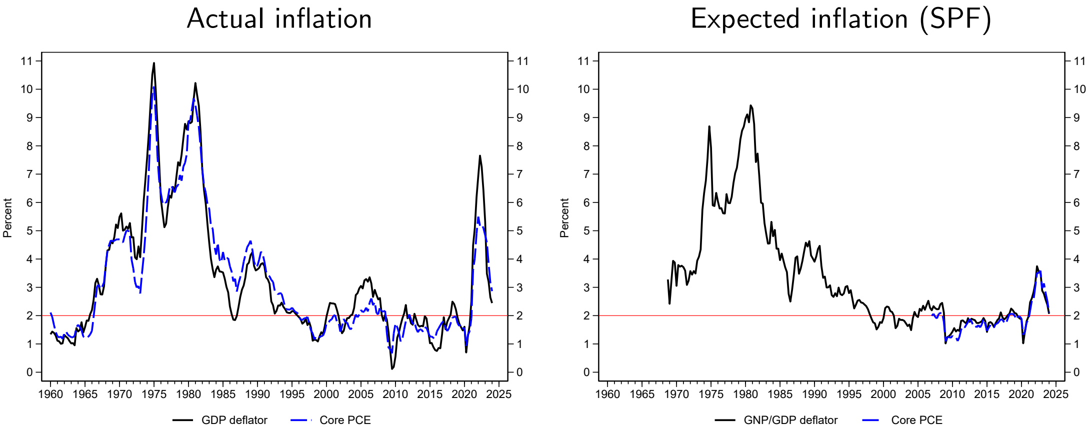
Enhancing Resilience with Monetary Policy Rules

Athanasios Orphanides

MIT

The Next Strategy Reviews
Getting Global Monetary Policy on Track
Hoover Institution, Stanford, May 3, 2024

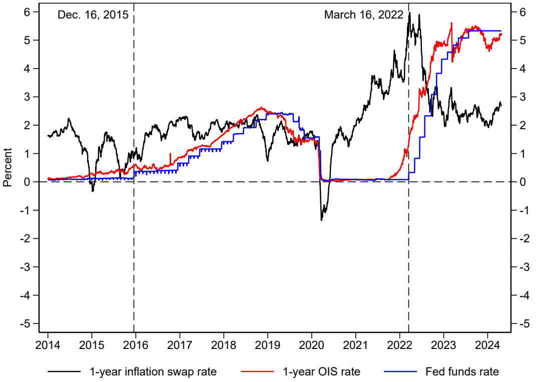
Actual and expected inflation



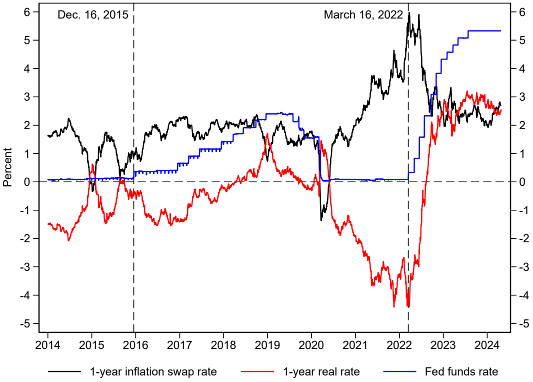
Actual inflation shown in quarter t reflects year-over-year inflation ending in quarter t.
Expected inflation reflects SPF median of year-over-year inflation ending in $t+3$.

The post-pandemic policy error

Expected inflation and nominal interest rate



Expected inflation and real interest rate



Expected inflation as measured by 1-year inflation swap rate. The real interest rate reflects the 1-year OIS rate minus the 1-year inflation swap rate.

The challenge of constraining unhelpful discretion

[S]ome useful policy strategies are "rule-like," in that by their forward-looking nature they constrain central banks from systematically engaging in policies with undesirable long-run consequences; but which also allow some discretion for dealing with unforeseen or unusual circumstances. These hybrid or intermediate approaches may be said to subject the central bank to "constrained discretion."

Bernanke, Ben and Frederic Mishkin. Inflation Targeting: A New Framework for Monetary Policy? Journal of Economic Perspectives, Spring 1997, p. 104.

Simple rules as a cross-check: Norges Bank

6. It may also be useful to cross-check by assessing interest rate setting in the light of some simple monetary policy rules. If the interest rate deviates systematically and substantially from simple rules, it should be possible to explain the reasons for this.

Norges Bank, *Inflation Report with monetary policy assessments*, 1/2005, p. 28.

Qvigstad, Jan. Norges Bank Staff Memo No. 2005/6, June 2005, p. 19.

Desirable characteristics of simple rules

- Must preserve price stability over time, maintain inflation expectations well-anchrored, in line with 2% goal.
- Be forward-looking, embracing informational benefits of current analysis, now-casting, short-term projections
- Be somewhat countercyclical, tempering business cycle booms and busts.
- Be robust to imperfect knowledge.

Two alternative simple rules with an interest rate instrument

- Level rule: Classic Taylor rule

$$i = r^* + \pi + \theta(\pi - \pi^*) + \theta y$$

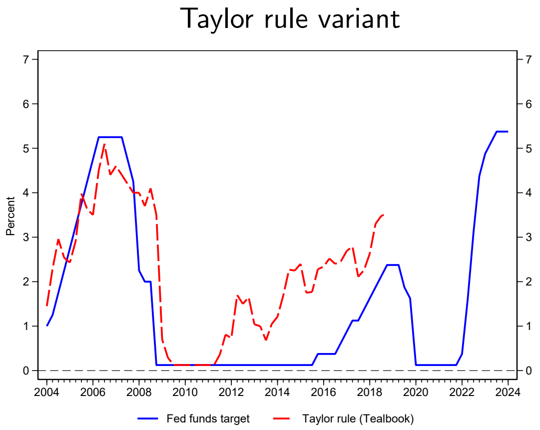
- Difference rule: Natural Growth Targeting

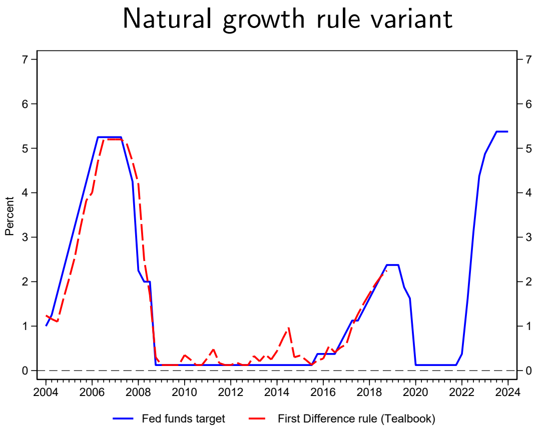
$$\Delta i = \theta(n - n^*)$$

π : Inflation
y : Output gap
n : Nominal income growth

- Variants of both alternatives presented in Bluebook/Tealbook starting with January 2004 FOMC meeting (with $\theta = 0.5$). To date, real-time prescriptions until end-2018 have been disclosed to the public.

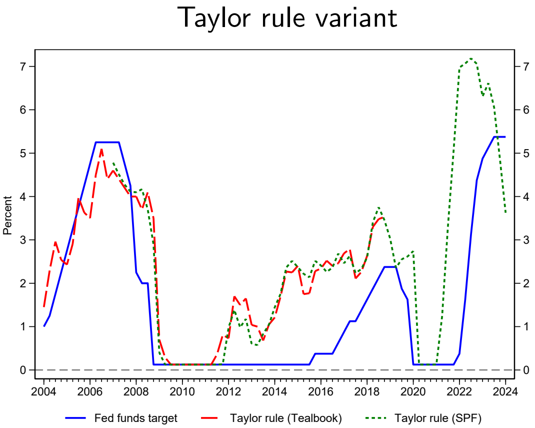
Two simple rules from the Fed's Bluebook/Tealbook

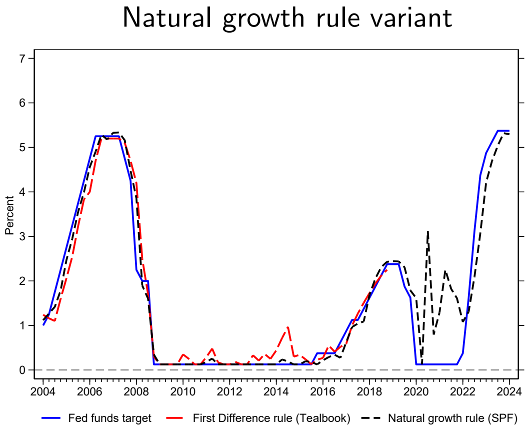




Fed funds target (or midpoint of target range). Rule prescriptions constrained by ZLB.
Post-2018 Tealbooks not yet available to the public.

Comparison of Tealbook rules with SPF-based variants





Next Strategy Review: Towards incremental improvement

- The Fed's next policy strategy review should aim to discipline discretion, help the FOMC be more systematic.
- Simple rules could serve as a cross check on discretionary policy.
- The SEP could provide presciptions from benchmark policy rules as presented in the Bluebook/Tealbook since the January 2004 FOMC meeting.
- The unhelpful forward guidance provided with the dots should end.
- Had this framework been in place, the post-pandemic policy error would have been checked.
- The resilience of the Fed's monetary policy strategy will be enhanced with guidance from monetary policy rules.