

The Policy Rule Debate: A Simpler Solution

There has been growing public debate over how the Federal Reserve should conduct and communicate monetary policy. Some recent proposals, for instance, would require the Fed to specify a monetary policy rule that it would follow in adjusting the key policy rate (i.e., the federal funds rate target) and for the Fed to explain any deviations from that rule.

Questions abound about these proposals: Is the idea for the Fed to use only one rule or a suite of rules, each with its own strengths and weaknesses? Among a suite of rules, which ones should receive more emphasis? What does “follow a rule” mean for the Fed, and what are the implications for not doing so? And, what about when the policy rate is near the zero lower bound? Should the Fed be encouraged to follow a rule even if it means that the policy rate would be negative?

These are good questions, but the case in favor of monetary policy rules is also compelling. We cannot really talk coherently about the future evolution of the macroeconomy without also talking about the future evolution of monetary policy. The two subjects go hand-in-hand: A monetary policy rule helps to map out the path of policy consistent with an envisioned path for the macroeconomy.

In light of these considerations, my recommendation is for the Fed to issue a quarterly monetary policy report to better explain its actions and projections on a regular basis. Reports like this are often issued by other central banks around the world. The information in the report could be organized around recommendations from a standard suite of monetary policy rules. This could improve the U.S. monetary policy debate by orienting it more toward a comparison of actual policy to recommendations from standard monetary policy rules.

Many Rules Already Used

In recent decades, monetary policy rules have become standard in the macroeconomics literature. A policy rule, such as the Taylor rule, named after John Taylor of Stanford University, is an equation that provides a recommended setting for a central bank's targeted interest rate. It is based partly

on values and targets for macroeconomic variables, including inflation as well as output or unemployment. Policy rules are popular among many economists and policymakers—including at the Fed—because these rules, when applied, help provide an understanding about future monetary policy, which is in turn important to households and businesses making investment and consumption decisions.

Much Fed communication, some within the Fed and some directed to the public, already involves using policy rules as benchmarks. As an input for the deliberations at each Federal Open Market Committee (FOMC) meeting, for instance, staff economists produce and distribute a briefing document to the FOMC known as the Tealbook. Publicly-released Tealbooks have included policy rate recommendations from a suite of monetary policy rules.¹ Similarly, there are many examples of public remarks by FOMC participants in which actual policy outcomes are compared with the prescription from a monetary policy rule. That includes remarks by the FOMC chair. For example, Fed Chair Janet Yellen discussed in 2012 (when she was Vice-Chair) what a variant of the original Taylor rule had prescribed for monetary policy at that time.² Another example is from 2010, when then-Fed Chair Ben Bernanke gave a speech that used a Taylor-type rule to argue that monetary policy had not been too accommodative during the period 2002-2006, which coincided with the housing bubble.³


A Solution to the Communication Problem

Monetary policy rules have been and will continue to be useful as guides for conducting monetary policy. A rules-based quarterly monetary policy report could provide a more complete and fulsome discussion of how the FOMC views the current state of the U.S. economy and the Committee's expectations going forward. Such a report, which I have advocated in the past,⁴ could include a regular discussion of various monetary policy rules and explain why any deviations from those rules seemed appropriate at that time. This type of reporting may provide an improvement over the so-called “dot plot,” which is



released each quarter in the FOMC's Summary of Economic Projections and shows FOMC participants' projections for the policy rate over the next few years. The dot plot does not allow the public to infer which policy rule any of the participants are using since individual dots are not connected across the years shown in the chart or to his or her projections for changes in real gross domestic product, unemployment and inflation.

Conclusion

The Fed has made significant strides in increasing the transparency of its actions since the financial crisis and recession of 2007-2009. Still, there is room for improvement, and further transparency regarding the Fed's use of policy rules in its monetary policymaking is within reach. Because the Fed already uses policy rules in many ways to describe monetary policy and to make a case for a particular policy, the Fed could push its public communications more in that direction. 

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ENDNOTES

¹ For example, see Tealbook B for the FOMC meeting in December 2010, at www.federalreserve.gov/monetarypolicy/files/FOMC20101214tealbookb20101209.pdf.

² See Yellen, Janet L. “Perspectives on Monetary Policy,” speech on June 6, 2012.

³ See Bernanke, Ben S. “Monetary Policy and the Housing Bubble,” speech on Jan. 3, 2010.

⁴ For example, see my column in the April 2013 issue of *The Regional Economist*, “A Quarterly Monetary Policy Report Would Improve Fed Communications.”