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Federal Reserve Takes Another Step Toward Rule-Based Monetary Policy

By: Timothy B. Lee – December 12th, 2012

The Federal Reserve made a big announcement today, promising to keep interest rates near zero until either the unemployment rate fell below 6.5 percent or the inflation rate rose above 2.5 percent. The Fed had *already* promised to keeping interest rates near zero until 2015, so why was this announcement important?

Good monetary policy is conducted according to predictable rules. This has at least two big advantages. First, the Fed is run by fallible humans. The Fed is less likely to screw up in a moment of panic if it has an objective yardstick to tell it how to react to changing economic conditions.

But more important, predictability has implications for the broader economy. When businesses are planning to invest, a key factor is the expected path of macroeconomic variables like inflation and real income growth. If the Fed operates according to a known, fixed rule, it's easier for firms to model the Fed's reaction to different developments, giving firms some confidence that their business plans won't be upset by a sudden change in monetary policy.

Between 1983 and 2007, the Fed's policy roughly approximated what came to be known as the Taylor rule, a formula that indicated the optimal interest rate given the current interest rate and gross domestic product. When inflation rose, the Fed would raise interest rates to bring it back down to its target of around 2 percent. IF GDP growth slowed, the Fed would cut rates to minimize the harmful effects of the recession. While the Fed didn't formally endorse the Taylor Rule, it followed it closely enough that the markets had a pretty reliable way of predicting how the Fed would behave.
But things ran aground in 2008. The economy fell into an unusually deep recession, and as a result the Taylor Rule started to indicate that interest rates should be negative. That's a problem because it's not possible for interest rates to be negative.

But there's nothing magical about interest rates. What the Fed actually does is create more or less money; the interest rate was just a useful benchmark for figuring how much money to print. When the Taylor rule says interest rates should be negative 6 percent, that's really just another way of saying the Fed needs to print more money.

So print money it did, with two rounds of "quantitative easing" in 2009 and 2010, respectively. But there were two problems. The short term problem was that because this

money printing was considered "unconventional," the Fed came under strong political pressure not to do too much of it. As a result, monetary policy wound up being way too tight, leading to a more severe and longer recession than necessary.

The more fundamental problem was that without its familiar interest-rate-based benchmark, it had no good way to figure out how much money it should print. And the market had no way to predict the Fed's future actions. When the Fed announced "QE2," in late 2010, it said it would print $600 billion over the next few months. But what would it do after that? Because QE2 wasn't part of any broader policy framework, the public got no guidance about what would happen once the latest round of money printing stopped. So with no guarantee the Fed would continue supporting the economy after QE2 expired, businesses were reluctant to make long-term investments.

What was needed was a replacement for the Taylor Rule, one that doesn't break when short-term interest rates fall to zero. The Fed's first tentative stab at this came in September, when the central bank announced an "open ended" round of quantitative easing. That is, rather than announcing plans to stop printing money at an arbitrary date or dollar figure, the Fed announced it would continue printing money until an economic recovery got under way. While in one sense this was less specific than the previous rounds of QE, it was more specific in the way that really mattered: it clearly tied the program's duration to objective economic variables, rather than to totally arbitrary dates and dollar amounts. That gave the market confidence the Fed wouldn't make the mistake it made in the two previous rounds of QE, when it stopped them before they'd achieved their purposes.

Today's announcement is another step toward an objective and predictable monetary policy rule. Rather than promising to print money until the economy starts to recover, a rather vague concept, the Fed is now promising to ease until one of two things happens: the unemployment rate falls below 6.5 percent or the inflation rate rises above 2.5 percent. These clear numerical targets should give the market greater confidence that the economy will be growing in the next few years, encouraging more investment today.

Of course, this new rule still leaves a lot to be desired. We know that the Fed will keep the money spigots open until the economy starts to recover (as reflected by higher inflation rates and/or lower unemployment). But what will it do after that? The Fed hasn't said, which means uncertainty could re-appear once the recovery gets under way.

A better approach would be Scott Sumner's idea of establishing a target path of nominal (that is, non-inflation-adjusted) gross domestic product. The Fed should announce that it plans to print as much money as necessary to get NGDP growing at an annual rate of 5 percent (perhaps along with a bit of "catch-up" growth in 2013 and 2014). This would have the advantage of binding the Fed's hands much more tightly than the current regime—the Fed would ease when NGDP growth rate fell below 5 percent and tighten when it rose above it, with very little room for discretionary decisions by Fed officials. And it also avoids the nasty problem of the zero lower bound. Because it doesn't say anything about interest rates, the rule continues to work fine when interest rates fall to zero during severe recessions.

A couple of years ago, NGDP targeting seemed like a radical idea. But you can think of the "Evans Rule" the Fed announced today as a distant cousin of NGDP targeting. Both are commitments to print money until key economic statistics achieve clearly-defined target values. The advantage of NGDP is that it's a general rule applicable in all

circumstance, whereas the Evans Rule is a narrow rule applicable only to today’s rather unusual circumstances.