Strategies for Monetary Policy

Tying Down the Anchor: The Task Gets Tougher

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One can view the proximity of the current Fed policy stance to the zero-lower-bound as an accident of history, or a wise choice. So, too, the grand scale and scope of the Fed's balance sheet. No matter one's judgment, the Fed finds itself with less conventional and unconventional ammunition.

With ammunition low, Fed credibility – to act independently, get policy right, and explain well the rationale for its actions—is at a premium.[1] Fed cred will be relied upon most when the economy slows or confronts a shock. So it's encouraging that Fed is open to considering reforms in the conduct of monetary policy.

John Williams and Monika Piazzesi will discuss possible changes to the Fed's inflation framework and monetary strategy, with the added burden of creating monetary space for the next downturn. We will then invite a robust discussion of the policy proposal, and query whether it's equal to the challenge.

The Fed has the good fortune of having John Williams as a leader. And we have the good fortune having him here to lead the discussion of monetary reform. I recall most favorably John's time in the bunker a decade ago, battling on the western front. We remain thankful for his service. And I am pleased that he has moved his talents east to serve as President of the New York Fed.

My Stanford economics colleague, Monika Piazzesi, will discuss the proposed changes to the Fed's inflation framework. Her scholarship combines theory and practice, and is influential in the corridors at the Fed and other leading central banks.

As Chair of the panel, I will first offer a few thoughts on the broader policy conjuncture. And discuss the environment in which changes in the Fed's monetary policy practices are being considered.

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Most of our students on campus know well the financial crisis of 2008-2009. But it's no more resonant than, say, the Great Depression. Big and consequential. An important chapter of our American history. But, the panic of the period is not something they experienced.

Many students of the financial crisis are neither scared nor scarred. Some of us who served view their innocence with equal parts envy and concern. The past isn't even past.

The regime change of the economy in the last decade--from 'crisis' to 'recovery' to 'sustained expansion'—did not correspond to a significant change in the profile or practice of the modern central banker. The Federal Reserve neither exited the front stage nor fell off the front page.

Some view monetary dominance over the last decade with grave concern, if not suspicion. Others, attuned to the polarization of our politics, are relieved that the Fed sees fit to be a steadying force. And in the high-minded spirit of a modern Wilsonian, they see a cadre of policy professionals compensating for the failings of much of the rest of government.

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[1] Warsh (2014)

The Fed's actions—and pre-eminence—continues to leave a heavy mark on the economy, banking system, and financial markets. And with its elevated status, the Fed finds itself considerably more exposed to the broader body politic. The central bank's prominence has caused its policy choices to be scrutinized through a different lens, and its independence to be tested.

The Fed has long been powerful. Setting interest rates matters to households and businesses and governments. In the period between the Treasury-Fed Accord of 1951 and the financial crisis of 2008, the Fed's monetary powers were thought to be limited, well-circumscribed. Monetary and fiscal policy were clearly delineated. And the distinction came with a difference: the conduct of monetary policy alone was largely accorded the benefit of central bank independence.

To what do we owe the heightened scrutiny of the Fed in recent years?

It is fashionable – and true – to talk about the hyper-partisanship of our time. And of the divisions in our country. It is less fashionable—but no less true – to believe that the financial crisis is of a piece with the polarization. One observes the casting of prospective nominees to our central bank in the last decade as either 'with us' or 'against us'. This is a troubling development.

Until the last couple of years, it's also true that growth in real economic output and median take-home pay were modest, and well-below consensus forecasts. Blame is assigned for the economic shortfall. And the Fed—at center stage—serves a useful, if sometimes undeserved, target.

The central bank has no shortage of good intentions. But, the Fed is not an altogether unwitting victim of the political scrum.

When monetary policymakers herald their record of job creation, they risk their institutional prerogatives. Policy pros can rarely force rank the individual efficacy of monetary, fiscal, trade and regulatory policy. Moreover, economic expansions often owe more to the resilient, micro-foundations of the economy than macroeconomic fine-tuning. Even if the Fed merits special commendation, bowing at center stage is incompatible with safeguarding independence.

For most of the post-crisis period, the Fed grew the size and scope of its balance sheet in order to provide greater monetary accommodation. In recent months, the Fed announced another big shift in its balance sheet plans. It would maintain a large balance sheet on a seemingly permanent basis. But, no longer was monetary policy the rationale. The Fed justified its new policy stance on regulatory and operational grounds: the big banks need high quality, Fed-provided reserves.

But, what happens when the bright line between monetary and regulatory policy fades? And when the line between monetary policy and fiscal policy blurs? Line-crossing poses real risks.

This is not about party or president. If Congress does not have the votes for an extension of the debt limit, why not get emergency relief from the Fed. If the appropriations process is deadlocked, call on the Fed to fund a government agency directly. If housing prices are falling, push the Fed to buy mortgages. If Congress and the administration cannot agree on new fiscal policy, pressure the Fed to provide more stimulus.

Demanding central bank independence in the conduct of quasi-fiscal and quasi-regulatory policy is a break with historic norms. By custom, the Fed is granted carefully circumscribed authority to conduct monetary policy independently. Not fiscal policy, which is the province of Congress. And not regulatory policy, which is to be executed under the rules that govern many other government agencies.

If the Fed becomes a general purpose agency of economic policy, it will lose its special monetary prerogatives. And the printing press it keeps will be a temptation for mischief.   Modern Monetary Theory (MMT) is the new name for an old temptation to conflate monetary and fiscal policy.

The Fed's monetary independence arises not by constitutional sanction, but from something more subtle, a norm. Independence requires constant vigilance by all parties, not least the central bank itself. Independence, however, is not the objective of sound monetary policy. Instead, it's a time-tested, effective means to get policy right. But that's not all.

Like sound legal opinions from the high court, monetary policy decisions are more important for the reasons they give, not the results they announce.[2] The Fed's real institutional power comes not from its ability to pronounce, but its ability to persuade. A policy decision that gets the reasons wrong gets a lot wrong.

The Fed is right to change its judgment when circumstances dictate, but its rationale must be comprehensive and compelling. Recitation of the Fed's latest quarterly dot-plot forecast-- inspired by the Fed's workhorse models-- is not sufficient to justify a policy stance. Nor is reference to an ostensibly settled monetary policy rule.

In my view, the scale and scope of monetary policymakers' ambitions have expanded over the past decade. Yet, its policy choices are narrower, and more difficult.

I look forward to the panel discussion of a new policy framework to begin to shed light on the challenge.

[2] Scalia (1994)

References

Scalia, A., *Dissents*, Supreme Court Historical Society, Washington, D.C. (June 1994).

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