Monetary Policy and the State of the Economy

Testimony Before
The Committee on Financial Services
United States House of Representatives
February 11, 2014
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Chairman Hensarling, Ranking Member Waters, and other members of the Committee on Financial Services, thank you for the opportunity to testify. I will review the current economic situation, discuss the role of monetary policy, and try to answer any questions you may have.

The Current Economic Situation

Recently released data indicate that the U.S. economy continues to underperform, with the recovery from the deep 2007-09 recession looking as disappointing as ever. Real GDP growth has been too slow to close the gap between real GDP and its pre-recession trend, even incorporating the temporary pickup near the end of last year.[1] Job growth has been too slow to raise employment relative the population, leaving the employment-to-population ratio below the recession low.[2] While the unemployment rate has declined recently, much of the decline is due to an unusually large number of people dropping out of the labor force because of the weak recovery.[3] It is good news that the inflation rate has averaged very close to the Fed's 2 percent goal during the past decade, but by any measure the performance of the real economy has deteriorated compared to the previous two decades.

I have argued that the main cause of the poor performance is a significant shift in economic policy away from what worked reasonably well in the decades before. Broadly speaking, 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.[4]

There is an obvious empirical correlation between this shift in economic policy and the poor economic performance. But it is more than a correlation: A significant body of economic research predicts that such a shift would result in poorer performance, a prediction that is confirmed by historical experiences from the 1970s to the 1980s and 1990s and by empirical

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[1] The gap between real GDP and the 2.5% growth trend from 2000 through 2006 is now 7 percent, about the same as at the end of the recession. Partly in response to this slow growth and the associated low investment rate, the Congressional Budget Office (CBO) recently lowered its estimate of potential GDP, implying a gap of about 4 percent.

[2] The employment-to-population ratio is now 58.8% compared with 59.3% at the start of the recovery.

[3] See Erceg and Levin (2013).

[4] See Taylor (2012)

studies of specific policy actions. Moreover, this "policy is the problem" explanation fits the facts better than alternative views that there has been a secular stagnation due to a persistent decline in the normal real interest rate or that weak recoveries normally follow deep recessions.

Unconventional Monetary Policy

Let me now focus on the role of monetary policy. I have been a strong supporter of Federal Reserve policy in the past, especially during the 1980s, 1990s and until recently, a period commonly called the Great Moderation because of the excellent macroeconomic performance. But starting around 2003-2005 monetary policy started to move in what many now call an "unconventional" direction.

The Shift Toward Unconventional and More Discretionary Monetary Policy

It began with the Fed's "prolonged period" and "measured pace" periods of forward guidance during 2003-2005. It was then that the Fed purposely held the federal funds interest rate usually low and began giving forward guidance that the rate would remain unusually low for a prolonged period (mainly during 2003) and then increase at a measured pace (mainly during 2004-2005).

Many researchers have shown that the federal funds rate was unusually low during this 2003-2005 period compared with the Taylor rule (1993), which described monetary policy in the previous two decades, and that this deviation exacerbated the housing boom or encouraged risk taking, and eventually led to the housing bust and defaults, leaving risky assets on the balance sheets of many financial institutions.[5] The financial crisis followed.

Of course monetary policy was not the only problem. The regulatory authorities also deviated from rules-based policy as supervisory officials permitted financial institutions to violate safety and soundness rules. The ensuing ad hoc bailout policy created additional uncertainty. But to understand the role of monetary policy, compare the two years 1997 and 2003. In 1997 the Fed set the federal funds rate at 5.5% with the inflation rate at about 2% and the economy operating at near normal levels. In contrast, in 2003 the Fed set the federal funds rate at only 1% with the inflation rate at about 2%, and the economy operating near normal levels. That very low short-term interest rate helped keep long-term mortgage rates very low; it also facilitated low teaser rates on adjustable rate mortgages, and originations of such mortgages more than doubled during this period. As demand for homes skyrocketed, housing price inflation jumped from around 7% per year from 2002-03 to nearly 14% per year in 2004-05 before plummeting in 2006-07.

[5] See Jarocinski and Smets (2008), Kahn (2010), Ahrend (2010), Bordo and Landon Lane (2013), Bekaert, Hoerova and Lo Duca (2013).

The Panic and Classic Lender of Last Resort Policy

During the panic of 2008 the Fed conducted classic lender-of-last-resort policy, providing liquidity in the form of loans to U.S. financial institutions and swaps with foreign central banks. In contrast to the policies taken before and after the panic most of these policies were in fact quite conventional, especially the discount window loans. When the panic subsided in late 2008 these liquidity facilities began to wind down. It is for these actions, which helped restore stability in the financial markets, that the Fed is rightly given high marks.

Doubling Down on Unconventional Monetary Policy

However, the Fed soon returned to its unconventional policies. After the panic and the drawdown of the short term liquidity facilities, it began an unprecedented policy of quantitative easing (QE1, QE2, and QE3) with large-scale purchases of mortgage-backed securities and long-term Treasury bonds. The purchases were financed mainly by increasing banks' reserve balances which rose from around $10 billion in 2008 to over $2,500 billion today. Little of this increase resulted in expansion of the money supply, but money growth has been volatile during this period.

The Fed also returned to and expanded its forward guidance procedures. Rather than simply saying that the interest rate would remain low for a "considerable period" or increase at a "measured pace," the Fed began saying that it would keep the federal funds rate near zero until a certain date, such as 2015. It then changed the policy, saying it would keep the rate at zero at least until the unemployment rate hit 6.5%. With the unemployment rate already at 6.6% today many are speculating that the Fed will have to change its forward guidance again. Underlying the forward guidance has been a promise to hold the federal funds rate lower and longer than would be appropriate under expected future economic conditions. Even though such a policy would be inconsistent over time, the rationale has been to keep expectations of future short-term interest rates exceptionally low in order to hold long-term interest rates low.

These changes, anticipated changes, and time inconsistency of policy add to uncertainty. With the large magnitudes of the securities purchases, frequent changes in the policy, and little consensus on the impacts, there is no way that such a policy could be characterized as predictable or rules-based. For these reasons a number of policymakers inside the Fed have publically disagreed with the policies.

Though the intention of the majority of those at the Fed in favor of the policies was to stimulate the economy, there is little evidence that the policy has helped economic growth or job growth. Growth has been less with the unconventional policies than the Fed originally forecast. In the year since QE3 gained full steam at the end of 2012, interest rates on long-term Treasuries and mortgage backed securities have risen rather than fallen as was the intent of the policy. Before quantitative easing, from 2003 to 2008, the average spread between one year and ten year Treasury securities was 1.3%. During the three quantitative easing programs, from 2009 through 2013 the average spread was 2.4%. So it is very hard to establish that QE reduced spreads.

Rules-Based Monetary Policy

An alternative more rule-like policy would have worked better during this period, and a return to such a policy would help restore stability and strong sustainable growth in the future.

There has been considerable research and experience with monetary policy rules, and the Taylor rule (1993), which emerged from years of extensive research by many people, has continued to attract a lot of interest, even as monetary policy has recently deviated away from rules in practice. In considering the history of the Fed, monetary historian Allan Meltzer (2012) concludes that "The longest period of low inflation and relatively stable growth that the Fed has achieved was the 1985–2003 period when it followed a Taylor Rule." Data confirm this. For example, the volatility of nominal GDP growth was less during 1985-2003 than in the years before and after. Similarly, formal statistical methods used by Nikolsko-Rzhevskyy, Papell, and Prodana (2013) show that macroeconomic performance is better when policy is described by this rule.

If the Fed had adhered to such a policy rule during 2003-2005, research suggests that the American economy could have avoided much of the housing boom, the search for yield, and risk taking which along with lax regulatory policy helped bring on the financial crisis. If the Fed had adhered to such a policy rule in the years since the crisis it would likely not have had engage in quantitative easing or forward guidance. The recommended setting for the federal funds rate would not have gone negative—one of the rationales for quantitative easing—for long or by a large amount. Policy would thereby have been more predictable, credible, and more consistent, which economic theory and experience tells us would have led to better economic performance.

I have proposed that legislation be enacted requiring the Fed to adopt a policy rule—of its own choosing—for the instruments of policy, and that if and when the Fed deviates from its chosen rule, the Fed Chair would have explain why in writing and in testimony before this Committee and the Senate Banking Committee. Some argue that such legislation is not needed to achieve such a reform if the Fed and the Congressional committees could agree to follow such a procedure on their own.

We are by no means close either to a legislated or procedural reform. In any case, given where Fed policy is now, I would advise moving gradually. The Taylor rule says that the federal funds rate should now be about 1¼ percent, but moving there from where the Fed is now too quickly without sufficient preparation could shock the market and the economy.

Nevertheless, there are some promising signs that policy could go in the direction of a policy rule in the future.

First, the Fed has recently adopted a 2% inflation target, which is the value originally built into the Taylor rule. It is significant that a 2% inflation target has now also been adopted by the European Central Bank, the Bank of England, and the Bank of Japan. This international congruence will provide for some lasting durability of that 2% value, and also have the added benefit of improved exchange rate stability.

Second, the long-run economic forecasts for the federal funds rate by the members of the Federal Open Market Committee average about 4%, implying a 2% real interest rate, which is also the value originally built into the Taylor rule.

Third, there is wide agreement that the Fed's response to changes in the inflation rate should be greater than one, though I am not aware of a formal survey of the FOMC on this issue. The biggest technical disagreement is over the appropriate response to real GDP, which varies from a coefficient of ½ in the original Taylor rule to 1 in modifications which have been favored by some at the Fed.

Fourth, Janet Yellen (2013) recently argued that "Many studies have shown that, in normal times, when the economy is buffeted by typical shocks—not the extraordinary shock resulting from the financial crisis—simple rules can come pretty close to approximating optimal policies." Then addressing the current economic situation she asked "why shouldn't the FOMC adopt such a rule as a guidepost to policy? The answer is that times are by no means normal now."

Thus, the debate now appears to be not over whether such a rules-based policy should be adopted, but rather over when it should be adopted. The key question is whether or not we have returned to normal times, and if not, when we will return. In either case it would appear to be time to prepare.

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