

Market-Based Taylor Rule

MBTR

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Agenda

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- Assumption: Everyone has read paper.
- The proposal
- The problem
- A bit of history
- Developments in economic theory
- Politics

The Proposal (in statute--not discretionary)

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- Fed sets **C**entral **F**ed **F**unds rate based on Taylor Rule
- **CFF** = $[r^* + 2.0] + \alpha(\pi - 2.0) + \beta(\text{EGAP})$
- Reset once per month after CPI release
- Fed lends on suitable collateral whatever is demanded at rate $\text{CFF} + \Delta$
- Banks can place reserves at Fed and earn rate of $\text{CFF} - \Delta$
- Mkt expectations of future **CFF** determine today's fed funds rate, given the rule that determines **CFF**₀.

The Problem

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- Policy design is an issue in *political economy*
- c.f. TRA of 1986
- Must get the economics right
- Must get the politics right

A Bit of U.S. History

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- Gold standard largely solved problem of excess money creation.
- But, system unstable.
 - Banking panics 1787-1907
 - Federal Reserve Act 1912 did not solve the instability problem
- Great Depression
- Great Inflations I and II
- House price bubble 2000-2006 & 2008 crisis

Modern History of Monetary Disorder

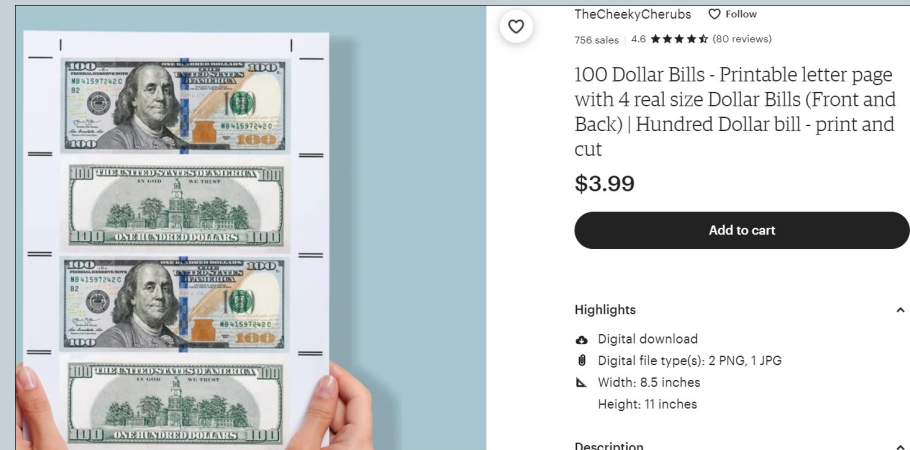
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- U.S. life expectancy \approx 80 yrs.
- W.P. born June 1937, 1-month after 1937-38 cycle peak. Depression ended \approx 1940. Then, 25 yrs latter
- Great Inflation I started \approx 1965
- Ended about 1981. Then, 27 yrs later ...
- 2008 financial crisis. Then, 13 yrs later,
- Great Inflation II started 2021.
- **2-3 periods of disorder every lifetime!**
- Not counting 12 post-WW II recessions.

One problem *was* solved

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- National banking acts, 1863 & 1864
 - Created uniform currency system
 - Treasury and Fed **have** created currency robust from counterfeiting
- When did you last look closely at a \$20 bill you got in change?



Developments in econ theory

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- Rational expectations
 - Muth, Lucas
 - Many others
- Economics of information
- Auctions
 - Coase, Vickrey
 - Many others

Auctions

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- Private auction ideas spread to govt
- Practical success of spectrum, oil leases and other such govt auctions
- Some auctions not designed to maximize revenue
 - Pollution auctions
 - Congestion pricing, airport landing slots, highway tolls

Public choice + related literatures

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- Behavior of elected and appointed officials
- Rationality of voter ignorance
- Private organization to exploit powers of govt
- Practical impossibility (?) of getting govt incentives right
- \therefore Must control & limit govt, incl Fed

Politics of Fairness I

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- Rule of law, due process, etc.
- Constitution Article I, Section 9: Powers Denied Congress
 - The Privilege of the Writ of Habeas Corpus shall not be suspended
 - No Bill of Attainder or ex post facto Law shall be passed
- Bill of rights—worth reading again!
- Ideas from 16th – 18th Centuries

Politics of fairness II

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- Disputes over primacy of econ goals.
- Resolve by placing equal weight on inflation and employment goals in the MBTR.
- Discretionary monetary policy has failed. Again, again and again.
- Unemployment and inflation unfair to almost all citizens.

Why Fed fails

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- Human error.
- Impossibility of writing down response function to “news/shocks”.
- Fed knowledge limited. Too many new *or possibly* new things can happen.
- Political pressures.
- Mkt focus on forecasting Fed.
- Poker, not solitaire.

W.P. mea culpa

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- **Check:** FOMC transcript and mtg materials, June 2005
- **Read:** HUD (**2004**). “HUD’s Housing Goals for the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) for the Years 2005–2008 and Amendments to HUD’s Regulation of Fannie Mae and Freddie Mac.” Federal Register / Vol. 69, No. 211, pp. 63580-887.

The MBTR

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- Could this idea work?
- Success of international monetary reform though floating exch rates
- Companion idea: banking reform through sub notes, contingent capital
- Eliminate much/most banking detailed regulation

Closing observation

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- Must not permit the perfect be enemy of the good.
- Under the MBTR:
 - Could another Great Depression occur?
 - Could another Great Inflation I occur?
 - Could another Great Inflation II occur?
 - Are these answers decisive?

Discussants turn now