market participants are simultaneously (and somewhat paradoxically) concerned with both deflation and inflation.

Finally, the third area to scrutinize the Federal Reserve’s evolving independence is in the role it takes, and the policies it adopts, in the new financial regulatory framework. The traditional approach – for the Federal Reserve System to oversee banks, to be the lender of last resort by freely lending to the market, and by allowing banks to borrow from the discount window at a penalty rate and with an enhanced level of scrutiny – was an attempt to balance off the system’s interest to supervise banks without being drawn into questions of favoritism and enabling the sense that some institutions were too big to fail. Starting with its role in the resolution of the hedge fund Long Term Capital in 1998, the

Federal Reserve's role in this balance has begun to wobble. Moreover, financial innovation has re-shaped the landscape that needs to be regulated, and it has made re-establishing the traditional approach in its current incarnation unsustainable.

The key question is whether a truly independent central bank can simultaneously fulfill its macroeconomic objectives, create a transparent, disciplined, rule based approach to oversee and resolve financial institutions in an impartial setting, and remain the lender of last resort to the market. It simply may not be possible. The current idea being floated, that large financial institutions should have documented "living wills" that will guide the resolution of the institution should it fail and that would be known to debtors and creditors, could be a step in the right direction as it would to some extent extricate the Federal Reserve from being accused of playing favorites during firm bailout. However, "living wills" for financial firms will need to be complemented with clear, credible and self-disciplining "do not resuscitate" orders by the central bank (should it take on this oversight role) if we are to end this era of "too big to fail".

## **Conclusion**

Notwithstanding current fashion, the best practices of monetary policy still include an objective for obtaining low inflation over the long run, and a desire to provide prudent counter-cyclical stabilization policy. In turn, such monetary policy principles help to insure that extraordinary emergency non-standard measures for monetary policy are seldom, if ever, required. The empirical evidence suggests that central bank independence provides the strongest institutional underpinnings to obtain low inflation rates in the long. Moreover, independent central banks can take a long-run timeless view of policy, which can in turn allow it to respond more prudently and with a less short sighted perspective when conducting counter-cyclical policy. Indeed, the principles of Monetary Policy 1.0 go hand in hand.

Re-establishing and enhancing its independence and credibility is a timely and critical issue facing the Federal Reserve. The leadership of the Federal Reserve System needs to

undertake potentially bold policies and actions to effectuate its independence. While the financial and monetary landscape has changed, efforts by the Federal to advocate and implement the principles of Monetary Principles 1.0 are essential for its ongoing success as an institution.

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