

U.S. Monetary Instability and the Global Consequences of Unfettered Discretion

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The recent history of U.S. monetary policy instability, and its global consequences, has been quite a roller coaster ride since 2000. Current prospects for favorable reforms in the U.S. to make monetary policy conform to a systematic framework seem bleak. Important casualties from recent Fed policies include the deep politicization of monetary policy, extreme dollar exchange rate instability, and confusion about the continuing need for unconventional monetary tools, such as interest on reserves and reverse repos. Silver linings, however, include a decade of favorable access to portfolio flows for emerging markets (EMs), and the encouragement of improvements in EMs' monetary policies that exchange rate instability from the U.S. has contributed to.

Around 2000, there was broad consensus (led by academics like Ben Bernanke) that systematic monetary policy rules (something like a flexible inflation targeting rule, along the lines of some version of the Taylor Rule) would be an important improvement to policy. This was a victory of the rational expectations school view that you cannot make progress in society by systematically fooling people, but are better off adopting a transparent, predictable and empirically defensible rule that (a) targets inflation as the primary objective of policy, with (b) a secondary objective of limited cyclical stabilization.

Strangely, the consensus disappeared almost as soon as it was in place, as the result, ironically, of Bernanke's advocacy of extreme loosening of policy from 2002 to 2005. That period witnessed a departure from a rough 2% inflation targeting Taylor Rule in the prior 20 years. On average, over the four years, 2002-2005, the fed funds rate was about 2% below the level that would have been warranted by a Taylor Rule.

There is little doubt that this bubble-inflating policy contributed to the crisis of 2007, which then ushered in a whole new phase of emergency and post-emergency monetary experimentation (quantitative easing, or QE1, QE2, and QE2, reverse repos, and interest on reserves), which have been implemented on an ad hoc basis with no guiding framework underlying Fed actions. The Fed today remains adrift, with nothing even approaching a systematic approach to policy.

Looking back on the recent experience of monetary instability in the U.S., and looking forward regarding prospects for improvement, several points warrant discussion.

Financial inflows into EMs from the U.S. and other developed economies since 2009 have shown enormous volume and volatility, and the main driver has been developed countries' monetary policies. This reflected search for yield (through the carry trade), and subsequently, opposite reactions to expected increases in U.S. rates. Who have been the EM winners and losers? On balance, this has been a big win for EM growth, despite the volatility, because of the large quantity of portfolio inflows and their impact on growth, as described in Calomiris, Larrain and Schmukler (2018). Even countries that suffered relatively from volatility/discipline since 2013 arguably also experienced some long-term gain from the adverse shocks of monetary tightening in the U.S., as the different experiences of EMs during the contraction have been shown to have reflected differences in country characteristics (IMF 2014, Karolyi 2015). Some EMs have been learning from the discipline of capital outflows to attend to institutional

weaknesses, and this has helped encourage constructive long-term changes (e.g., Brazil and Indonesia).

Dollar value unpredictability was another major consequence of the QE experiments. The trade weighted dollar has varied enormously over the past eight years, as the dollar initially fell and subsequently rose dramatically. More importantly, the predictability of exchange rates was substantially reduced after 2010 as the result of QE policies (Taylor 2017, Calomiris and Mamaysky 2018). Weakening the dollar after 2009 was not just an unintended byproduct, but very much part of the intended “transmission mechanism” of U.S. monetary policy, which was an aberration from historical practice (the Fed generally goes to great lengths to say its intent is not to affect the value of the dollar; but this time, some Fed staff have acknowledged that depreciating the exchange rate was an important and intended part of the means through which QE was effective). QE made exchange rates unpredictable – i.e., it substantially reduced the ability of a model to predict medium-term exchange rates – because (a) there was no timeline or exit criterion established for the special balance sheet growth, and (b) it set in motion competitive devaluation policies by the major central banks, with unpredictable consequences for exchange rates. Interestingly, other central banks did not entirely offset the depreciating impact of U.S. QE policy, perhaps because of the relative power of the Fed, and the need of other central banks to rely on Fed cooperation in supplying dollars to their banks.

This volatile exchange rate environment may also have contributed to global protectionism’s rise. After all, the need to reestablish international trade by removing the exchange rate as a tool of policy (in light of competitive devaluations) was a major policy conclusion outcome from the competitive devaluation (beggar-thy-neighbor) policies of the 1930s, and that policy conclusion was embodied in the Bretton Woods System (Steil 2013). How strange for the new normal of best-practice policy to be competitive devaluations!

While developed countries have pursued unfettered discretion in their monetary policies, monetary policy in EMs, ironically, has become more systematic, partly as a reaction to the risks posed by dollar volatility. For example, Mexico has become more like Chile, with a purer adherence to a monetary rule (and less FX meddling), partly because its FX interventions became a lightning rod for attacks on the peso as a means of betting in favor of dollar appreciation against EMs as a group. More generally, policy rules that target inflation with greater exchange rate flexibility seem to have gained ground in thinking within EMs over the past two decades.

Within the U.S., the politicization of monetary policy in the U.S. has been a major consequence of the departure from systematic policy (as Milton Friedman predicted; see also Calomiris 2018). Having a rule – one that makes inflation the primary goal, and that requires the Fed to develop, state, and adapt its policy mappings as circumstances change, and explain any deviations from it – helps policy makers defend themselves against myopic political threats from the Administration or Congress. When policy is adrift, it becomes open season on the Fed. So we see all sorts of attacks from all sides, and all sorts of political deal making (e.g., one Democrat Representative has been alleged by informed parties to have been successful in pressuring Janet Yellen to see to it that one of the Federal Reserve Banks appointed a favored

candidate as its new President in exchange for that Representative's not continuing to question the Fed about its violating the statutory limits on its interest on reserves policy).

New tools of policy add to the confusion (reverse repos and setting the rate of interest paid on reserves). These tools are unnecessary, as there is no good reason the Fed cannot tighten through open market operations. The new tools have two political, rather than economic, purposes: (a) to prevent the Fed from realizing politically hazardous large losses on its portfolio by shrinking it, and (b) preventing the Fed from engaging in the politically hazardous withdrawal of its interventions to subsidize mortgage credit (i.e., mortgage-backed securities purchases; see DiMaggio, Kermani and Palmer, 2016).

An overarching lesson of the volatility, politicization, and chaotic policy that resulted from QE is that a systematic framework for monetary policy in the U.S. should include a clear discussion of what would happen in the future if the U.S. were again to reach the zero lower bound for interest rates. That discussion would specify: (a) when a QE policy would be initiated; (b) a systematic rule explaining how it would be implemented while it was in effect; and (c) what conditions would lead to exiting from the policy. This commitment would reduce uncertainty with respect to central bank actions and risks of competitive devaluation (e.g., if the rule was clearly linked to inflation targeting, following the logic of Obstfeld and Rogoff 2002).

President Trump had a golden and historically unique opportunity: to appoint an entirely new Fed Board of Governors committed to reestablishing clear rules for monetary policy and rationalizing its regulations of banks. A good start at a roadmap to both objectives was provided by the House of Representatives' hearings and proposed legislation, under the leadership of Jeb Hensarling. It remains unclear whether the recent and future Fed appointments will take a reform-minded path, but so far, there is not much reason for optimism.

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