Implementing Monetary Policy Post-Crisis: What Have We Learned? What Do We Need to Know?

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Columbia-FRBNY Seminar
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Discussion of Marvin Goodfriend, “Understanding Central Banking in Light of the Credit Turmoil”

- I agree with Marvin

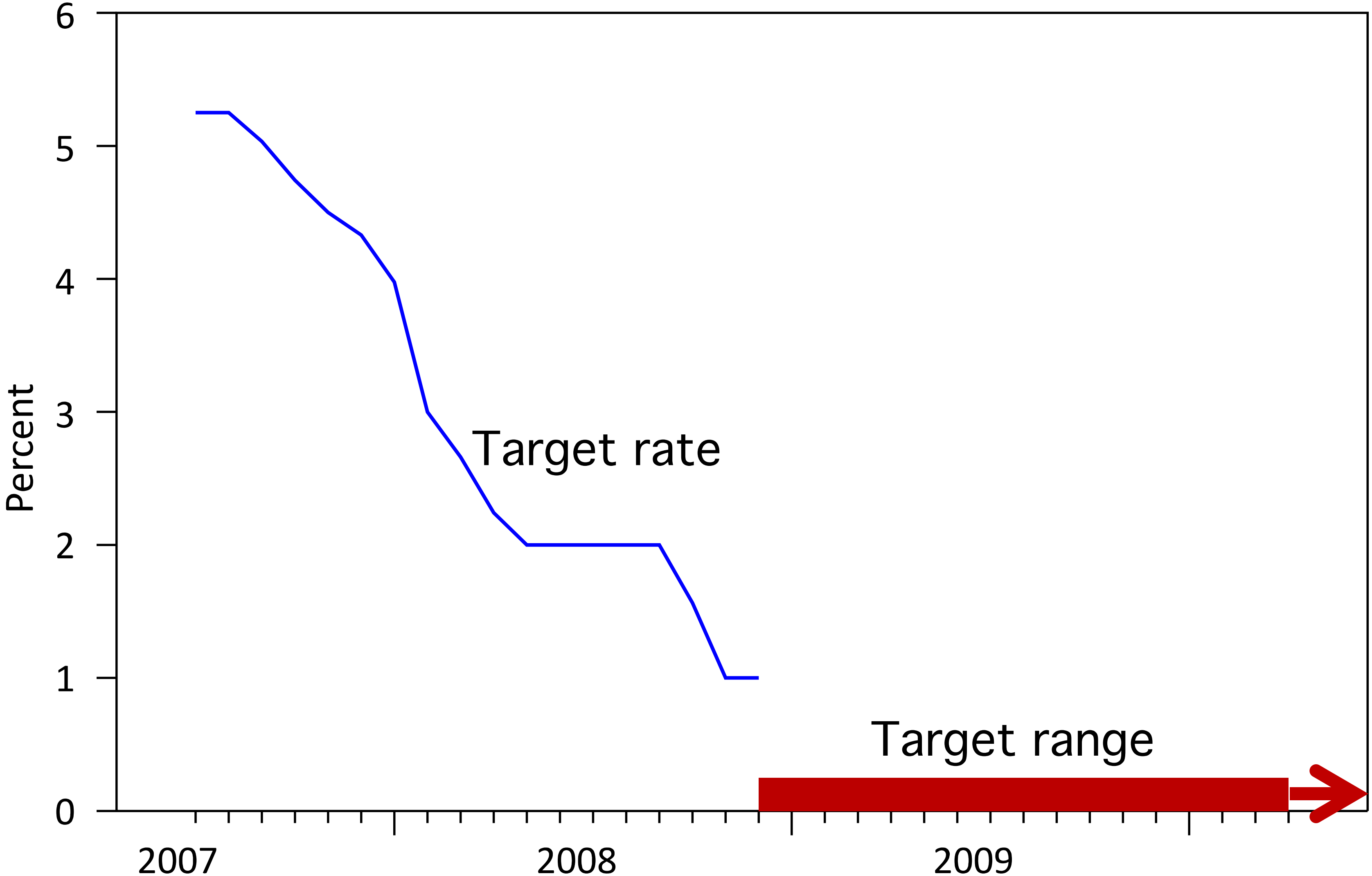
Three Areas of Focus Emerging from the Post-Crisis Period

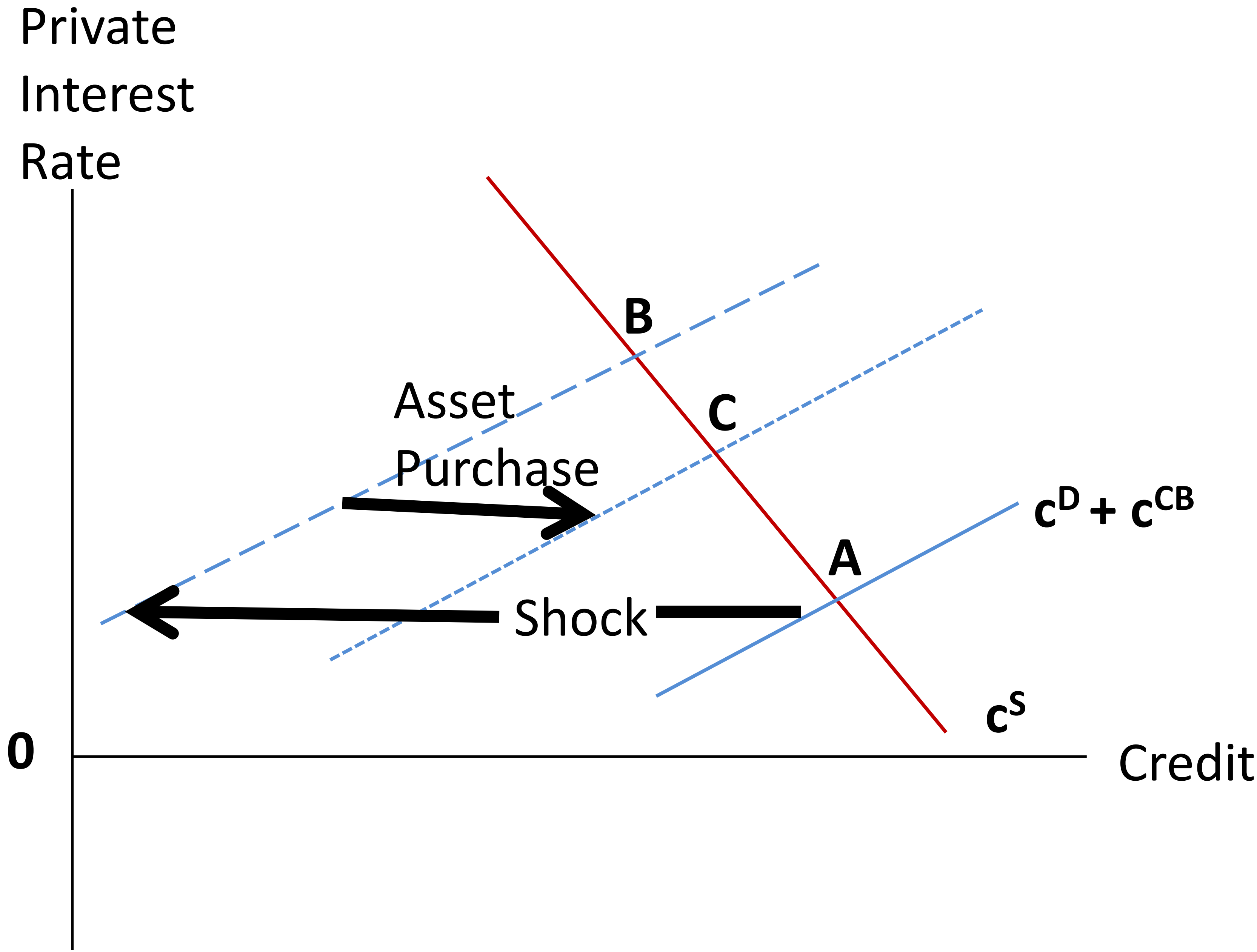
- Asset purchase programs
- Forward guidance
- Inflation targeting

Asset Purchases

- What was the intended consequence?

The federal funds rate reached the zero lower bound by yearend 2008





Private
Interest
Rate
B
C
A
Asset
Purchase
Shock
$c^D + c^{CB}$
c^S
0
Credit

Asset Purchases

- What was the intended consequence?
- Did it work?
  - Yes, for long-term interest rates (also CP)

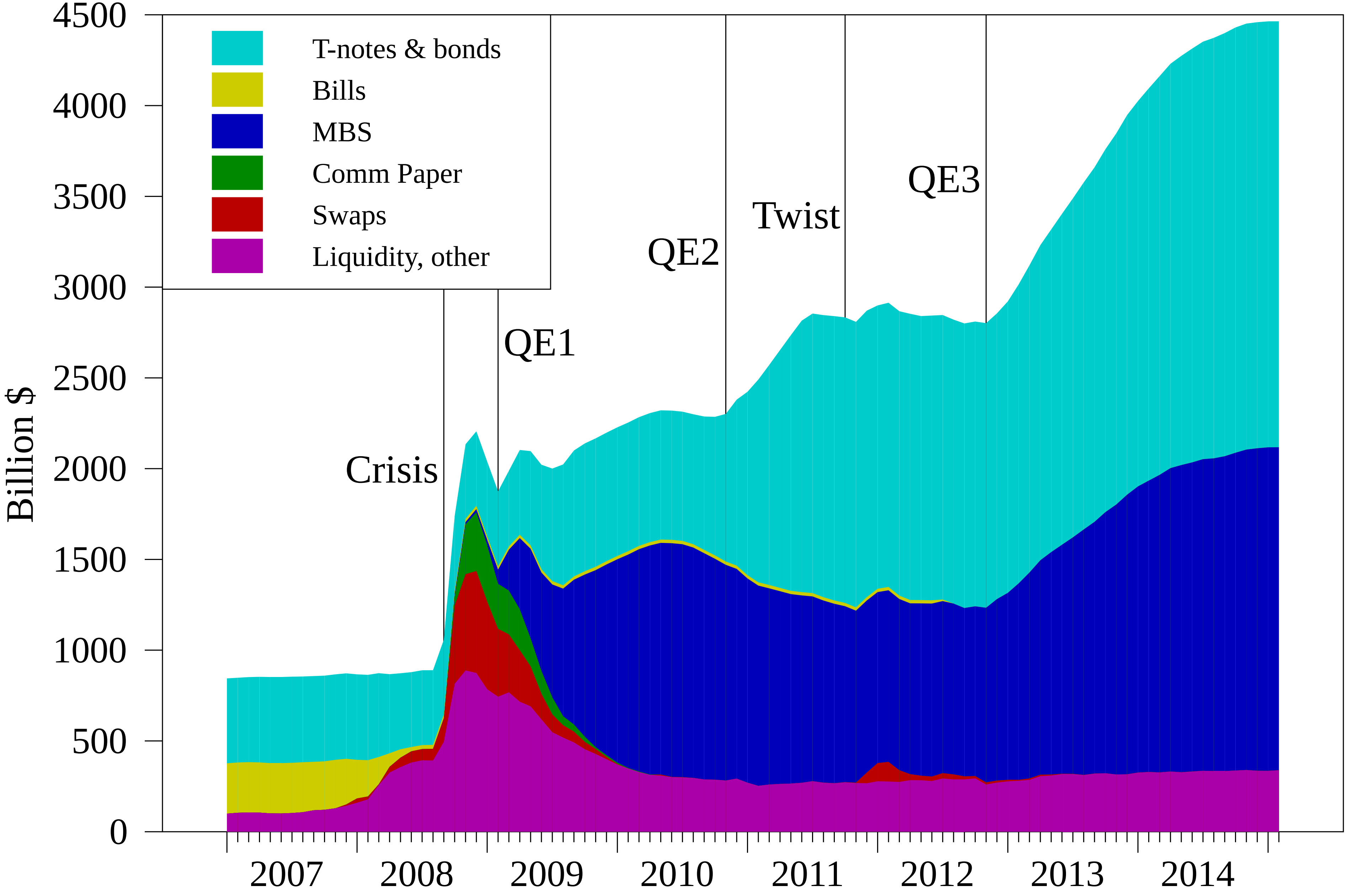
30-year Mortgage – 10-year Treasury Spread

Source: Federal Reserve Board Statistical Release H.15

Commercial Paper – OIS Spread

Asset Purchases

- What was the intended consequence?
- Did it work?
  - Yes, for long-term interest rates (also CP)
  - Plus effects on equity prices and the dollar
- Should they do it again, even if the ZLB isn’t binding?
  - Yes, and symmetrically
  - Moreover, not a “blunt instrument”



T-notes & bonds
Bills
MBS
Comm Paper
Swaps
Liquidity, other
Crisis
QE1
QE2
Twist
QE3
Billion $
0
500
1000
1500
2000
2500
3000
3500
4000
4500
2007
2008
2009
2010
2011
2012
2013
2014

Asset Purchases

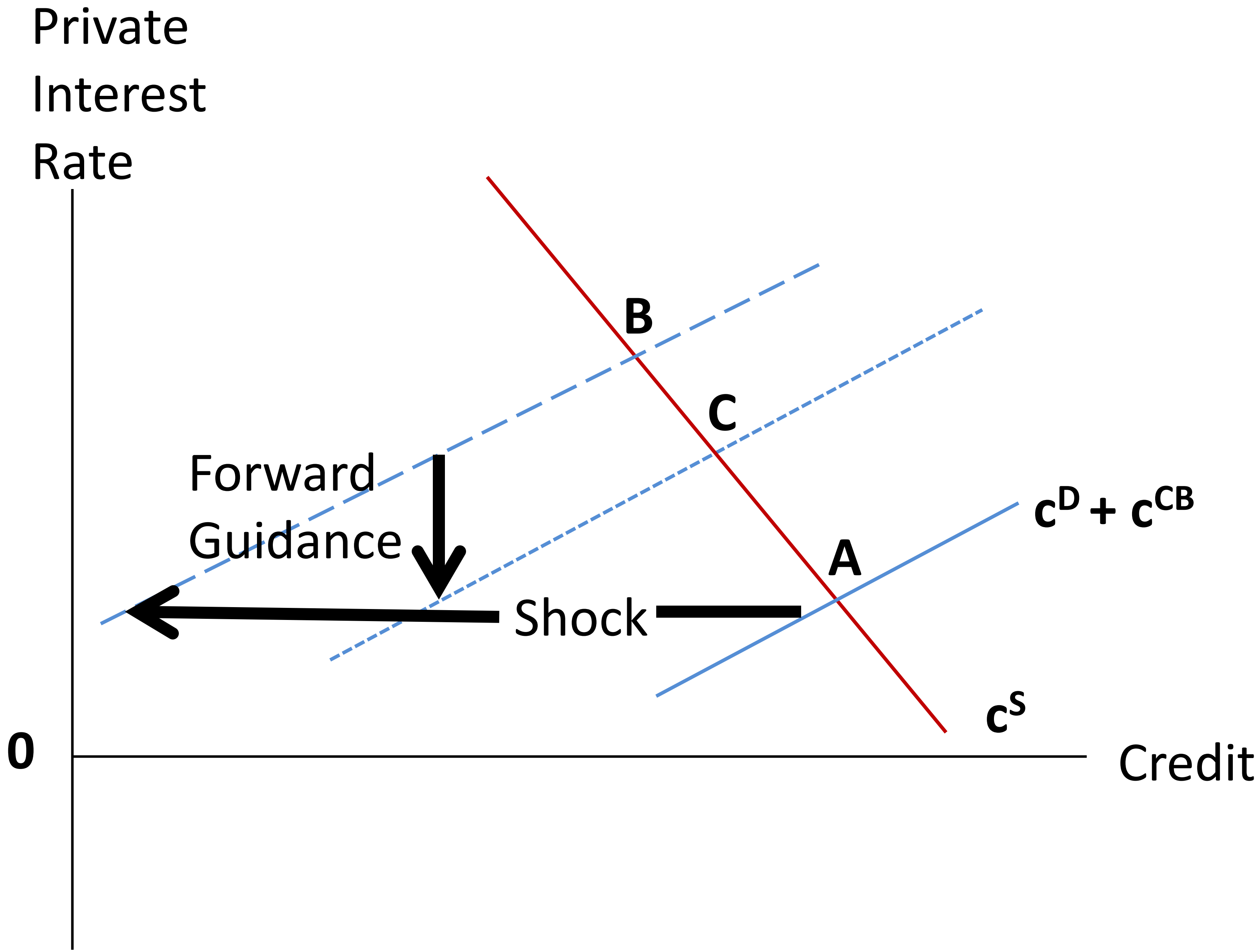
- Hence an important *current* implication: *don't* restore the balance sheet to the pre-crisis "normal"
  - Potential counter-arguments
    - Concern for potential central bank losses
    - Fears of (hyper-) inflation
    - Dislike of central bank interference with credit allocation (buying assets other than Treasuries)
  - All three are unpersuasive

Asset Purchases

- Also, important implications for the *theory* of monetary policy
  - Monetary policy no longer has just one independent policy instrument
  - Shift in attention to the *asset* side of the central bank’s balance sheet (Do central bank liabilities still matter? If so, for what?)
  - In effect, the end of the quantity theory

Forward Guidance

- What was the intended consequence?



Private
Interest
Rate
B
C
Forward
Guidance
A
Shock
$c^D + c^{CB}$
c^S
0
Credit

Forward Guidance

- What was the intended consequence?
- How does a central bank guide expectations of its own actions?

- “the Committee anticipates that weak economic conditions are likely to warrant exceptionally low levels of the federal funds rate **for some time**”

  December 2008 FOMC Statement

- “the Committee … anticipates that economic conditions are likely to warrant exceptionally low levels of the federal funds rate **for an extended period**”

  March 2009 FOMC Statement

Calendar-specific guidance

- “the Committee currently anticipates that economic conditions … are likely to warrant exceptionally low levels for the federal funds rate **at least through mid-2013**”

  August 2011 FOMC Statement

- “the Committee … currently anticipates that exceptionally low levels for the federal funds rate are likely to be warranted **at least through mid-2015**”

  October 2012 FOMC Statement

Outcome-dependent guidance

- “the Committee … currently anticipates that this exceptionally low level for the federal funds rate will be appropriate **at least as long as the unemployment rate remains above 6 ½-percent, inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee’s 2-percent longer-run goal, and longer-term inflation expectations continue to be well anchored**.”

December 2012 FOMC Statement

Guidance contingent on other policies

- “The Committee continues to anticipate, based on its assessment of these factors, that it likely will be appropriate to maintain the current target range for the federal funds rate **for a considerable time after the asset purchase program ends**, especially if projected inflation continues to run below the Committee's 2 percent longer-run goal, and provided that longer-term inflation expectations remain well anchored. … The Committee currently anticipates that, even after employment and inflation are near mandate-consistent levels, economic conditions may, for some time, warrant **keeping the target federal funds rate below levels the Committee views as normal in the longer run**.”

April 2014 FOMC Statement

Guidance centered on the central bank's emotional state

- "Based on its current assessment, the Committee judges that **it can be patient** in beginning to normalize the stance of monetary policy. … The Committee currently anticipates that, even after employment and inflation are near mandate-consistent levels, economic conditions may, for some time, warrant **keeping the target federal funds rate below levels the Committee views as normal in the longer run**."

December 2014 FOMC Statement

Back to outcome-dependent guidance, but vaguer

- "The Committee anticipates that it will be appropriate to raise the target for the federal funds rate when it has seen **further improvement in the labor market** and is reasonably confident that inflation will move back to its 2 percent objective over the medium term."

April 2015 FOMC Statement

Guidance unconnected to calendar time *or* to specific economic outcomes

- The Committee expects that economic conditions will evolve in a manner that will warrant only gradual increases in the federal funds rate; the federal funds rate is likely to remain, for some time, below levels that are expected to prevail in the longer run.

April 2016 FOMC Statement

Forward Guidance

- What was the intended consequence?
- How does a central bank guide expectations of its own actions?
- Has it worked?
  - Much less evidence than with assets purchases: a harder empirical challenge
  - Some evidence of perverse effects (e.g., the spring/summer 2013 “taper tantrum”)

Forward Guidance

- Should they keep doing it, even when the ZLB is no longer binding?
  - Distinguish: transparency vs. deliberate attempts to shape public expectations
    - But: The central bank can *never* fully satisfy the markets' demand for transparency
  - Shaping expectations is problematic too
    - Are these statements promises? If so, are they credible?
    - If they're not promises but merely statements of policymakers' own expectations, in what sense are they an independent policy tool?

Forward Guidance

– Many (most?) observers think the Federal Reserve's guidance-based communication effort is a muddled embarrassment

– Bottom-line recommendation: drop it

Inflation Targeting

- Has the specific numerical definition of “price stability” outlived its usefulness?
  - Inflation came down two decades ago
  - Is there any evidence that public confidence in the Federal Reserve’s commitment to the price stability goal is enhanced by the 2% target?
    - Is the commitment to the 2% target now *undermining* public confidence in the Federal Reserve?
  - Does anyone, other than Federal Reserve officials, care whether inflation is 2% ?

- Is 2% the right number?
  - How did we decide on 2% in the first place?
  - Have we really learned nothing relevant in the last eight years?
    - Likelihood of hitting the ZLB
    - Costs of being at the ZLB
- Then why not change it?
  - The standard answer: Doing so would undermine confidence in the Federal Reserve's commitment to price stability
  - Translation: We said that was the right number, and it would be embarrassing to change our minds

- A better strategy
  - Get rid of the specific numerical target
  - But of course retain the central bank’s emphasis on maintaining price stability (as required by law)

In summary …

- DO continue using asset purchases (and sales)
- Hence DON'T shrink the balance sheet back to pre-crisis levels

- Continue to be as transparent as possible
- But phase out forward guidance except under extraordinary circumstances

- Phase out the numerical inflation target in whatever way is most convenient and institutionally least embarrassing