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

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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.

Target rate: A line graph showing the target rate from 2007 to 2009. The rate starts at around 5% in 2007, sharply decreases to below 2% by yearend 2008, and stays at the lower bound until yearend 2009.

Target range: A red horizontal bar extending from yearend 2008 to yearend 2009, indicating the zero lower bound for the federal funds rate.
Private Interest Rate

Credit Purchase Shock

\( c^D + c^{CB} \)

\( c^s \)
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”
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?
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
“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