

Monetary Policy Normalization Should Be More Systematic and Less Wobbly

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ECONOMIC POLICIES FOR THE 21ST CENTURY

As the Powell era begins, the FOMC finds itself living in interesting times. The changing of the guard at the Federal Reserve brings with it both challenges and opportunities. Chair Yellen has handed over an economy in good condition: The unemployment rate suggests that the monetary policy accommodation and support provided by the Federal Reserve in the years following the crisis have restored full employment to the country, and, inflation, as measured by the PCE index, is close to the FOMC's 2% goal. Interestingly, while the concerns about deflation have waned, the drumbeat of fear that the economy is now overheated and that inflation may return can be heard in the not-so-far-off distance.

Under Chair Yellen, a gradual process of policy normalization was also started. Over the past two years, the federal funds rate has been gently raised from its historic lows and, in the past few months, the FOMC has implemented a slow process of unwinding the quantitative easing (QE) that had raised the size of the Fed's balance sheet by about 500% in the aftermath of the crisis. Numerous challenges remain, however, making the current calm potentially precarious for the Federal Reserve and for the economy. At the same time, the leadership change at the FOMC offers opportunities for the new Chair: Policy could be more systematic and less wobbly. Grasping these opportunities can help the new Chair safeguard the country against the current fragility and promote better policy over time.

Two of the challenges left behind by Chair Yellen are particularly important for understanding the tenuousness of the current calm. The first relates to the structural changes in the US economy that have made our understanding of inflation dynamics and of the monetary transmission mechanism less certain. Evidence for this is the less than stellar record of the FOMC's projections of inflation and unemployment in recent years. Figure 1 plots the projections made each December since 2011 and compares them with the historical outcomes as measured by currently available data.

As can be seen on the left panel of Figure 1, over this period the FOMC's unemployment projections have systematically missed the pace of decline. To be sure, errors in forecasting are not uncommon. In such a small sample, surprising developments that may have boosted aggregate demand could easily explain such misses, resulting in unemployment falling by more than forecast. Had this been the case, however, and using the analytical framework common in Federal Reserve analyses and communications, one would have expected corresponding misses in the FOMC's projections of inflation in the opposite direction.

In other words, if the structure of the economy had been stable and aggregate demand surprises were the main reason for U.S. unemployment outcomes being systematically below the FOMC's unemployment projections, then observed inflation outcomes should have been higher than the corresponding inflation projections. Instead, as can be seen on the right panel of Figure 1, the exact opposite is true. Both unemployment *and* inflation have surprised on the downside. This patterns suggest two important policy insights: first, that the FOMC's understanding of the link between inflation and unemployment may have deteriorated. The FOMC has acknowledged this uncertainty, as noted in its discussion on inflation analysis and forecasting that is described in the Minutes of the January FOMC meeting (Federal Reserve

Board, 2018). Just as importantly, it also suggests that the FOMC must have benefited from a positive aggregate supply development just as we enter the Powell era. “Good luck,” however, does not last forever.

The second, and more important challenge, relates to the fact that under Chair Yellen the Fed missed an opportunity to make its policy framework more robust by adopting a systematic rule that could inform all interested observers about its future policy. Contrary to all the lessons that could be drawn from monetary history and theory for over a generation, the Federal Reserve continues to formulate policy with meeting-by-meeting discretion, without adoption of a concrete strategy that could ensure a more systematic policy. The Federal Reserve continues to favor a framework that perpetuates dynamic inconsistency in its actions, making it more difficult for businesses and households to form expectations and plan for the future. Paradoxically, while uncertainty is often invoked to justify the continued reliance on meeting-by-meeting discretion, uncertainty raises the cost of the Federal Reserve’s discretionary approach: It makes it even harder for businesses and households to plan for the future (Orphanides, 2018).

The combination of these two challenges – uncertainty in the FOMC’s understanding of the linkage between inflation and output coupled with financial market uncertainty induced by the FOMC’s meeting-by-meeting discretionary approach to monetary policy – poses a heightened risk for the Federal Reserve under Chair Powell. It makes the Federal Reserve susceptible to an inflation scare, an adverse shift of inflation expectations and rising premia in bond markets. Marvin Goodfriend (1993) has documented inflation scares early in the tenures of Chairmen Volcker and Greenspan. In the case of Chair Volcker, it could be argued that an inflation scare was perhaps unavoidable, given the weak record the Federal Reserve had accumulated before he became Chair. But another inflation scare, which proved more dangerous, also materialized early in Chair Greenspan’s tenure, even after the Federal Reserve had enjoyed considerable success under Chair Volcker in dramatically reducing inflation. The first few months of Chair Greenspan’s tenure proved a difficult period to navigate. The tensions in the bond markets in the summer were followed by a stock market crash in October of that year.

The risk of inflation scares can be avoided when monetary policy follows a systematic approach that leaves little room to doubt the Federal Reserve’s commitment to protect price stability in the long run. Adoption of a clear quantitative inflation goal, as the Federal Reserve has done since 2012, is a step in the right direction (Orphanides and Williams, 2005). However, in light of the inevitable short-run conflicts in policy priorities that result from the Federal Reserve’s multiple goals, adoption of an inflation target is insufficient to ensure systematic policy. As a result, the risk of inflation scares remains. Such “wobbly” policymaking diminishes the reputation of the FOMC, and ultimately makes its job that much harder.

The Fed’s failure to adopt a systematic policy approach and continued reliance on meeting-by-meeting discretion is more problematic at present than it was before the crisis. Since the zero lower bound on interest rates was reached in 2008, QE has become another important policy tool. At present, to assess the complete stance of monetary policy requires an understanding of

how the FOMC plans to change the federal funds rate, as well as an understanding of what it intends to do with the size of the Fed's balance sheet. Expectations about the size of the balance sheet well into the future are embedded in the term structure of interest rates and form an integral part of the monetary policy transmission mechanism. (This has been nicely documented in recent work by Ihrig, *et al*, 2018.)

In recent years, the FOMC has provided some forward guidance with respect to the federal funds rate—the so-called “dot plot.” However, no similar forward guidance is provided for the size of the Fed's balance sheet, which makes it impossible to assess where the FOMC is headed in this critical policy area. Consider the current situation, as summarized in Figure 2. The left panel shows historical data for the federal funds rate and the median projection of the “appropriate” federal funds rate as presented in the FOMC's latest Survey of Economic Projections (SEP) published in December 2017. (Note that the “long-term” dot, for which no explicit date is provided, is shown in 2025 Q4.) The right panel shows historical data and projections of the size of the balance sheet of the Federal Reserve. The three scenarios are based on analysis by the Federal Reserve Bank of New York (FRBNY) that incorporate FOMC decisions on the future redemptions of assets. While the FOMC's decisions provide guidance for the gradual reduction of the balance sheet, no information has been provided about the desired targeted size of the balance sheet. Three alternative scenarios are presented, corresponding to those examined by FRBNY. The difference between the smallest and largest is about a trillion dollars, making the overall stance for monetary policy very different even for the fixed path of the federal funds rate provided in the dot plot.

Despite the appearance of “transparency” resulting from the FOMC's decision to publish the dot plot, the information provided is inadequate to assess the Federal Reserve's policy strategy. Together with the uncertainty regarding our understanding of inflation dynamics and the monetary transmission mechanism, the Federal Reserve's failure to adopt a systematic policy approach and continued reliance on meeting-by-meeting discretion makes the current calm fragile for the Federal Reserve and for the economy.

How can the Federal Reserve improve its communication of systematic policy? The change of leadership at the Federal Reserve presents an opportunity. Chair Powell can embrace the current challenge and move toward a more robust policy framework. The FOMC could adopt a concrete strategy that transparently explains how policy will evolve in response to changes in the outlook—a policy rule. Doing so would defend against the risk of inflation scares in the process of normalization and beyond and make monetary policy normalization more systematic and less wobbly.

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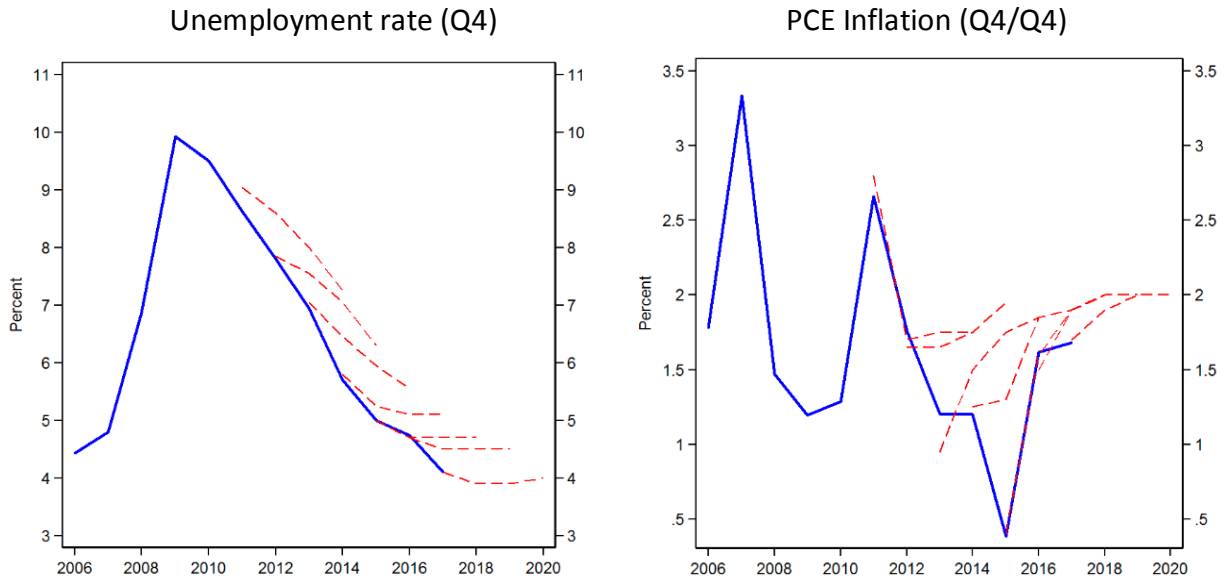
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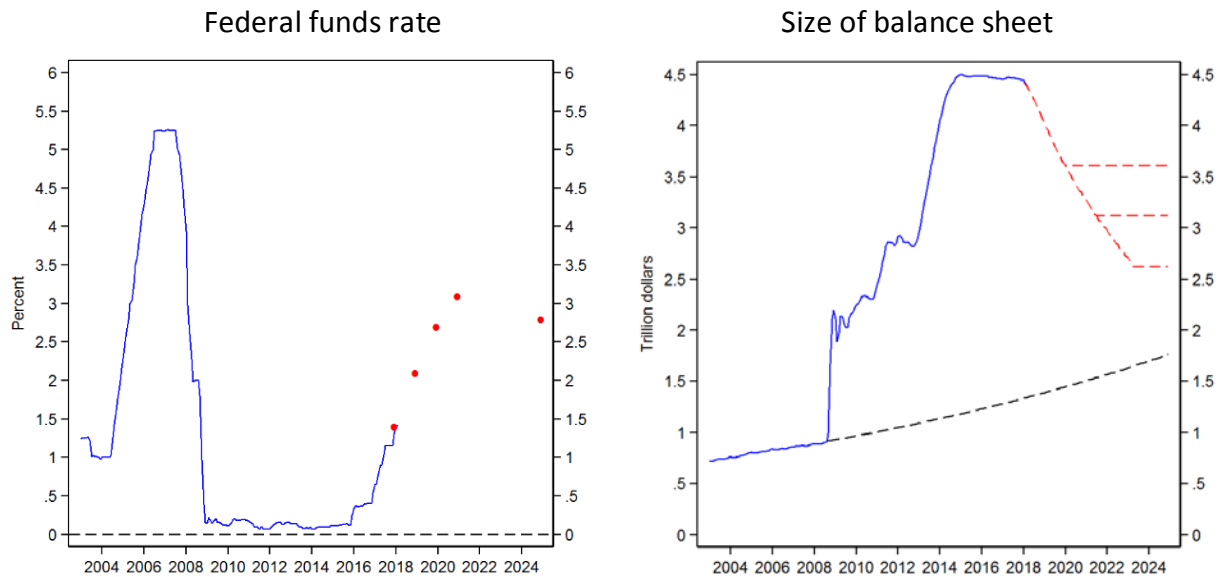
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Figure 1: FOMC projections and outcomes



Notes: Dashed lines show FOMC projections as published in each December SEP from 2011 to 2017.

Figure 2: Where is the FOMC headed?



Notes: Red dots show FOMC projection of the federal funds rate from the December 2017 SEP. Red dashed lines show projections of balance sheet based on alternative FRBNY scenaria. Black dashed line shows pre-crisis trend.