Achieving Normalcy in Monetary Policy

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Economic performance continues to improve and in most regards has moved close to normal, but the Federal Reserve's monetary policy remains far from normal. As the Fed tapers its asset purchases, it relies on forward guidance as a vehicle for artificially suppressing real interest rates even though the economy is in its fifth consecutive year of expansion and unemployment is declining.

Sustaining aggressive monetary stimulus carries high risks, even with inflation below its 2 percent target. The Fed's policies that constrain the natural fluctuations in real rates distort decisions to consume, save and invest, and generate resource misallocations. The Fed's contributions to improving economic performance have been more limited than the Fed suggests and inflation likely will overshoot the Fed's objective.

The Fed seems to have lost sight of what normal monetary policy should be, and the historic pitfalls of excessive focus on short-term conditions and monetary fine-tuning. As the economy and labor markets approach capacity, the need to artificially suppress real rates—and forward guidance--dissipates. Yet the Fed forecasts a zero real Federal funds rate at year-end 2016 when it forecasts the unemployment rate to be at its natural rate and inflation 2 percent.

There is now a strong rationale for the Fed to acknowledge its limitations, change the thrust of its forward guidance away from signaling sustained monetary stimulus far into the future and establish a transparent strategy to more quickly achieve monetary policy normalcy.

Fed Guidance in Prior Cycles. The monetary tightening cycles of 1994 and 2004-2006 provide relevant counters to the benefits of forward guidance and excessive efforts to over-manage market interest rates, and impart valuable lessons for today's Fed.

The 1994 Rate Hikes. The Fed's rate hikes in 1994 are widely considered to be the most effective "soft-landing" monetary tightening in Fed history, even by the Fed. ***Yet there was virtually no forward guidance!*** The Fed hiked rates substantially—from 3 percent to 6 percent between February 1994 and February 1995—and real rates rose sharply. This disinflationary monetary tightening paved the way to an extended economic expansion and robust performance in the second half of the 1990s, and built significant credibility for the Fed.

Even after benchmark revisions restored many of the "lost jobs" of the early 1990's "jobless recovery", by 1993Q4 the unemployment rate was 6.6 percent, well above the 5.5 percent at the end of the prior expansion. U-6, the broadest measure of unemployed plus part time plus marginally detached workers, was 11.8 percent in January 1994 (only a touch below its 12.6 percent level in February 2014). CPI inflation, then the Fed's designated measure-of-choice, had receded to 2.7 percent, only slightly below the 3 percent Federal funds rate. Back then, the Fed did not have a 2 percent inflation target and put little explicit emphasis on its dual mandate. The economy strengthened significantly in late 1993, but market yields edged up only modestly.

In response to the Fed's first rate hike of 25 basis points in February 1994, bond yields rose sharply, the yield curve steepened and the forward curve began building in significant further

rate hikes. Amid stable inflation, the Fed hiked rates another 25 basis points at its March meeting and then *surprised* markets with an intermeeting 25 basis point rate hike in April, followed by a 50 basis point increase at its May meeting and an increase at every subsequent meeting through February 1995.

The Fed's Policy Statements following its 1994 FOMC meetings were understated and virtually absent any hint of the forward guidance. The short Policy Statement announcing its first rate hike in February stated: "…the Federal Open Market Committee decided to increase slightly the degree of pressure on reserve positions…The decision was taken to move toward a less accommodative stance in monetary policy in order to sustain and enhance the economic expansion." Subsequent rate hikes were announced in a similar manner, with statements saying that stable low inflation was the best foundation for sustained economic growth, but without any guidelines regarding future monetary policy. In non-official speeches, Fed members provided more details about economic and financial conditions, but by today's standards they were vague about future monetary policy.

During the year of Fed tightening, the 10-year Treasury bond yield rose from 5.75 percent to 7.5 percent, and real bond yields rose sharply, reaching 4.5 percent. The stock market chopped sideways following large gains from 1991-1993. In response to the first three Fed rate hikes, the yield curve steepened, but as the Fed further removed monetary accommodation, it gained credibility. Strikingly, bond yields were virtually unchanged in response to the Fed's 75 basis point rate hike in November 1994 and declined into the Fed's last "insurance" rate hike.

Economic growth remained healthy as real rates rose in 1994, decelerated temporarily in the first half of 1995 and then accelerated strongly. Some of the leading interest-sensitive sectors of the economy—consumption of durable goods, business investment in equipment and housing—led the acceleration.

The Fed's credibility soared and the mid-cycle rate hike episode became the proto-type for efficient aggregate demand management.

The 2004-2006 Fed Rate Hike Cycle: First Generation Forward Guidance. The Fed was overly cautious in raising rates, using an "early version" of forward guidance, before the term was formally introduced into the monetary policy lexicon. Markets took their cues from Greenspan, and real rates actually declined as inflation rose faster than the Fed's gradual rates. Economic growth remained strong and the stock market rose significantly. The decline in real rates contributed to the unsustainable bubbles in housing, mortgage and private debt and otherwise facilitated excess risk taking and distorted economic and financial behavior.

The economic recovery and job creation from the mild 2001 recession was slow, despite monetary stimulus and tax cuts. By Spring 2003 unemployment had risen to 6.2 percent and the Fed was concerned about deflation (the core PCE deflator had receded to 1.2 percent) and how to conduct monetary policy at the zero bound.

In June 2003 the Fed lowered its funds rate to 1 percent, and said in its Policy Statement that while the risks on the economy were balanced, the probability of inflation risks were skewed to

the downside, and concluded "the Committee believes the latter concern is likely to predominate for the *forseeable future*" (italics added). In August, the Fed repeated its concern about undesirably low inflation and strengthened its commitment to low rates: "In these circumstances, the Committee believes that policy accommodation can be maintained for a *considerable period"* (Italics added). The use of such language in the Fed's official policy statements was a break from the past: the Fed was providing official forward guidance.

In the second half of 2003, the economy accelerated sharply and inflation turned up. Although it was clear that rate hikes were necessary, the Fed was extraordinarily cautious, and continued to try to manage market expectations. In January 2004, the Fed's Policy Statement noted that "output is expanding briskly" and that the upside versus downside risks on inflation were "almost equal", but concluded: "With inflation quite low and resource use slack, the Committee believes that it can *be patient* in removing its policy accommodation." (italics added). In May, with core inflation 1.9% and real GDP in its third consecutive quarter of 4.25 percent growth, the Fed emphasized that "policy accommodation can be removed at a pace that is likely to be *measured*." (italics added). Although markets priced in modest rate hikes, the futures markets were very slow to comprehend how much rates would need to rise.

Indeed, the Fed did hike rates at a measured pace—25 basis points per meeting—eventually raising the funds rate from 1 percent in June 2004 to 5.25 percent in July 2006. Greenspan's guidance and the predictable, measured pace of rate hikes calmed market concerns (the term "measured" was prominent in every Policy Statement through year-end 2005); in fact, it worked too well. During the two year rate hike period, even as economic growth remained healthy and

core inflation accelerated from 1.8 percent to 2.7 percent, 10-year bond yields barely rose, increasing from 4.7 percent to 5.1 percent. Real bond yields fell. Ironically, Greenspan lamented the very modest rise in bond yields that his forward guidance had contributed to, referring to it as a "conundrum".

In light of the Fed's 1994-1995 success in orchestrating a soft-landing and low inflation and enhanced credibility, its go-slow removal of monetary accommodation in 2004-2006 is puzzling. Even in 2005 when the Fed acknowledged strong real growth and a pickup in inflation, it maintained its measured pace guidance.

The Fed's go-slow policy seems to stem from Greenspan's fear of a rapid rise in bond yields that occurred in 1994. This too is an ironic response to the Fed's earlier successful policy. Certainly, the rate increases in 1994 hurt bond holders, but the housing market slowed only modestly before reaccelerating and other sectors of the economy fared fine. In 2004-2006, the housing sector was soaring, along with mortgage and household debt outstanding. There was little reason to fear quicker rate hikes.

The Fed seemed to have paid insufficient attention to the positive lessons from the 1994 rate hikes. It overlooked any distorting impacts of the declining real bond yields amid strong real growth and rising inflation. Even in the minutes of the FOMC meetings in 2004-2005, there was virtually no mention of the run up in mortgages or household debt, or the sharply rising share of residential investment in GDP. Perhaps when distortions are positive (higher stock market, housing and homeownership, etc.), expressed concerns carry little weight.

Forward Guidance, Policy Objectives and Normalizing Monetary Policy. Presently, the Fed's insistence on sustained monetary stimulus seems to be paying too little attention to the lessons from prior cycles. And the Fed's obsession with forward guidance seems to be a manifestation of its over-management and overly-discretionary monetary policy. This becomes more and more apparent as the financial crisis becomes more distant and the unemployment rate declines faster than predicted.

The Fed has proceeded from guiding language ("extended period") to an unemployment rate guideline for concluding QEIII (remember 7 percent?) and date-specific targets for its funds rate to unemployment rate triggers (6.5 percent) for raising rates to modifications and qualifications that dilute those triggers. Also, beginning in 2012, the Fed's quarterly forecasts of future "appropriate" Federal funds rates to accompany its economic forecasts (SEPs) have become important guidance. Most recently, some members assert that "qualitative" forward guidance may replace "quantitative" forward guidance.

What's the difference between quantitative triggers/guidelines that are constantly being changed and qualitative forward guidance? In practice, not much: it's discretionary monetary policy. The Fed underlines this by emphasizing that its policies are data driven.

The Fed's December 2013 forecasts are striking: for year-end 2016, the Federal funds rate forecast centers on 1.75 percent-2.0 percent; the unemployment rate, 5.4 percent-5.9 percent; and core inflation (core PCE deflator), 1.9 percent-2.0 percent. The Fed will update its forecasts at

next week's March meeting. How appropriate would it be for the real Federal funds rate to be zero nearly 3 years from now (eight years after the financial crisis) when the unemployment rate has receded to its estimated natural rate and three years (2014-2016) of 3 percent growth has lifted real GDP to estimated potential, closing the GDP Gap? Not very.

A zero real Federal funds rate would still be far from normal and inappropriately stimulative at a time when the economy is not just normal but is operating at full capacity. Compared to the Fed's go-slow rate increases of 2004-2006, its present forecasts call for a snail's pace of monetary policy normalization. Basing monetary policy on speculation that the natural real interest rate is closer to zero than 2 percent is misguided.

The Fed's forward guidance clearly has influenced market expectations. Presently, the futures largely accept the Fed's forecasts and now predict that the Federal funds rate will be zero in mid-2017. Effectively the Fed seemingly has gained bond vigilante status. But how long will the Fed be able to control bond yields?

The modest economic recovery and low inflation give the false impression that the Fed is fully capable of controlling bond yields; in reality, its control over the longer run is quite limited. Over time, bond yields reflect the real economy, inflation and inflationary expectations and risk premia. Looking forward, as economic growth accelerates and/or either wages or inflation rise, markets will respond and the Fed will have difficulty constraining increases in bond yields.

Consider the dramatic rise in interest rates last May-June: it was triggered when Chairman Bernanke first floated the notion of tapering asset purchases; but in reality, both the Fed and markets were responding to the stronger economic conditions. Bond yields rose approximately 5-times more than the Fed's earlier estimates.

If stronger economic performance and/or higher inflation leads the futures markets to price in faster or a higher Federal funds rate than currently forecast, will financial markets adjust gradually, or abruptly? Nobody knows. But history suggests the Fed will have little control over the magnitude or speed of the adjustment.

This brings up an important issue of how the Fed is using forward guidance. Forward guidance that establishes a Fed reaction function would improve transparency and build financial market confidence in the Fed. Reducing uncertainties about monetary policy by spelling out the Fed's exit strategy would enhance financial and economic performance. It would also provide a guideline for the Fed, requiring it to explain deviations in policy from the reaction function.

On the other hand, the appropriateness and efficacy of using forward guidance to augment a policy objective or rule hinges on the integrity and appropriateness of the objective or rule, and whether the Fed abides by the parameters it establishes. Forward guidance to augment a 2 percent long-run inflation target, which is an appropriate goal within the Fed's control, would provide valuable signaling to markets. In contrast, using forward guidance to augment a long-run employment-based target that is affected by nonmonetary factors and beyond control of the

Fed is inappropriate and lead to misguided monetary policy. That's the current policy path. Forced changes in forward guidance add uncertainty and hurt economic performance.

The Fed has even modified its interpretation of its dual mandate: as the unemployment rate has fallen continuously faster than predicted, but for the "wrong reasons", the Fed has established "overall labor market conditions" as more important than the unemployment rate. This adds confusion and uncertainty. Similar to 2004-2006, concerns about the distortions generated by sustained very low interest rates receive little attention within the Fed.

The Fed is quick to attribute the lingering high unemployment to insufficient demand, understating the impacts of nonmonetary factors (government policies and related uncertainties; international competition; skill mismatches and labor saving technological innovations) on labor markets. Uncertainties about the Fed's exit constrains business hiring.

The Fed's notion of insufficient demand likely has been influenced by Michael Woodford's argument that forward guidance should be used to augment a goal of boosting nominal GDP to the level that would have occurred had it never declined during the deep 2008-2009 recession (August 2012). This is inappropriate. Why base monetary policy on the end-of-expansion level of nominal GDP in 2007 that was bloated by the unsustainable debt and economic and excess risk taking fueled by the Fed's keeping rates too low too long earlier in the expansion?

The Fed needs to change the focus of its forward guidance. Trying to artificially suppress real rates far into the future is less necessary and poise higher risks as the economy and labor markets

continue to improve. Present Fed's policies are adding unnecessary "ambiguity risk" to economic decision making, domestically and globally, and harming economic performance. The focus of forward guidance should be a transparent strategy for how the Fed will normalize monetary policy. Being more precise and following a rule that is within its scope would be a big step forward for monetary policy and would improve economic performance.