

Monetary Policy Rules: SOMC History and a Recent Case Study

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March 2020

Karl Brunner and Allan Meltzer founded the Shadow Open Market Committee in the early 1970s, under economic and political circumstances that differ considerably from those that prevail today. Meltzer (2000, pp.120-1) explains:

... the inflation rate in the second quarter of 1971 was 4.4%, measured by the annual percentage rate of change of the consumer price index. At the time, 4% inflation was said to be politically unacceptable. With the election approaching, President Nixon chose price and wage controls as one major element of his revised economic strategy.

Karl Brunner and I decided to organize a group to criticize the decision and point out the error in the claim that controls could stop inflation.

We wanted to show that better policy choices were available and that inflation could be controlled at acceptable cost, if the Federal Reserve controlled money growth.

... we chose the name Shadow Open Market Committee, combining the names of the Federal Reserve's principal policymaking body with the British term for the government's opposition, the Shadow Cabinet.

The SOMC first met on September 14, 1973. The SOMC archives, available freely to the public through the page at <https://www.shadowfed.org/archives/>, collect policy statements and position papers from that first meeting and all that have followed. With Anna Schwartz joining

* Prepared for the March 2020 meeting of the Shadow Open Market Committee, on "Current Monetary Policy: The Influence of Marvin Goodfriend." I would like to thank Michael Belongia for extremely helpful comments on an earlier draft of this paper, while retaining full responsibility for all errors, omissions, and misstatements that remain.

Brunner and Meltzer at the inaugural meeting, it is no exaggeration to say that the SOMC was started by three of the greatest economists who ever lived.

Nor it is exaggeration to say that the SOMC has played, according to Meltzer's intent, a role analogous to that of the British Shadow Cabinet. Numerous SOMC members have also held key positions within the Federal Reserve system, particularly at the Federal Reserve Banks. Original SOMC members included Homer Jones, who had been Director of Research at the St. Louis Federal Reserve Bank where, as Bordo and Prescott (2019) explain, he played a critical role in advancing the Bank's distinctive, monetarist approach to policy evaluation. The original line-up also included Robert Rasche, who would become Research Director, again at the St. Louis Bank. Others who joined the SOMC later, either before or after serving on the Federal Open Market Committee, include Lee Hoskins (Cleveland Bank President, 1987-91), Jerry Jordan (Cleveland Bank President, 1992-2003), Charles Plosser (Philadelphia Bank President, 2006-15), and William Poole (St. Louis Bank President, 1998-2008).

Marvin Goodfriend, likewise, joined the SOMC in 2009 after working for many years at the Federal Reserve Bank of Richmond, serving terms as Research Director and Chief Monetary Policy Advisor. From 2009 through 2017, Goodfriend contributed a series of position papers – also available through the SOMC's on-line archives – on a range of topics including the distinction between monetary and credit policies (2009, 2010*a*), effective monetary policymaking at the zero lower interest rate bound (2010*b*, 2016), the benefits and risks of the Fed's 2008 decision to begin paying interest on bank reserves (2014, 2015*a*), and the importance of the Fed's credible commitment to a policy of aggregate nominal price stability (2012*a*, 2012*b*, 2015*b*, 2017).

In 2014, Goodfriend helped the SOMC publish a new statement of “Core Beliefs,” (SOMC 2014) posted at <https://www.shadowfed.org/wp-content/uploads/2014/10/SOMC-CoreBeliefs2014.pdf>, as a reflection of both continuity and change at the Fed since the Shadow’s founding. The statement begins by acknowledging that the Federal Reserve, under Chairs Paul Volcker and Alan Greenspan, successfully ended the inflation of the 1970s by following the strategies espoused much earlier by Brunner and Meltzer: eschewing price and wage controls and exercising restraint over the rate of money growth instead. The statement goes on to recognize, however, that the financial crisis and recession of 2007-9 greatly expanded and transformed the Fed’s role within the American monetary and financial system. Many of these changes left the public uncertain and confused as to what monetary policy can and cannot be expected to achieve. Though today’s most pressing economic problems differ significantly from those of the early 1970s, Federal Reserve officials still face great challenges in responding most effectively to them, and often confront intense political pressure as they try to do so.

Two of the seven core beliefs listed in the SOMC’s statement pertain directly to the design of an effective monetary policy strategy. Point 3 echoes Brunner and Meltzer’s proposition that monetary policy’s principal role is to achieve and maintain an environment of nominal price stability, and implicitly acknowledges the importance of the FOMC’s 2012 announcement of a specific, two-percent target for long-run inflation:

Price stability is the best contribution that monetary policy can make to overall macroeconomic performance and for this reason should be the primary objective of the central bank. “Price stability” should be defined to insure that the inflation rate, on average, is not above 2 percent per year.

Point 4, however, identifies an important gap that remains in the Federal Reserve’s strategy by arguing that, to successfully achieve its long-run inflation objective in a manner that is consistent

with its existing, statutory dual mandate, the central bank must announce and make consistent reference to a specific monetary policy rule:

Monetary policy should be conducted in a rule-like manner and be somewhat countercyclical with respect to output and employment, as long as price stability over the long run is not compromised. We expect the central bank to announce the policy rule that it follows so that it can be monitored and held accountable.

Of course, the proposition that monetary policy works best when it is conducted according to a simple, pre-announced rule has always been the “best-known feature of monetarism” (Meltzer 1995, p.69). Goodfriend (1997, p.7) provides details to support this monetarist proposition by identifying two key features of the Fed’s “go-stop” policies that led to high and volatile rates of both inflation and unemployment from the late 1960s through the 1970s:

First, because inflation became a major concern only after it clearly moved above its previous trend, the Fed did not tighten policy early enough to preempt inflationary outbursts before they became a problem.

Second, by the time the public became sufficiently concerned about inflation for the Fed to act, pricing decisions had already begun to embody higher inflation expectations. Thus delayed, a given degree of restraint on inflation required a more aggressive increase in short-term interest rates with a greater risk of recession.

Goodfriend (1997, p.14) goes on to describe how adherence to a monetary policy rule can help the Fed resist the temptations that generate these go-stop dynamics:

The main tactical problem for the Fed is to decide when preemptive policy actions are necessary and how aggressive they should be. In this regard, the Fed must be careful to consider any adverse effect that a poorly timed policy tightening could have on employment and output. For that matter, the Fed must be prepared to ease monetary policy when a weakening economy calls for it. The central bank’s credibility depends not only on its inflation-fighting credentials but also on its perceived competence.

A natural starting point to balance these concerns is to use a policy rule-of-thumb based on historical data to benchmark Fed policy. The stance and direction of monetary policy can then be chosen in light of historical experience conditioned on any special current circumstances.

Finally, Goodfriend (1997, p.15) identifies two specific rules that “can be of great practical value in benchmarking actual policy decisions.” The first is former SOMC member Bennett McCallum’s (1988) rule for adjusting the growth rate of the monetary base to stabilize nominal GDP around a target growth path. The second is John Taylor’s (1993) rule for adjusting the federal funds rate in response to movements in inflation and the output gap.

Goodfriend (1997, p.15) points out that McCallum’s rule has the advantage of making clear that “the ultimate power of the Fed over the economy derives from its monopoly on the monetary base.” McCallum’s rule might also have the additional robustness property of applying even under circumstances, like those experienced during the United States during and after the financial crisis of 2007-9, when the federal funds rate reaches a range close to zero; Belongia and Ireland (2015, 2017) explore this possibility in detail, with favorable results. Ireland (2019) argues, more generally, that the Federal Reserve could conduct monetary policy more effectively, in both good times and in bad, if it described its policy actions in terms of their implications for the monetary base instead of interest rates.

But, as Goodfriend (1997, p.15) also notes, “Taylor’s rule matches more closely the way the Fed thinks of itself as operating.” Thus, the Taylor rule or something like it could – and should – be adopted by the Fed as a benchmark so long as it continues to implement monetary policy with a focus on managing interest rates. In fact, the most recent episode of United States monetary history provides yet another example of the gains that would accrue, if only FOMC

members were more willing to refer consistently to a rule like Taylor's in describing their policy actions.

The Federal Open Market Committee raised its target for the federal funds rate four times in 2018, by a total of one percentage point, from a range between 1.25 and 1.50 percent to a range between 2.25 and 2.50 percent. Those rate increases were implemented against a backdrop of continuing growth in income and employment and, most important, under the expectation that inflation would soon converge to the Committee's long-run two-percent target. The first of the four rate increases, approved at the FOMC's March 21 meeting, was accompanied by a Policy Statement (FOMC 2018) that explained:

The economic outlook has strengthened in recent months. The Committee expects that, with further gradual adjustments in the stance of monetary policy, economic activity will expand at a moderate pace in the medium term and labor market conditions will remain strong. Inflation on a 12-month basis is expected to move up in coming months and to stabilize around the Committee's 2 percent objective over the medium term. Near-term risks to the economic outlook appear roughly balanced, but the Committee is monitoring inflation developments closely.

The FOMC used very similar language to justify its three subsequent rate hikes, made in June, September, and December.

Reinforcing the impression, given by the Policy Statement, that the 2018 rate increases were exactly the kind of preemptive actions called for by Goodfriend (1997, p.14) to stabilize inflation while prolonging the economic expansion, median FOMC projections released during 2018 and tabulated below called for solid rates of real GDP growth, low and steady rates of unemployment, and most importantly rates of headline and core inflation returning to target by the end of 2019 and, if anything, displaying a slight overshoot above target in 2020. Certainly, those rate increases would have been prescribed by a Taylor rule as well.

Median Projections of Federal Reserve Board Members and Bank Presidents

<u>Variable</u>	<u>Date of Forecast</u>				
	<u>Mar 2018</u>	<u>Dec 2018</u>	<u>Jun 2019</u>	<u>Sep 2019</u>	<u>Dec 2019</u>
GDP Growth 2019	2.4	2.3	2.1	2.2	2.2
Unemployment 2019	3.6	3.5	3.6	3.7	3.6
PCE Inflation 2019	2.0	1.9	1.5	1.5	1.5
Core PCE Inflation 2019	2.1	2.0	1.8	1.8	1.6
GDP Growth 2020	2.0	2.0	2.0	2.0	2.0
Unemployment 2020	3.6	3.6	3.7	3.7	3.5
PCE Inflation 2020	2.1	2.1	1.9	1.9	1.9
Core PCE Inflation 2020	2.1	2.0	1.9	1.9	1.9

Source: <https://www.federalreserve.gov/monetarypolicy/fomccalendars.htm>

However, the FOMC's fourth rate hike, in December 2018, appeared to trigger a spell of severe financial market volatility that included, among other events, a decline of more than 7.5 percent in the S&P 500 stock index over the four trading sessions spanning December 19, the day of the FOMC meeting, and December 24, just before the Christmas holiday. Although movements in stock prices are virtually impossible to predict and often very difficult to explain even with the benefit of hindsight, the fact that this particular sharp decline in the stock market began, specifically, during Chair Jerome Powell's post-meeting press conference strongly suggests that observers saw that something was wrong, or at least that something important was missing, in the way that the FOMC was communicating its policy decisions and expectations to the public. Along those lines, Hetzel (2019, p.47) first asks

What was wrong? Why would a strong economy abruptly enter recession? ... The salient fact is that apart from the 1945 recession, recessions in the United States have always been associated with contractionary monetary policy.... But why should markets expect a monetary policy sufficiently contractionary to cause the economy to enter recession?

and then answers,

The answer here is that without an explicit MP [monetary policy] strategy, the FOMC cannot reliably control how financial markets form their expectations of future MP actions. At year-end 2018, markets were looking back to past episodes in which the FOMC had raised the funds rate until a recession ensued. Subsequently, the FOMC calmed markets with assurances that policy was not on a preset path of funds-rate increases. However, the response was ad hoc. It would have been better to have had an explicit MP strategy in place.

As Goodfriend (1997, p.15) points out, the biggest advantage to adopting a Taylor rule is that it would allow the FOMC to articulate its strategy more explicitly, without changing its basic approach to monetary policymaking: adjusting its federal funds rate target to stabilize inflation, while remaining sensitive to the effects its policy actions have on output and employment as well. Had FOMC members been making more consistent reference to a monetary policy rule, they would not have appeared in December 2018 to be holding monetary policy stubbornly to a preset course. Market participants would have understood more clearly that while the FOMC must always stand ready to raise its interest rate target, preemptively, to prevent inflation from rising persistently above its two percent target, it remains prepared, in Goodfriend's (1997, p.14) words, "to ease monetary policy when a weakening economy calls for it."

In fact, the FOMC did reverse course in 2019, lowering its federal funds rate target three times, by a total of 75 basis points, from a range between 2.25 and 2.50 back down to a range between 1.50 and 1.75. The Committee provided a brief rationale in its Policy Statement (FOMC 2019), explaining that its actions reflected "the implication of global developments for the economic outlook as well as muted inflationary pressures." Once again, however, more detail can be found in the shifting FOMC projections shown in the table from above. Although Committee members' forecasts for real GDP growth and unemployment held steady throughout 2019, their projections for inflation changed considerably. Regardless of whether the inflation

rate is measured using the headline or core PCE price index, the median forecast for 2019 declined by 50 basis points. Moreover, expectation of a slight overshoot was replaced by a forecast suggesting that inflation would remain below target throughout 2020 as well.

And here is what appears most remarkable: with its famous coefficients of 1.5 on inflation and 0.5 on the output gap, the original Taylor (1993) prescribes, in response to a 50 basis-point decline in inflation accompanied by steady, trend growth in real GDP, a decrease in the federal funds rate of ... exactly 75 basis points!

Why did the FOMC cut the funds rate by that amount in 2019? Was it in response to political pressures from Congress, the President, or the American public? It could not have been, since Federal Reserve Board governors enjoy 14-year terms and Federal Reserve Bank Presidents are appointed by their own Board of Directors subject to approval by the Governors. These institutional features work, deliberately, to insulate FOMC members from short-run political pressures. Was it in direct response to tariffs or a slowdown in the growth rates of key foreign economies? It could not have been, because FOMC members know that US monetary policy can do little to offset barriers to international trade or stimulate the growth of foreign economies. It must have been because one or more unexpected shocks, originating either here or overseas, combined to push US inflation significantly and persistently below target. Through reference to the Taylor rule, FOMC members could have explained this much more clearly.

It is true that the Federal Reserve Board's semi-annual Monetary Policy Report to Congress (Board of Governors of the Federal Reserve System 2019, pp.36-9) includes a discussion of monetary policy rules and their implications for setting the federal funds rate in the face of ever-changing economic conditions. By emphasizing that different rules prescribe different numerical settings for the funds rate at any given time, however, these discussions

work, perversely, to ignore the considerable value that any one of the individual rules might have in helping the FOMC emphasize how ongoing adjustments to its interest rate target are made, in a deliberate and consistent way, to maintain a favorable environment of long-run price stability within which the private economy can do what it does best: generate robust growth in income and jobs for all Americans.

But, as Goodfriend (1999) points out, the decentralized structure of the Federal Reserve System has always been one of its greatest strengths, allowing Reserve Bank Presidents and their research staffs to advocate innovations that at first seem radical but gain eventual acceptance as their value in repeated use becomes clear. And as Bordo and Prescott (2019) explain, Marvin Goodfriend worked with Richmond Bank President J. Alfred Broaddus, Jr. to pave the way for the Fed's subsequent push towards greater transparency (Goodfriend 1986), to warn of the risks to central bank independence raised by the Fed's purchases of foreign exchange (Broaddus and Goodfriend 1996) and other assets (Broaddus and Goodfriend 2001), and to emphasize the importance of systematic policies that help the Fed build and maintain credibility for its anti-inflation policies (Goodfriend 1993, Broaddus and Goodfriend 2004).

For reasons unknown, FOMC members have always rejected the explicit use of monetary policy rules in making and explaining their policy decisions. But nothing prevents a current Federal Reserve Bank President or Research Director from blazing a trail, in Broaddus and Goodfriend's style, by making consistent reference to a specific monetary policy rule in his or her own public statements. Others on the FOMC will surely follow, as the advantages of a rule-based approach become obvious to all.

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