Undoing Extraordinary Monetary Policy

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Normalizing monetary policy will require more than returning short-term interest rates and the Fed's balance sheet to conditions reminiscent of the past, desirable though that may be. The challenge of normalizing policy will be to undo bad habits that have developed in how monetary policy is explained and understood.

Former Cleveland Fed President Jerry Jordan has thoughtfully observed that in order to have a debate about "rules versus discretion" we first had to reach agreement on "targets and indicators" – we first needed a consensus understanding of how monetary policy works.[1] After ten years of extraordinary policy such a consensus is sadly absent.

To re-establish a shared understanding, we will need to reassess both the imperatives that justified the extraordinary actions and the imperatives about monetary policy that were claimed. This will require candidly acknowledging the uncertainty associated with the transmission mechanism and the challenge of decision-making in conditions of uncertainty.

It appears to me that the Fed and other central banks have avoided being candid about the uncertainty in order to maintain their credibility. I think this is backwards. Central banks cannot and will not regain their credibility unless they are candid about the uncertainty and how they confront that uncertainty.

I. The incomplete justifications for extraordinary monetary policy.

Three claims were made to justify extraordinary actions. Given the woeful conditions we found ourselves in during the Great Recession, it was claimed that: (1) the central banks *had to do something*, (2) they *had to experiment* and try new, untested approaches and, (3) imagine *how much worse* things would have been had they not done what they did.

The first claim, that they *had to do something*, is not an argument from economics or finance but, rather, is a moral claim. It is a claim that action is better than inaction.

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[1] Jordan, *Rethinking the Monetary Transmission Mechanism,* forthcoming in Spring/Summer 2017 Cato Journal.

My understanding is that the philosophers who have thought hard about this have concluded that the moral imperative of action is an empty bag. If there is such an imperative what other imperatives does it supersede? Does it supersede the imperative to do no harm? Does it supersede the imperative to be effective, to do good? Of course not.

There is no inherent virtue in acts – or omissions – apart from whether they produce good or, at least, are *reasonably likely to produce good*. But we mortals are often confused about this and mistakenly accept the false imperative of action. This is how the medical profession spent three thousand years bleeding their patients to remove the bad humors because *they had to do somethin*g.

In normalizing policy, the Fed will walk back from the false imperative of action. When it finds itself being called upon to "do something" about the dollar and about our deficient infrastructure, the Fed will find itself explaining that "doing something" is the wrong imperative, that their policy actions require a careful assessment of whether they can reasonably be expected to produce good outcomes and that this requires consideration of negative side effects. But I'm getting ahead of myself.

Let's agree that in the desperate conditions in which we found ourselves ten years ago, the Fed had a duty *to be effective* – to do no harm and preferably to do some good. How do we know that an action is reasonably likely to produce good outcomes?

The second claim, that the central banks had a duty to experiment, is a stronger one and suggests a way of knowing whether an action may produce good outcomes. But simply invoking the scientific method is not enough. A duty to experiment, particularly when making guinea pigs of the rest of us, presumably carried with it a corresponding duty to scrutinize rigorously the results of their experiments – to apply what the late, great physicist Richard Feynman called "scientific integrity" requiring "a kind of utter honesty"[2] – so as to learn from their failures and shortcomings.

Curiously, the Fed has acknowledged no failures. All the experiments have been successful, every one: no failures, no negative side effects, no perverse consequences, only diminishing returns.

The third claim, inviting us to imagine how much worse things would have been had the central banks not done exactly what they did, suggests exactly the opposite of the scientific method and a striking lack of imagination. It implies that the only other possible courses of history would have been worse. It leaves no room for perverse consequences or negative side effects. It claims the counterfactual all to itself, leaving no room for doubt.

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[2] Feynman (1985), *"Surely You're Joking, Mr. Feynman"*, p. 385.

I so admired the candor of a doctor who I heard prescribing steroids. He explained that steroids are powerful drugs that have a hundred different effects on our bodies, one of which we call "therapeutic", the other ninety-nine we call "side effects'; and if the side effects overwhelm the therapeutic effect he explained that he would stop the treatment and try something else.

With that framework in mind, undoing extraordinary monetary policy will require a candid reappraisal, a vigorous scrutiny, an utter honesty, about the therapeutic effects and the negative side effects of all monetary policy actions.

II. The dubious imperatives of extraordinary monetary policy.

Without any great injustice, it seems to me that the extraordinary policies of the last ten years can be summed up in four imperatives. When confronted with overnight interest rates of zero and seeking to stimulate aggregate demand: (1) a bigger central bank balance sheet is always better; (2) smaller term and credit premia will always stimulate credit; (3) the wealth effect is a free lunch that will stimulate consumption; and (4) forward guidance is always a good idea.

While each of the policy actions suggested can produce therapeutic effects on aggregate demand they can also produce negative side effects, at least as I see things. Sorting out the therapeutic and negative side effects is the challenge of making monetary policy.

Is bigger always better? During the financial crisis and its immediate aftermath, expanding the liability side of the Fed's balance sheet had the important therapeutic effect of ensuring more than ample liquidity in the banking system, reducing the risk of further asset price declines and deflationary pressures. A devout monetarist might reason that expanding central bank money to offset the contraction of private credit would also prevent further deflationary pressures and eventually contribute to an expansion of credit. But beyond the second trillion of excess reserves it is hard to see much of a therapeutic liquidity effect and the Fed did not have the patience of a monetarist.

A negative side effect, however, of a very large central bank balance sheet is that the high level of central bank liabilities, held as assets by commercial banks, will tend to crowd out other forms of lending by commercial banks on the asset side of their balance sheets. This is likely to have dampened credit creation from what it might have been.

When it comes time to shrink the Fed's balance sheet, most analysts are focused on the potentially contractionary consequences, on the burden that will fall on private intermediaries to fill the gap left by the Fed. But with this burden comes opportunity. It seems equally plausible – or, at least, one effect may be – that when the amount of balance sheet space that the banking system is forced to rent the Fed is reduced that this will free up space for private credit growth and, thereby, stimulate the economy.

I am uncertain which effect will dominate. I think – but I don't know for sure – that the stimulative effect may be greater. But I am confident that normalizing the Fed's balance sheet will be an experiment the net consequences of which are still now uncertain.

Demand but not supply of credit? The second imperative of extraordinary policy is that when confronted with overnight interest rates at zero, and a concern that the natural rate of interest may be negative, one should then act to compress the term premium and the credit premium as low as possible for a long as possible.

Let me confess that for me this as a non sequitur. I understand the importance of ascertaining or choosing an estimate of the natural rate of interest in order to conduct monetary policy. But I am perplexed by those who claim to know the precise relationship between the unobservable natural rate, on the one hand, and the shape of the yield curve and the healthy functioning of the credit system, on the other.

The imperative to compress the term and credit premium expresses the hope that demand for credit will be stimulated by lowering its cost. But this ignores the impact on the incentive to lend and the supply of credit. So there may be a therapeutic effect on demand but a negative side effect on supply. Moreover, compressing the credit premium will likely have reduced the resilience of the banking system in the next cyclical downturn.

Targeting the level of long-term interest rates, and assuming that lower ones will better stimulate the economy, was in my view a dreadful mistake. While I may be wrong about that, I am no longer feeling quite so lonely. Just a few years ago every basis point decline in long-term rates was claimed to measure the success of quantitative easing but, more recently, central bankers have disowned responsibility for the low level of long-term rates.

Indeed, the transformation of the banking system that the central banks have wrought with their big balance sheets and compressed term and credit premia, combined with changes in demographics and in the distribution of wealth and income, may well have undermined the central banks' influence on the shape of the yield curve. I think it likely that their influence has been diminished; how much I don't know for sure.

But in order to normalize monetary policy the Fed will have to walk back from their early assurances that the "exit would be easy". The Fed will also have to confront the likelihood that the transmission mechanism itself has been profoundly altered.

Wealth effect or wealth illusion? The other therapeutic effect of lower-for-longer interest rates is the wealth effect. By driving up the value of future cash flows with lower rates of interest, all manner of assets – stock, bonds, and houses – increase in value and, thereby, can stimulate our marginal propensity to consume. More simply put, the imperative was to make rich people richer so as to encourage their consumption. It is not so hard to imagine negative side effects.

There are the obvious distributional effects between those who have assets and those who do not. Returning house prices in California to their 2005 levels may be good for those who own them, but what of those who don't?

There are also harder-to-observe distributional consequences that flow from the impact of lower-for-longer interest rates on the value of *our liabilities*. This is most easily observed in pension funds.

Consider two pension funds, one with a positive funding ratio and one with a negative funding ratio. When we create a wealth effect on the asset side of their balance sheets we also drive up the value of their liabilities. Lower long-term interest rates increase the value of all future cash flows – both positive and negative. Other things being equal, each pension fund will end up approximately where they started, only more so.

The same is true for households but is much more ominous, given the inequality of wealth with which we began the experiment. Consider two households: one with savings and one without savings. Consider also not just their legally-defined liabilities, like mortgages and auto-loans, but also their future consumption expenditures, their *liability* to feed and clothe themselves in the future.

When the Fed engineered its experiment to promote the wealth effect, the family *with savings* experienced an increase in the present value of their assets and also an increase in the present value of their liabilities. Because our financial assets are traded in markets and because we receive mutual fund and retirement account statements, we promptly saw the change in the value of our assets. We are much slower to appreciate the change in the present value of our liabilities, particularly the value of our future consumption expenditures.

But just because we don't trade our future consumption expenditures on the stock exchange does not mean that the conventions of finance do not apply. The family *with savings* likely ends up where they started, once we consider the necessity of revaluing their liabilities. They may more readily perceive a wealth effect but, ultimately, there is only a wealth illusion.

But what happened to the family *without savings*? There were no assets to go up in the value, so there is no wealth effect – real or perceived. But the value of their future consumption expenditures *did* go up in value. The present value of their current and expected standard of living went up but without a corresponding and offsetting increase in assets, because they don't have any. There was no wealth effect, not even a wealth illusion, just a cruel hoax.

Median incomes have been stagnant. And most Americans will, in fact, rely on Social Security for their retirements, which is a financial asset that will have appreciated in value as a consequence of a lower rate of discount. You may also think it unlikely that many households without savings will spend much time calculating the net-present value of their future consumption expenditures. But they can and do assess exactly the reciprocal, namely, they recognize that the (present value) cost of their hoped-for standard of living has been rising even as their incomes have been stagnant.

Haven't you wondered how it is that, after ten years of the lowest consumer price inflation in several generations, so many Americans feel that they are "falling behind"? Falling behind what? The standard of living that they hoped for but which the Fed re-priced.

The Fed's engineering of a wealth illusion is by no means the only cause of angst among Americans. But the next time you hear that the net-wealth of American households is at an all-time high, do spend a minute thinking about the present value of the unrecorded future consumption expenditures, particularly of households with no savings.

Normalizing monetary policy will require that the Fed disown the idea that the level of wealth is an appropriate objective of monetary policy. It is one thing to recognize that the rate of change of asset prices (both positive and negative) may be a constraint upon the Fed's ability to smooth the peaks and troughs of the business cycle. But targeting the level of wealth as an objective of monetary policy is to stretch the Fed's mandate from Congress well past its breaking point. Out of both humility and self-preservation, let's hope that the Fed finds a way to stop targeting the level of wealth.

Forward guidance and extrapolative expectations. Forward guidance is a practice that the Fed began prior to the crisis but which now seems to be a permanent part of its tool kit, the better to guide market expectations.

There are several apparent therapeutic effects. The expected path of short-term interest rates is monetary policy's most powerful tool. Given that, it seems odd for everyone on the planet to state publicly their opinions on the subject, everyone expect the central bank. Surely the central bank knows better and uncertainty can be reduced if the central bank expresses its views on the subject.

Through the crisis, however, the arguments in favor of forward guidance tended to focus on the importance of pulling down long-term interest rates. So it was not only about reducing uncertainty but also about providing a measure of certainty to produce a particular outcome. Finally, forward guidance is also thought to be an expression of the central bank's reaction function.

Let me acknowledge that forward guidance is not a binary choice but, rather, a question of degree. But there is a significant difference between suggesting the likely direction of short-term rates over the next few months and pinpointing where you predict rates will be a year, or two, or more in the future.

I perceive at least one important negative side effect that needs to be considered, as well as an important constraint that I will discuss in a moment.

Implicit in forward guidance, as practiced by the Fed, is the idea that dampening short-term market uncertainty and volatility is a good thing. But removing uncertainty from our capital markets is not, in my view, an unambiguous blessing. Why do we think that less uncertainty, less volatility, will produce an optimal allocation of resources in society? Forward guidance is an indirect means of targeting volatility but without any articulated theory of the optimal level of volatility.

To say the same thing somewhat differently, forward guidance does not express the Fed's reaction function at all but, rather, the exact opposite. Forward guidance expresses the Fed's *inertial tendency.* While we are offered platitudes about data dependency, the Fed's forward guidance creates a presumptive path of short-term rates which will only be rebutted if the actual economic data that unfolds is somewhat different from the Fed's initial expectations.

This accentuates one of the most profound weaknesses of our system of traded capital markets: namely, the extrapolative expectations on which we base asset pricing. Keynes called this the "conventional valuation" reflecting our assumption "that the existing state of affairs will continue indefinitely, except in so far as we have specific reasons to expect a change."[3]

So, as I see it, forward guidance is the process through which the Fed – through its more explicit influence on the expected rate of interest – becomes the much more explicit owner of the "conventional valuation" of asset prices. Even if the Fed had not pursued the wealth effect, the Fed now has a heightened responsibility and sensitivity to asset pricing. This is not an unmixed blessing.

III. The embarrassing denial of uncertainty.

How do we know whether our actions are *reasonably likely to produce good outcomes*? We only know – we only accumulate knowledge – by applying our doubts and rigorously scrutinizing our assumptions and our claims. This is reflected

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[3] Keynes, *The General Theory of Employment, Interest and Money,* (1936) Ch. 12, page 152.

in the scientific method and also in how we make decisions in conditions of uncertainty.

We begin by being candid about our priors, our assumptions and hypotheses, and by acknowledging that they may be misplaced. We consider new evidence and the probability that it may, or may not, support our priors. We must also consider the probability that the new evidence may support a completely different outcome, not consistent with our priors.

The big changes in our outlook and in our decisions come when we confront new evidence that leads us *to revise our priors*. We saw this in 2007 and 2008 when the Fed was forced to revise its prior beliefs that we could never suffer a nation-wide decline in house prices and that any losses in the financial system would not exceed the total loss in home values. When the Fed revised its priors its outlook changed dramatically and so did its actions.

Going forward the Fed faces a similar challenge, made worse by forward guidance. By publicly broadcasting their inertial tendency, the Fed is reinforcing their priors, making it harder rather than easier for the Fed to reconsider them. But when the new evidence is compelling enough – whether it be of strength or weakness in aggregate demand – the Fed *will be forced* to revise its priors and, at that point, forward guidance will be awkward at best.

To normalize monetary policy the Fed needs to acknowledge forthrightly the limitations of forward guidance and, particularly, how and when it will likely be overwhelmed by the necessity of decision making in conditions of uncertainty.

What has been most extraordinary about extraordinary monetary policy is the awkward denial of uncertainty in defense of extraordinary actions. Wanting so badly to manipulate our expectations, the central bankers did not want to leave us any room for doubt.

As I said at the outset, the Fed and other central banks appear to have avoided being candid about the uncertainty in order to maintain their credibility. But this is backwards. They cannot regain their credibility unless they are candid about the uncertainty and how they confront it.

Acknowledging the alternative outcomes, admitting to the uncertainty, would be a much better way of expressing their reaction function. It would also be a most welcome signal of the undoing of extraordinary monetary policy.