Fed Policy *In the* Age of Trump

Would a rule make a difference?

BY JOHN M. BERRY

In early May, John C. Williams, president of the San Francisco Federal Reserve Bank, gave a talk in New York with the title, "Preparing for the Next Storm."

It was an apt description of what central bank policy has been all about for the past couple of years. Eventually the Fed will again have to deal with an economic storm whose advent and magnitude are unknowable, particularly given the great uncertainty about what policies President Trump may decide to pursue. All the Fed can do for now is to continue its slow, cautious steps to move its policies back to a neutral position—a process called normalization.

Fed officials, from Chair Janet L. Yellen on down, hope that process, which began in 2014, can be completed before any storm arrives because there are so many flash points around the world that could precipitate one, including the extremely unpredictable man in the White House. Investors have bid up most stock prices partly in expectation that Trump will follow through with promises to cut taxes significantly, reduce federal regulation of business, and spur economic growth with a $1 trillion program of infrastructure investments. He and various federal agencies have begun to trim regulation, but his tax cut plans were described on a single page with few details, and other than an insistence that Congress approve money for the promised wall on the Mexican border—which did not get included in this year's budget—no infrastructure program has been laid out.

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Stanley Fischer

If a rule had to be updated very often, wouldn't it be hard to convince the public that the rule was binding at all? Or as Fed Vice Chairman **Stanley Fischer** *put it in a May 5 speech, "A frequently revised rule does not really qualify as a rule in the sense that we currently use the term."*

In short, there is no sign of the faster economic growth investors appear to be anticipating. Manufacturing jobs continue to be lost as productivity gains reduce the need for factory workers and hundreds of thousands of retailing jobs are being lost as chains such as Macy's and Sears lose sales to Amazon and other online competitors. With unemployment nevertheless below 4.5 percent and the Fed slowly raising its target for overnight rates, the likelihood of a sustained increase in growth seems extremely unlikely. So what happens if investors accept that reality and the incredible stock market rally runs out of gas? Perhaps nothing much, but what if something else happens too, such as a crisis involving North Korea or another critical spot, or perhaps a failure of some European banks?

One of the key things that worries Williams and most other officials is that if some sort of crisis erupts, they have very little room to combat it with the traditional cuts in their overnight interest rate target. Many observers expect the Federal Open Market Committee to raise that target by a quarter percentage point when they meet in June, but if they do, it would still be at a range of 1 percent to 1.25 percent—a scant 1 percentage point above the effective lower bound of the zero to 0.25 percent range at which the FOMC held it for five years in the wake of the financial crisis. The uncomfortable fact is that no one thinks a 1 percentage point cut in short-term rates would do a great deal to help an ailing economy.

Nor do Yellen, Williams, and most other officials think it is safe to raise the current target rapidly in order to have more ammunition on hand if a storm arises. The current plan is to move slowly to normalize policy, because it is far from clear exactly at what point policy would move from reducing monetary stimulus to beginning to slow economic growth.

Yellen has taken great pains to explain to the public the somewhat complicated reasoning behind the current policy stance, including why she and most other Fed officials have fended off some congressional efforts to force the Fed to adopt some sort of rule to guide policy. The reality is that the links between monetary policy and the economy have changed over time and are likely to continue to do so. In their view, no simple rule could work very well for long.

In a speech earlier this year, Yellen said it is difficult to know at what point policy becomes neutral. That is, she said, the point at which "monetary policy neither has its foot on the brake nor is pressing down on the accelerator." And what is the inflation-adjusted, or "real" overnight rate associated with this neutral policy stance when the economy is operating at close to its potential?

"Last December most FOMC participants assessed the longer-run value of the neutral real federal funds rate to be in the vicinity of 1 percent. This level is quite low by historical standards, reflecting, in part, slow productivity growth and an aging population not only in the United States, but also many advanced economies," she said.

But in the wake of the financial crisis and persistent slow growth in many parts of the world, "the current value of the neutral real federal funds rate appears to be even lower than the longer-run value," Yellen continued.

Recent research, some of it by Williams and his colleagues, suggests that the current value is roughly zero.

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That means that with the current actual value of the real fed funds rate somewhat below zero, a zero neutral rate indicates that policy is "moderately accommodative," Yellen said. Another indication of that accommodation is that employment continues to increase by around 180,000 a month, while the long-term trend of labor force growth is between 75,000 and 125,000 monthly, she added.

Another important assumption is that as the financial crisis effects continue to fade, the neutral real interest rate will gradually rise to that estimated 1 percent level. "This expectation partly underlies our view that gradual increases in the federal funds rate will likely be appropriate in the months and years ahead," Yellen continued. "Those increases would keep the economy from significantly overheating, thereby sustaining the expansion and maintaining price stability."

Two years ago, the FOMC formally adopted a 2 percent inflation objective, with prices measured by changes in the personal consumption expenditure price index, a somewhat broader measure than the more familiar consumer price index. In the twelve months ended in April,

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the PCE index rose 1.7 percent. In fact, that measure of inflation has not exceeded 2.1 percent in the past five years. Some have debated whether 2 percent should be regarded as a ceiling or an average over a period of time. Yellen has said numerous times that she would not be disturbed if inflation were to be a bit higher than 2 percent for a while. When the FOMC issued its statement after the March committee meeting, at which it raised the target range by a quarter-percentage point, a key word, "symmetric," was used for the first time to describe the 2 percent goal. In other words, it was not to be regarded as a ceiling but an average over some unspecified period.

Williams did not mention this change, but indirectly addressed it in a larger context by focusing on the role expectations play in determining inflation. In the 1970s, he said, the central bank did a very poor job of controlling inflation—as almost all economists would agree. As inflation rose, the Fed did not move quickly enough to bring it down again. That caused the public and business executives to make decisions assuming that inflation would remain high, which in turn contributed to its further acceleration. Williams said that recent research done by himself and economist Athanasios Orphanides of the Massachusetts Institute of Technology showed that the Fed could have halted the sharp acceleration had it targeted the level of prices rather than an ever-higher inflation rate. That approach would have lowered inflation expectations and headed off the extremely high inflation that eventually was controlled by sky-high interest rates and a severe recession in 1982.

Monetary policy mistakes will continue to occur from time to time, the San Francisco Fed president said, because "underlying constants like potential gross domestic product, the natural rate of unemployment, and the natural rate of interest are not really constant. They change over time in unpredictable ways." And if a mistake means that inflation gets too high or too low, the Fed should seek to move it in the other direction for long enough to keep expectations anchored. One way to do this would be to target the price level rather than just the inflation rate, he said. However, Williams was not proposing a zero inflation rate, as a few Fed officials did thirty years ago, but a price level rising over time, say at 2 percent.

Some economists, including Orphanides, believe the FOMC should adopt some sort of rule to guide policymaking rather than having committee members exercise full discretion to do as they wish from meeting to meeting. At the same policy forum sponsored by the Manhattan Institute at which Williams spoke, Orphanides said the lack of a "simple policy rule" means there is "a lack of clarity" in the process. And the changes in aspects of the economy such as the level of the neutral real interest rate do not obviate the usefulness of a rule, because a rule can be changed if need be, he said.

However, if a rule had to be updated very often, wouldn't it be hard to convince the public that the rule was binding at all? Or as Fed Vice Chairman Stanley Fischer put it in a May 5 speech, "A frequently revised rule does not really qualify as a rule in the sense that we currently use the term."

Nor would such an approach likely satisfy congressional critics, such as Representative Jeb Hensarling, the

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A Call for Clarity

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Athanasios Orphanides

Taylor Rule Updated

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—*J. Berry*

TIE *interviewed* **John Taylor** *in 2001 while he was serving as Under Secretary for International Affairs at the U.S. Treasury Department.*

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Texas Republican chairing the House Financial Services Committee, who wants the Fed to be required to adopt a rule, preferably one focused primarily on keeping inflation low.

The classic rule described by economist John Taylor of Stanford University in a major paper in 1993 was built around an assumption—accurate at that time—that the neutral real fed funds rate was about 2 percent. The rule was also a good description of how Fed policy had been made over a recent period of years. But following that version of the rule after the financial crisis hit in 2007 would have been a disaster.

In two recent speeches, Fischer has said that policy rules are discussed in the materials prepared by FOMC staff for committee participants before each committee meeting, and they play a "benchmark" role in policy discussions. On the other hand, he said, "the overall discussion in FOMC meetings is not generally cast in terms of how it relates to one version or another of the Taylor rule or any other rule."

Fischer also argued that policy rules are not well suited to committees making policy decisions.

"A policy rule prescription is more consistent with a single perspective on the economy than is associated with a committee policymaking process," Fischer said. FOMC participants share a commitment to the Fed's two legal goals, price stability and maximum employment, and have agreed on a statement of longer-run goals and strategy. "But while they have this common ground, each FOMC participant brings to the table his or her own perspective or view of the world. Part of their role in meetings is to articulate that perspective and perhaps persuade their colleagues to revise their own perspectives—or vice versa."

Fischer noted that most central banks in democratic countries use a committee policymaking process rather than a rule, and even when he was governor of the Bank of Israel, and had sole policymaking power, his initial views sometimes changed after he consulted with an informal advisory committee.

"Emphasis on a single rule as the basis for monetary policy implies that the truth has been found, despite the record over time of major shifts in monetary policy—from the gold standard, to the Bretton Woods fixed but changeable exchange rate rule, to Keynesian approaches, to monetary targeting, to the mandate of the Fed, and more," Fischer said. "We need our policymakers to be continuously on the lookout for structural changes in the economy and for disturbances to the economy that come from hitherto unexpected sources."

Certainly with the country being led by Donald J. Trump, who follows no known, consistent rules whatsoever, monetary policy rules might be more of a hindrance than a help. Though it's politically impossible, what the Fed really needs in order to be prepared for an eventual storm is the restoration of the Depression-era authority to lend to essentially any entity that needs to be kept alive to prevent a collapse of the financial system and therefore the economy. Of course, during the financial crisis that led to bailouts of big banks, Bear Stearns, and American International Group with its myriad insurance subsidiaries whose customers had little real protection from state backup commitments.

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Meanwhile, Yellen and her colleagues are watching the weather forecasts as closely as they can. ◆