Monetary Rules in an Independent Fed

A long-running debate in central banking is whether policymakers should follow an explicit formula for setting monetary policy or whether they should be allowed some leeway to exercise their best judgments. Recently, the "rules versus discretion" debate has been reanimated by lawmakers who argue the Fed operates with too much freedom and not enough transparency. They have proposed legislation that would require the Federal Open Market Committee (FOMC) to establish and follow a monetary policy rule — that is, an equation that specifies how the federal funds rate should respond to changes in economic variables.

Perhaps the best-known rules are Taylor rules, first developed by John Taylor of Stanford University in 1993 to describe past central bank behavior during a time when it was thought to be conducting policy effectively. Taylor rules express the federal funds rate as a function of inflation and some measure of real economic activity, such as employment. In general, Taylor rules prescribe lower interest rates when inflation is below target or employment is falling short and higher interest rates when inflation exceeds target or labor markets are exceptionally tight.

Research suggests there are a number of benefits to using such rules. For example, many economists, including some at the Richmond Fed, have found that the Fed generally did follow a Taylor rule during the Great Moderation, the period from the mid-1980s to the mid-2000s when policy was relatively successful at keeping inflation low and stable and minimizing fluctuations in employment. A key element of this success is that the Fed appeared to follow an aspect of the rule known as the "Taylor principle," which states that the Fed should increase the federal funds rate more than one-for-one in response to increases in inflation. In contrast, during the 1960s and 1970s, when inflation was much more erratic, policymakers departed from this principle.

Given that monetary policy has been fairly close to the prescriptions of a Taylor rule in recent decades, with some exceptions, and that inflation expectations have been well-anchored over that period, departing from such behavior may erode the public's confidence in the Fed's commitment to price stability. From this perspective, there might seem to be little harm in legislating the Fed's adherence to a Taylor-type rule.

But it's neither reasonable nor realistic to expect monetary policymakers to unthinkingly follow a single rule. In my view, a rigid requirement, like the one in some proposed legislation that the FOMC choose a single rule and explain any departures after every meeting, is too draconian. (Although the proposed legislation does give the Fed the option to depart from the rule, the strict conditions attached to deviation would create too strong an expectation of adherence.)

One reason is that simple and strict rules might be too inflexible for the real world, unable to accommodate unforeseen events or changes in financial technology, as my colleague John Weinberg discussed in the First Quarter 2015 issue of this magazine. In addition, there is no single "correct" Taylor rule; multiple versions have been proposed, all of which rely on assumptions about unobserved variables, such as the natural rates of unemployment or interest. Finally, and most importantly, there is the danger that in legislating a Taylor rule, Congress could drift into dictating the day-to-day setting of monetary policy instruments — and history has shown that results are superior when the Fed sets interest rates independently in pursuit of monetary policy goals set by Congress.

This does not mean we face an all-or-nothing choice between blind devotion to a rule and policymakers acting capriciously, as some would argue. Instead, I believe there is a sensible middle course.

Policymakers should — and I do — consult the recommendations of a range of policy rules when setting monetary policy. We should generally stay relatively close to those recommendations and should depart only with careful consideration and good reason to believe that a departure is warranted. As we know from the pre-FOMC meeting briefing materials released with FOMC transcripts, at least through 2011 those materials included calculations for a number of alternative Taylor-type rules. Whether policymakers consulted rules — and if they did, which rules — in 2012 and beyond will not be known publicly until the meeting materials are released (five years after the meeting date).

But the public deserves to know more about the rules the committee consults. We could include the calculations for these rules in the Board's semiannual Monetary Policy Report to Congress, along with a discussion of how and why policy departed from these rules, if applicable. This is a step the Fed could take voluntarily, without the need for legislative action. This approach would help meet the objective of increasing the Fed's transparency and accountability without tying policymakers' hands or threatening the Fed's independence. **EF**

JEFFREY M. LACKER
PRESIDENT
FEDERAL RESERVE BANK OF RICHMOND