What Should the Federal Reserve Do Next?

Editor's note: A prolonged period of near-zero interest rates and unprecedented asset purchases by the Federal Reserve has failed to return the U.S. economy to robust growth or make an appreciable dent in unemployment. It is now commonly asserted that the Fed is "out of ammunition." Is it? We asked six authorities on monetary policy what the Fed should do next.

Return to Rule-Based Policy
By John B. Taylor

To establish Fed policy going forward, the best place to start is to consider what has worked in the past. During the two decades before the recent financial crisis, the Fed employed a reasonably rule-based strategy for adjusting the money supply and the interest rate. The interest rate rose by predictable amounts when inflation increased, and it fell by predictable amounts during recessions.

Economists cite the Taylor rule—which says that the Fed's target interest rate should be one-and-a-half times the inflation rate, plus one-half times the shortfall of GDP from potential plus one—as evidence that this approach worked. Performance was good during the 1980s and 1990s when policy was close to the rule. And it was poor when policy was far away from the rule, as it was during the 1970s and the Great Depression.

Unfortunately, leading up to and during the recent crisis, the Fed deviated from this framework. It held interest rates too low for too long from 2002 to 2005, and after the crisis began to flare up in 2007 it engaged in massive discretionary credit operations. While some actions helped halt the panic in the fall of 2008, others, like the unpredictable on-again off-again bailouts, brought it on and left a legacy of uncertainty that's holding back recovery now.

So the answer to the question is simple: Get back to the rule-based policy that was working before the crisis. To get there without causing more market disruption, announce and follow a clear exit rule, in which the Fed's bloated balance sheet is gradually pared back by predictable amounts as the economic recovery picks up.

Such a policy would be a much better stimulus than another large dose of quantitative easing in which the Fed's balance sheet explodes even further, raising more uncertainty about how it will ever be unwound. A rules-based monetary policy could also serve as a model for fiscal policy—an area where increased predictability and certainty are sorely needed.

Mr. Taylor, a professor of economics at Stanford and a fellow at the Hoover Institution, is the author of "Getting Off Track: How Government Actions and Interventions Caused, Prolonged and Worsened the Financial Crisis" (Hoover Press, 2009).