Design and Implementation of Monetary Policy Frameworks in ASEAN Countries

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Keynote Address²

High-Level Peer-to-Peer Forum
Monetary Policy in ASEAN-5
Indonesia, Philippines, Singapore Thailand and Vietnam
Organized by IMF’s Institute of Capacity Development and Asia-Pacific Department, and the Monetary Authority of Singapore

July 10, 2018

It is a pleasure to address this audience which has the important responsibility for designing and implementing monetary policy in this crucial part of the world. In this talk I would like to discuss the design of modern monetary policy frameworks at central banks such as those that are part of the Association of Southeast Asian Nations (ASEAN) and are attending this conference. I also consider the recent challenges of implementing such frameworks with an emphasis on international issues in the integrated global economy, especially in the upcoming years during which a global monetary policy “normalization” is underway.

The talk begins with a brief description of what is meant by a monetary policy framework and considers empirical evidence which shows the benefits of such a policy framework that have been revealed as countries moved toward such a rules-based framework. It then considers how policy again deviated from such a framework in many countries starting about a dozen years ago, as deviations from actions in the advanced countries spread internationally. I make the case for a return to rules-based global monetary framework in which each country designs and implement its own rules-based monetary framework.

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² This is a written version of a speech to be given in Singapore on July 10.
Rules-Based Monetary Policy Frameworks

At its most basic level a monetary policy framework consists of a goal for monetary policy, such as stability of the inflation rate or real GDP, and a policy for setting the instruments of monetary policy to achieve this goal. This general approach characterizes research on monetary policy for many years, at least since the 1970s. It is common in such research to specify a loss or utility function which depends directly or indirectly on the fluctuations of inflation around a target and fluctuations of real GDP from a given full employment level. The connection between the policy instrument and the policy goal is of course important and can be represented by a quantitative economic model, such as those used by researchers at the IMF and most central banks.

The policy problem is to find a good procedure to use to set the monetary policy instrument—usually the money supply or the short-term interest rate—to best achieve this goal. In most cases, research has focused on finding a transparent rule or systemic approach to setting the policy instrument as a function of variables on the economy which can be communicated broadly both domestically and internationally. It is thus effectively a rules-based monetary policy framework.

A very important practical example of such a monetary policy framework is inflation targeting, which has been used for nearly three decades in one form or another at emerging market and developed market central banks. Chile was one of the first emerging-market adopters of inflation targeting back in 1990, and it is useful to consider their experience. Jose De Gregorio (2014), who served as governor of the Central Bank of Chile from 2007 to 2011 and thus during the Global Financial Crisis, puts it this way: “The inflation target is an efficient framework to conduct monetary policy. The issue then is how to operationalize this framework. When should
monetary policy be tightened or loosened? The most traditional answer is the Taylor rule” or, more generally, as further explained in Central Bank of Chile (2007), “a policy rule that associates the policy rate with the gap between projected and target inflation, and the output gap.” I should also note that I have had the opportunity over the years to speak either as an academic or policy official at central banks in emerging market countries in Asia, Latin America, and Africa on this connection between inflation targeting and monetary policy rules and some of these speeches have been written up, for example, in Taylor (2000a, 2000b, 2001, 2006, 2014a, 2014b).

In practice, inflation targeting has not been “strict.” Again, to quote from the Central Bank of Chile: “Under inflation targeting, the fundamental goal of monetary policy is price stability,” but “given that the economy’s position in the cycle determines short- and medium-term inflation…monetary policy can help to reduce the volatility of inflation and output.” Thus, in practice the goal is represented as a tradeoff curve between the variance of inflation around a target and the variance of real GDP around its potential, as shown in Taylor (1979). Part of the job of monetary policy is to choose a point on that curve.

Much empirical work shows that the experience with a rules-based monetary policy framework has been very good, with early evidence in the United States provided by Clarida, Gali and Gertler (2000), with more recent U.S. evidence provided by Nikolsko-Rzhevskyy, Papell, and Prodan (2014), and with recent international evidence provided by Teryoshin (2017). Bernanke (2004) illustrated the better policy and better performance in the United States in the 1980s and 1990s compared with the late 1960s and 1970s using a tradeoff curve. I replicate the diagram used by Bernanke (2004) by the black shaded lines and axes in Figure 1. He showed that as the Fed moved to a more rules-based monetary policy framework (from A to B), economic
performance improved without any movement in the Taylor Curve (TC) from TC\textsubscript{1} to TC\textsubscript{2}. I have added the red lines to the diagram and will come back to those later in the talk.

Figure 1

Experience in ASEAN Countries Since the Asian Financial Crisis

But most relevant to this Forum is the ASEAN countries’ experience with moving toward a monetary policy framework, frequently with inflation targeting, following the Asian Financial Crisis of the late 1990s. As demonstrated by the International Monetary Fund’s recent ASEAN Cluster Report (2016), the switch was from monetary policies which had created inconsistencies between a fixed or very inflexible exchange rates and increasing inflation, and thereby had allowed pressures to build which eventually caused the crisis. In contrast, “Monetary policy frameworks of the ASEAN-5 economies have on the whole performed well since the AFC, delivering both price and financial stability during a period of significant domestic and regional transformation, and global macroeconomic and financial turmoil.”
The Asian Financial Crisis hit ASEAN countries such as Thailand, Malaysia, and Indonesia very hard. The crisis was evident in Thailand in the spring of 1997 and by the end of the year had spread. In 1998 real GDP declined by 10 percent in Thailand, 7 percent in Malaysia, and 13 percent in Indonesia. Though the rebound from the crisis was very fast in 1999, economic growth did not return to pre-crisis levels on a sustained basis until much later.

Although there are debates over the reasons for these crises, overvalued exchange rates and loans with currency mismatches were clearly key factors. In the years preceding the crisis, each of these countries was using either a fixed exchange rate or a crawling peg, while inflation at home was exceeding inflation abroad. Hence, the real exchange rate became overvalued, and trade deficits were becoming large and persistent. A depreciation seemed to be needed to bring the exchange rates back in line, and market pressures began to build. The pressures could be resisted for a while by central bank interventions, but eventually the currencies depreciated substantially. The sharp depreciations then led to other problems. Banks had borrowed heavily from abroad to finance loans to domestic corporations. Many of these loans were in foreign currencies and the devaluation raised the amount of local currency earnings need to service the loans. The result was that many firms failed, and banks became insolvent.

The crisis seemed to hit one country after the other in rapid fashion. In May 1997 the Thai Baht came under significant pressure. At first the government tried to defend the Baht through exchange market intervention and through jaw-boning by government officials. But by July the Baht was devalued. Soon thereafter the Malaysian currency was under attack; again, for a while the central bank tried to defend the currency, but eventually it was devalued. Late in the summer the Indonesian currency came under attack. It too was devalued.
The experience of the crisis changed monetary policy for the better as improved monetary policy frameworks were adopted. Thailand switched to a more flexible exchange rate system combined with inflation targeting, and other countries endeavored to do the same.

Many Challenges

Of course, many complications arise in implementing such monetary frameworks in practice. There is great deal of uncertainty about the models that connect the instrument to the goal variables, but such uncertainty is common to all economic policy. It can be handled by adjusting the size of the responses, and by being transparent that there is such uncertainty.

In smaller open economies the exchange rate is a very important part of the impact of monetary policy, and this may affect the correct degree of responsiveness of the instrument to the exchange rate or other variables. For example, in the meetings leading up to this Forum, some asked about the difficulties of both achieving exchange rate stability and meeting an inflation objective. I think that the goal of an inflation target, by reducing exchange rate pass through, has taken away some of the fear of floating and has made it easier to deal with both goals. In other words, a monetary policy framework with inflation targeting reduces exchange rate instability and makes it easier to deal with. In some cases, it may be desirable to have a single currency, which means monetary policy and central banks are merged; but the same monetary policy framework can be adopted by the combined central bank, as in the case of the European Central Bank.

In recent years the issue of forward guidance—or announcements about the policy instrument in the future—has arisen sometimes in response to constraints on current instrument settings, such as an effective lower bound. Forward guidance can be handled within a rules-based
monetary policy framework by specifying that the same policy rule will be followed in the future.

Other challenges arise in the broader economic policy context. Different objectives may come into play in practice, including income distribution or international competitiveness. And central banks may be urged to implement non-monetary instruments, such as credit allocation, and add such instruments to their toolkit. It is operationally and politically important for central banks to remain limited purpose institutions, focused on the stated goals in their monetary policy framework. But the central bank may not be sufficiently independent from politics to make the tough tradeoff decisions implicit in the framework. This is another reason why having a transparent framework is so important. In fact, central banks can work well with different degrees of independence and one has seen big variations in the quality of monetary policy even with the same degree of de jure independence. In other words monetary policy frameworks work.

**New Challenges from the Global Financial Crisis to Global Normalization**

During the last dozen years, however, a new challenge has arisen. The challenge is stated clearly in the IMF’s ASEAN Cluster Report (2016): “The explicit or implicit inflation targeting frameworks put in place post-AFC have served the ASEAN-5 economies well as in other emerging market economies (EMEs), but they faced new challenges. In the wake of the global financial crisis (GFC), many EMEs found the monetary policy of “center” countries imperfectly calibrated, and in many cases out of sync, to their own domestic macroeconomic and financial stability conditions and other concerns. EMEs’ central banks—including the ASEAN-5’s—were therefore compelled to adapt their policy framework and toolkits in order to strengthen policy autonomy and mitigate risks” This is the challenge I now want to address.
To understand the challenge, it is helpful to examine how interest rate decisions made at different central banks around the world have become interrelated and highly correlated in recent years. Figure 2 from Bank for International Settlements (BIS) illustrates this.

![Figure 2](image)

**Figure 2.** Source: Updates of Hofmann and Bogdanova (2012) by Boris Hofmann of the Bank for International Settlements

The chart on the left includes both advanced countries and emerging market countries, and the chart on the right includes emerging market countries only. The emerging market economies are the ASEAN countries Indonesia, Malaysia, the Philippines, Singapore, and Thailand, as well as Argentina, Brazil, Chile, China, Chinese Taipei, Colombia, the Czech Republic, Hong Kong, Hungary, India, Israel, Korea, Mexico, Peru, Poland, and South Africa. The global group also includes Australia, Canada, Denmark, the Euro area, Japan, New Zealand, Norway, Sweden, Switzerland, the United Kingdom and the United States.

The “policy rate” is the weighted average of policy interest rate for each group. The Taylor rates are given by $i = r^* + \pi^* + 1.5(\pi - \pi^*) + 0.5y$, where $\pi$ is a measure of inflation, $y$ is a measure of the output gap, $\pi^*$ is the inflation target and $r^*$ is the long-run real interest rate, here
proxied by real trend output growth. The “mean Taylor rate” is the average of a “range of Taylor rates” created with four different measures of inflation and the output gap. This is, of course, a way to characterize the outcome of a rules-based monetary policy framework, and it is consistent with inflation targeting. The Taylor rates are calculated based on weighted averages of the respective inflation and output gap measure for the two country groups.

Figure 2 shows that the interest rate decisions and the interest rates implied by the policy rule were similar in the 1990s, and up until somewhere around 2003. But in the following years—the years leading up to the Global Financial Crisis—there was a large deviation: the policy rule in many central banks called for a higher policy interest rate than the actual decisions. When the Global Financial Crisis and the Great Recession came, central banks lowered their interest rates in accordance with such rules.

Starting soon after the crisis, many again began to deviate from rules-based policy, and that deviation continued throughout most of the post crisis years. Thus, the chart reveals that many central banks throughout the world—including in the emerging markets—have deviated in much the same way from this representative monetary policy rule for the interest rate.

Figure 3 shows the Fed. The graph uses the same BIS approach as in Figure 2, and the pattern is much the same. The Federal fund rate starts to deviate from the rules-based policy around 2002, gets close again during the crisis, and deviates again. During the past year and a half, the policy rate has begun to move up.
Figure 3

I have argued that the deviation from rules-based policy in 2003-2005 resulted in poorer economic performance. To illustrate this, I add the point C and the red arrow showing the movement toward it in Figure 1 which otherwise is a replica of the chart used in Bernanke (2004). Clearly the red arrow shows an increase in the volatility of output associated with the Global Financial Crisis.

My empirical research found that this policy shift was a significant cause of this change in performance, though regulatory policy, which failed to enforce or overlooked existing rules, was also a problem. The empirical evidence is based on a comparison of monetary policy decisions in the 1980s and 1990s with those leading up to the crisis, especially in the years 2003-2005. Examining the deviation of policy from a monetary policy rule that worked well during the Great Moderation is one way to do this, but there are other ways.

Figures 4 through 8 show the data for some of the ASEAN countries: Thailand, Philippines, Singapore, Indonesia, and Malaysia, all central banks that are part of the average of Figure 2. Though there are many differences between the countries, the facts of the deviation...
since the Global Financial Crisis are clear. Often there is a deviation that began just before the Global Financial Crisis, followed by a rule-like reduction in the policy rate during the crisis, and then a period after the crisis when the rate is “too low” again. Of course, there are exceptions, such as in Malaysia where the interest rate apparently reflects exchange rate concerns, in Indonesia during the Asian Financial crisis when the policy rate got very high, and in Singapore where the exchange rate policy requires a close correlation with the dollar interest rate. Nevertheless, the overall characterization of the data is clear: The averages and the individual country data throughout ASEAN region reveal correlated deviations of central bank interest rate from the policy rule for the interest rate in the years since the Global Financial Crisis.

Figure 4
One reason for the correlations is that central banks tend to follow each other in setting interest rates. Central banks follow each other, in part, because they are concerned about exchange rate appreciation: if a large foreign central bank cuts its interest rate by an unusual amount, then the home currency will tend to appreciate unless the home central bank adjusts its own interest rate down. The appreciation could have a negative effect on exports and the economy.

This rationale is evident in the IMF’s GPM6 model as shown in the simulations in Figure 9 which plots the impact of a deviation of the interest rate in the United States below the policy rule for the Fed; the impact on output in the Asian emerging market countries (and in Latin American countries) shown in Figure 9b is the opposite sign of the output effect in United States shown in Figure 9a. For each percentage point monetary policy-induced change in output in the United States, output changes by .13 percentage points in the opposite direction in the emerging Asian countries, which includes the ASEAN countries of Indonesia, Thailand, Philippines, Singapore, and Malaysia, as well as China, India, South Korea, Taiwan, and Hong Kong. It changes by .25 percentage points in the opposite direction in the Latin American countries. As described by the authors of the IMF’s GPM6 model, this occurs in these countries because “the exchange rate channel is stronger than the direct output gap effect.”
These actions and reactions can occur in reverse if a large central bank increases its interest rate. Then capital tends to flow out of the other countries, depreciating their exchange rates and bringing about a central bank reaction that raises their interest rate. However, central banks might worry less about a depreciation of their exchange rate than an appreciation, which would impart a bias toward lower interest rates internationally. Moreover, with more than one
central bank reacting to each other, this type of deviation in interest rate policy can multiply as it spreads from one country to another and back-and-forth.

Many empirical studies show that deviations from domestic policy rules are directly tied to interest rate changes in other countries. This evidence is usually based on estimated policy rules in which one can detect the response of the interest rate in one country to changes in interest rates in another country. He and McCauley (2013) examined monetary policy frameworks in the ASEAN countries of Indonesia, Malaysia, Philippines, and Thailand, (as well as in China, Korea, Taiwan, and India); they found that “controlling for domestic inflation, output gaps and the nominal effective exchange rate, foreign interest rates have a substantial if uneven effect on domestic monetary settings in East Asia.” The coefficient was .77 in the Philippines equation.

There is much more econometric evidence cited in the references in Taylor (2018b) which provides more background information. I included the U.S. federal funds rate in an estimated interest rate policy rule for the European Central Bank, during the period from 2001 to 2006. I found that the foreign interest rate was statistically significant. There is direct evidence from those making decisions at central banks that this type of interest rate policy spillover is influenced by exchange rate concerns. Central bankers often admit to these reactions. The Norges Bank, for example, transparently provides a great deal of detail about interest rate decisions and the rationale for them. The policy interest rate decisions at the Norges Bank have been adjusted roughly in tandem with the interest rate decisions in the ECB in order to reduce the size of fluctuations in the exchange rate. The Norges Bank compares its interest rate setting to

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3 That forthcoming book also considers balance sheet policy as well as interest rate policy in small open economics with empirical evidence from the Swiss National Bank.
several policy rules. These comparisons show that deviations of the actual policy rate below the domestic monetary policy rule (such as the Taylor rule) were almost entirely due to the very low interest rate abroad. Their research also shows that a policy rule with the external interest rate included comes much closer to describing the policy actions than the policy rules without external interest rates.

**Alternative Explanations for the Correlations**

The patterns in Figure 2 may be due to some common economic factors which drove interest rate decisions away from more rules-based policies at many central banks. If so, then the correlation may not reflect a contagion of policy, but rather a reaction to these common factors or a common assessment of other factors.

To the extent that common factors are part of the policy rule used in each country, then the factors are already taken account in Figure 2, and thus do not constitute and “alternative” explanation for the global deviation from rule-like behavior. For example, as shown in Figure 1, the interest rate fell sharply in most countries during the commonly-felt decline in real GDP and inflation at the time of the Global Financial Crisis. But that effect is already in the policy rules and the weighted average policy rule because output and inflation in each country are in the rules used by the BIS in its analysis. That common factor caused policy to be closer to rule like behavior: The policy rule line and the policy rate line moved back in alignment during the crisis. That rule-like behavior was observed at most central banks throughout the world at that time.

Perhaps the most widely discussed common factor in the past few years has been a decline in the so-called “equilibrium real interest rate,” designated as $r^*$ in this talk. If a policy
rule does not include a change in \( r^* \), and policy makers adjust their interest rate because they observe or perceive a change in \( r^* \), then a deviation of policy from the rule will occur.

However, for the rules calculated in Figure 2 through 8 changes in \( r^* \) are built into the policy rule at each central bank because the \( r^* \) term in the policy rule moves. The procedure is to model changes \( r^* \) by changes in trend real output growth. Thus, movements in \( r^* \) translate into movements in the policy rate given by the policy rule, not into deviations of the actual interest rate and the policy rate. It may be that the movements in \( r^* \) as seen by central banks are not described well by this method.

That economic shocks have become more globally synchronized over time is also an alternative explanation for the global deviation shown in Figure 2. But if those shocks are included in the policy rules of the various countries—as shocks to real GDP, inflation, and the equilibrium real interest rate are—then the increased synchronization would not lead to increased deviations from policy rules.

Yet another possibility is that there was a spread of a view among central bankers around the world starting around 2003 that deviations from policy rules are appropriate. For example, the decision by the Fed to deviate in 2003-2005 from the type of policy rule that it followed in the previous two decades may have been discussed in international central bank fora and found appealing at other central banks and their research departments. I do not know of evidence for this occurring before the financial crisis, and indeed the general move then toward more-rules based inflation targeting in many emerging markets seems to go in the opposite direction during this period.

In addition to changing the interest rate, central banks engaged in other actions aimed at preventing an appreciation of their currency. In recent years there have been increases in
restrictions on capital flows or some form of temporary “macro-prudential” action aimed at reducing the attractiveness of international investment in their country. As explained by Ghosh, Ostry, and Qureshi (2017), around 2010 several countries were “re-imposing capital controls to stem inflows in the wake of historically unprecedented accommodative monetary policies of the US Federal Reserve (later joined by the European Central Bank and the Bank of Japan). Capital controls, a long-forgotten subject in academia and a taboo among mainstream policy circles, were back in the limelight….After a remarkable internal effort at consensus building” at the IMF during which many papers were written and seminars were held, a “compromise was hammered out” in the form of the Institutional View at the IMF.

However, as discussed in Taylor (2018a), these capital controls can have adverse effects. Moreover, having recognized that the source of the increased volatility of capital flows is the advanced country central banks, the Institutional View effectively takes these actions as given and proceeds to develop a tool kit for emerging market economies to use to limit the flows into and out of their countries.

**A Rules-Based International Monetary Framework**

The main policy implication of the analysis is that we should find a rules-based international monetary framework without international contagion and other potentially harmful interventions. A practical approach would be for each central bank to describe and commit to a monetary policy rule or strategy for setting the policy instruments. The rules-based commitments would remove some of the reasons why central banks have followed each other in recent years. Because each central bank would know what other central banks are doing, they will not need to guess one another’s behavior and try to make ad hoc adjustments. For example, if the Fed lowers
its interest rate for reasons that are clearly part of a strategy, other central banks can properly
adjust their interest rate according their own strategy without deviating from the strategy. By
transparently reporting their monetary policy strategies, central banks would automatically create
a global system that works well, at least according to economic history and economic models.

The strategy in each country could include a specific inflation target, a list of key
variables to react to in certain specified ways, and an estimate of the equilibrium interest rate $r^*$
using, for example, the method employed by the Bank for International Settlements in Figure 2.
The process would not impinge on other countries’ monetary strategies. It would be a flexible
exchange rate system, though currency zones, like the Eurozone, and their central banks could
certainly be part of it.

Such a system would pose no threat to either the national or international independence
of central banks. Each central bank would formulate and describe its strategy. Central banks
participating in the process would not have a say in the strategies of other central banks, other
than that the strategies be reported. And the strategies could be changed or deviated from if the
world changed or if there was an emergency. An agreed-to procedure for describing the change
and the reasons for it would be useful. It is possible that some central banks will include foreign
interest rates in the list of variables they react to, so long as it is transparently described. But
when they see other central banks not doing so, they will likely do less of it, recognizing the
amplification effects. The agreement would be completely global, rather than for a small group
of countries. As with the process that led to the Bretton Woods system it could begin informally
with a small group and then spread out.
Many have called for reforms of the international monetary system, reflecting concerns about instabilities, international policy spillovers, volatile capital flows, and poor economic performance. So, the time might be right for reform.

Many central banks now have explicit inflation goals, and they use policy rules that describe strategies for the policy instruments. Thus, explicit statements about policy goals and strategies to achieve these goals are feasible. That there is wide agreement that some form of international reform is needed would help move the implementation along.

The biggest hurdle to an agreement is a disparity of views about the problem and the solution. Some are not convinced of the importance of rules-based monetary policy; others may doubt that it would deal with the problems of volatile exchange rates and capital flows. Some believe that the competitive depreciations of recent years are simply part of a necessary process of world monetary policy easing.

Earlier research, such as in Taylor (1985), helps address such concerns. This research shows that there would be little additional gain from the central banks jointly optimizing their policies. In other words, the “Nash equilibrium,” in which each country chose its monetary strategy taking as given other countries’ strategies, is nearly optimal, or nearly an internationally cooperative equilibrium.

**Minimizing the Costs and Maximizing the Benefits of Global Normalization**

A prerequisite for this reform would be for the global international monetary system to normalize. Getting back to a balance sheet with a level of reserves close to the normal level observed before the crisis will require that the Fed and other large central banks gradually reduce their securities holdings.
It is also essential that the normalization be predictable and strategic, so as not to cause international market turbulence. That lesson was learned from the “taper tantrum” in 2013, when Federal Reserve Chair Ben Bernanke indicated it might be in “the next few meetings” that the size of the purchases of securities would diminish, and market turbulence increased for a while. As soon as the tapering strategy was announced in advance and thus became more predictable, the markets digested it very easily. In this way, the costs of normalization can be minimized and likely be much less than the benefits.

The Fed’s recent policy is consistent with this approach. In the “Addendum to the Policy Normalization Principles and Plans” issued in 2017 the FOMC said it intends to gradually reduce the Fed's securities holdings by decreasing its reinvestment of principal payments to the extent that they exceed gradually rising caps. In many ways, the Fed has begun to bring policy back to a rules-based monetary policy framework as it emphasizes a strategy and the use of monetary policy rules. On January 18 of last year, former Chair Janet Yellen described the Fed’s strategy for the policy instruments, saying that “When the economy is weak…we encourage spending and investing by pushing short-term interest rates lower….when the economy is threatening to push inflation too high down the road, we increase interest rates…” In a speech the following day, she compared this strategy with the Taylor rule and other rules, and she explained the differences.

On February 11 of last year, former Vice-Chair Stanley Fischer gave a talk with a similar message, comparing actual policy with monetary rules and explaining how rules-based analyses feed into FOMC discussions to arrive at policy decisions. And on July 7 of last year, the Fed added, for the first time ever, a whole new section on “Monetary Policy Rules and Their Role in the Federal Reserve’s Policy Process” in its Monetary Policy Report. It noted that “key
principles of good monetary policy” are incorporated into policy rules. It listed specific policy rules, including the Taylor rule and variations on that rule. It showed that the interest rate was too low for too long in the 2003-2005 period according to the Taylor rule. It showed that, according to three of the rules, the current fed funds rate should be moving up.

This year the Fed, now with new Chair Jerome Powell, again included a whole section on policy rules in its latest Monetary Policy Report, elaborating on last July’s Report and thus indicating that the new approach will continue. On February 27 and March 1 of this year, in his first testimony in the House and Senate as Fed Chair, Jerome Powell referred explicitly to making monetary policy with policy rules. He said that “In evaluating the stance of monetary policy, the FOMC routinely consults monetary policy rules that connect prescriptions for the policy rate with variables associated with our mandated objectives. Personally, I find these rule prescriptions helpful. Careful judgments are required about the measurement of the variables used, as well as about the implications of the many issues these rules do not take into account. I would like to note that this Monetary Policy Report provides further discussion of monetary policy rules and their role in the Federal Reserve’s policy process, extending the analysis we introduced in July.” This emphasis on rules and strategy did not go unnoticed by those who follow policy: As Larry Kudlow put it before he became director of the National Economic Council: “I’ve never seen that in any testimony before….and I think that’s progress.”

On March 8 of this year, the Fed posted a new web site on the principles of sound monetary policy, Monetary Policy Principles and Practice, with a very helpful note on Policy Rules and How Policymakers Use Them. These reforms represent substantial progress.
Conclusion

It is important to point out that the general issues I raise in this talk are not new. Although the technical issues and governance challenges are different as technology has developed and markets have globalized, recent discussions of issues and problems in the international monetary system are analogous to the discussions and debates about exchange rates and capital flows that occurred many decades ago. Milton Friedman argued that monetary policy factors were the cause of the exchange rate and capital flow volatility while many others argued that destabilizing speculation was the cause. For Friedman, the answer was an open international monetary system with monetary policy rules and flexible exchange rates; this system would lead to both less volatility of capital flows and more stable exchange rates. For others, the answer was limits on exchange rate fluctuations and controls on capital flows.

The use of macroprudential policy and capital controls has been intensified in recent years in part because of the unconventional policies. After the return to normal and other reforms to create a more resilient financial system, there will be little or no need for such interventions. As shown in Taylor (1985) a high degree of capital mobility need not interfere with good monetary policy frameworks.

Most important for this ASEAN Forum is that such an international reform does not require discarding rules-based monetary policy frameworks or inflation targeting in each country. Rather it means being more transparent about the framework and about how such country frameworks combine to form an international rules-based monetary policy framework.
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