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Guest editor's introduction: What monetary policy can and cannot do

Daniel L. Thornton

Federal Reserve Bank, Research and Public Information, 308 Valparaiso Ct., St. Louis, MO 63088, United States

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ABSTRACT

This introduction briefly discusses each of the 10 papers that make up the special issue of the Journal. Specifically, I briefly describe each paper and, when appropriate, I add my own critique. I hope you find these papers as interesting and informative as I have.

When I was asked if I would like to guest edit an issue of the *Journal*, I responded with an enthusiastic, Yes! I suggested that the issue address the question of what monetary policy can and cannot do. In contrast with what appears to be conventional wisdom, I have long been skeptical of the power of monetary policy to affect output, and especially employment, in the way the standard new Keynesian models, or other similar models suggest. Indeed, I had just published a paper in the *Journal* titled, Monetary Policy: why money matters (and interest rates don't), arguing: (i) monetary policy (specifically, money) is critical for determining inflation, (ii) the Fed cannot control interest rates using open market operations, and (iii) the Keynesian circa the 1960s–70s were correct—interests are a relatively unimportant determinant of investment or consumer spending. I was hoping to receive papers that addressed what I consider to be basic fundamental issues about monetary policy's effectiveness: the interest sensitivity of spending, the extent to which the Fed can control interest rates (open market versus open mouth operations), the existence of aggregate supply or aggregate demand, the Phillips curve, etc. The only papers that strictly satisfy this criterion are the comments by James Lothian and Michele Boldrin on the lead article by Glenn Rudebusch and John Williams. Nevertheless, the special issue contains contributions that make interesting and important contributions to understanding of the effectiveness of monetary policy.

I put the paper by Glenn Rudebusch and John Williams as the lead article because the authors are directly connected to U.S. monetary policy and because the paper is motivated by Yellen's suggestions that (i) long-term unemployment remains relevant of assessing slack in the economy and (ii) full employment also takes into account discouraged job-seekers and

E-mail address: dan@dlthornton.com

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part-time employees who would prefer to have full-time jobs. The paper is important if, for no other reason, it is likely to excite some discussion about the extent to which policy can affect the unemployment rate.[1] Their analysis is motivated by the observation that long-term unemployment has been uncharacteristically high during the recent expansion. Hence, they address the question: How does long-term employment affect the optimal monetary policy response? Based on their model, they conclude that optimal policy should trade off a transitory period of excessive inflation (beyond what the standard model would suggest) in order to bring broader measures of underemployment to normal levels more quickly. The motivation and the model are presented clearly and they do an empirical analysis using data over the period 1960Q1 through 2013Q4. They find that the optimal inflation rate should be about 50 to 70 basis points higher relative to their baseline model. They characterize increase as "quantitatively important."

The paper is interesting, but the reader should be cautioned that the equations that are fundamental to the model's conclusions are motivated by statistical regularities, not be economics. Michele Boldrin discusses this aspect of the paper in more detail, but does not explicit discuss a feature of these models that I find particularly perplexing. Namely, the fact that these models critically depend on the assumption that investment and consumer spending is highly sensitive to the level of real interest rate, when a large volume of empirical and survey evidence suggests that the opposite is true—investment and consumer spending are only marginally affected by changes in interest rates. Moreover, the large increase in long-term unemployment following 2007–09 recession is likely due in large part to the collapse of construction. A large number of construction workers were more or less permanently displaced and the transition other employment takes time. Furthermore, given the argument that the recent increase in long-term unemployment is uncharacteristically large, I am not certain why I should believe that parameter estimates that are based largely on data prior to the 2007–2009 recession can provide useful information how policy should react to this event. In any event, particularly interesting is the fact that Rudebusch and Williams' analysis implies a quicker and larger response of the federal funds rate relative to the baseline model, but that either model would have policymaker increasing the funds rate sooner and to a much higher than it is now—in a range of 3–4%. Hence, whatever usefulness for policymaking the model might have, it is clear that the FOMC did follow the models' recommendations. If it had, the funds rate would be in the range of 3–4% by now.

James Lothian comments on the Rudebusch and Williams' paper. He questions whether policymaker's knowledge of the dynamics linking monetary policy, inflation and real growth are sufficient to make Rudebusch and Williams implementable. Conducting his own analysis, and citing the work of others, he concludes that while there is generally a negative relationship between inflation and unemployment, "it does not appear to be reliable enough for policy makers to use…" He then addresses the tradeoff between inflation volatility and output volatility and finds it to be positive and temporally stable and suggests that for this relationship the causation runs from money to the economy, rather than the other way around.

Michele Boldrin also questions the dynamic linkages of the model. Specifically, he suggests that they are several questionable assertions in the sequence of arguments that generate Rudebusch and William's model. Important among these are the model's assumption of a stable Phillips curve, the assertion that long-term unemployment affects wages less than short-term unemployment, and the model's bi-polar causal chain. Boldrin notes that the Fed's "Dual Mandate" did not spring for "political wishful thinking," but rather from a "deeply-rooted model of the world that has dominated policy-making circles (almost) worldwide since the end of World War II" which Rudebusch and William's take for granted. He notes that their model and all other such models depends critically on the belief that there is a causal relation between employment and inflation that goes from inflation to output to employment that has virtually no empirical support. He goes on to discuss three other reasons that such models should not be used to guide real-world policymaking

The remaining seven papers deal with monetary policy in the wake of the financial crisis. Five papers are empirical; two are models. The paper by Durre and Beaupain investigates how one of the European Central Bank's (ECB's) unconventional measures—the fixed-rate full-allotment (FRFA)—affected the trading volume, rate volatility, and liquidity of the interbank money market. Their methodology is consists of a vector auto regression (VAR) of excess liquidity and five variables that reflect the volume, volatility, depth, liquidity risk, and resiliency of the interbank market. They conclude that while this measure provided "liquidity insurance" precisely when it appeared that banks were "hoarding" liquidity, banks' large holdings of excess liquidity reduced the ECB's ability to control the dynamics of the market; specifically, it reduced trading volume and increased the volatility of interest rates.

The paper by Gibson, Hall, and Tavlas also investigates the effects of the ECB's unconventional measures; namely, the ECB's asset purchase program from 2009 to 2012. Specifically, they look at the effect of the ECB's Securities Market Program (SMP) and its two Covered Bond Purchase Programs (CBPPs) on sovereign bond spreads and covered-bond prices for Greece, Ireland, Italy, Portugal and Spain. Their methodology consists of linear cross-section regression of the five sovereign's bond yields relative to Germany's and a vector of "weakly exogenous" fixed effects that capture idiosyncratic country features, and economic and other variables, such as bond ratings and fiscal news. Instead of using dummy variable to represent these purchase programs, as is commonly done, they have access to confidential data on the actual amounts of covered bonds and sovereign bonds purchased. They find that the ECB's programs had and modest effect on covered-bond prices sovereign

[1] I argued elsewhere (Thornton, 2013) that the FOMC's December 2012 decision to tie its exit from the zero interest rate policy to the unemployment rate was a bad idea. I suggested that policy actions should never be subject to something that the FOMC has little control over, noting that the then observed decline in the unemployment rate was largely due to a decline in labor force participation; not to a large increase in employment. The labor force participation rate continued to decline uncharacteristically causing the unemployment rate to reach the threshold level much more quick than the FOMC had anticipated. The FOMC was forced to remove the threshold, which it did at its March 2014 meeting.