Enhancing Resilience with Monetary Policy Rules

Athanasios Orphanides

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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.
Some 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.”

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.


Desirable characteristics of simple rules

- Must preserve price stability over time, maintain inflation expectations well-anchored, 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

Taylor rule variant

Natural growth rule variant

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

Taylor rule variant

Natural growth rule variant
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 prescriptions 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.