

FEDERAL RESERVE BANK OF ST. LOUIS

Commentary

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It is a pleasure for me to participate in this conference in honor of Darryl Francis. In the late 1960s and early 1970s, when Darryl Francis was president of the Federal Reserve Bank of St. Louis, I had recently arrived at Washington University. I had just completed my graduate work at MIT, primed during those years for combat with the monetarists at the Federal Reserve Bank of St. Louis. Needless to say, I engaged in many vigorous debates, often with Leonall Anderson and Jerry Jordan, and often at conferences presided over by Darryl Francis. I can only imagine the degree to which Darryl Francis enlivened the FOMC meetings during this period.

It is also a distinct pleasure to comment on this stimulating and thought-provoking paper by Charles Goodhart. It is just what many of us hoped we would be treated to when Charles returned to full-time academic pursuits after his experience as a member of the Monetary Policy Committee (MPC) at the Bank of England—an insightful assessment of the strategy and process of monetary policy-making by the MPC.

Charles covers a lot of ground in this paper, challenging the ability of even a fast-talker like me to do justice in a short comment. I will focus on three questions that Charles poses, with most of my attention on the first two questions, which form the centerpiece of his paper.

1. Is the MPC's implicit two-year policy horizon the optimal one for their inflation targeting approach?
2. Is the MPC's practice of conditioning its forecast on a constant path for the nominal short-term interest rate appropriate?
3. Under what circumstances should policy today respond to asymmetric risks in the outlook?

THE POLICY HORIZON

Charles starts by asking what the relationship is between the lag in the response of the economy to monetary policy actions and the policy horizon

in the inflation targeting approach at the MPC. My immediate response was that this was an interesting question, and I looked forward to the analysis and answer. Unfortunately, Charles did not follow up in this direction very effectively. He could, for example, have varied the length of the lag of the response of the economy to monetary policy in some of the models he considered and traced the effect on the optimal policy horizon.

Instead he reviewed a series of studies, each of which offered multiple simulations, leaving us with a smorgasbord of results. This led Charles to conclude, correctly I believe, that the appropriateness of the two-year policy horizon of the MPC is unclear because the optimal horizon is so sensitive to the shocks, the model, and the loss function.

This should not suggest that Charles's analysis was a dead-end. The point, it seems to me, is that one cannot determine a single optimal policy horizon for an inflation targeting approach precisely because the optimal horizon should be variable, depending on the source and size of shocks, which affect the speed of the desired return to the inflation target. I do not read this as the conclusion that Charles reaches, but it seems it is a conclusion that follows from his careful analysis and survey of the literature.

The fundamental problem with the selection of an arbitrary policy horizon in an inflation targeting approach is its inability to deliver on its *raison d'être*. The policy horizon in an inflation-targeting approach is a device for taking into account the unacceptable output variability that would follow from an excessively rapid return to the inflation target following a departure from the target. Charles approvingly quotes Batini and Haldane: “[A]ny degree of output stabilization can be synthetically recreated by judicious choice of parameters entering an inflation-targeting formula. There is no need for any *explicit* output terms to enter this rule.”

This may be true on average over some period, but it is clearly not true episode by episode, depending on the source and size of the shocks. The ability of forecast-based rules that exclude the output gap to achieve any desired level of output stabilization by adjusting the forecast horizon is not robust across models, and there are several cases in which the cost of excluding the output gap are quite significant.

It seems to me that the interesting question here is, Why use an imperfect, synthetic device to

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allow for output stabilization when you can use the real thing, that is, take output variability directly into account? The answer I sometimes hear—usually from policymakers at inflation-targeting central banks—is that admitting that a central bank carries out its monetary policy in part to stabilize output would undermine the public’s confidence in its commitment to price stability. But this would be a strange answer from a central bank that prides itself on its transparency.

Let me compare the MPC’s well-articulated inflation targeting approach to the Fed’s less well-articulated strategy. First, the Fed’s mandate, given by the Congress, is to promote full employment and price stability, an explicit dual mandate, with a clear directive to worry about output stabilization. Given that policymakers inevitably face a trade-off between output and inflation variability and the public cares about both, this seems to me the right way to frame a central bank’s objectives. In addition, I don’t see any reason to saddle the Federal Open Market Committee (FOMC) with an arbitrary horizon for returning inflation to the target—that requirement that would force us to deviate from the optimal policy response to a given shock that balances the two objectives.

THE INTEREST RATE PATH IN AN INFLATION FORECAST

The next question tackled by Charles was the appropriateness of the fixed short-term interest rate path in the MPC’s inflation forecast. I thought Charles did an admirable job of presenting the *prima facie* case against this approach. I was convinced.

This approach is unnecessary, suboptimal, and may undermine the credibility of the MPC’s inflation forecast. It reflects a historical precedent that no longer applies, as well as institutional inertia and an over-emphasis on simplicity.

Let’s model the constant nominal interest rate path in this inflation targeting exercise as a variant of the Taylor rule. It sets the real interest rate as a function of the (expected) inflation rate with a coefficient of -1 , assuming there is some variation in (expected) inflation over the policy horizon. This leads to an immediate insight. It would be better to set the coefficient to zero. So a still-simple, but I believe clearly improved, approach would be to set a constant real interest rate.

Still better, it seems to me, would be for the

MPC to set the entire path for the real interest rate as consistent with its forecast and policy objectives. Charles’s conclusion is that such an approach, while desirable in principle, simply would not be practical, given the likely difficulty the committee would face in reaching a consensus about the full path of interest rates. But one has to be concerned if the policy process is set up in such a way that it potentially distorts the current policy decision as well as the communication to the market about prospective policy.

Let me now shift to the FOMC practice, because the staff has to take into account the interdependence between the forecast and policy process. The FOMC makes forecasts only twice a year, when a central tendency is reported; the forecast is, at most, two years out based on members’ forecasts of fourth-quarter-to-fourth-quarter inflation and output growth and the fourth-quarter level of the unemployment rate. The staff makes the forecast presented at each FOMC meeting. The FOMC is a more eclectic group than the MPC—fewer economists and fewer members who would be comfortable putting together a forecast. We have an implicit deal with the staff. We let them put together the forecast without interference and we don’t promise to use their forecast to make our policy decisions. I am not sure it makes sense, in fact, to require the policy committee to reach a consensus on the forecast. Policy decisions of the respective members should reflect their individual judgment about the outlook as well as their individual policy preferences.

The staff, on the other hand, faces a dilemma similar to that faced by the MPC before the Bank of England received its operational independence. How is the staff to make a forecast without some assumption about the path of the policy rate? How can the staff specify the path for the policy rate when this would appear to prejudge the outcome of the policy decision?

This dilemma is sometimes resolved by the staff conditioning its forecast on a constant path of the nominal funds rate, at the initial setting for the policy rate, so that it represents no change in policy. This is the simplest way to separate the forecast from the policy decision, as long as you don’t mind that the staff’s forecast is not its best judgment about the outlook over the forecast horizon. Still, this simple approach has proved a very effective device for the staff to provide the FOMC with information about what the outlook

might be in the absence of any change in the policy rate. This can be a powerful motivator to action.

Sometimes, however, this assumption seems so out of line with the committee's long-term objectives that the staff cannot—and, I believe, should not—resist a more activist approach. The first fallback is the constant real rate assumption, aligned to the prevailing real rate. But, at times, the staff will go still further and condition the forecast on a rising or falling real federal funds rate path, though never with a change assumed as the outcome at the current meeting.

But the MPC situation is quite different. It publishes a forecast that extends a couple of years. If the MPC wants this forecast to be credible, it has to condition it on a credible path of interest rates. Charles says that it would be a slur on the MPC to imply that they fudge the forecast relative to the path of interest rates so that the forecast should be credible even if the path of interest rates is not. I apologize for any offense taken, but I have had my doubts about the credibility of the MPC's forecast because of the restrictions under which it is made.

Charles then suggests that the decision to condition the forecast on a constant nominal interest rate has the desirable consequence of encouraging policymakers to be more preemptive than they otherwise would have been. What was missing from this discussion was an explanation of why the committee would be less preemptive than would be optimal if it were freed from the restraint on its forecast procedure. What is it that biases the MPC to be suboptimally responsive to changing economic conditions? Actually, this might be an interesting line of inquiry because I suspect that there is a bias toward waiting longer than is appropriate to change policy. This arises perhaps from the view that it would be undesirable to move rates in one direction and then have to reverse course in short order, as would be more likely to be the case if policy were the random walk that Charles talked about. To avoid this outcome, a high hurdle is set for rate moves, especially at turning points. The result may well be a bias toward holding rates too long.

Charles then proceeds to offer an alternative to the current procedure of a constant policy rate in the MPC forecast. I was, however, a little confused about the alternative approach Charles suggested. After all, he had just concluded that there were constructive incentives that followed from the current approach and that the forecast was in fact

fully consistent with the rate path. Why, based on this assessment, even offer an alternative? At any rate, Charles recommends that, in addition to the forecast conditioned on a constant nominal interest rate, the MPC publish two alternatives. One alternative would have higher rates and the other would have lower rates, initially, but in each case rates would be set later in the forecast to ensure the same conformity of inflation with the target at the policy horizon. It seems to me that this option would leave the MPC with three arbitrary, potentially suboptimal forecasts instead of one. I view Charles's solution, therefore, as multiplying the problems with the existing approach rather than resolving them.

I have struggled to come up with some alternatives of my own, abiding by the restriction that the alternatives maintain the concept of a policy horizon. First, the MPC could set a constant real interest rate, as discussed above. Second, the MPC could set the current policy rate, as it does today, but then allow the remainder of the rate path to be set according to a simple feedback rule. It might be relatively easy, in such a practice, to limit the perception of commitment to the rules-based path and therefore preserve a high degree of flexibility for the MPC with respect to future policy actions. This might be a better "device" to reconcile the forecast with the absence of a fully agreed to policy path. On the other hand, it would likely be difficult to get agreement on a specific rule, even though that rule might not carry a clear policy commitment. Third, the MPC could continue to set a constant nominal path but not insist that inflation be aligned with the target at the 18- to 24-month horizon, as appears to be the case today. This would remove the possible perception that the current interest rate path is the MPC's best judgment about the path consistent with achieving the inflation target at the policy horizon. On the other hand, it would give the market a reading on the likely direction of future policy actions and therefore be a highly explicit statement of a policy bias related directly to prospects for future policy.

SKEWS AND MONETARY POLICY

Charles then asks whether and when policymakers should explicitly take account of asymmetric risks in the forecast. That is, should policy respond to only the mode of the forecast probability distribution—presumably the point forecast—or to the mean, when the two are differ-

ent on account of an asymmetric probability distribution of forecast outcomes.

I have often felt there were asymmetric risks in the outlook. I nevertheless have suspicions when others tell me that *their* forecasts have asymmetric risks! I usually suggest that they to go back and work on their forecasts until they can return with a symmetric probability distribution. When they tell me the risks are to the downside, for example, I wonder if they just got lazy about changing the forecast and didn't line it up on their true mode.

But as I said, the risks to the forecast do on occasion appear asymmetric, and Charles's question is therefore a most interesting one. Should policy with symmetric risks be different from policy with asymmetric risks if the modal forecast is the same in the two cases?

Charles's answer is, It depends. This is one of my favorite answers to interesting questions, so I thought this was a promising start. But as I always told my students, you also have to tell me what it depends on when you choose this answer.

Charles did precisely that. He believes that it depends on whether the risks are observable or not. Don't respond to observable risks, because you will know when they come into play and you can wait to respond then. On the other hand, if

they are unobservable, respond immediately, because you will never be in a better position to clarify their relevance. Charles also argues that you should not take into account low-probability, high-payoff risks such as earthquakes and wars.

I thought the discussion of asymmetric risks related to asset prices was particularly interesting. Otherwise, I was not very satisfied with his criteria for when policymakers should or should not respond to asymmetric risks. I would have thought that the issue was not whether the risks are observable but instead whether timely action is needed. For example, if an upside risk is that the stock market may start to surge again, there may be no need to react today to such a possibility. The impact of an increase in the stock market on the economy is gradual and policymakers will have time to react. But I am only scratching the surface of a most interesting question. I judge Charles's answers here to be quite preliminary ones and I hope he will return to this topic in future work.

REFERENCES

- Batini, Nicoletta and Haldane, Andrew G. "Forward-Looking Rules for Monetary Policy," in John B. Taylor, ed., *Monetary Policy Rules*. Chicago: University of Chicago Press, 1999, pp. 157-92.