How Can the Fed Best Achieve Its Goals Using Available Instruments?

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Outline

- In what ways have the Fed's policy frameworks been obstacles to using its available instruments to achieve its goals?

- What are the resulting implications for how the Fed can improve its framework?

    - Throughout, my analysis will rely heavily on research conducted with Christina Romer.

The Recent Episode

Our Question

- How, if at all, did each of the new elements of the framework adopted in August 2020 contribute to the Fed's slow response to inflation?
- We address this question by looking at what monetary policymakers said about why they were waiting: FOMC statements and minutes, Fed Chair speeches and testimonies, and speeches by other key Fed officials.

Two Obvious Suspects That Played Little or No Role

- #1: Asymmetric flexible average inflation targeting (FAIT).
- The reason it played little role: Policymakers saw quickly that average inflation by reasonable measures was over 2%; and they expected inflation to return to 2% from above, not to fall below.
- Thus they didn’t see FAIT (or cite it) as a reason to hold off.

Two Obvious Suspects That Played Little or No Role (cont.)

- #2: The switch from “deviations” to “shortfalls” in describing when departures from maximum employment would prompt a monetary policy response.

- The reason it played little role: Policymakers never thought employment was above its maximum level.

The Two Less Obvious Suspects That Did Play Important Roles

- #1: Strengthening and elevation of the maximum employment goal.
- Strengthening: Interpretation of maximum employment shifted from a normal, natural, sustainable level toward a hot labor market.
- Elevation:
  - Reversal of the order in which price stability and maximum employment were discussed.
  - The forward guidance implementing the framework made maximum employment a stand-alone goal that needed to be met before rates were raised.

Reinterpretation of Maximum Employment

"our revised statement emphasizes that maximum employment is a broad-based and inclusive goal. This change reflects our appreciation for the benefits of a strong labor market, particularly for many in low- and moderate-income communities."

Powell speech, August 27, 2020.

"This sizzling hot labor market …."

"With the unemployment rate back to very low pre-pandemic levels, and a variety of indicators showing the labor market is very strong, maximum employment has been achieved."

Williams speech, May 5, 2022.

Maximum Employment as a Stand-Alone Goal

"The Committee decided to keep the target range for the federal funds rate at 0 to 1/4 percent and expects it will be appropriate to maintain this target range until labor market conditions have reached levels consistent with the Committee's assessments of maximum employment and inflation has risen to 2 percent and is on track to moderately exceed 2 percent for some time."

FOMC Statement, September 20–21, 2020.

Impact on Policy

"Participants pointed to a number of signs that the U.S. labor market was very tight, including near-record rates of quits and job vacancies, as well as a notable pickup in wage growth. … [T]he Committee expected that it would be appropriate to maintain the current target range of 0 to ¼ percent until labor market conditions had reached levels consistent with the Committee's assessments of maximum employment."

FOMC Minutes, December 14–15, 2021.

The Two Less Obvious Suspects That Did Play Important Roles (cont.)

- #2: Move away from forward-looking policy.

Policy Was to Depend on Actual Outcomes

"The Committee decided to keep the target range for the federal funds rate at 0 to 1/4 percent and expects it will be appropriate to maintain this target range until labor market conditions have reached levels consistent with the Committee's assessments of maximum employment and inflation has risen to 2 percent and is on track to moderately exceed 2 percent for some time."

FOMC Statement, September 20–21, 2020.

"Participants … noted that the existing outcome-based guidance implied that [policy] would depend on actual progress toward reaching the Committee's maximum-employment and inflation goals. In particular, some participants emphasized that an important feature of the outcome-based guidance was that policy would be set based on observed progress toward the Committee's goals, not on uncertain economic forecasts."

FOMC Minutes, April 27–28, 2021.

Table 1. Economic projections of Federal Reserve Board members and Federal Reserve Bank presidents, under their individual assumptions of projected appropriate monetary policy, September 2021

Percent

Variable	Median[1]				
	2021	2022	2023	2024	Longer run
Change in real GDP	5.9	3.8	2.5	2.0	1.8
June projection	7.0	3.3	2.4		1.8
Unemployment rate	4.8	3.8	3.5	3.5	4.0
June projection	4.5	3.8	3.5		4.0
PCE inflation	4.2	2.2	2.2	2.1	2.0
June projection	3.4	2.1	2.2		2.0
Core PCE inflation[4]	3.7	2.3	2.2	2.1	
June projection	3.0	2.1	2.1		
Memo: Projected appropriate policy path					
Federal funds rate	0.1	0.3	1.0	1.8	2.5
June projection	0.1	0.1	0.6		2.5

Projection Materials, September 21–22, 2021.

Previous Episodes

Two Sets of Features of the Fed's Frameworks That Have Been Obstacles to Using Its Available Instruments to Achieve Its Goals in Earlier Episodes

- #1: Features that led it to aim for a hot labor market.

Table 1. Outcomes of Episodes When the Federal Reserve Staff Projected a Hot Labor Market

Period	*Undesirable macroeconomic outcome*
1967–1970	Inflation
1972–1973	Inflation
1978	Inflation
1988	Inflation
1996–2000	Dot-com boom and bust
2017–2018	None

Source: Authors' compilations.

Note: The periods shown are times when the Federal Reserve staff projected average unemployment over the coming four quarters at least 0.5 percentage points below their estimate of the natural rate.

Source: Romer and Romer (forthcoming).

Two Sets of Features of the Fed's Frameworks That Have Been Obstacles to Using Its Available Instruments to Achieve Its Goals (cont.)

- #2: Features that led it to use its tools cautiously (or not at all).
- Especially:
  - The Great Depression.
  - The Great Inflation.
  - The recovery from the Great Recession.

IMPLICATIONS FOR IMPROVING THE FRAMEWORK

Interpret Maximum Employment as Corresponding to the Best Available Evidence of the Normal Long-Run Equilibrium of the Labor Market

- “best available evidence”—that is, realistic, but not cautious or pessimistic.

Respond to Departures in Either Direction of Employment from Maximum

- Times when the Fed thought its policies were likely to lead to above-maximum employment have generally not ended well.

- See Kiley (2024) for additional evidence.

- Closely related: Don’t require that one side of the dual mandate be fully achieved before attention is paid to the other.

Fully Embrace Forward-Looking and Preemptive Policy

- Decisions should be based on the best available information about likely conditions when policy actions have their effects.

Make Clear That an Important Part of the Framework Is Forcefully Using All Relevant Tools in Pursuit of the Goals

Maintain Asymmetric Flexible Average Inflation Targeting

- It didn’t contribute to the delay in the recent episode.
- It addresses important issues.
- But, tie it explicitly to the lower bound on interest rates.

CONCLUSION