Failure to Be Boring

By Steven J. Davis

“Become as boring a public figure as possible.” Such was Greg Mankiw’s sincere advice to new Fed Chairman Ben Bernanke in early 2006. Not long after, the Global Financial Crisis of 2007-09 cast an intense spotlight on Bernanke and other central bankers. Bernanke became, if not a rock star, a man widely seen as one of the most consequential policy makers in decades.

The Fed took extraordinary and unprecedented actions to contain the financial crisis and its effects. Five years on, the Fed carries a much bigger toolbox than before the GFC and a hugely expanded balance sheet. Last May, bond yields in emerging-market economies jumped in response to a mere hint the Fed might taper the pace of its bond purchases sooner than previously anticipated. Around the world, financial market participants parse every statement by senior Fed officials for clues about the direction of U.S. monetary policy. Not exactly boring stuff.

The failure to be boring extends beyond the Fed. European Central Bank President Mario Draghi is widely credited with saving the Euro by forcefully declaring his intention to “do whatever it takes.” Chicago Booth Professor Raghu Rajan, now serving as Governor of the Reserve Bank of India, conducts monetary policy in a highly challenging economic and political environment while drawing favorable comparisons to James Bond!
The Global Financial Crisis (GFC) compelled central bankers to revisit an old question: What is the proper role of monetary policy in securing financial stability? That question was front and center at the Asian Monetary Policy Forum (AMPF), held in Singapore on 24 May. In an excellent opening speech at the AMPF, Ravi Menon, Monetary Authority of Singapore Managing Director, reviews current thinking on the conduct of monetary policy in relation to financial stability.

The pre-GFC approach to monetary policy involved several well-understood elements: an independent central bank, price stability as the chief policy goal, and the use of a short-term interest rate as the main policy instrument. The Fed and many other central banks also applied monetary policy to dampen fluctuations in the pace of output growth.

In practice, the behavior of the Fed’s policy interest rate was well characterized by a Taylor Rule. Viewed as a prescriptive device, the Taylor Rule provides quantitative guidance for adjusting the policy rate as a function of the gap between potential and actual GDP and the deviation of inflation from its long-run target. To be sure, the precise recipe for monetary policy differed among leading central banks, but the core ingredients had become remarkably widespread. Boring monetary policy appeared to be a goal within reach.

We know now that things did not work out that way, and the goal receded – perhaps for many years to come.

As Menon explains in his speech, the crisis delivered two harsh lessons. First, macroeconomic stability – defined as stable inflation and sustainable output growth – does not ensure financial stability. Second, the prudential supervision of
individual financial institutions is no guarantee against a dangerous buildup of systemic financial risks, with potentially disastrous consequences. These lessons prompted central bankers and outside observers to reconsider the role of monetary policy, and central banking more broadly, in securing financial stability. That reconsideration virtually ensures that monetary policy will fail to be boring for some time to come.

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