

**Shadow Open Market Committee Statement:  
Rules-Based Guidelines for Monetary Policy Normalization**



Shadow Open Market Committee Meeting

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## **Rules-Based Guidelines for Monetary Policy Normalization Shadow Open Market Committee**

The economy is growing, labor markets have improved dramatically, and inflation is forecast to return to two percent over the intermediate term. However, the Fed still expresses extreme caution about normalizing monetary policy, citing myriad concerns, ranging from sluggish wage growth and low inflation to foreign economic and political risks, which might delay the date at which interest rates finally lift off their zero lower bound. This creates the potential for an erosion of the FOMC's credibility and suggests the Fed lacks a clear strategy for getting monetary policy back on track.

Departing from the consensus that prevailed throughout the Volcker and Greenspan Fed Chairmanships, which held that a commitment to low and stable inflation is the best contribution that monetary policy can make to sustained economic growth, FOMC officials in recent years have relied on a shifting array of ad hoc labor market indicators to guide their policy actions. Not surprisingly, these labor market measures have proven unreliable and unpredictable, and have led the Fed through a series of awkward policy target changes that have added uncertainty and reduced the credibility of FOMC members' interest rate forecasts.

To repair its damaged credibility and place its policies back on solid analytic foundations, the FOMC should place greater emphasis on its continued commitment to the two percent long-run inflation target first established in January 2012. Next, the FOMC must embody its objectives in an explicit and empirically defensible monetary policy rule.

Points 2 through 4 from the Shadow Open Market Committee's statement of "Core Beliefs," presented at our November 2014 meeting, identify the desirable features that any monetary policy rule ought to have. The rule must focus on the Fed's long-run inflation target, restoring and operationalizing the Volcker-Greenspan consensus that maintaining price stability provides the most favorable backdrop against which product and labor markets function most efficiently.

The monetary policy rule should also be somewhat countercyclical, recognizing that, within limits, monetary policy can be used to stabilize output and employment over the medium term, even as it focuses principally on stabilizing prices in the long run. The

policy rule will then ensure that the Fed remains accountable in achieving both sides of its statutory dual mandate.

Any workable rule must limit the set of variables to which policy responds. This imposes discipline on policymakers, avoiding the temptation of excessive fine-tuning and ensuring that the Fed remains insulated from fiscal pressures. It also helps the Fed remain forward-looking, as it must be to account for the long and variable lags with which its policies affect the economy.

Finally, the monetary policy rule should be announced publicly, so that outside observers are able to predict, monitor, and understand the Federal Reserve's policy actions and hold the Fed accountable in meeting its stated goals. Comparing the prescriptions of the rule to the policy decisions actually made would become a productive part of the Fed Chair's semi-annual testimony before Congress.

Within such a rules-based system, several very specific points of guidance for monetary policymakers become clear. First, historical experience tells us that whenever interest rates are too low for too long, financial markets become distorted and inflation begins to rise. After an extended period of exceptionally low policy rates, three rounds of quantitative easing that have substantially expanded the Fed's balance sheet, and four full years of robust M2 growth, there is already enough stimulus flowing through the economy to lift inflation back to the Fed's two percent long-run target. In light of the present size of the Fed's balance sheet, interest rate increases without further delay are necessary to avoid an even more costly overshooting of that inflation target down the road.

Second, the modest rate hikes that the Fed is contemplating now would still leave the policy rate at levels that are historically quite low. This puts initial rate increases into proper perspective: monetary policy would continue to be highly accommodative, but the degree of accommodation would be more in line with that applied under similar circumstances in the past.

Third, in guiding inflation back to its two percent target, the Fed needs to be forward-looking, recognizing that its policies affect the economy with long and variable lags. A related issue concerns the impact that falling energy prices have on measured inflation. Lower oil prices have only a temporary impact on lowering inflation, like shifts in the price of any individual good or service. The Fed should help the public see through this

purely transitory effect and stress that inflation is expected to return to target once these transitory effects fade.

By emphasizing its own systematic and forward-looking behavior, the FOMC would encourage observers to take a longer-run view as well. The Fed should avoid public comment on whether or when it may move policy rates based on individual data releases, each one of which is contaminated with statistical noise. This behavior produces volatile market responses and reduces the Fed's credibility. FOMC officials should express more clearly their confidence that the cumulative effect of past policy actions will bring inflation back to the two percent target. They should also explain that interest rate increases are needed to prevent future inflation from overshooting that target, and will set the stage for prolonged economic growth and prosperity.