

Project Syndicate: Who's afraid of rules-based monetary policy?

The US Federal Reserve this year has announced a fundamental change in its overall strategy. Yet in doing so, it has unnecessarily introduced more uncertainty into the policy mix, setting a bad example for the world's other major central banks, **writes John B. Taylor for [Project Syndicate](#)**



Fed Chair, Jerome Powell

The Fed's new approach adds unnecessary uncertainty

Many of the world's central banks have been formally reviewing their monetary-policy strategies in light of Covid-19 and the experience leading up to the pandemic. Unfortunately, they appear to be drawing the wrong lessons from the challenges they face.

One of the first to complete this process was the US Federal Reserve System, which decided to move to a new “flexible form of average inflation targeting,” as Fed Chair Jerome Powell described it in a speech at the annual Jackson Hole monetary-policy conference in August. Similarly, European Central Bank President Christine Lagarde recently told the annual ECB and Its Watchers XXI conference that the ECB is in the middle of its own “monetary policy strategy review.” And according to Bank of Japan Governor Haruhiko Kuroda, there are ongoing discussions with the new government of Prime Minister Yoshihide Suga about how to deal with the pandemic and whether a

new monetary-policy strategy is in order.

In light of these discussions, it previously looked like there was a move underway to reform the entire international monetary system, with each country or region following a strategy similar to the Fed, though attuned to its own circumstances. But it no longer looks that way. “At the very least,” argues Otmar Issing, a former chief economist and member of the ECB Board who was largely responsible for charting the original course of ECB policymaking, “other central banks should not blindly follow the Fed’s new strategy.”

Issing is not alone in seeing problems with the Fed’s new approach. In early September, Robert Heller, a former Federal Reserve governor, argued in a letter to the Wall Street Journal that the Fed should “not target an average inflation rate of 2%.” Then, at a virtual conference convened by Stanford University’s Hoover Institution this month, Charles I. Plosser, a former president of the Federal Reserve Bank of Philadelphia, and Mickey D. Levy of Berenberg Capital Markets criticized the Fed for not being specific about the timespan over which average inflation will be measured. Is it one year or several years?

Powell himself acknowledged this lack of specificity at the Jackson Hole conference in August. Noting that “we are not tying ourselves to a particular mathematical formula that defines the average,” he added that, “Our decisions about appropriate monetary policy ... will not be dictated by any formula.” Then, in a press release the same day, the Fed’s Board of Governors explained that policy decisions would be based on “assessments of the shortfalls of employment from its maximum level” rather than by “deviations from its maximum level,” as had been previously stated.

But whether the focus is on “deviations” or “shortfalls,” this new approach adds unnecessary uncertainty, because shortfalls are not defined. Moreover, there is no mention of how monetary policy will be used to generate higher inflation to make up for periods when inflation is less than 2%. Is the Fed considering additional changes in its procedures beyond the current mix of near-zero interest rates and large-scale asset purchases?

A rules-based approach would still be preferable

In adopting this “flexible” approach, the Fed seems to have shifted away from the more strategic, rules-based policy that it had been pursuing at least since 2017. As of this summer, its Monetary Policy Report no longer includes material on monetary-policy rules, whereas the previous six reports going had featured a whole section in which different rules were presented and compared with actual scenarios. Among the rules considered were transparent settings for the Fed’s interest-rate policy, including the so-called Taylor rule, a price-level rule, and a modified Taylor rule to deal with the zero bound.

It is understandable that Issing and others would be reluctant to go along with the Fed’s less strategic, discretionary approach, especially when there are alternatives that other central banks can pursue. Rather than casting about for something new or simply different from the Fed, they can embark on the same rules-based-policy path that the Fed itself was on before the pandemic struck.

In fact, this would be easier done than said. When I first developed the Taylor rule, which has been widely discussed for three decades now, I based it on an average inflation rate. But, unlike the vague definition that the Fed has now adopted, I explicitly defined the “average” as “the rate of

inflation over the previous four quarters.” In other words, the Fed could still switch to an average-inflation approach and yet be far more specific than it has decided to be.

Moreover, the formal policy rules previously listed in the Monetary Policy Report all have variables to account for factors other than the inflation rate, such as the unemployment rate or the gap between real and potential GDP. These variables could be included in the current strategy without neglecting the inflation target, as could policy rules to deal with asset purchases and their eventual unwinding. Developing such an approach would not be difficult for the Fed to do, especially if other central banks also chose to go in this direction.

A decade ago, I wrote a paper with John C. Williams, now the president of the Federal Reserve Bank of New York, titled “Simple and Robust Rules for Monetary Policy,” in which we emphasized the importance of rules-based policymaking. And there are reams of additional studies showing the benefits of rules-based monetary policy. That is why so many distinguished monetary scholars have endorsed this approach.

It is promising that the ECB and other central banks often use the word “strategy” when describing their own monetary-policy reviews. A strategic approach is necessarily a rules-based approach, which is precisely how the international monetary system should be run.

The full and original article first appeared on Project Syndicate [here](#) on 16th October 2020.

Author

Amrita Naik Nimbalkar

Junior Economist, Global Macro

amrita.naik.nimbalkar@ing.com

Mateusz Sutowicz

Senior Economist, Poland

mateusz.sutowicz@ing.pl

Alissa Lefebvre

Economist

alissa.lefebvre@ing.com

Deepali Bhargava

Regional Head of Research, Asia-Pacific

Deepali.Bhargava@ing.com

Ruben Dewitte

Economist

+32495364780

ruben.dewitte@ing.com

Kinga Havasi

Economic research trainee

kinga.havasi@ing.com

Marten van Garderen

Consumer Economist, Netherlands

marten.van.garderen@ing.com

David Havrlant

Chief Economist, Czech Republic

420 770 321 486

david.havrlant@ing.com

Sander Burgers

Senior Economist, Dutch Housing

sander.burgers@ing.com

Lynn Song

Chief Economist, Greater China

lynn.song@asia.ing.com

Michiel Tukker

Senior European Rates Strategist

michiel.tukker@ing.com

Michal Rubaszek

Senior Economist, Poland

michal.rubaszek@ing.pl

This is a test author

Stefan Posea

Economist, Romania

tiberiu-stefan.posea@ing.com

Marine Leleux

Sector Strategist, Financials

marine.leleux2@ing.com

Jesse Norcross

Senior Sector Strategist, Real Estate

jesse.norcross@ing.com

Teise Stellema

Research Assistant, Energy Transition

teise.stellema@ing.com

Diederik Stadig

Sector Economist, TMT & Healthcare

diederik.stadig@ing.com

Diogo Gouveia

Sector Economist

diogo.duarte.vieira.de.gouveia@ing.com

Marine Leleux

Sector Strategist, Financials

marine.leleux2@ing.com

Ewa Manthey

Commodities Strategist

ewa.manthey@ing.com

ING Analysts

James Wilson

EM Sovereign Strategist

James.wilson@ing.com

Sophie Smith

Digital Editor

sophie.smith@ing.com

Frantisek Taborsky

EMEA FX & FI Strategist

frantisek.taborsky@ing.com

Adam Antoniak

Senior Economist, Poland

adam.antoniak@ing.pl

Min Joo Kang

Senior Economist, South Korea and Japan

min.joo.kang@asia.ing.com

Coco Zhang

ESG Research

coco.zhang@ing.com

Jan Frederik Slijkerman

Senior Sector Strategist, TMT

jan.frederik.slijkerman@ing.com

Katinka Jongkind

Senior Economist, Services and Leisure

Katinka.Jongkind@ing.com

Marina Le Blanc

Sector Strategist, Financials
Marina.Le.Blanc@ing.com

Samuel Abettan
Junior Economist
samuel.abettan@ing.com

Franziska Biehl
Senior Economist, Germany
Franziska.Marie.Biehl@ing.de

Rebecca Byrne
Senior Editor and Supervisory Analyst
rebecca.byrne@ing.com

Mirjam Bani
Sector Economist, Commercial Real Estate & Public Sector (Netherlands)
mirjam.bani@ing.com

Timothy Rahill
Credit Strategist
timothy.rahill@ing.com

Leszek Kasek
Senior Economist, Poland
leszek.kasek@ing.pl

Oleksiy Soroka, CFA
Senior High Yield Credit Strategist
oleksiy.soroka@ing.com

Antoine Bouvet
Head of European Rates Strategy
antoine.bouvet@ing.com

Jeroen van den Broek
Global Head of Sector Research
jeroen.van.den.broek@ing.com

Edse Dantuma
Senior Sector Economist, Industry and Healthcare
edse.dantuma@ing.com

Francesco Pesole
FX Strategist
francesco.pesole@ing.com

Rico Luman

Senior Sector Economist, Transport and Logistics
Rico.Luman@ing.com

Jurjen Witteveen
Sector Economist
jurjen.witteveen@ing.com

Dmitry Dolgin
Chief Economist, CIS
dmitry.dolgin@ing.de

Nicholas Mapa
Senior Economist, Philippines
nicholas.antonio.mapa@asia.ing.com

Egor Fedorov
Senior Credit Analyst
egor.fedorov@ing.com

Sebastian Franke
Consumer Economist
sebastian.franke@ing.de

Gerben Hieminga
Senior Sector Economist, Energy
gerben.hieminga@ing.com

Nadège Tillier
Head of Corporates Sector Strategy
nadege.tillier@ing.com

Charlotte de Montpellier
Senior Economist, France and Switzerland
charlotte.de.montpellier@ing.com

Laura Straeter
Behavioural Scientist
+31(0)611172684
laura.Straeter@ing.com

Valentin Tataru
Chief Economist, Romania
valentin.tataru@ing.com

James Smith
Developed Markets Economist, UK
james.smith@ing.com

Suvi Platerink Kosonen

Senior Sector Strategist, Financials

suvi.platerink-kosonen@ing.com

Thijs Geijer

Senior Sector Economist, Food & Agri

thijs.geijer@ing.com

Maurice van Sante

Senior Economist Construction & Team Lead Sectors

maurice.van.sante@ing.com

Marcel Klok

Senior Economist, Netherlands

marcel.klok@ing.com

Piotr Poplawski

Senior Economist, Poland

piotr.poplawski@ing.pl

Paolo Pizzoli

Senior Economist, Italy, Greece

paolo.pizzoli@ing.com

Marieke Blom

Chief Economist and Global Head of Research

marieke.blom@ing.com

Raoul Leering

Senior Macro Economist

raoul.leering@ing.com

Maarten Leen

Head of Global IFRS9 ME Scenarios

maarten.leen@ing.com

Maureen Schuller

Head of Financials Sector Strategy

Maureen.Schuller@ing.com

Warren Patterson

Head of Commodities Strategy

Warren.Patterson@asia.ing.com

Rafal Benecki

Chief Economist, Poland

rafal.benecki@ing.pl

Philippe Ledent

Senior Economist, Belgium, Luxembourg

philippe.ledent@ing.com

Peter Virovacz

Senior Economist, Hungary

peter.virovacz@ing.com

Inga Fechner

Senior Economist, Germany, Global Trade

inga.fechner@ing.de

Dimitry Fleming

Senior Data Analyst, Netherlands

Dimitry.Fleming@ing.com

Ciprian Dascalu

Chief Economist, Romania

+40 31 406 8990

ciprian.dascalu@ing.com

Muhammet Mercan

Chief Economist, Turkey

muhammet.mercan@ingbank.com.tr

Iris Pang

Chief Economist, Greater China

iris.pang@asia.ing.com

Sophie Freeman

Writer, Group Research

+44 20 7767 6209

Sophie.Freeman@uk.ing.com

Padhraic Garvey, CFA

Regional Head of Research, Americas

padhraic.garvey@ing.com

James Knightley

Chief International Economist, US

james.knightley@ing.com

Tim Condon

Asia Chief Economist

+65 6232-6020

Martin van Vliet

Senior Interest Rate Strategist

+31 20 563 8801

martin.van.vliet@ing.com

Karol Pogorzelski

Senior Economist, Poland

Karol.Pogorzelski@ing.pl

Carsten Brzeski

Global Head of Macro

carsten.brzeski@ing.de

Viraj Patel

Foreign Exchange Strategist

+44 20 7767 6405

viraj.patel@ing.com

Owen Thomas

Global Head of Editorial Content

+44 (0) 207 767 5331

owen.thomas@ing.com

Bert Colijn

Chief Economist, Netherlands

bert.colijn@ing.com

Peter Vanden Houte

Chief Economist, Belgium, Luxembourg, Eurozone

peter.vandenhoute@ing.com

Benjamin Schroeder

Senior Rates Strategist

benjamin.schroeder@ing.com

Chris Turner

Global Head of Markets and Regional Head of Research for UK & CEE

chris.turner@ing.com

Gustavo Rangel

Chief Economist, LATAM

+1 646 424 6464

gustavo.rangel@ing.com

Carlo Cocuzzo

Economist, Digital Finance

+44 20 7767 5306

carlo.cocuzzo@ing.com