THE WALL STREET JOURNAL.

http://www.wsj.com/articles/the-case-for-a-rules-based-fed-1482276881

OPINION | COMMENTARY

The Case for a Rules-Based Fed

Neel Kashkari is wrong. My proposed rules-based reform of the Fed would not be run by a computer.

PHOTO: ISTOCK/GETTY IMAGES

By **JOHN B. TAYLOR**
Updated Dec. 20, 2016 6:46 p.m. ET

There is a growing consensus that monetary reform is necessary. Eight years after the 2008 financial crisis and the extraordinary measures taken—most notably near-zero interest rates, frequently changing forward guidance, and hundreds of billions of dollars in asset purchases—the goals of insulating the Federal Reserve from political pressures and creating a more predictable, accountable, rules-based monetary policy are widely held.

Yet in a recent Journal op-ed, Neel Kashkari, president of the Minneapolis Fed and the newest member of the Federal Open Market Committee, joined the debate by arguing against rules-based reform. Those in favor of reform, he said, want the Fed to "mechanically follow a simple rule" and "effectively turn monetary policy over to a computer."

This is a false characterization of the reforms that I and many others support. In those reforms the Fed would choose and report on its strategy, which would neither be mechanical nor run by a computer.

To understand why reform is needed, recall that the Fed moved away from a rules-based policy in 2003-05 when it held the federal-funds rate well below what was indicated by the favorable experience of the previous two decades. The results were not good. The excessively low rates brought on a risk-taking search for yield and excesses in the housing market. Along with a breakdown in the regulatory process, these actions were a key factor in the financial crisis and the Great Recession.

During the panic in the fall of 2008, the Fed did a good job in its lender of last resort capacity by providing liquidity and by cutting the fed-funds rate. But then the Fed moved sharply in an unconventional direction by purchasing large amounts of Treasury and mortgage backed securities, and by holding the fed-funds rates near zero for years after the recession was over.

These policies were ineffective. Economic growth came in consistently below what the Fed forecast and much weaker than in earlier recoveries from deep recessions. Such policies discourage lending by squeezing margins, widen disparities in income distribution, adversely affect savers and increase the volatility of the dollar. Experienced market participants have expressed concerns about bubbles, imbalances and distortions.

Because this 12-year period represents a deviation from the more rule-like and predictable monetary policy that worked well in the 1980s and '90s, many are calling for the Fed to normalize and reform. Normalization now appears to be the intent of the Fed, but the pace has been slow and uncertain. Nobel Prize winners, former Fed officials and other monetary experts have signed a statement in support of legislation proposing such reform.

Mr. Kashkari, by contrast, argues that a rules-based approach would shackle Fed policy makers, forcing them to "stick to" a rigid rule "regardless of economic conditions." That too is false. The Fed could change or deviate from its strategy if circumstances changed, but the Fed would have to explain why. And he wrongly claims that rules cannot take account of changes in productivity growth.

Mr. Kashkari's argument against rules-based strategies focuses on the "Taylor rule," which emerged from my research in the 1970s and '80s and has been used in virtually every country in the world. The rule calls for central banks to increase interest rates by a certain amount when price inflation rises and to decrease interest rates by a certain amount when the economy goes into a recession.

Mr. Kashkari ignores the hundreds of research papers that have been written on the effectiveness and robustness of such a rule and refers only to one study by "my staff at the Minneapolis Fed," which reports that unemployment after the 2008 financial crisis would have been higher with such a rule.

Yet in a recent empirical study, Alex Nikolsko-Rzhevskyy of Lehigh University and David Papell and Ruxandra Prodan of the University of Houston divided U.S. history into periods, like the 1980s and '90s, where Fed policy basically adhered to the Taylor rule and periods, like the past dozen years, where it did not. Unemployment was 1.4 percentage points lower on average in the Taylor rule periods, and it reached devastating highs of 10% or more in the non-Taylor rule periods.

Studies such as this are more realistic because they evaluate policy as a continuing contingency strategy—the essential characteristic of monetary rules—rather than as a one-time policy change, as with the Minneapolis Fed's study. Moreover, Fed calculations that only look at macroeconomic effects of low rates overlook their negative microeconomic effects on bank lending found by economists Charles Calomiris of Columbia University and David Malpass of Encima Global.

Had the Fed not deviated from rules-based policy before the crisis, unemployment would not have increased so much. Mr. Kashkari questions this view by referring to other countries with crises, but he overlooks studies by Rudiger Ahrend at the Organization for Economic Cooperation and Development and by Boris Hofmann and Bilyana Bogdanova at the Bank for International Settlements which found below-rule interest rates in other countries that were connected to crises.

Unconventional monetary policies with near-zero rates have spread to other central banks, causing a break in the rules-based international monetary system. As a result, governments are intervening more frequently in exchange markets, often in nontransparent ways that raise suspicions of currency manipulation. Reform by the Fed would catalyze international monetary reform, benefiting the United States.

Mr. Kashkari finishes off with a non sequitur that a Fed without a rules-based strategy is a less interventionist Fed. History shows the opposite. Recent unconventional monetary policies have raised concerns that the Fed is being transformed into a multipurpose institution, intervening in particular sectors and allocating credit. Setting a clear monetary strategy will help the Fed be a limited-purpose institution, which is appropriate for an independent agency of government.

Mr. Taylor, a professor of economics at Stanford University and senior fellow at the Hoover Institution, previously served as undersecretary of Treasury for international affairs. Parts of this op-ed are based on his

Dec. 7 testimony at the House Financial Services Subcommittee on Monetary Policy and Trade.