Dollars and Sense:
Policy Rules Were Made To Be Broken

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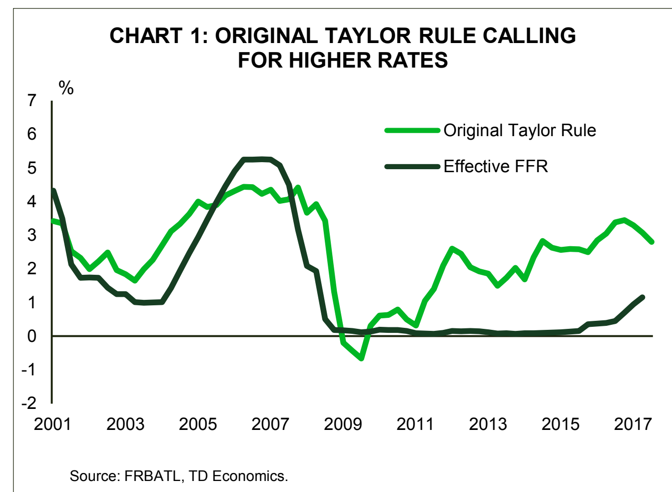
Highlights

- With changing appointments at the Federal Reserve, many wonder how this will impact the the current path of Fed rate hikes and the normalization of the Fed's balance sheet.
- With Jerome Powell coming in as Chair and three other Governor positions up for grabs, as well as a turnover of the regional Fed Presidents, the composition of the FOMC and its relative dovish/hawkish tilt towards interest rates will likely be changing in the coming months.

With Janet Yellen's term as Federal Reserve Chair expiring and three other positions are open on the Board of Governors, the composition of the FOMC is in for a radical makeover. New members impose a learning curve on financial markets regarding how these individuals will interpret and respond to unfolding economic conditions via the fed funds path and the speed of balance sheet normalization. With clear knock-on effects to asset prices and overall financial stability, there is debate of whether new members will favor a more rules-based approach to setting interest rates (Chart 1).

Policy rules grab spotlight

The concept of a monetary policy rule has been around since the 1980s, but was made popular by John Taylor in 1993 via his seminal work, Discretion vs. Policy Rules in Practice. The Taylor Rule is a simple numerical formula that relates the nominal fed funds rate (FFR) to the current state of the economy based on three major variables: inflation, economic slack, and the equilibrium real fed funds rate that balances savings and investment (also known as R*). The degree to which inflation or capacity pressures deviate from trend estimates determines the appropriate level of the FFR. When we apply the original Taylor Rule to current economic data, it would call for the FFR to be about 3.00 to 3.25%. If that seems high, it is. Even though the Fed first raised its policy rate in December 2015, the current upper bound of the policy rate is only 1.25%.



Descriptive vs. Prescriptive

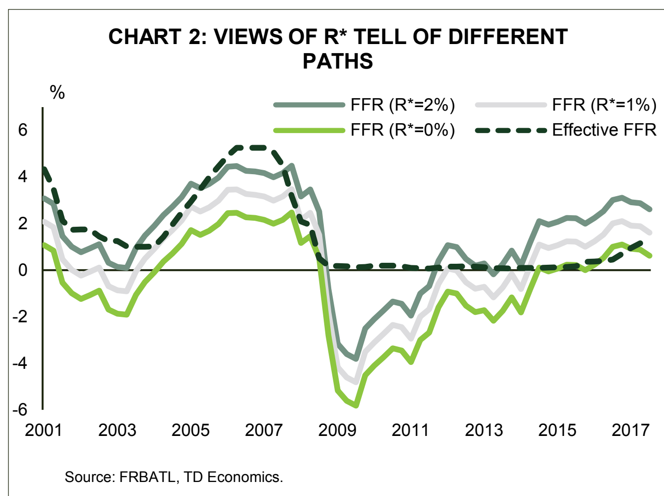
The main debate of the policy rule is whether it should be viewed as descriptive (a guide) versus prescriptive (a mechanical adoption). John Taylor (who is always in conversation for a Board seat) leans more towards the latter, laying blame at the

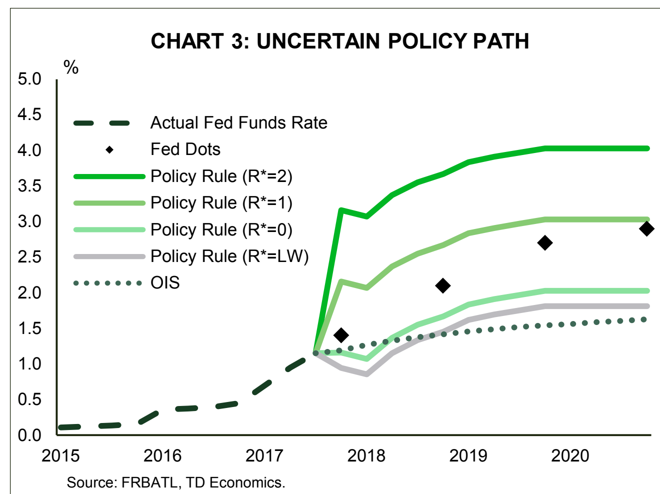
Fed's feet for the housing bubble due to overly accommodative monetary settings that did not adhere to the prescription offered by the Taylor Rule. Yellen and the current Fed view monetary policy rules more as guideposts and argue against a mechanical application.

We side with Yellen and company on this front due to the inherent shortcomings of mechanical approaches to monetary policy. Many factors evolve within each economic cycle, including structural adjustments and risk-management considerations. Yellen's speech in January 2017 expressed it well: "simple rules ignore such important factors as fiscal policy, trends affecting global growth, structural developments influencing the supply of credit, and overall financial conditions."

A mechanical approach hinges on a number of assumptions regarding the current state of the economy. First, it requires policymakers to know and agree on the size of the output gap. This is quite a leap of faith. The measurement of economic slack is not strictly defined or transparent within the economics community, and there is wide scope for interpretation. For instance, regarding the measurement of labor market slack, Yellen has a dashboard that takes into consideration a wide array of variables such as: underemployment, participation rates, wages, and so forth. Looking at today's traditional metrics, output and employment gaps would appear closed, but more micro data would argue against this notion.

Second, a mechanical rule revolves around R*. When Taylor initially estimated his model, R* was assumed to be a static at 2%, consistent with roughly its historical average. Empirical research has since demonstrated that R* is not static and has steadily declined over the last couple of decades. According to the median forecast of FOMC members, R* is closer to 1%, whereas Janet Yellen has even cited a rate closer to zero over the medium-term (Chart 2).





Third, how the FOMC should respond to a shock to inflation or output is implicit in the weight these variables have within the policy rule equation. Here too there lacks agreement based on subsequent research. The original Taylor Rule imputes that a 1% shock to output (relative to potential) or inflation (relative to target) should be met with a 0.5% change in the policy rate. This may seem esoteric, but it implies that upon entering the next recession, a central bank that follows a mechanical rule would be slower to react due to the lagging nature of the inflation and output variables.

In Chart 3, we demonstrate how these three factors combine to reveal a myriad of choices for the appropriate fed funds path. In other words, uncertainty abounds and judgement becomes critical as an anchoring policy tool should the Fed become more rules-based. A nine-year history of disappointing economic and inflation trends relative to forecasts argues that a set-it-and-forget-it policy rule is not the best solution. As a result, financial market participants would likely demonstrate more angst should a view similar to John Taylor's be implemented. Absent a record of past FOMC decisions to assess, it's unclear the degree to which the FOMC would be

willing to accept and react to the ill-precision of forecast models to the evolution of data. Under the tutelage of Chair Yellen, the Fed has become a beacon of transparency during changing macroeconomic conditions. She has been effective in building consensus amongst the FOMC voting members and has shared criticism of being over reliant on models that fail to capture the dynamics of the current cycle. We are in different times relative to the 1990s, and the flexibility that Yellen has shown over her reign as Chair has been astute.

The Future FOMC

There's no question that the composition of the Fed is going through an overhaul. Of the seven Governor positions, only four are currently occupied (including Chair Yellen and new Vice Chair Quarles). In addition, decisions that are not in the hands of President Trump include the turnover of the four alternate regional Presidents in 2018.

The Fed under Yellen's oversight can be characterized as largely dovish, adopting slow, deliberate and well-telegraphed policy moves. This places the balance of risks that the composition of the new Fed will shift towards a more hawkish camp, even if it's only on the margin. However, we caution against overstating the importance of Powell replacing Yellen and its influence on the economic cycle, the Treasury curve, global financial linkages and, ultimately, financial stability. Fed policy meeting outcomes are consensus based. Each member has one vote. Although the Chair is responsible for shaping consensus, the entire composition is what matters, and this will continue to unfold long after President Trump's announcement.

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