Developing an inclusive approach to Federal Reserve monetary policy

Overview

In the run-up to the financial crisis of 2008, many policy makers and academic economists had a very positive view of U.S. monetary policy. Beginning the in the mid-1980s the behavior of the U.S. macroeconomy appeared to change significantly. Compared to earlier decades, the volatility of GDP growth declined, and price inflation was low. Although trend GDP growth was lower than in earlier decades, it appeared that the real economy had become demonstrably more stable. These changes – dubbed "the Great Moderation" – were often attributed, at least in part, to improved Federal Reserve monetary and stability policy.

In retrospect it is clear that economic changes during the Great Moderation were not limited to reduced GDP volatility and output price stability. During this period there was a significant alteration in the distribution of income and wealth, the stability of the financial system was undermined, and the conditions for a devastating downturn were created.

Average real wages began to lag productivity growth in the mid-80's, and by 2000 median household income stagnated as women's labor force participation ceased to compensate for stagnant wages. As the house price bubble of the 2000's inflated, and household debt expanded dramatically, the largest banks and other important financial institutions provided the credit to sustain the bubble. In the process important banks raised their leverage and risk exposure to fatal levels. When the housing bubble burst and the prices of mortgage-related assets collapsed, the real economy was pushed into a classical liquidity trap and the Great Recession.

Research and Policy Framework

Now is good moment to begin a thoughtful public discussion of the monetary and financial stability policy structure that was developed during the Great Moderation, and which continues to inform Fed policy as the economy works its way out of the Great Recession. Examples of questions that deserve a more thorough examination include:

1. To what extent -- through a progressively altered "Taylor Rule", which sets a Fed interest rate target on the basis of deviations from an inflation target, and on the size of the real output gap – has Fed monetary policy focused increasingly on the control of inflation, and less on unemployment?
2. To what extent has a focus on inflation contributed to weak cyclical recoveries, and to the decreasing income gains for the bottom 90% of households during Great Moderation cyclical expansions?
3. What is the overall empirical and theoretical case for the Great Moderation monetary policy regime? What are the policy alternatives?
4. What was the contribution of the Fed's stability and monetary policy to the current "balance sheet recession", which has forced the Fed to push policy rates to the zero lower bound?

5. Are the Fed's post-crisis changes to bank regulation sufficient to prevent balance sheet recessions in the future, and assure that monetary policy can be used effectively to counteract downturns?
6. Should the major Fed monetary and stability goals be redefined in light of the events we have witnessed during the Great Moderation and the Great Recession?
7. Do we need changes to Federal Reserve structure or governance to achieve an effective more inclusive policy goals?

Work Strategy

CAP will approach these and related policy questions by hiring an economist with significant expertise to lead our work in this area. That person will be supported by the full range of our research, government relations, and media resources. Our ultimate goal is to enable our economic policy team to develop thoughtful, well-articulated policy positions that are widely disseminated and influential with the Fed, Congress, the Administration, academics, policy analysts, and the public generally.

We will start our work with a process that increases our connections to established experts, and allows us to learn the lay of the land efficiently. We will begin by holding convenings -- either in the form of private roundtables, or public panels and discussions – of academics, policy makers, and other experts. At these convenings we can raise issues that we think are relevant, and learn from people who are well-informed. We might, for example, hold convenings on topics such as:

- What are the strengths and weaknesses of policy-making governed by a Taylor Rule?
- What are the implications of an expanded shadow banking system for monetary policy?
- What is the relationship between monetary policy, asset bubbles, and longer-term economic stability?

As we hold these convenings, and get more deeply into our own research, CAP will publish policy work designed to define and influence the ongoing debate. This might include an evaluation of the effects Taylor-rule policy on cyclical expansions and income distribution, with recommendations for changes in how this policy is implemented, or changes to the policy goals themselves; a discussion of whether the Fed should become the "dealer of last resort" for financial institutions who will not pay for this form of insurance, and over whom the Fed has limited control, together with proposals for effective change; a discussion of how monetary and stability policy need to be adjusted and coordinated to guide a macroeconomy that is characterized by secular stagnation.

We also will find opportunities to have CAP experts testify before relevant Congressional committees, engage with the Fed, the OCC, the FDIC and FSOC, and reach out to print, radio and television outlets to promote our views.

Our ability to produce and advocate for sophisticated policy on a consistent basis will make it easier for progressive groups and politicians to push more or less in the same direction. While there is continuing interest in these issues, progressive focus tends to be reactive, or limited to a subset of issues. In addition, a sustained effort to advocate progressive ideas will make it easier for elite thinkers to consider and adopt them.

We will use CAP's existing system of internal metrics to track our progress in this endeavor. We will look for impact on policy (e.g. changes to agency or Fed rules, inclusion in legislation affecting banking regulation), on the policy debate (e.g. inclusion in the positions taken by important financial regulators), and on other organizations (e.g. adoption of our positions by other progressive organizations). Using this information we will over time adapt to increase our effectiveness in this policy space.