



The Unlikely Return to “Normalcy” in U.S. Monetary Policy

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It's Worse than You Think

When will monetary policy return to “normalcy”? To answer that question, one must begin with a definition of normalcy. By normalcy, I mean a monetary policy regime in which the Fed uses changes in the fed funds rate to predictably control variation in aggregate demand. Some believe that a return to normalcy depends only on the eventual exit from the zero-interest-rate policy. I disagree with that point of view. Other major policy changes enacted during the crisis are likely to have long-term impacts that will make it difficult to restore pre-crisis monetary policy normalcy, and these are under-appreciated. As the Fed emerges from the zero-interest-rate policy era, it will be more challenging than ever for the Fed to use traditional monetary policy tools to achieve predictable results. In this essay, I explain why, and conclude by offering some suggestions for how the Fed, and other central banks, can deal with the new combination of challenges that they face.

Prior to the crisis of 2007-2009, a consensus had emerged among most macroeconomists that (1) the Federal Reserve was able to employ monetary policy – through management of the fed funds rate – to predictably alter growth in nominal demand, and that (2) the Fed generally was doing so by following some sort of “Taylor Rule” (although 2002-2005 saw a major deviation from that Rule). It is almost hard to remember the days when people took the power and precision of fed funds rate changes so seriously. Greenspan was a “maestro” and no one worried about the Fed’s ability to control nominal demand, or about whether the Fed could predict the quantitative impact of its interest rate policy changes.

Normalcy, of course, was not nirvana. Prior to the crisis the Fed’s policy objectives were not clearly stated, and therefore, Fed accountability was far from perfect. There was no explicit inflation target, and the Fed did not choose to explain how it viewed its triple mandate with respect to employment, inflation and interest rates, and how it would implement policy accordingly.

Still, in spite of the absence of explicit commitments, the Fed’s impact was predictable for two reasons: its policy actions were fairly predictable, and it operated within a stable financial system. Why were policy predictability and the stability of the structure of the financial system so important for making policy impact predictable?

First of all, the transmission mechanism of monetary policy is complex and multi-faceted. Economists see changes in the fed funds rate affecting nominal aggregate demand through various channels, including its effects on the supply of money, the supply of bank credit, the net worth of borrowers and lenders through monetary policy induced changes in the valuation of assets and liabilities, and changes in long-term interest rates and the equity risk premium which are important components of the cost of investing for many firms. Each of these dimensions that shape monetary policy’s impact depends on the structure and regulation of the financial system, which affect key factors such as the lending supply functions of banks and market perceptions of risk, which in turn affect the investment and savings behavior of businesses and households. Changes in the structure of the financial system will produce changes in the impact of monetary policy that are hard to gauge in advance precisely because so little is known about how monetary policy transmission works in the first place.

Second, none of these aspects of monetary policy transmission operates “mechanically.” The impact of any change in the fed funds rate matters not because of the physical fact of the change, but because of the broader meaning of the current policy change, including what it implies about prospective future policy changes. Reactions to a fed funds rate change depend on what it (and the language that surrounds it) portends for future policy. Thus, the past predictability of the sum of the various channels of transmission reflected the facts that (1) the structure of the financial system, including the regulatory framework applied to financial intermediaries, was reasonably stable and (2) the implications of current policies for future policies were reasonably predictable.

If there are many channels of transmission for monetary policy, and if the magnitude of transmission depends on the stability of the regulation and structure of the financial system, and on the clarity of the connections between prospective and current policy actions, then it becomes clear why the past predictability of monetary policy’s effects on nominal demand should not be taken for granted going forward. We are not in Kansas anymore. In the current environment, we face a combination of continuing unpredictable and tectonic shifts in financial regulation and an “anything-goes” Fed that never ceases to amaze by concocting new ideas for how it will influence the market (recently those include unprecedented forward guidance and ad hoc targeted purchases of mortgage-backed securities). In the current environment, the two key factors of policy predictability and a stable financial structure are non-existent.

The problems are not easy to fix for two reasons. First, central banks earn their reputations for transparency, predictability, and accountability over long periods of time. Once damaged, reputations can be hard to repair quickly. Markets will forgive a central bank for deviating from its rule during a crisis, but when the economy is three years beyond that crisis and the Fed continues to behave unpredictably in so many ways, it is reasonable for the market to believe (as I believe) that there is little coherence between the past behavior and commitments of the Fed and its future ones.

Second, predictability of monetary policy actions is only *part* of the problem. Changes in the regulatory framework within which monetary policy occurs will continue to undermine the stability of the transmission mechanisms linking monetary policy and nominal demand growth, and thus make it much harder for monetary policy’s impact to be predicted. Commercial banks have accumulated vast excess reserves, not just as insurance against liquidity risk, but as a response to the higher and more uncertain regulatory costs (e.g., the consequences for capital requirements) of lending more. This conservative behavior reflects the facts that (1) the precise nature of prudential requirements going forward (e.g., capital ratios and liquidity ratios) remain undefined, and (2) the fundamental structure and business functions of financial institutions remain matters of heated policy debate. Just about everything about the banking system and its regulation seems to be up for grabs. Some politicians and influential commentators regularly argue for breaking up the banks, or restoring Glass-Steagall, or just about anything else that comes into their minds.

In the short run, once this uncertainty is resolved, there will be a major and unpredictable set of adjustments. One thing is for sure: the massive, voluntary holdings of excess reserves will contract sharply, implying huge new risks of inflation.

Although the problem of regulatory uncertainty, and its implications for money growth, credit growth, and inflation, are especially worrying in the short run, regulatory instability is not just a short run problem. Indeed, long-term regulatory uncertainty has now been baked into the cake in the form of a new set of policy initiatives known as “macro-prudential regulation.”

Policy makers believe that they have learned from the crisis that macro-prudential policy was a missing ingredient in counter-cyclical policy, and that they should incorporate new macro-prudential tools into the counter-cyclical policy framework. Under Basel III, it has been agreed that countries will expect to vary the minimum capital ratios required of their banks by roughly 2.5 percentage points over the cycle, and that they will do so in response to numerous amorphous criteria, including credit growth, asset price growth, concentrations of risk within the financial system, and other poorly measured and poorly conceived and hard-to-observe phenomena. The general idea is to raise capital requirements on banks when credit growth seems to be overheating, and reduce them when credit supply is anemic. This means that central banks will be wielding a major new cyclical regulatory tool that, among other things, targets credit growth over the cycle.

Bear in mind three facts about macro-prudential policy: (1) The magnitude of macro-prudential policy effects on credit growth are highly uncertain, as little reliable research on this topic has been done to date. (2) The studies that have been done (using the most econometrically revealing examples, namely the experiences of the UK and Spain, along with episodic evidence from Colombia’s experiment with macro-prudential policies implemented in 2008 and a few other less dramatic cases) indicate that the effect of prudential policy changes on bank credit growth can be quite dramatic; indeed, judging from the UK’s experience from 1998 to 2007, changes in capital requirements of, say, one percentage point, can have much larger effects on the supply of bank lending than very large changes in central bank-controlled interest rates.¹ (3) There is no agreed framework for implementing macro-prudential policy changes. That is, there is no agreement about precisely what objectives will motivate policy, what indicators will be relied upon to achieve those objectives, or what changes in capital requirements or other measures will be undertaken in response to changes in those yet-to-be-defined, multiple, and hard-to-observe indicators.

In the presence of this new 800 lb cyclical policy gorilla known as “macro-pru,” how will monetary policy produce predictable consequences for nominal demand over the cycle? How will central banks return to normalcy in their interest rate policies while also varying bank capital ratio requirements to achieve all their various ill-defined policy objectives? Given the uncertainties attendant to this new policy mix, how will central banks make their intentions known to the market, and how will they be held accountable for the consequences of these policy actions?

My answers to these questions are not heartening. The next few years likely will not only witness unpredictable tectonic shifts in regulation, with uncertain consequences for loan supply and inflation, they will also be the testing ground for the new macro-pru framework. Central banks’ macro-pru experiments likely will be major sources of unintended variation in loan supply and

¹See Jimenez, Saurina, Ongena, and Peydro (2011), and Aiyar, Calomiris and Wieladek (2012a, 2012b, 2012c).

nominal demand fluctuations (the opposite outcome to that intended by the architects of macro-pru). And the variation introduced by macro-pru experimentation, alongside the one-time shifts in regulatory structure, will make it harder to track the effects of monetary policy, all of which will make it much harder to formulate rules for monetary policy, or to hold central banks accountable for following (non-existent) rules.

The Way Out

If this dismal forecast is to be avoided, the Fed must prioritize: (1) avoiding the inflationary consequences of its balance sheet expansion, (2) restoring its credibility in targeting inflation, and (3) stabilizing the transmission mechanism of monetary policy by reducing regulatory uncertainties and by restoring the clear connection between current policy statements and market perceptions of its future policies. How can this be achieved? I will confine myself to suggesting five policy changes that would be especially helpful for achieving those objectives.

1. A substantial, phased in increase in banks' reserve requirements held at the Fed (with interest paid on required reserves to avoid further taxing banks) would avoid short-run inflation risk, while also establishing an important and neglected long-term tool for prudential regulation (for more discussion of the neglected importance of cash reserve requirements as a prudential tool, see Calomiris 2012, Calomiris, Heider and Hoerova 2012). Finally, the elimination of the huge amount of current excess reserves would also be helpful in making the effects of Fed interest rate changes more predictable going forward, by reducing the extent of unpredictable change in bank reserves.
2. The Fed should immediately begin raising the fed funds rate, gradually and predictably, make it clear to the market that it is exiting a zero-interest-rate policy regime, and immediately explain to the market what rule it will follow for implementing monetary policy in the future using the fed funds rate. Whatever rule the Fed chooses (whether some sort of Taylor Rule, or some sort of nominal GDP targeting rule, or something else) that rule should be clearly stated. Then, deviations from the rule would be apparent, and would require explicit discussion and justification. This would do much to restore Fed accountability, and therefore, to restore Fed credibility.
3. The Fed should reduce the uncertainty related to Dodd-Frank and other regulatory actions by working with Congress and the Administration to resolve ongoing debates about the proper structure and function of banks, and the structure of the prudential regulatory framework. I emphasize that this is not just a job for the Fed. The U.S. Treasury and Congress must work together to streamline the regulatory framework to achieve reasonable objectives without burdening the financial system and the economy with unnecessary compliance costs and never-ending fundamental uncertainties. A starting point for that effort would be to redesign prudential regulatory policy to make it simpler, more credible, and more effective (Calomiris 2011).

4. The Fed must simplify its monetary policy toolkit. The Fed should immediately cease its purchases of mortgage-backed securities, making clear that this was a crisis-related aberration that it hopes to never repeat. It should also cease its new forward guidance policy of quasi-committing to maintaining quantitative easing or interest rate policies into the distant future. There are reasonable arguments for using forward guidance, especially during a zero-interest-rate policy regime. But the version the Fed has employed has been deeply flawed. The Fed's forward guidance policy attempts to predict the future to an extent that exceeds the foresight of the Fed, or anyone else. Unconditional forward guidance commitments risk either promoting an acceleration of inflation (if the Fed sticks to its quasi-promises) or doing significant additional damage to Fed credibility from not meeting its quasi-promises.
5. The Fed should clarify the implementation of macro-prudential policy in two important ways: limit the ambitions of macro-pru, and make it predictable. Macro-prudential policy should not be a continuously employed tool of counter-cyclical policy. Given the large and uncertain impact of macro-pru, using it that way would add substantial ongoing uncertainty to the credit cycle, and would undermine the stability and predictability of the impact of monetary policy. Furthermore, to ensure accountability in the implementation of macro-pru policy, variation in minimum capital ratio requirements for banks should follow clear rule-based guidelines, so that central banks would have to explain themselves whenever they deviate from those guidelines, just as they would have to explain deviations from their stated monetary policy rule. For example, increases in capital ratio requirements could be linked to observably exceeding a dual-threshold criterion of sufficiently high aggregate bank credit growth and sufficiently high asset price growth over a sufficient period of time. Such a policy would achieve the main objectives of macro-pru policy without disrupting normal monetary policy, and would ensure the accountability of both monetary and macro-pru policy makers. Finally, by making capital requirement changes the predictable consequence of high loan growth, a pre-announced macro-pru policy would encourage banks to increase their capital ratios as the aggregate loan growth trigger point approached, which would reduce the likelihood of tripping the trigger, and avoid the disruptions to the banking system from unpredictable changes in capital requirements.

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