

Responders of First or Last Resort:
Central Bank Strategies (in Era of Ultra-Low Interest Rates)

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Fundamental Fed Reform

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Fundamental Fed Reform

Confronting the Challenge

"I do not believe that the system can rise to the challenge without major changes in its method of operation."

-Milton Friedman in letter to Paul Volcker (1979)

The Fed's Predicament

- General purpose agency of government
- Ill-defined strategy
- Detrimental reliance on untested tools
- Chronic myopia
- Poor positioning for future economic scenarios
- Cacophonous communications
- Strained governance
- Expanding policy objectives
- Credibility, public support and standing at risk

Institutional Dynamics Matter

- Fed policy is made neither by fixed rule nor unfettered discretion. It is made by committee.

- Institutional setting affects committee's policy decision
 - ✓ Statutory remit
 - ✓ History
 - ✓ Culture
 - ✓ Process of deliberation and decision
 - ✓ Relationship with rest of government
 - ✓ Relationship with financial markets
 - ✓ Ideas
 - ✓ Personnel

- Comprehensive, fundamental Fed reform agenda required
 - ✓ Strategy
 - ✓ Operating regime
 - ✓ Communications
 - ✓ Governance

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Devising a Fed Strategy

- Strategies endure. Plans are fleeting.
- Successful central bank strategies are:
 - ✓ Clearly delineated (and understood)
 - ✓ Within scope of policy tools (and achievable)
 - ✓ Broadly measurable (without false precision)
 - ✓ Attainable over time and circumstance (avoid regime-switching)
 - ✓ Enhancing of institutional accountability (legitimacy)
 - ✓ Focused on medium-term (comport with lagged effects of policy)
- Do the Fed's words and actions in recent years satisfy these criteria?
- In the absence of a clear and consistent strategy, has the Fed, nonetheless, achieved appropriate policy?

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A New Strategy Paradigm

Existing Fed Statement on Monetary Policy Strategy

- Inflation target of 2.0% (PCE)
- Committee "seeks to mitigate deviations of inflation from its long-run goal and deviations of employment from the committee's assessment of its maximum level"

Real Reform Agenda

- Avoid false precision in inflation measurement
 - ✓ Resurrect 'comfort zone'
- Arrest fine-tuning of "deviations"
 - ✓ Policy should adjust when deviations are large and significant
 - ✓ Resist dangers of short-termism
 - ✓ Pay heed to 'long and variable' lags
 - ✓ Be humble about defining deviancy down with r^* excuse
 - ✓ Resist exploiting any short-run Phillips curve tradeoff

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A New Strategy Paradigm

- Stop treating labor market data as the ultimate arbiter of price stability
 - ✓ Wages are not as central or forward-looking as other prices
- Concentrate on the financial cycle
 - ✓ Significantly higher loss function from credit cycle than business cycle
 - ✓ Finance, money and credit should no longer be at the fringe of Fed's dominant model and framework
 - ✓ Credit gap can be more consequential than output gap, especially given non-linearity of credit booms and busts on output and inflation
- Institutionalize new strategy and boldly pursue medium-term inflation target
 - ✓ Avoid the noise/myopia associated with 'data dependence'
 - ✓ Substitute new concept of trend dependence
 - ✓ Keep the focus on the horizon
 - ✓ Change in strategy and operating regimes should be "experienced gradually and moderately"

Implications for Fed's Other Objectives

- Prevailing Fed view: proliferation of tools required to match expanded responsibilities
 - ✓ Interest rates, balance sheet and forward guidance all needed to set monetary policy
 - ✓ Micro-prudential tools suffice for supervision/regulation
 - ✓ Macro-prudential policies well-suited for financial stability
- New reform strategy: Getting monetary policy right has large, positive spillover effects on Fed's other objectives
 - ✓ More powerful, reliable and better understood than newfangled tools (at least as of now)
- Relegate current ride-the-wind policy and elevate lean-against-the-wind policies (especially at key points in cycle)
- New, effective strategy essential part of comprehensive reform
 - ✓ Tools, communications and governance also demand fundamental review, revision and reform
 - ✓ Stakes are high, and timing consequential