Re-Normalize, Don't New-Normalize Monetary Policy

John B. Taylor

Economics Working Paper 14109

HOOVER INSTITUTION
434 GALVEZ MALL
STANFORD UNIVERSITY
STANFORD, CA 94305-6010

April 2014

This paper is a written version of a presentation given at the IMF Conference on Monetary Policy in the New Normal in Washington DC. It argues central banks should re-normalize monetary policy—including the de facto independence of policy—rather than new-normalize policy to some so called new normal. It focuses mainly on the United States and looks back to the time before the recent financial crisis.

Re-Normalize, Don't New-Normalize Monetary Policy

John B. Taylor[1]
Stanford University

April 2014

Abstract: In this paper I argue that central banks should re-normalize monetary policy—including the de facto independence of policy—rather than new-normalize policy to some so-called new normal. I explain his view and show that it follows from a review of the actual practice of monetary policy in recent years. I also consider some objections that might be raised to this position. I focus mainly on the United States and go back to the time before the recent financial crisis.

Now is a good time to take stock and consider where monetary policy and central bank independence should be going in the future. In my view central banks should re-normalize monetary policy—including the de facto independence of policy—rather than new-normalize it to some so-called new normal.

Lessons from the Practice of Monetary Policy

Let me explain by briefly reviewing the actual practice of monetary policy in recent years, and then consider some objections that might be raised to this position. I will focus mainly on the United States, going back to before the recent financial crisis. It will help to keep track of what happened if I refer to the timeline in Figure 1. It shows inflation and monetary policy decisions. In the late 1960s inflation was picking up, but monetary policy was falling behind the curve: with an inflation rate of 4%, the interest rate was just a bit over 4 %. And so

[1] This is a written version of a presentation at the IMF Conference on Monetary Policy in the New Normal, April 13, 2014, Washington, D.C. It draws on Taylor (2013a, 2013b)

inflation rose and so did unemployment. That was a highly discretionary and interventionist period, and the results were poor.

After more than a decade of this, policy changed. You can see that in the timeline. With an inflation rate of 4 percent in the 1980s the funds rate was nearly twice as high, and this type of policy lowered both inflation and unemployment. This policy continued through the 1990s and into the start of this century: as you can see when the inflation rate was 2 percent the interest rate was 5.5% in 1997. Policy was systematic and rule like. I doubt if there was greater fan of monetary policy than me during this period.

But then there was a setback. The Fed started to hold rates very low starting around 2003. In the timeline you can see that with the inflation rate at 2%, the funds rate was only 1%. That was a deviation from the policy that had been working well, and the results were not good. In my view this brought on a search for yield, excesses in the housing market, and, along with a regulatory process which also broke the rules for safety and soundness, was a key factor in the financial crisis.

During the panic in the fall of 2008 the Fed did a good job of providing liquidity to the markets through loans and swaps to foreign central banks. Reserve balances at the Fed expanded due to these temporary liquidity facilities as shown in Figure 2. But then the Fed started on its unconventional monetary policy, as you can see in Figure 3 by the massive increase in liquidity due to quantitative easing. Regardless of what you think of the impact of these policies, they were not rule like or predictable. My research shows that they were not effective, and may even have been counterproductive.

So what I am suggesting here is that we have seen shifts toward and away from steady predictable monetary policy and these have made a great deal of difference for the performance of the economy, just as basic macroeconomic theory tells us.

This informal picture is corroborated by more formal statistical and historical classifications. Alex Nikolsko-Rzhevskyy, David Papell and Ruxandra Prodan (2014) ran monetary policy decisions through their statistical filters and detected rule-like policy from 1983 to 2002. Their results can be seen in their timeline chart copied here in Figure 4. Allan Meltzer (2012) used an historical methodology and found nearly the same thing. It was during this period that we had such good economic performance that economists have dubbed it the Great Moderation, the Long Boom or simply NICE, for Non-Inflationary Consistently Expansionary, in the words of Mervyn King (2003).

All these results can be summarized with the conventional macro stability tradeoff curve used by Ben Bernanke 10 years ago and shown in Figure 5. It shows the two objectives of monetary policy: price stability and output stability. Bernanke (2004) argued that the change in monetary policy was the reason for the shift from point A to point B, not simply some divine coincidence or a new normal. I agree. But I have updated the chart to show the deterioration in performance since the end of the Great Moderation. I would argue that a change in monetary policy is a big factor behind the movement to point C, not some devilish takeover of the divine coincidence or a new normal.

Now, what is quite amazing for the subject of this panel is that the de jure independence of the Fed did not change much at all during this period, as shown by Christopher Crowe and Ellen Meade (2007). But clearly the de facto independence changed greatly. Many agree that the Fed in the 1970s gave up a great deal of independence and that Paul Volcker took it back in the

1980s. Some now argue that with the events in recent years, central banks have again begun to give up some de facto independence as they have entered into areas of fiscal policy and credit policy.

The implication of this experience is clear to me: monetary policy should re-normalize or move back to a predictable rule-like policy that worked in the past and central banks who have de facto given up some of their independence should take it back.

Possible Objections

Now let me briefly consider some of the objections to this conclusion.

What about the ***zero bound***? Wasn't that the reason that the central banks had to deviate from rules? Well it was certainly not a reason in 2003-2005 and it is not a reason now. By my calculations the short rate should be about 1-1/4 % in the US, so the zero bound is not really binding. It appears that there was only a short period in 2009 when zero was binding. But the zero bound is not a new thing in research. Policy rule design research took that into account long ago. The default was to move to a stable money growth regime not to massive asset purchases. And David Reifschneider and John Williams (2010) proposed a rule-based way to deal with the problem back in 1990s.

What about ***monetary policy spillovers and international cooperation***? I believe the spillovers are largely due to these policy deviations and to unconventional monetary policy in particular. We heard complaints about the spillovers during the stop-go monetary policy in the 1970s and of course during their necessary undoing under Volker. But during the 1980s and 1990s and until recently there were few such complaints. There as was another NICE—near international cooperative equilibrium (Taylor, 2013c)—to go along with Mervyn King's NICE during this period much as economic theory predicted.

Should ***forward guidance*** be part of monetary policy? Yes, but only if it is consistent with the policy rule or strategy of the central bank, and then it is simply a matter of transparency. But if it is purposely meant to promise for the future what will not be appropriate in the future, then it is time-inconsistent, raises credibility issues, and is not a good idea. Frequently changing forward guidance causes problems for monetary policy.

Macro-prudential policy of the countercyclical variety is not necessary if the required levels of capital and liquidity are sufficiently high. We do not know enough about the impacts of cyclical movements in, say, the loan to value ratio to move it around over the cycle and it clearly puts the central bank in the middle of a very difficult political issue. If interest rates had not been so far below appropriate levels leading up to the crisis, I do not think people would have been talking about macro-prudential in the cyclical sense.

Some argue that we should have ***QE forever***, leave the balance sheet bloated, and use reverse repos to set the short term interest rate. I think the distortions caused by these massive interventions and the impossibility of such policy being rule-like indicate that such a new-normalized policy would be a huge mistake. It is best to have a goal of getting the balance sheet back to levels where the demand and supply of reserves determine the interest rate. Of course, interest rates on reserves and reverse repos could be used during a hopefully short transition. And a corridor system would work if the market interest rate was in between the upper and lower bands and not hugging one or the other.

Conclusion

So, in conclusion, based on the experience with actual practice of central banking in recent years and the problems with a so-called new normal for policy, my recommendation is to declare that the goal is to return to a normal policy, to describe the policy rule or strategy that that would characterize that normal, and to lay out a transition strategy to get there.

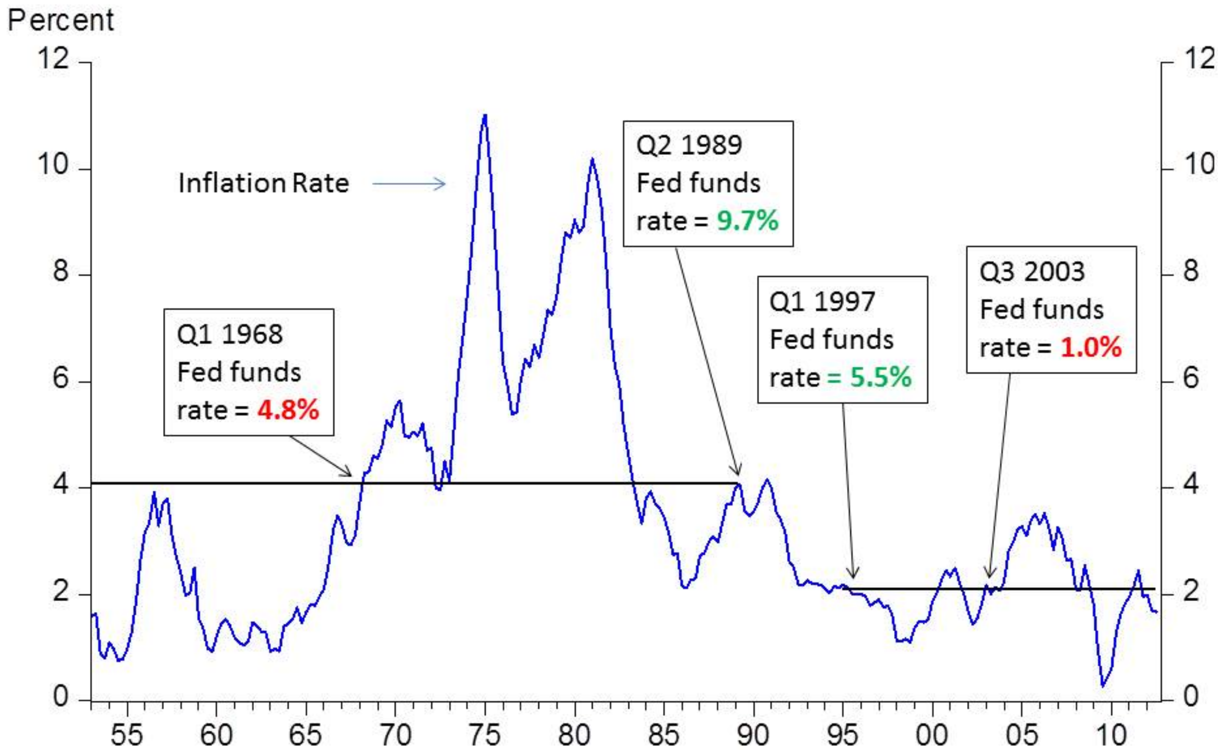

Figure 1
Source: Taylor (2013b)

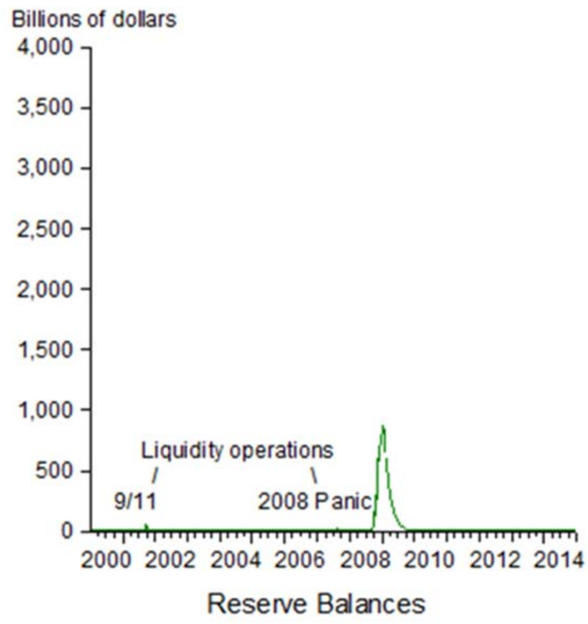

Figure 2

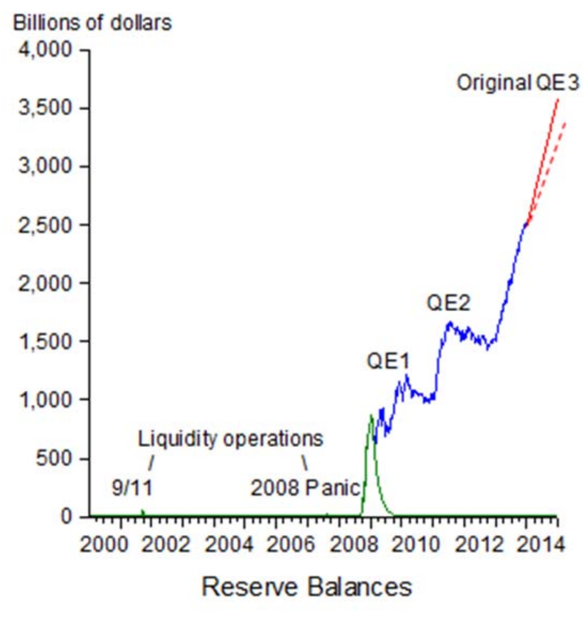

Figure 3
Source: Taylor (2013b), updated through 2014

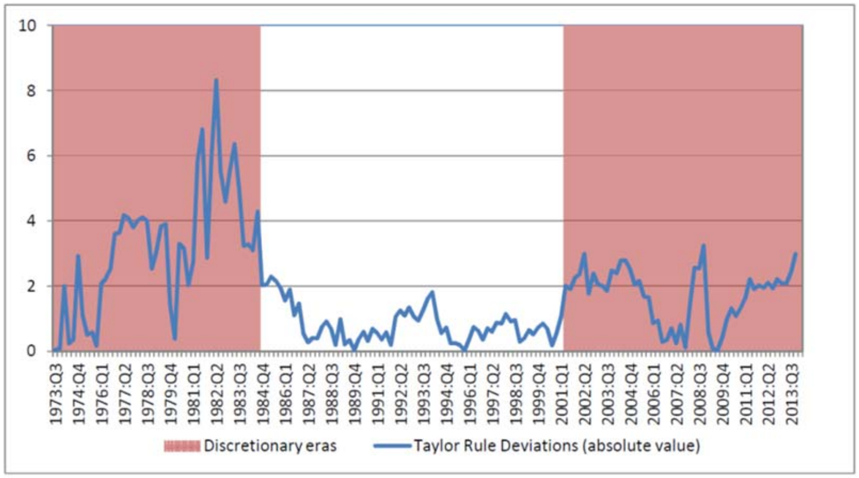

Figure 4
Source: Nikolsko-Rzhevskyy, Papell, and Prodan (2014)

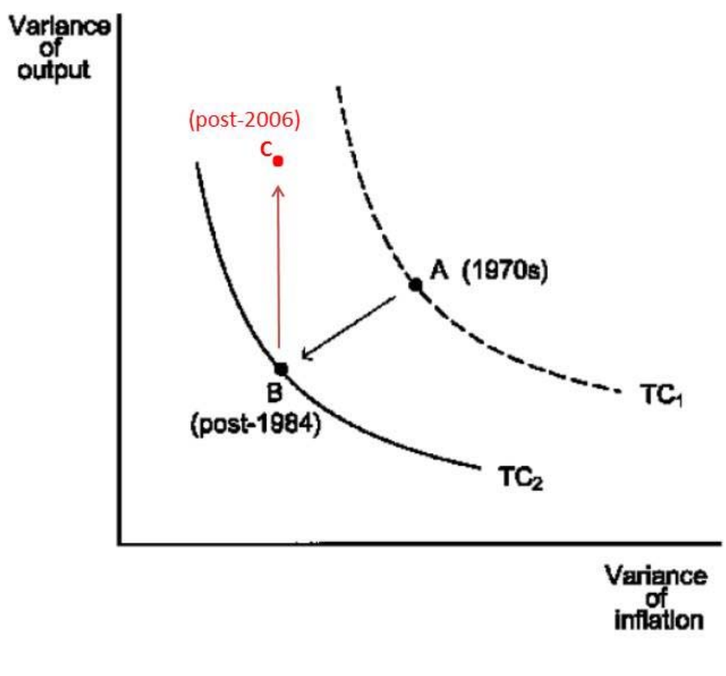

Figure 5
Source: Bernanke (2004), updated to post-2006

References

Bernanke, Ben S. (2004) "The Great Moderation," Eastern Economic Association, Washington, DC, February 20

Crowe, Christopher and Ellen E. Meade (2007), "The Evolution of Central Bank Governance around the World," *Journal of Economic Perspectives*, Vol. 21, No. 4, 69–90

King, Mervyn (2003) "Speech at the East Midlands Development Agency/Bank of England Dinner," Leicester, October 14

Meltzer, Allan (2012), "Federal Reserve Policy in the Great Recession," *The Cato Journal*, Vol. 32, No. 2

Nikolsko-Rzhevskyy, Alex, David H. Papell, Ruxandra Prodan (2014), "(Taylor) Rules versus Discretion in U.S. Monetary Policy," March 19

Reifschneider, David and John C. Williams (2000), "Three Lessons for Monetary Policy in a Low-Inflation Era," *Journal of Money, Credit, and Banking*, vol. 32 (November), pp. 936-66.

Taylor. John B. (2013a) "The Effectiveness of Central Bank Independence Versus Policy Rules," *Business Economics*, 48 (3), July, pp. 155-162.

Taylor, John B. (2013b) "Monetary Policy During the Past 30 Years With Lessons for the Next 30 Years," *The Cato Journal*, Volume 33.

Taylor, John B. (2013c), "International Monetary Policy Coordination: Past, Present and Future," Bank for International Settlements Working Paper No. 437, December