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Stanford's Taylor Says Discretionary Monetary Policy Saps Growth

By Jeff Kearns - Feb 11, 2014

Stanford University Professor John Taylor, creator of a rule for guiding monetary policy, said discretionary economic and spending policies are to blame for the U.S. recovery being "as disappointing as ever."

The main cause of the poor performance is economic policy's shift away from "what worked reasonably well in the decades before," Taylor said today in written testimony to the House Financial Services Committee. He will speak to the panel after Federal Reserve Chairman Janet Yellen gives her first semi-annual testimony. Mark Calabria of the Cato Institute, Abby McCloskey from the American Enterprise Institute and Donald Kohn of the Brookings Institution also will speak.

"Monetary policy, regulatory policy, and fiscal policy each became more discretionary, more interventionist, and less predictable starting in the years leading up to the financial crisis and have largely remained in that mode," said Taylor, who served as a Treasury undersecretary in Republican President George W. Bush's administration.

Representative Jeb Hensarling, the Texas Republican who leads the Financial Services Committee, added the second panel following Yellen today to react to her testimony. Hensarling has criticized Fed asset purchases, which pushed its balance sheet to a record $4.1 trillion, and has begun a series of hearings which he has said he aims to be "the most rigorous examination and oversight" in the Fed's 100-year history.

Taylor first published in 1993 his interest-rate formula, which measures where a central bank should set its policy rate based on inflation and growth.

Policy 'Limits'

Kohn, a former Fed vice chairman before he was succeeded by Yellen in 2010, said the central bank should keep working on communicating clearly, "but everyone should recognize its limits," according to his prepared testimony.

"The Federal Reserve can't promise more certainty than consistent with a highly uncertain environment," Kohn said. "It needs to retain flexibility to react to the unexpected."

The Fed must be able to change course when conditions change, Kohn said.

“Our economy is a complex mechanism, whose state is not readily summarized in one or two variables and policy needs to react to the whole array of indicators pointing to the evolution of economic activity and prices,” Kohn said. “This complexity presents challenges for communication and guidance about how interest rates might evolve, but it is a reality.”

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