Maximum Employment and the Federal Reserve's Monetary Policy Strategy

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Shadow Open Market Committee

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The Fed’s legislative monetary policy mandate

The Board of Governors of the Federal Reserve System and the Federal Open Market Committee shall maintain long run growth of the monetary and credit aggregates commensurate with the economy’s long run potential to increase production, so as to promote effectively the goals of **maximum employment**, **stable prices**, and **moderate long-term interest rates**.

12 U.S. Code § 225a

Consensus Statement on maximum employment

The maximum level of employment is largely determined by nonmonetary factors that affect the structure and dynamics of the labor market. These factors may change over time and may not be directly measurable. Consequently, it would not be appropriate to specify a fixed goal for employment; rather, the Committee's policy decisions must be informed by assessments of the maximum level of employment, recognizing that such assessments are necessarily uncertain and subject to revision.

There are two ways to interpret this description of "maximum employment":

1. The employment corresponding to the natural rate of output in standard models
2. The employment corresponding to the non-accelerating inflation rate of unemployment (NAIRU), that is, a slowly moving trend variable, perhaps corresponding to the longer-run expected value of unemployment rate

Woodford on the natural rate

"The level of output that *would* occur in an equilibrium with flexible wages and prices, given current real factors (tastes, technology, government purchases)—what is called the "natural rate" of output, following Friedman (1968)—turns out to be a highly useful concept,...

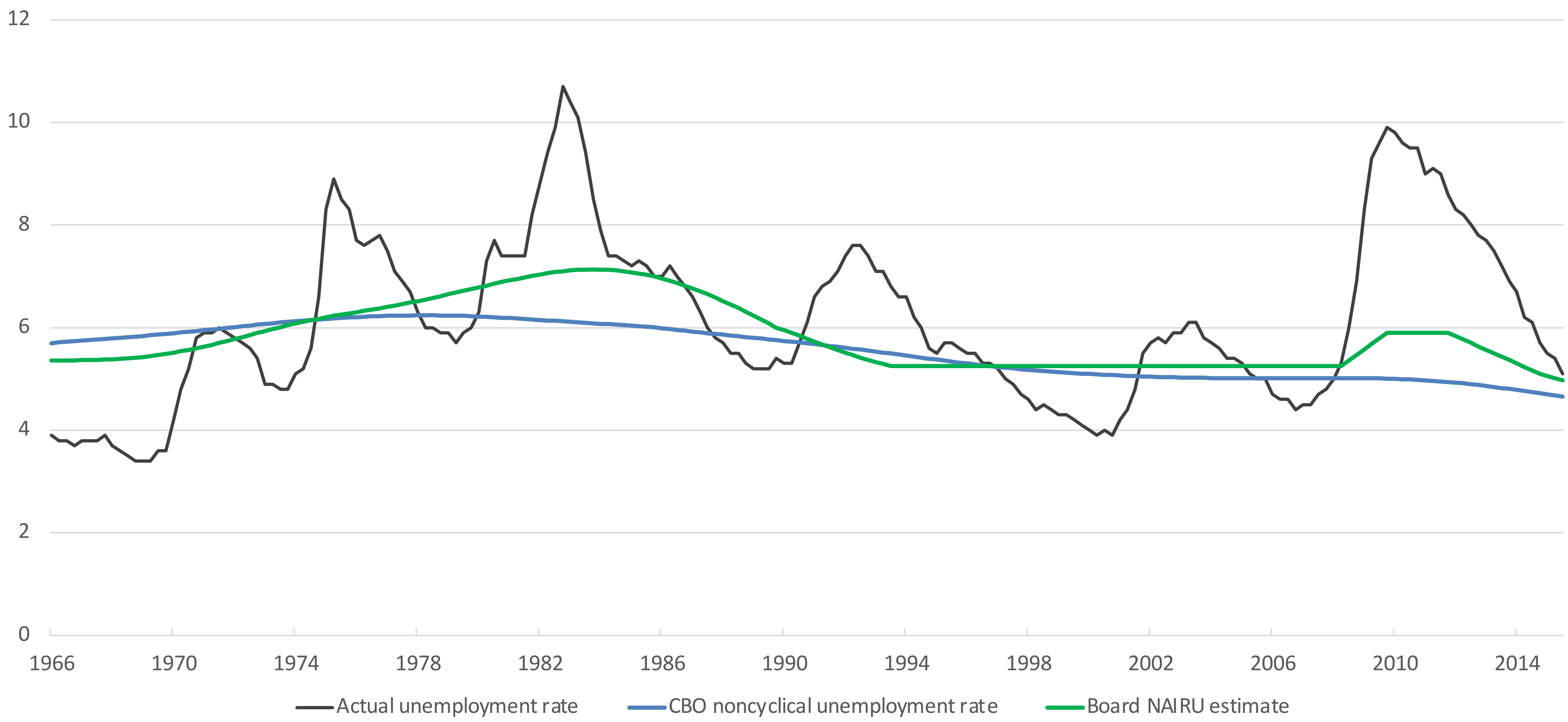
It is the gap between actual output and this natural rate,… that is:

- related to inflation dynamics in a properly specified Phillips-curve relation;…
- to which interest rates should respond if a "Taylor rule" is to be a successful approach to inflation stabilization;…
- that monetary policy should aim to stabilize in order to maximize household welfare;…
- and to which optimal interest rate rules and/or optimal inflation targets should respond….

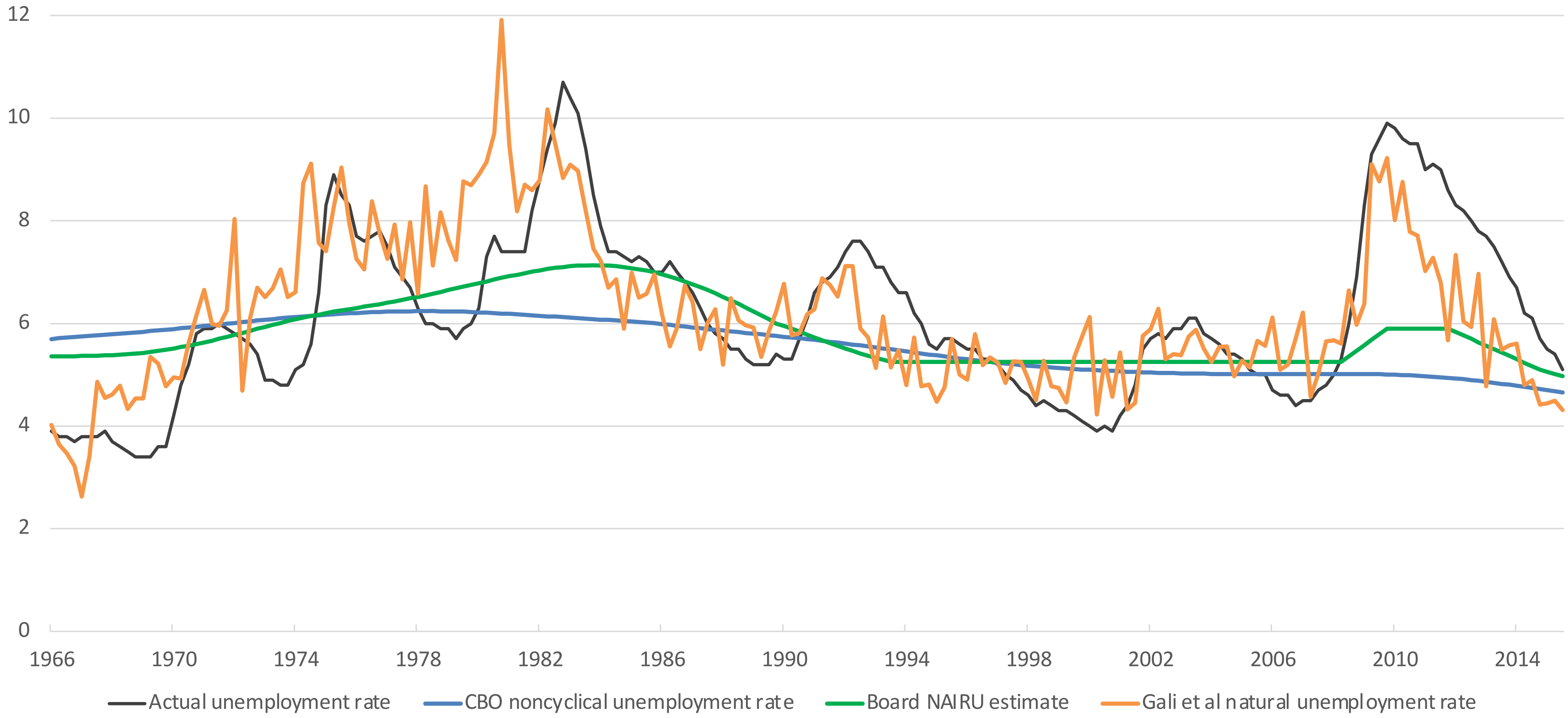
From the point of view of any of these applications, the fact that the natural rate of output may vary at business cycle frequencies, as argued in the RBC literature, is of tremendous practical importance."

Woodford, Michael. 2003. *Interest and Prices: Foundations of a Theory of Monetary Policy*. Princeton, N.J.: Princeton University Press. Pp. 8-9.

Actual unemployment rate and two NAIRUs



Actual unemployment rate, two NAIRUs and a natural rate



Exegesis: 2012 Consensus statement

P Source

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G Source

The Committee considers a wide range of indicators in making these assessments and information about Committee participants' estimates of the longer-run normal rates of output growth and unemployment is published four times per year in the FOMC's Summary of Economic Projections. For example, in the most recent projections, FOMC participants' estimates of the longer-run normal rate of unemployment had a central tendency of 5.2 percent to 6.0 percent, roughly unchanged from last January but substantially higher than the corresponding interval several years earlier.

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2020 Revision: Maximum employment first

P source

The maximum level of employment a broad and inclusive goal that is not directly measured and changes over time owing ~~is~~ largely to ~~determined by~~ nonmonetary factors that affect the structure and dynamics of the labor market. ~~These factors may change over time and may not be directly measurable.~~ Consequently, it would not be appropriate to specify a fixed goal for employment; rather, the Committee's policy decisions must be informed by assessments of ~~the~~ shortfalls ~~maximum level~~ of employment from its maximum level, recognizing that such assessments are necessarily uncertain and subject to revision.

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2020 Statement tilted toward employment mandate

- Maximum employment goal: "broad and inclusive" – "shortfalls" not deviations
- Make-up strategy: asymmetric average inflation target that tolerates overshooting
- Implementation tilted further toward employment goal
  - Forward guidance promised no interest rate increases until maximum employment achieved
  - *Assumed NAIRU-type interpretation of maximum employment*
  - *Relied heavily on ability to estimate maximum employment*
  - *Discounted possibility of higher short-run maximum employment*
- Framework and its implementation contributed to mistakes of 2021-22
- **Fundamental problem was the mistaken notion of maximum employment**
  - June 2021: Core PCE inflation 4.3%, UER 5.9%, SEP Longer-run UER 4.0%,
  - Taking SEP LR UER as "maximum employment" suggested "shortfalls"
  - View that actual UER was close to the natural rate and output was close to natural output was apparently discounted

Looking ahead

- Current review should correct widely cited shortcomings of 2020 revisions
  - Remove asymmetric make-up strategy, tolerating inflation overshooting
  - Restore pre-emptive policy options
- Should push ahead to a better-grounded and more humble treatment of maximum employment
  - Explicitly recognize difference between longer-run and near-term maximum employment
  - Emphasize variability in near-term maximum employment, particularly how it may fall below longer-term maximum employment
  - Say more about what maximum employment is
    - For example: "highest level that does not generate sustained inflation pressures"
  - Don't pretend to have too much quantitative information about maximum employment
  - Strengthen the emphasis on the asymmetry between inflation and employment mandate

  → ***"Price stability is the best contribution monetary policy can make to maximum employment over time"***