

## Opening Remarks for “The Fed at a crossroads: Where to go next?”

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I wish to thank David Wessel for inviting me to participate in this conversation with Bill Dudley and for serving as moderator. It is very good to be back at Brookings. I remember the first paper I gave here. It was in 1982. The paper was on “The Swedish Investment Fund as a Policy Rule” and Stanley Fischer was the discussant. Stan summarized the paper by saying “it reaches a surprising conclusion: somewhere, sometime, a government policy worked in a way it was intended to.”

And over drinks afterwards,<sup>2</sup> Paul Volcker came by. Jim Tobin was there too and he asked: Why don’t you lower interest rates, Paul? Volcker said the Fed controls the money supply not the interest rate; the market determines the interest rate.

That was during a very difficult transition period—another crossroads—a turn from a period of a highly discretionary, go-stop monetary policy to a period of more rules-based policy. The results were amazing. We got the period economists call the Great Moderation, or NICE, for non-inflationary-consistently-expansionary, though I always liked the term Long Boom. There’s much evidence that the Fed had a lot to do with this improvement, and likewise with other central banks in improvements in their countries.

It did not last of course. The Fed decided to hold the interest rate very low during 2003-2005, thereby deviating from the rules-based policy that worked well during the Great Moderation. The results were terrible. In my view this policy change brought on a search for yield, excesses in the housing market, and, along with lapses in the regulatory process was a key factor in the financial crisis and the deep recession.

During the ensuing panic in the fall of 2008 the Fed did a good job of providing liquidity. But when the panic was over, the Fed started on a new unconventional monetary policy—including quantitative easing (QE) and an ever-changing forward guidance. Regardless of what you think of the impact of QE and forward guidance, it was not rule-like or predictable. My research shows that QE was not effective.

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<sup>1</sup> Mary and Robert Professor of Economics at Stanford University and George P. Shultz Senior Fellow at Stanford’s Hoover Institution. This is a written version of remarks I gave following opening remarks by Bill Dudley. After the opening remarks, there was a panel discussion moderated by David Wessel.

<sup>2</sup> It may have been a different day around the same time.

This is why I think it is so important for monetary policy to re-normalize and get back to a predictable rule-like strategy for the policy instruments. Re-normalizing also requires getting the Fed's balance sheet back down to levels where the demand and supply of reserves determine the interest rate.

So the Fed is at a crossroads again. Crossroads can be dangerous places. I was looking out at Dupont Circle this morning. At that crossroads you have ten choices of which road to take: Massachusetts Avenue, Connecticut Avenue, New Hampshire Avenue, 19th Street and P Street with 2 ways on each. Unfortunately, the Fed now seems to be stuck in the Dupont Circle roundabout, circling around and around, deciding what to do. I think they should get on with it. How about west on P-Street, which stands for prosperity and is all downhill?

Bill Dudley expressed his reservations about the Fed's taking the rules-based road. I disagree with him, but I appreciate his efforts, as in his speech to the Council on Foreign Relations in 2012, to compare his more discretionary approach with a more rules-based framework.<sup>3</sup> This kind of discussion coming from the Fed is helpful regarding recent legislation that would require the Fed to report its strategy for monetary policy.

Many of the points Bill makes are about the Taylor rule. I am happy to respond to such points, and have done so before, though I emphasize that the recent legislation does not require the Fed to follow the Taylor rule.

Bill makes three main points.

First, he says that the Taylor rule is not forward-looking because it includes current inflation and output rather than forecasts of those variables. But the Taylor rule was designed to deal explicitly with forecasts, and it is in fact forward-looking in important ways. Note that when a central bank indicates that it will predictably follow a rule in which the interest rate reacts to the current inflation rate, it automatically says that next period's interest rate will react to next period's inflation rate. That's forward-looking. Moreover, the current level of inflation and output are key factors in the forecast of inflation, and the coefficients in the Taylor rule take that into account.

Now, one could replace current inflation with a forecast of inflation in the Taylor rule—as Bill seems to suggest, but the coefficients would most likely have to be different. And that approach raises the question of whose forecast to use and how to evaluate the rule. Remember that forecasts—including the Fed's forecasts—are not that good. Also rules with forecasts of inflation and output on the right hand side tend not to be robust.

Second, Bill says that the equilibrium interest rate in the Taylor rule is not a constant; it moves around. The original rule took the real equilibrium rate to be 2%, meaning that with the 2% target inflation rate in the rule, the equilibrium nominal rate would be 4%. But there is no

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<sup>3</sup> William C. Dudley, "Conducting Monetary Policy: Rules, Learning and Risk Management," Council on Foreign Relations, May 23, 2012

reason why a moving rate could not be incorporated into the rule, and many have suggested doing so. In my view debates about the implications of changes in the equilibrium interest rate are more productive if they are conducted within the framework of a policy rule rather than in the abstract. According to the Fed's dots, the equilibrium rate is slightly lower than FOMC members earlier believed—3.5% rather than 4.0%. That's no reason to steer away from rules-based policy.

The adjustment that I suggested in 2008 is an example of how such developments can be incorporated into the Taylor rule.<sup>4</sup> Bill mentions this adjustment as reason why the Taylor rule should not be used mechanically. I agree that the Taylor rule should not be used mechanically, and I emphasized that in the original paper.<sup>5</sup> But the adjustment I suggested in 2008 was meant to deal in a systematic way with a particular problem in the money market when the spread between Libor and the overnight index swap widened significantly. The models that were used to find the Taylor rule in the first place implied such an adjustment.

Bill also refers to zero lower bound. Well, that was certainly not a reason to have deviated from rules-based policy in 2003-2005 and it is not a reason now, with the zero bound no longer binding. The zero-bound appears to have been binding in 2009, but that bound was taken into account in policy rule design research.<sup>6</sup> My view has been that interest rate rules are best thought of as part of a more encompassing rule in which the instrument becomes money growth in deflationary or hyper inflationary situations.<sup>7</sup>

Third, Bill says the Taylor rule is too simple because it omits certain variables. Well, the Taylor rule is simple, because we made it simple. At the time people were coming up with all sorts of complex rules that included many of the types of variables that Bill thinks should be there, including asset prices. These rules were too complex to be workable in practice. So we boiled them down. It was amazing that we could. We found that removing certain variables gave just as good a performance in many models and was more robust over all. It certainly was something more practical for policy makers to work with.

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<sup>4</sup> John B. Taylor, "The Costs and Benefits of Deviating from the Systematic Component of Monetary Policy," Keynote Address at the Federal Reserve Bank of San Francisco, Conference on "Monetary Policy and Asset Markets" February 22, 2008.

<sup>5</sup> John B. Taylor "Discretion Versus Policy Rules in Practice," *Carnegie-Rochester Series on Public Policy*, North-Holland, 39, 1993, pp. 195-214. Also released as Stanford Center for Economic Policy Research (CEPR, now SIEPR) Publication No. 327, November 1992.

<sup>6</sup> See John B. Taylor *Macroeconomic Policy in a World Economy: From Econometric Design to Practical Operation* W.W. Norton, 1993 which states that "Since negative nominal interest rates are not feasible, [the policy rule] must be truncated below some nonnegative value, which is taken to be 1 percent in this analysis" This then is the type of policy rule we simulated.

<sup>7</sup> See John B. Taylor, "Policy Rules as a Means to a More Effective Monetary Policy," *Monetary and Economic Studies*, Bank of Japan, 14 (1), 1996, or "The Need to Return to a Monetary Framework," *Business Economics*, 44 (2), 2009, where I state that in the region where rates would be negative, "policymakers could use Milton Friedman's famous constant growth rate rule...Or policymakers could design another procedure for determining the quantity based on economic principles."

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In any case Bill seems to want to complicate things again by adding in many more variables. But saying you need to take account of everything under the sun is not a good way to make policy. A “careful elucidation,” as he describes it, of key factors sounds better, but not if you don’t have a strategy to react to those factors. That strategy is what is missing from Bill’s favored approach. That is why I disagree with it, and why I favor striving for a rules-based policy. Thank you.