

ECONOMICS: US PERSPECTIVES—FEBRUARY 26, 2010

Monetary Policy Rethink Must Move Beyond Narrow Inflation Focus

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The time is right to reexamine the Fed’s approach and policy guidelines. But, instead of raising the target for consumer prices as some have suggested, we believe a broader price measure would be a better tool to help monetary policymakers identify and address systemic imbalances more effectively.

As the dust begins to settle on the biggest recession in a generation, central banks and economists are taking a fresh look at the tenets of monetary policy. For now, the debate is primarily focused on inflation targeting and its ability to prevent the next financial and economic catastrophe.

Since the early 1990s, inflation targeting has defined monetary policy in the US as well as in other industrialized and emerging economies. Olivier Blanchard, chief economist of the International Monetary Fund, recently suggested that central bankers should raise their inflation targets. If policymakers aim for a higher inflation target when economic conditions are normal, he argues, they will also be operating with a higher target on policy rates, which will give them more flexibility to lower rates and cushion the blow when a sudden and sharp economic downturn materializes.

In our view, increasing inflation targets is not the solution and Blanchard’s proposal will be rejected by central banks. Policy-

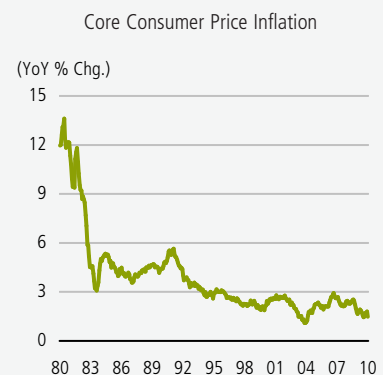
makers will be loath to sacrifice their hard won inflation-fighting credentials, and targeting a higher inflation rate is a simplistic solution that does not offer any assurance of mitigating the severity of a future downturn.

Is the Price Rule Obsolete?

There is a more fundamental issue at hand. We think the time has come for the guardians of monetary policy to reexamine their approach and reconsider whether interest rate policy should continue to be guided by the so-called narrow price-rule. Under the price rule, policymakers make a firm commitment to keep core consumer inflation within a specified range over the long term (**Display 1**). But there is little evidence to suggest that stability in core consumer prices alone promotes greater stability in the economic growth cycle (**Display 2**).

Monetary policy has always used a varying mix of rule-based policies and discretion. Policy rules have been central to the process for two main reasons. First, the

Display 1
Stability in Inflation Has Not Led to...



Source: Bureau of Labor Statistics and Haver Analytics

Display 2
...Stability in the GDP Cycle...



Source: Bureau of Economic Analysis and Haver Analytics

policy rules—based on money, prices or other economic and financial series—provide some feedback on the economy’s performance. They help gauge whether the economy is growing too fast or too slowly, while attempting to detect imbalances that could threaten the sustainability of an expansion and undermine the quest for full employment. Second, policy rules create a systematic framework that provides a sense of consistency and transparency in central bank decisions for the financial markets, which are an important agent in transmitting monetary policy changes to the real economy.

Changing Criteria for Policy Rules

Although policy rules have always been central to decision making, the rules or criteria used to set them have often changed. In addition, policymakers have not always followed the rules with the same degree of rigidity. These changes reflect the dynamic nature of the economy and changing relationships between financial variables and the real economy’s performance. Adherence to policy rules has also been influenced by different outlooks of different Federal Reserve chairmen and members.

For example, until the early 1990s the Fed relied on money supply measures—first M1 and then M2¹—as an anchor for monetary policy because there was a well-established relationship between money growth and inflation.

However, financial innovation reduced the reliability of signals from broad money growth. For example, in 1982 the introduction of nationwide NOW accounts, which paid interest on balances but offered the liquidity of traditional checking accounts, made M1 too sensitive to interest rate changes. Later, as bond and equity mutual funds provided new saving vehicles without sacrificing liquidity, M2 became less reliable as well. As a result,

policymakers were forced to downgrade or reduce the importance of money supply growth when debating the monetary policy stance and setting official rates.

In the early to mid-1990s, with relatively low and stable inflation, US policymakers adopted a rule designed to maintain stability in core consumer prices, which exclude food, energy and housing costs.² Policymakers argued at the time that this shift in the focus of monetary policy was based on research showing that price stability was a necessary prerequisite for achieving long-term goals of maximum sustainable growth and full employment.

Different Policy Approaches: Greenspan vs. Bernanke

Although policymakers deliberately did not define the range initially, it was often described by former Fed Chairman Alan Greenspan as a change in price that did not affect economic and investment decisions. Under Greenspan, the price rule framework was followed, but movements of core prices were not the only consideration in policy decisions, which were generally more subjective. During his tenure, the Fed also raised interest rates to counter potential imbalances that could lead to overheating in the economy, and lowered rates when weak growth threatened to increase unemployment.

In contrast, current Fed chairman Ben Bernanke’s monetary policy has stuck much more closely to the price rule. In fact, under his leadership, policymakers went a step further to define price stability as a change in core consumer prices of 1.5% to 2.0% over the longer run.

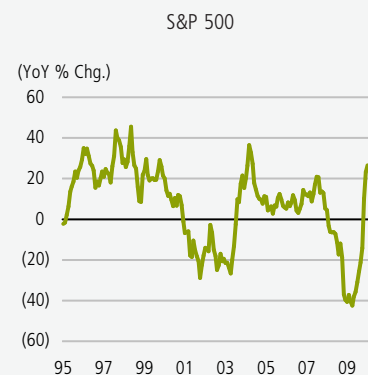
Rules Failed to Detect Imbalances

Yet, today policymakers must ask whether the core consumer price measure is the best gauge of broader economic health in an ever-changing and more complex economy and financial system.

1. M1 is the most narrow definition of money supply, including currency and checking deposits only. M2 include M1 as well as assets in money market accounts and short-term deposits.

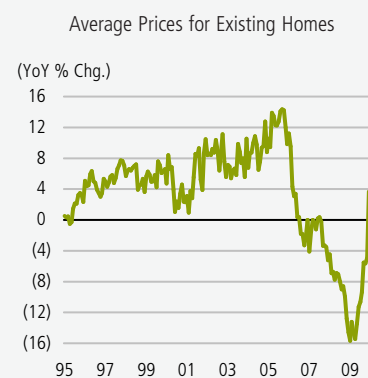
2. Core inflation included direct housing costs before 1982.

Display 3
...or Stock Prices...



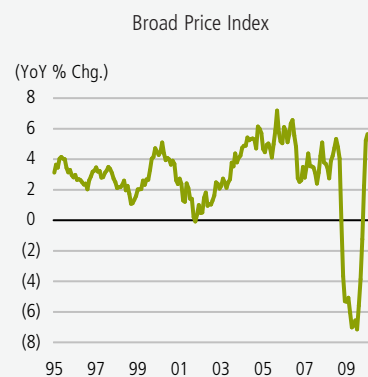
Source: Wall Street Journal

Display 4
...or Real Asset Prices



Source: Haver Analytics and National Association of Realtors

Display 5
Broad Price Measures Capture Systemic Imbalances



Source: Bureau of Labor Statistics, Haver Analytics and AllianceBernstein

For more than a decade, core consumer prices have been relatively stable, while the GDP cycle has been increasingly unstable. In our view, a strict interpretation of the price rule doesn't seem relevant for today's environment, especially since each of the past two US downturns were triggered by sharp declines in asset prices (**Displays 3 and 4, previous page**), while core consumer price gains were close to their target range. Perhaps it is time to revisit the question that Mr. Greenspan asked back in 1996: Is the stability of asset prices essential to the stability of the economy?

Policy rules should not be static. In fact, they have adapted to changing economic conditions over time, and they must continue to change as economic patterns

evolve. Perhaps the failure of monetary policy in recent years is because of strict adherence to an obsolete price rule combined with a reluctance by policymakers to use their tool kit for eradicating imbalances in specific sectors, for fear that they would harm overall economic growth in the process.

In our view, this approach must also be reexamined because recent history clearly shows that a persistent and large increase in prices in one area of the economy such as housing can have adverse macroeconomic consequences. Often, the damage wrought by allowing an imbalance to fester is much more severe in scale and depth than the dangers of implementing large and early interest-rate hikes. Ultimately, no

policy rule or guideline can ever outweigh the importance of sound economic analysis and judgment by central bank leaders.

Rethinking the foundations of monetary policy is a worthwhile effort, especially with the wounds of the recent recession still raw. However, this debate must extend beyond a limited attempt to fine-tune the shortcomings of the current approach. In our view, there are several convincing reasons for policymakers to reevaluate the core consumer price rule and to consider replacing it with a broader price measure (**Display 5, previous page**) or an alternative policy measure—such as credit growth—that is more suitable for the 21st century economic and financial environment. ■

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