

Short-Sighted Monetary Policy and Fear of Liftoff

Athanasios Orphanides
MIT

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Shadow Open Market Committee Meeting

Princeton Club, New York City
October 2, 2015



Monetary policy operates in an uncertain environment with long and variable lags. Different macroeconomists and policy advisers can reasonably have different views about what would be the most appropriate monetary policy strategy at any moment in time and differ on their views on the appropriate policy setting. This is often cited to justify different views about the stance of monetary policy. There is little disagreement, however, that monetary policy works best when it is systematic and avoids short-sighted, seat-of-the pants discretionary decision making that places undue importance to perceived short-term gains and ignores larger long-term costs.

The Federal Reserve, like other central banks, has been granted operational independence to protect against political pressures that constitute one source of unsystematic short-sighted policy. The risks are well understood. However, Federal Reserve policymakers retain immense discretionary power and, as the history of the Federal Reserve suggests, Federal Reserve policymakers have often used that power inappropriately, adopting policies that placed excessive emphasis on perceived short-term gains.

The Great Inflation serves as an important example. For over a decade, the Federal Reserve pursued inappropriately expansionary monetary policy focusing on short-term gains on employment and growth. Instead, the excessive focus on employment gains resulted in greater economic instability, higher inflation and lower growth. For a generation following the Great Inflation, under the leadership of Paul Volcker and Alan Greenspan, the Federal Reserve followed a more systematic policy approach based on the premise that the best way the Federal Reserve could contribute to long-term sustainable employment and growth was by protecting price stability over the long-term. The Great Moderation, a period of low inflation and greater economic stability reflected in large part the systematic nature of monetary policy.

Following the crisis, the Federal Reserve has followed a different approach. In the past few years, the Federal Reserve has once again started placing undue emphasis on short-term employment. The sustained reduction in the rate of unemployment appears to have become the guiding principle of monetary policy. Long after the end of the recession, reducing unemployment served as the justification for QE3, a policy that expanded the Fed's balance sheet by 1.5 trillion dollars over a period of two years. And this year, six years after the end of the recession, and despite larger declines in the unemployment rate than projected by the policymakers themselves, the Fed has been unable to even begin the process of policy normalization.

A short-termist mentality is the antithesis of systematic monetary policy. The fear of liftoff exhibited in Fed decisions suggests a return to the unsystematic, short-term oriented policy approach pursued before the Great moderation. This should be a cause

of great concern.

So what's wrong with current policy? Let's first reflect on inflation, the one and only thing that the Fed can control in the long run. Since the start of the crisis in 2008, core measures of inflation have been moving roughly sideways. Core inflation has not fallen as much as many feared at the beginning of the crisis and is only slightly below the Fed's target. This can justify the maintenance of somewhat accommodative monetary conditions. The issue is whether this can be used to justify the continuation of the unprecedented accommodation the Fed has engineered not only during the recession, but since then. The short-term real interest rate has remained significantly negative for many years, much longer than in any recessions in the past several decades. In addition, the expansion of the balance sheet has added to this accommodation what may be equivalent to a few hundred basis points of additional easing.

What about the real economy? The Fed *correctly* responded aggressively to the downturn in 2008. In my view, the Fed deserves credit for that policy easing. The problem at present is that the Fed has been unable, unwilling or reluctant to begin the process of normalization.

The economy has recovered from the Great Recession long ago and labor markets are not far from normal. For those who measure slack in terms of deviations of the unemployment rate from measures of the natural rate of unemployment, the economy is very close and perhaps beyond full employment, depending on the estimates. The unemployment rate is at 5.1, within the central tendency of FOMC members, according to the latest Survey of Economic Projections (SEP). (The latest survey reports the central tendency as 4.9 – 5.2.)

There is disappointment that real GDP growth has been subdued, that productivity is lower than what was hoped. However, given the rapid improvement in employment markets, this appears to reflect lower trend productivity and lower potential output growth. We may all wish for better trend productivity and should lobby for better fiscal and structural policies to encourage higher long-term productivity and growth but higher trend productivity is *not* something the Fed can deliver. The best way the Fed can contribute to long-term growth is by following a systematic policy that defends price stability over the medium and long term.

With the economy close to full employment, the current massive degree of policy accommodation cannot be justified. The process of policy normalization should have started long ago. Liftoff is *not* the end of accommodative conditions. Liftoff was needed to prevent an overheating in labor markets that would threaten longer term stability.

Why would systematic policy need to begin the process of normalization before inflation concerns become immediate? Is tighter policy justified, given that core inflation measures are somewhat below the Fed's target?

The Fed *should* retain a somewhat accommodative stance given that inflation is somewhat below its target. However, this cannot be used as an excuse to retain the massive accommodation that was engineered to fight the recession years ago.

Monetary policy operates with long and variable lags. According to some Fed models, the maximum effect is around two years after a policy action. The Fed has been adding accommodation with QE until less than a year ago, which will continue to stimulate the economy and push inflation upward well into 2016. Policy needs to be preemptive. The degree of policy accommodation should be reduced to avoid an overheated economy which would surely destabilize inflation and make a recession more likely.

The costs of further delay in normalizing policy will not be felt in the next year or two. The success of the Fed under Paul Volcker and Alan Greenspan in anchoring inflation expectations serves as a shield. Given the long lags in the monetary policy process, even major mistakes at present are unlikely to have large destabilizing effect on price stability in the next year or two. Short-sighted policies always shifts costs into the future.

The need for a somewhat accommodative policy cannot be used to defend the current non-systematic policy and excessive emphasis on short-term employment gains. First and foremost, the Fed should take a long view and return to a systematic policy approach that preserves and defends price stability. As Paul Volcker and Alan Greenspan kept reminding us over a generation while cleaning up the mess that short-sighted policies created before their chairmanships, this is best way monetary policy can contribute to enhancing growth and employment in the long run.