



Monetary Policy

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Monetary Policy

- Best practices in monetary policy—theory and experience
- How does current policy in the U.S. stack up against best practices?
- The outlook and challenges ahead

Breakdown of Bretton Woods

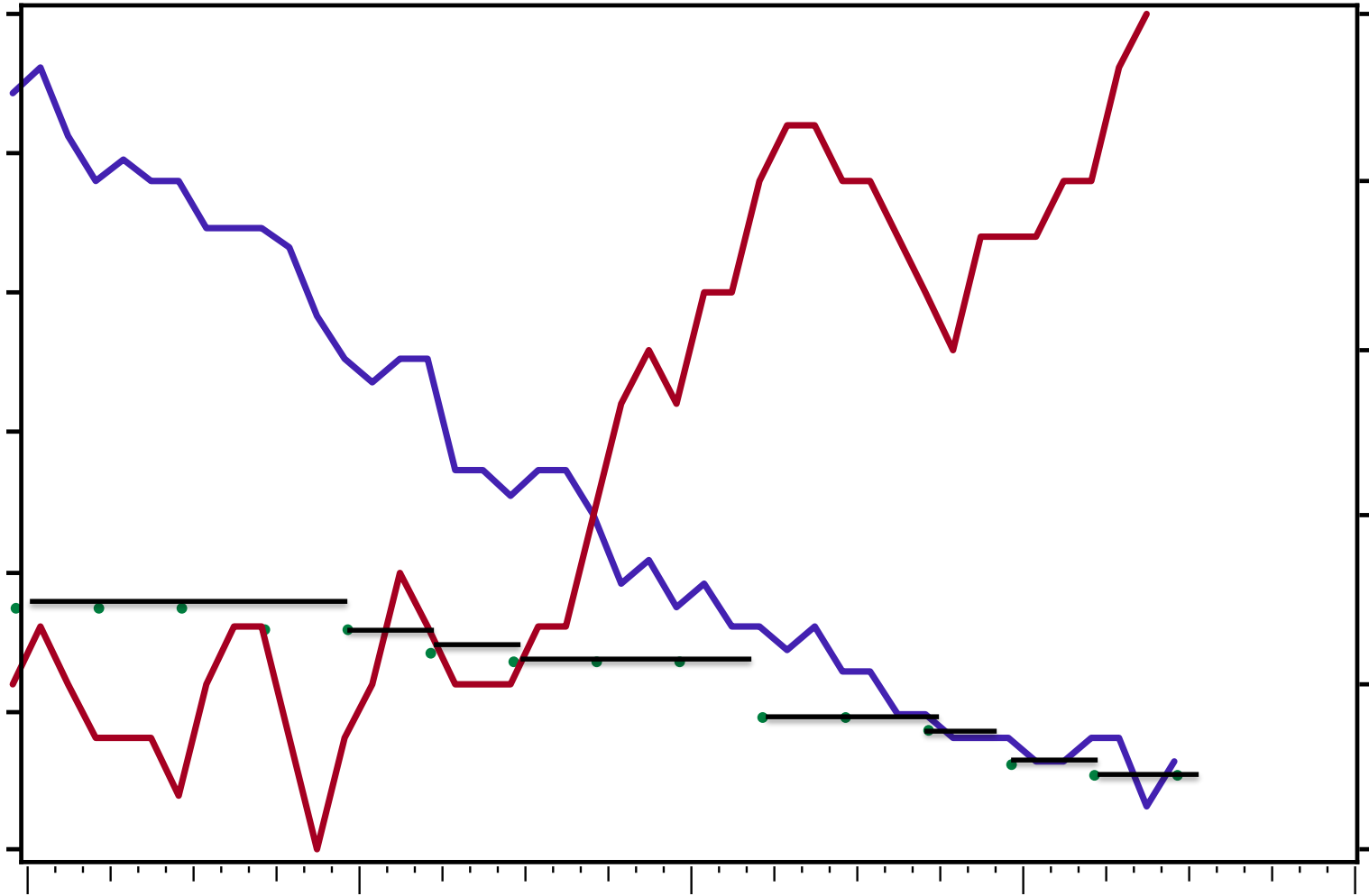
- Bretton Woods created a gold reference standard for global monetary policy
- Gold convertible into dollars at \$35/oz though only for central banks and the exchange rates were fixed to the dollar
- U.S. acted inconsistently with gold conversion promise and President Nixon closed the gold window in 1971 (system started deteriorating badly from 1968)
- The end of Bretton Woods marked the birth of the new era of fiat currencies and discretionary monetary policy
- Inflation soared in the decade following the collapse of Bretton Woods.

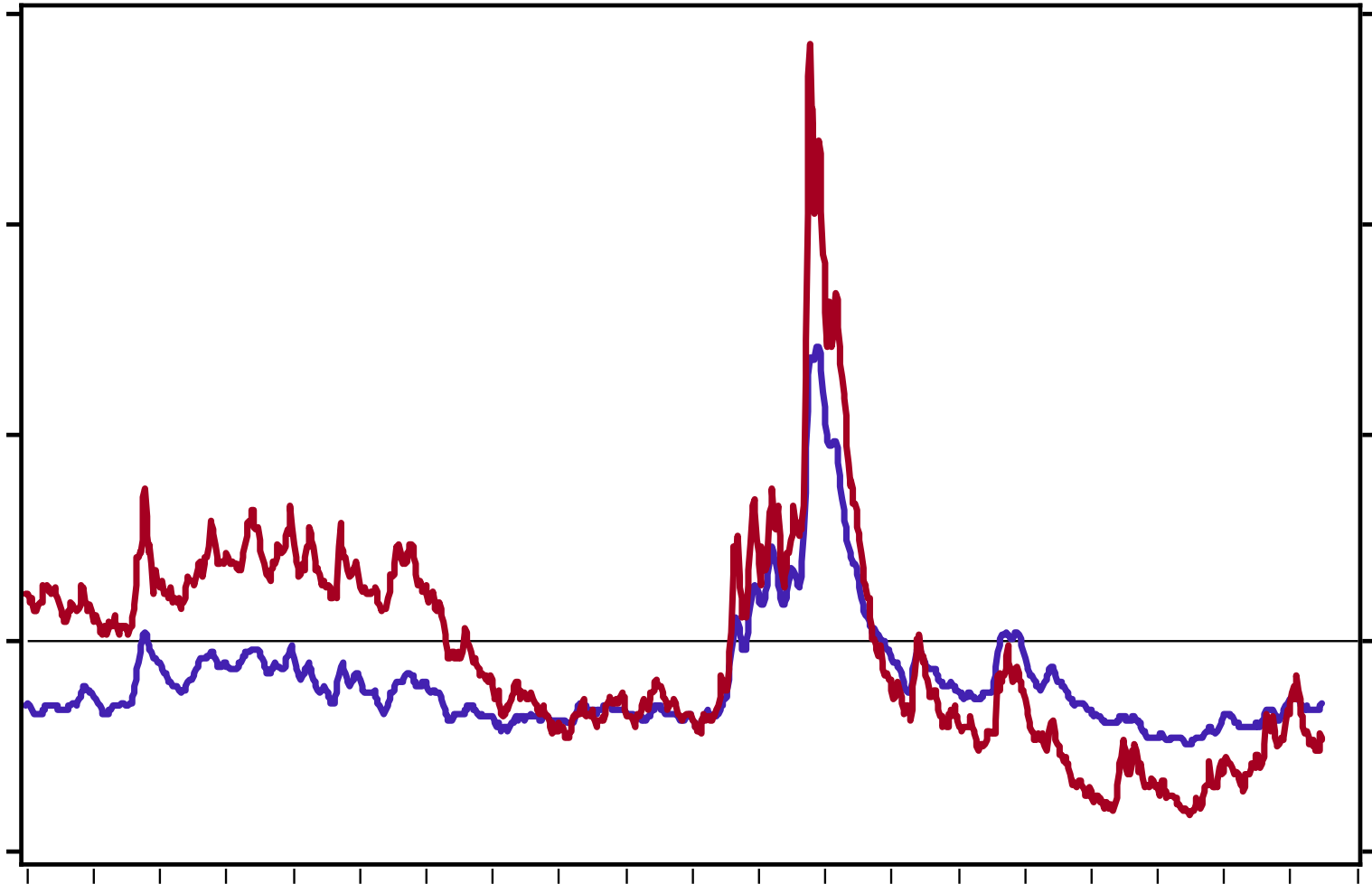
Evolution of Best Practices

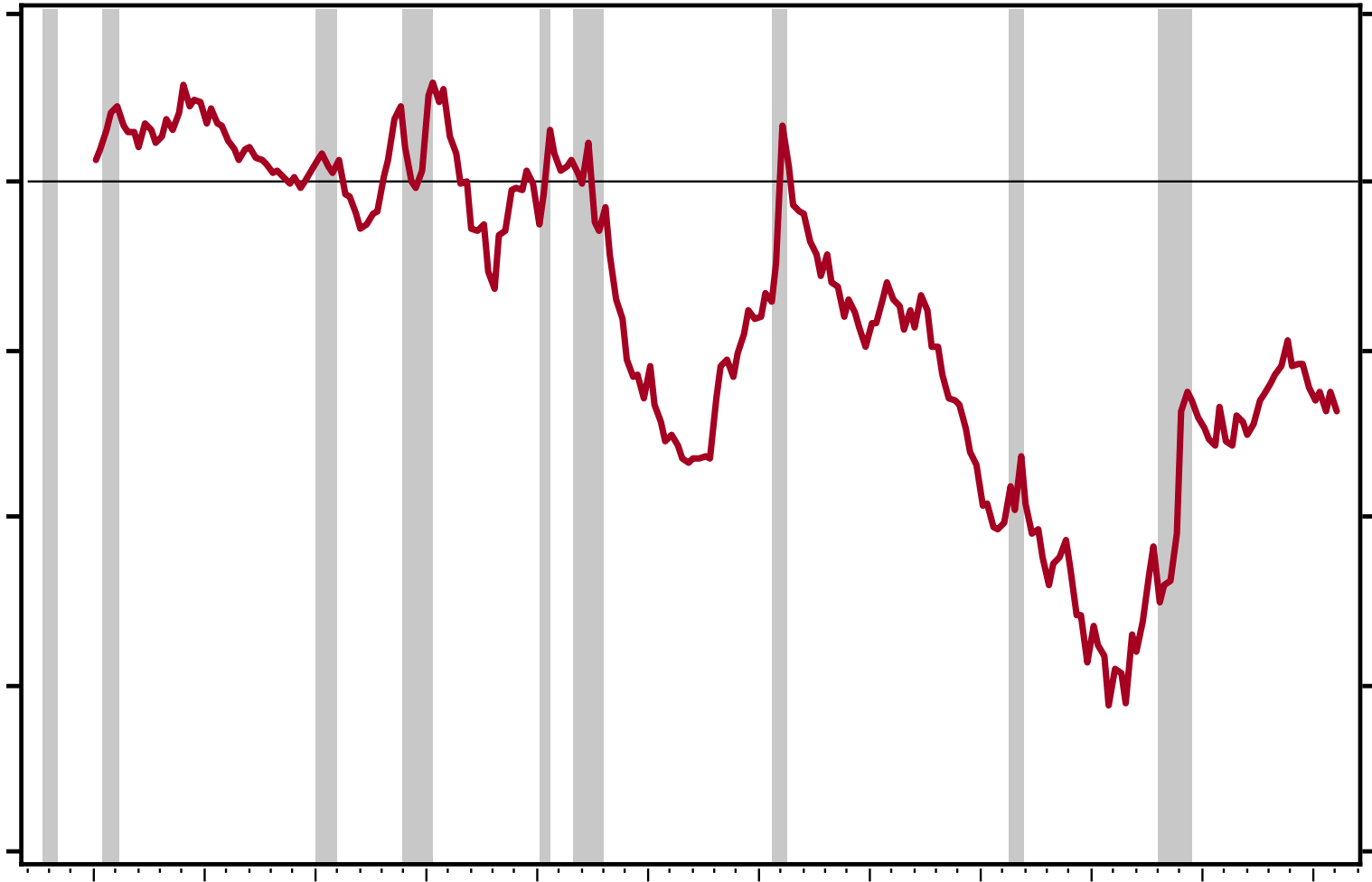
- **Rules versus Discretion:** Friedman & Schwartz (1963), Friedman AEA address (1968); Kydland and Prescott (1977) time inconsistency; Taylor (1993). Robust rules. Role of lags.
- **Single versus Dual Mandate:** Tinbergen (1952) on targets and instruments. Rise of inflation targeting central banks—New Zealand (1989), Bank of England (1997), ECB
- **Independent Central Bank:** Experience of monetary policy conducted by Treasury/Government poor. Bank of England (1997)—Inflation rate 88-97 3.9%, 97-06 1.5%
- **Exchange Rate Targeting:** Outsourcing monetary policy: small versus large economies
- **Central Bank credibility:** Observable objectives, inflation focused, independence.

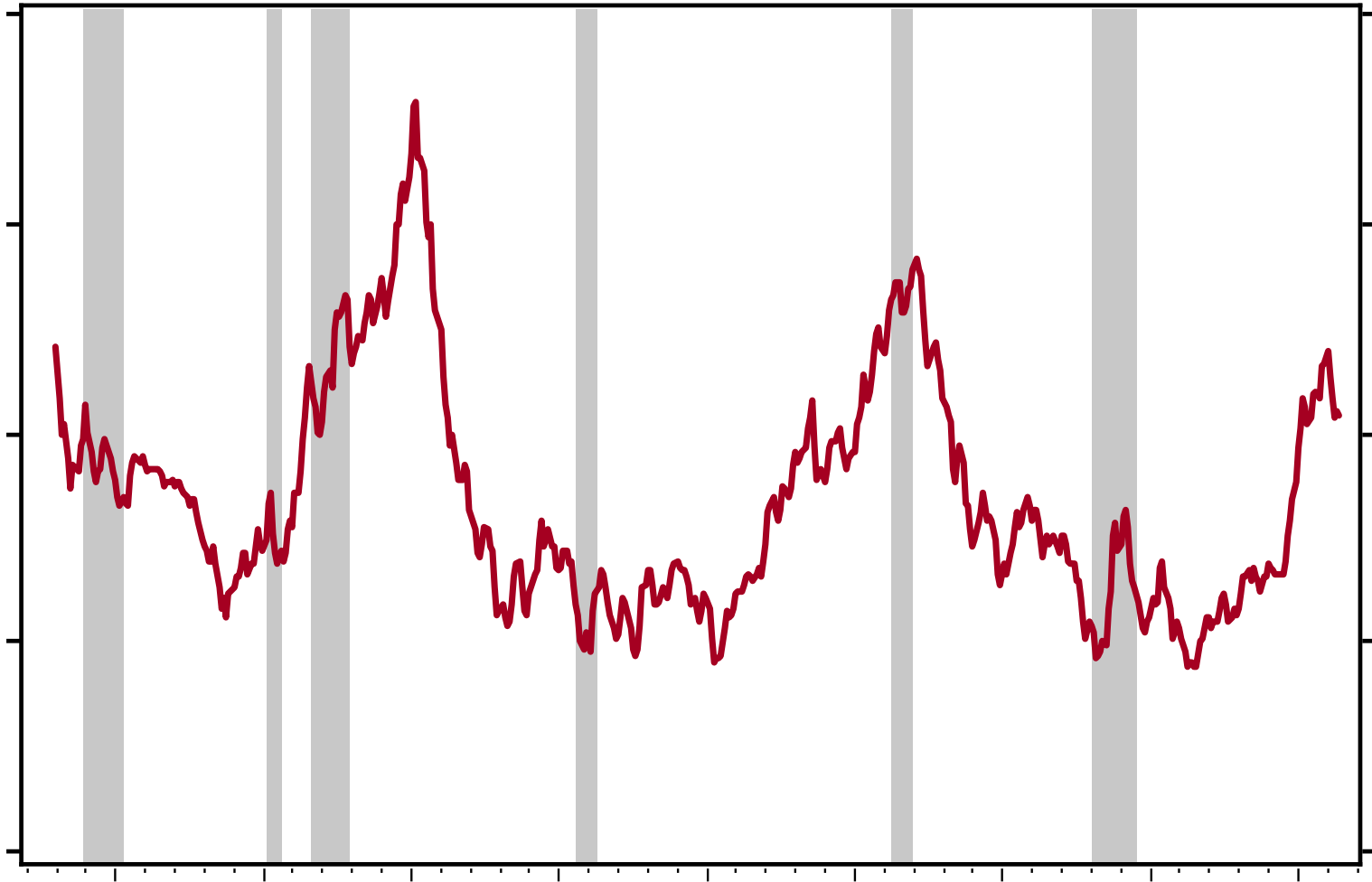
State of U.S. Monetary Policy

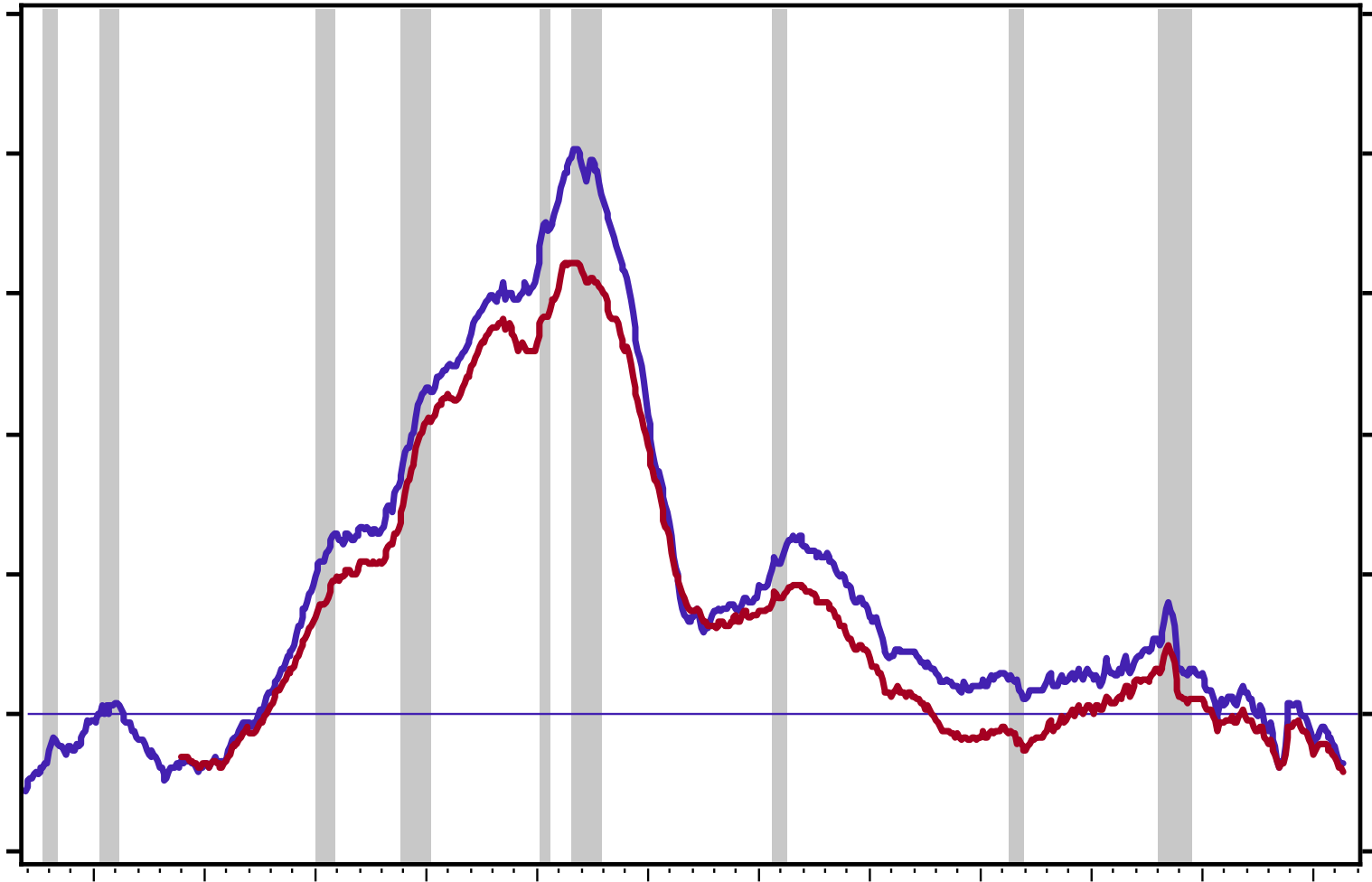
- **Multiple Objectives with Time Varying Weights:** Use of Taylor Rule with double unemployment weight; including global and financial conditions in statement. The dangers of *Catch-22* monetary policy
- **Moving Goalposts:** Fed abandoned Evans Rule (6½%/2½% in March 2014 with rate at 6.7%) and has cut NAIRU estimates 7 times from 5.6% to 4.8% from 9/13 to 3/16. Easing of SEPs with end-16 rate seen at 0.875% in June versus 2.5% in 6/14
- **Additional Ease of Balance Sheet & Forward Guidance:** QE1; QE1.5 (reinvestment); QE2; Twist; QE3; runoff v sales; delay runoff
- **Only Lip Service to Lags:** Unemployment at 4.9%, core PCE inflation at 1.6% but fed funds at 0.375%
- **Lack of Continuity of Analysis:** Where is optimal control now? Downplaying the Phillips Curve (Powell & Tarullo). Exchange rate as policy indicator

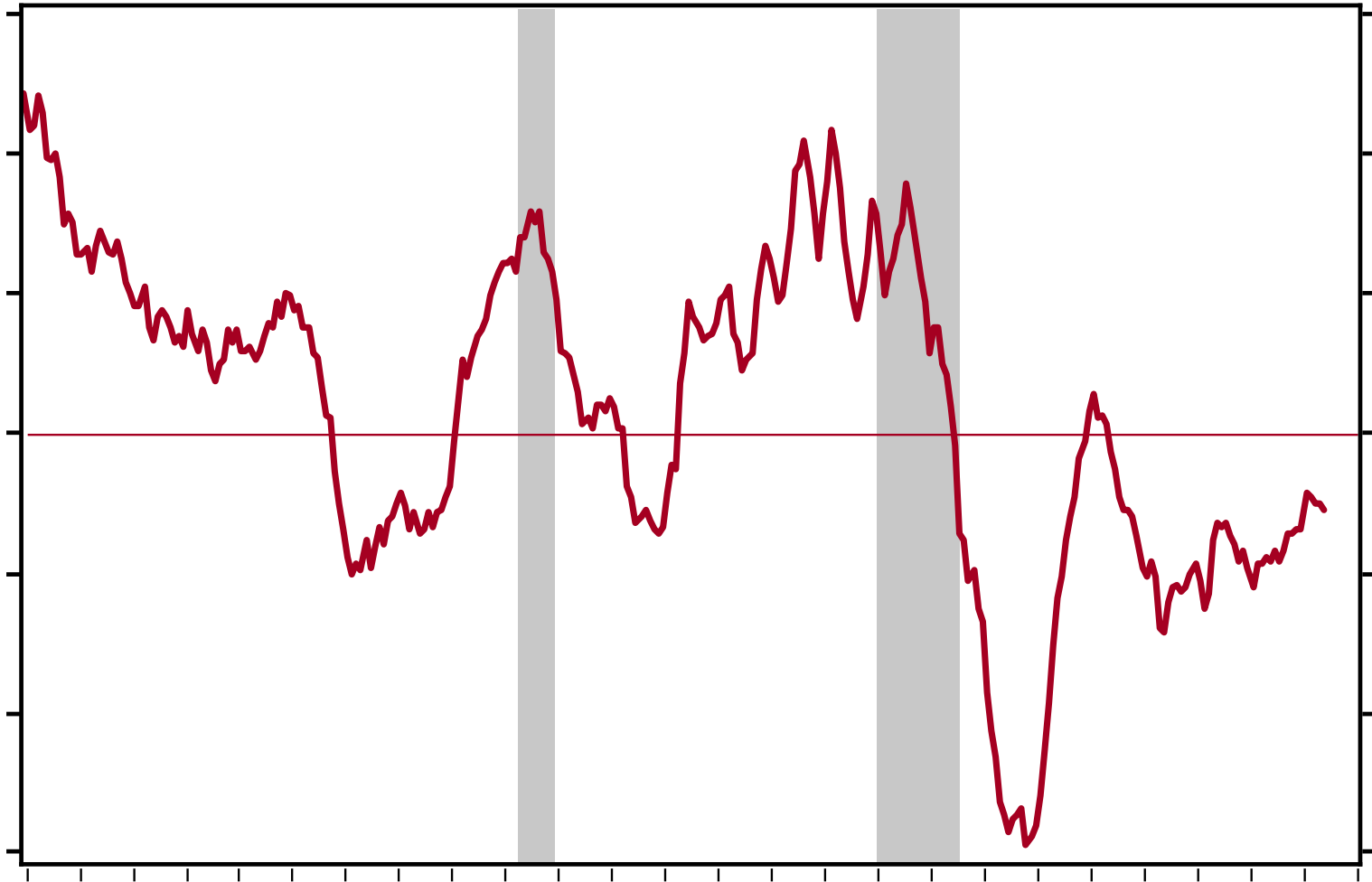








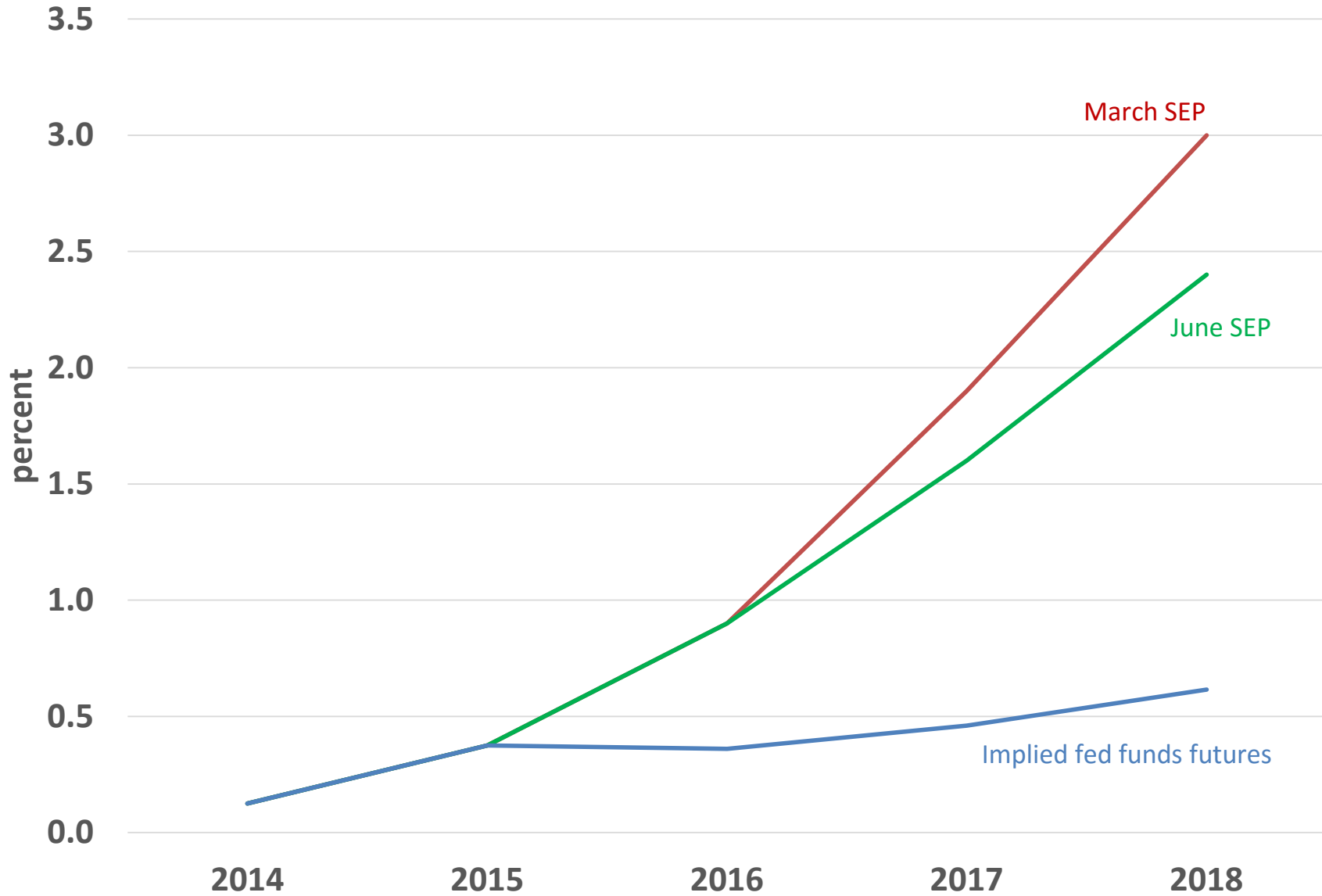


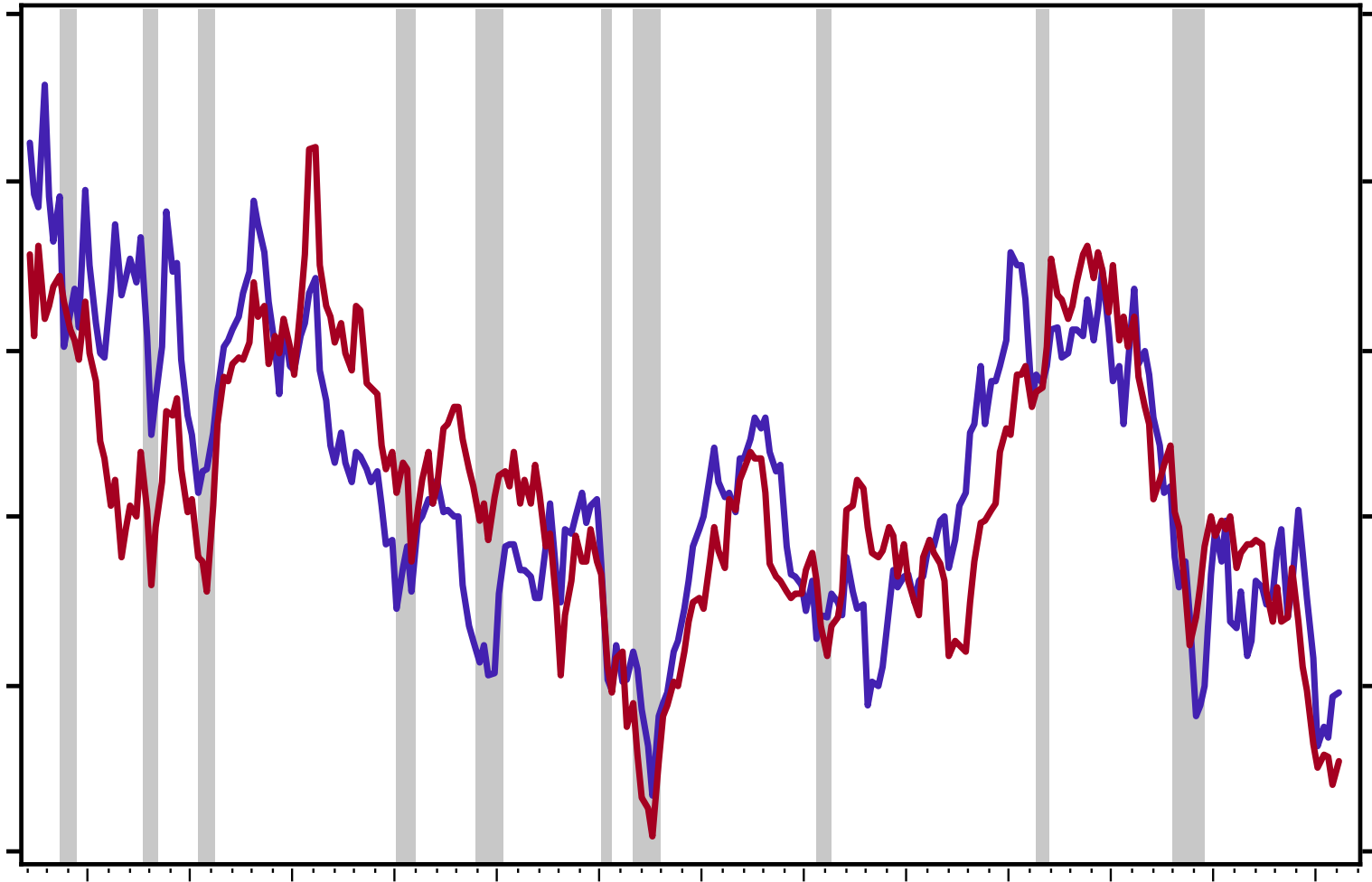


Challenges for Monetary Policy

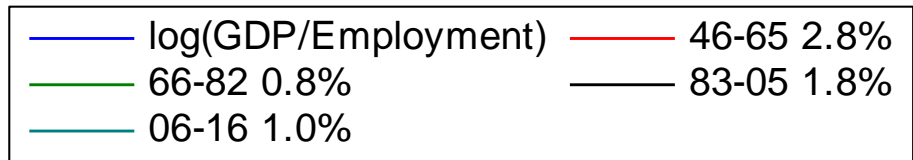
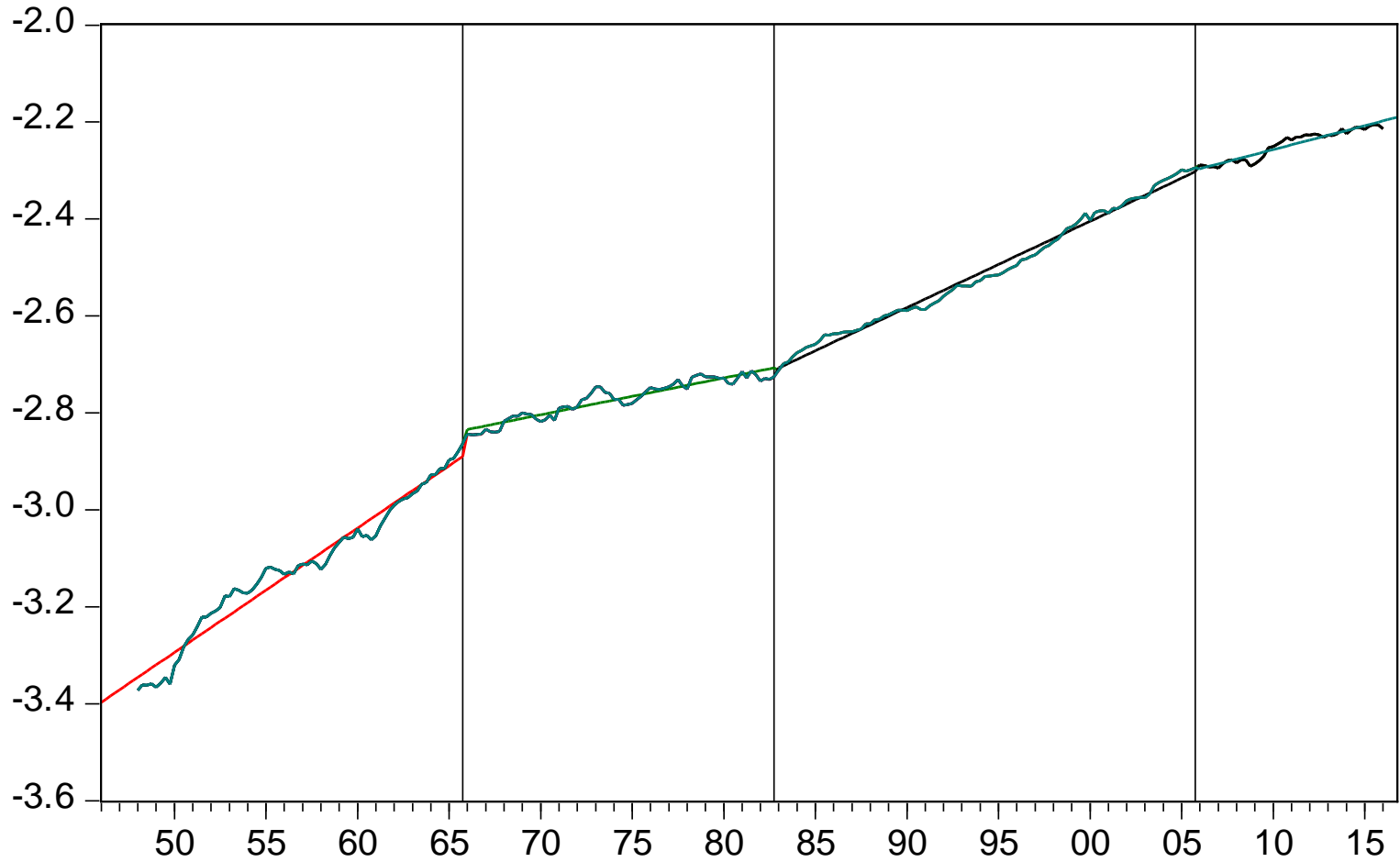
- **Communications**—FOMC reluctant to meet even its own shallow path for rate increases as shown in SEP. Reluctance dressed in incoherent ‘data-dependent’ rationale plus ad-hoc factors (China exchange rate, Brexit, stock market volatility)
- **Credibility**—Is the Fed operating largely discretionary monetary policy targeting labor market—can get away with it for now because of low inflation but what happens when inflation picks up?
- **Supply-Side**—Low productivity growth distorting growth metrics (slow potential and thus actual GDP growth) but monetary policy may hurt rather than help. Relationship between wages, productivity and prices present major challenge to sustainable growth.
- **Global**—As the world’s largest economy, how much can the Fed rely on the world to set U.S. monetary policy?
- **Other Policies**—Fed needs help from fiscal, labor market, and other policies facing constraints such as skills gap. No help likely to come

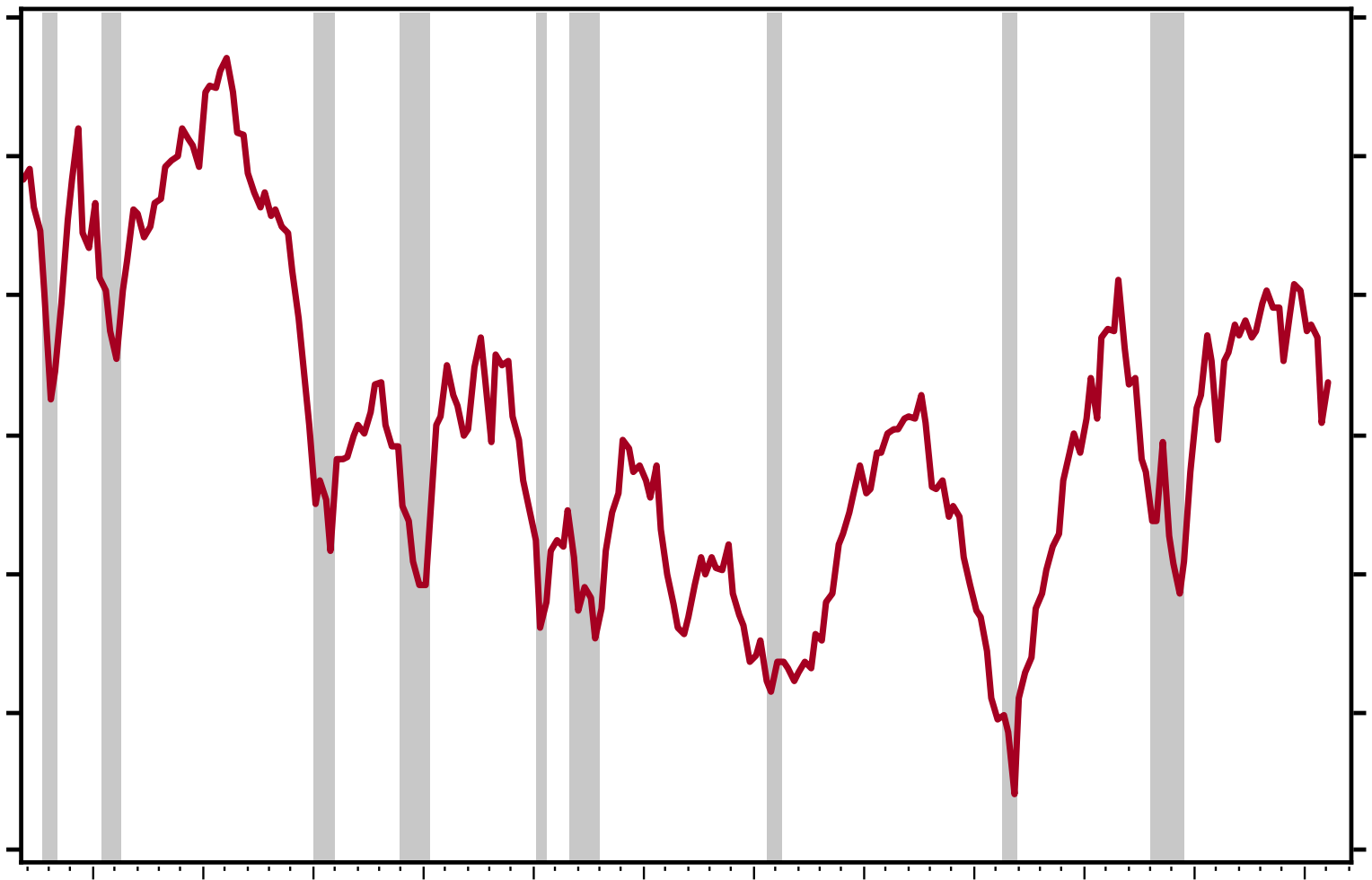
Fed Funds Rate Paths



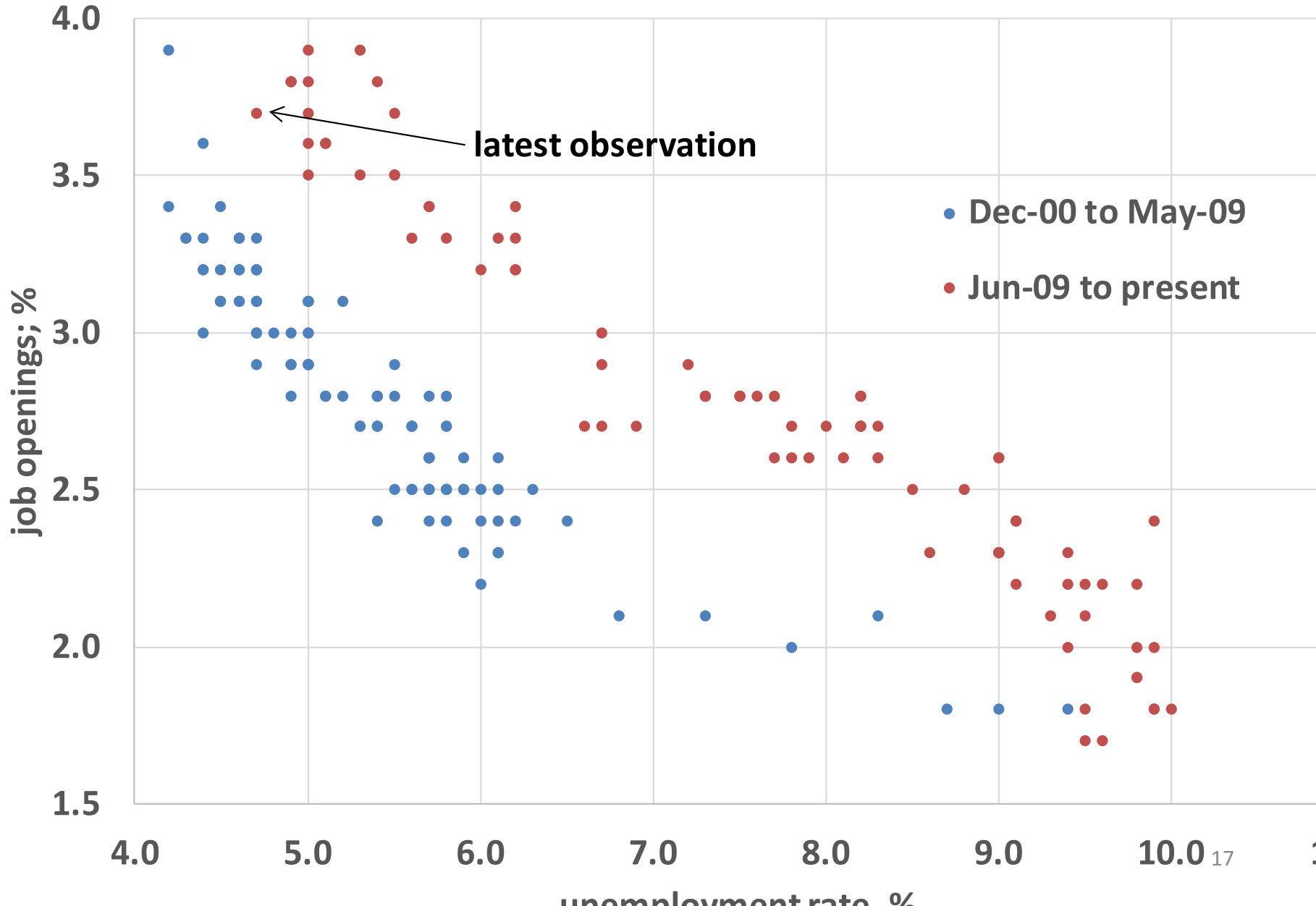


Whole Economy Productivity Trends 46-16





Beveridge Curve: Unemployment Rate and JOLTS



Beveridge Curve: Short-Term Unemployment Rate and JOLTS

