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The Murky Future of Monetary Policy

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The Murky Future of Monetary Policy

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The Federal Reserve first published a "Statement on Longer-run Goals and Monetary Policy Strategy" in January 2012. The purpose was to enhance transparency and accountability by clarifying its interpretation of the statutory mandates established by Congress. The two key elements of that effort were to formally establish a 2% longer-run inflation target as being consistent with its price stability mandate and to stress that it was not appropriate to establish a quantitative target for maximum employment as it was not directly observable and was influenced by many factors unrelated to monetary policy. This document was frequently referred to by the Fed as the "consensus statement."

During the ensuing eight years the economy continued its recovery from the 2008-2009 recession. The unemployment rate fell to a 50-year low of 3.5 percent prior to the pandemic and government shutdowns. The inflation rate remained modestly below the Fed's adopted inflation target, averaging about 1.4 percent over the 2012-2019 period. In response to mounting concerns about low inflation and monetary policy challenges arising from the effective-lower-bound (ELB), the Fed announced in November of 2018 its intention to review the "strategies, tools, and communication practices it uses to pursue its congressionally-assigned mandates." [2]

The result of this review was revealed in a revised "Statement on Longer-Run Goals and Monetary Policy Strategy" released in August 2020.[3] An explanation and rationale was provided by Fed Chair Jerome Powell at the Federal Reserve Bank of Kansas City's annual Jackson Hole symposium.[4] The revised policy document makes some significant changes to the Fed's interpretation of its statutory dual mandates, elevating and broadening its interpretation of the maximum employment mandate and adding greater complexity that leads to excessive flexibility to its interpretation of the inflation, or price stability, objective.

In our view, the consequences are likely to be a more discretionary and less predictable or systematic approach to monetary policymaking. Attempts to address its broadened mandate for employment,

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[2] Board of Governors (2018).
[3] Board of Governors (2020).
[4] Powell (2020).

which the Fed acknowledges is beyond the scope of monetary policy, could further undermine the Fed's accountability and invite greater politicization, further eroding its independence. The new flexible and asymmetric average inflation targeting framework adds confusion and lacks clarity. The Fed does not provide a strategy for how to raise inflation or a guideline for how it will respond when inflation rises above 2 percent. As economic performance gets back to normal, this will add confusion to financial markets and challenge the Fed's communications and transparency as well as its credibility. We elaborate on these themes below.

The New Perspective on Price Stability

The January 2012 consensus statement was important because it established a specific quantitative target for inflation. The Fed was explicit in saying that an inflation rate of 2 percent was most consistent with its statutory mandate. Moreover, it was symmetric in that whether inflation was running below or above 2 percent, the Fed made clear that it would seek to return to 2 percent in an effort to maintain or anchor long-run expectations firmly at the target. The Fed chose this single numeric mandate because it had the advantage of being a simple, clear and precise long-term commitment. It was easily communicated and widely understood. Since the 2012 consensus statement, inflation has persisted modestly below 2 percent but most measures of inflationary expectations have remained well anchored near 2 percent.

While the Fed acknowledges that the sub-2 percent inflation has not harmed economic performance, a major concern is that sustained sub-2 percent inflation could result in a downward spiral in inflationary expectations. The Fed is concerned that lower inflation expectations lowers the nominal interest such that encounters with the ELB would become more frequent, complicating the task of monetary policy. The Fed's aversion to adopting a negative policy rate and its concern that quantitative easing (QE) may be less effective than it had previously thought underline its concerns and its search for an alternative approach.

In response to these concerns, the Fed's new policy framework seeks to establish a form of average-inflation targeting (AIT), which is similar to a form of price-level targeting (PLT). The key difference in AIT from the prior inflation-targeting (IT) framework is that to achieve an average inflation rate goal policy must make-up for below average outcomes and above average outcomes to maintain the average. That is, IT lets bygones-be-bygones, whereas AIT anticipates a make-up strategy. But as discussed below, the Fed's credibility to manage inflationary expectations is critical to the success both in its ability to raise inflation and the sought after benefits when operating at the ELB. This credibility is presumed in the rationale for new framework, even though the Fed never explains why its monetary policies have failed to achieve its 2 percent inflation target and has not articulated its strategy for how it will raise inflation.

The new policy framework that attempts to address the Fed's concerns muddles the picture. It establishes a flexible average inflation target (FAIT) that is asymmetric around 2 percent. The messaging retains the view that 2 percent inflation is consistent with its price stability mandate, and stresses that it seeks an "average" inflation rate of 2 percent rather than a target. But the Fed complicates its inflation objective and the task at hand in several ways. First, it states that if inflation has been running below 2 percent for some time, the Fed will take action to achieve inflation above 2 percent for some time to keep inflation expectations from falling and help re-establish the average inflation objective. Such a "make-up" strategy, of course, is implicit in an averaging concept.

Yet the Fed explicitly, and presumably intentionally, does not specify how much undershooting or overshooting in terms of length of time or magnitude would trigger a monetary policy response. The phrase "for some time" instead of "temporarily" adds uncertainty and confusion. Without clearer quantitative guidelines for its make-up strategy, the Fed provides insufficient information about its intermediate-term goals and when it will react to movements in inflation. This may undercut the Fed's ability to manage inflationary expectations. For example, if the Fed measures the shortfall since January 2012, four years of 3 percent inflation would lift average inflation to 2 percent during 2012-2024. Of course, it would take longer if the inflation rate rose to only 2.5 percent. The desired path of inflation in a make-up strategy would be different if the Fed used a rolling window. Would the Fed allow 2.5 percent or 3 percent inflation for several years? Financial markets can only guess. This new flexible inflation averaging is too flexible and too discretionary for efficiently and credibly managing inflationary expectations. Without clearer guidance, the Fed seemingly is de-anchoring itself from its 2 percent target. In one sense, the strategy outlined by the Fed suggests the 2 percent average inflation rate is closer to a floor than a goal.

The second problematic feature of the new framework is that the make-up strategy will be asymmetric. The Fed conveys the message is that it will make-up for shortfalls of inflation but makes no mention of a response to over-shoots. One can infer from Powell's remarks that this framing was intentional and is to be interpreted as an asymmetric policy. This is troubling, as it is hard to see how such an asymmetric approach can result in an average inflation of 2 percent over the longer term. This approach would more likely result in average inflation and inflation expectations above 2 percent, especially if there were shocks that drove inflation higher than anticipated for a period of time. If such movements were not offset by a monetary policy response, or lacked a make-up strategy, average inflation would drift above 2 percent. For this reason, Powell stresses in his speech that the "average" inflation goal is flexible and not to be construed in terms of some "mathematical formula that defines the average," and Vice Chair Richard Clarida said "inflation that averages 2 percent over time represents an *ex ante* aspiration."[5]

The asymmetry of the framework suggests that the Fed is unconcerned about the possibility that elevated inflation for the intermediate term required by the make-up strategy might lead to an unexpected increase in longer-term expectations. This is especially relevant if the Fed's commitment to 2 percent is not fully credible. Will the Fed be able or willing to bring inflation and expectations back down in a timely way even if the make-up is incomplete? The behavior of the FOMC when, and if, inflation rises above two percent will be a real test for the policy, particularly if inflation comes sooner rather than later and lasts longer than anticipated. This strategy of fine-tuning or managing a varying inflation target and varying inflation expectations in such a controlled manner seems overly complex and likely difficult to execute with any confidence.

As indicated earlier, the Fed sees two related reasons for the desirability of the make-up strategy. The first stems from the concern that a sustained period of below 2 percent inflation risks dragging down inflation expectations through some self-fulfilling mechanism that could be harmful and this might be a

[5] Clarida (2020).

consequence of the ELB.[6] This has certainly not been the case in recent years when inflation has been modestly but persistently below 2 percent while most measures of expected inflation have remained adequately anchored. This should not be interpreted as a license to accept inflation outcomes that persistently and significantly depart from target. The Fed's biggest concern should be that failing to return inflation closer to 2 percent risks harming its credibility. Yet the Fed's new framework seems to argue that the solution is to promise higher inflation without an assessment of the tools at their disposal that can make that promise credible.

The second reason why the Fed does not want expected inflation to fall is that it would imply a lower equilibrium nominal short-term rate that would push it closer to the ELB and reduce the Fed's flexibility to respond to an economic downturn. As mentioned earlier, in some models, when monetary policymakers are confronted with the ELB, monetary policy might be able to increase current demand by promising more inflation and a booming economy in the future. This "lower for longer" strategy aimed at lifting inflationary expectations might provide the Fed a way of offsetting the perceived constraint of the ELB.[7] But the efficacy of such a strategy assumes the Fed has complete credibility to achieve its goals and the commitment to follow through regardless of future conditions.

Nevertheless, while credibility is essential, implementing this basic approach to confront the ELB does not require an asymmetric strategy. A symmetric strategy could accomplish much the same thing with less complexity and more transparency. A PLT could work as well. Why make policy more complex when credibility and commitment are so important to its success?[8]

The strategy the Fed seems to want to pursue, although it does not say so in a straight-forward manner, is a form of regime switching approach to monetary policy, where the make-up strategy is only applied after the ELB has actually been binding and not at other times.[9] If the Fed has this in mind, it should be more forthcoming and describe its approach. The challenges would be formidable and much the same as have been highlighted. In it, the Fed would be seeking to raise expectations above 2 percent for some period of time to offset the shortfalls of inflation that occurred during the binding constraint of the ELB. Because the Fed's objective would be to credibly manage inflationary expectations, it would need to develop guidelines that would signal under what circumstances and how policy would respond. Communicating this time varying approach to inflation and inflation expectations and securing the credibility and commitment to make it successful seems quite difficult.

Interestingly, the Fed's emphasis on asymmetry of the strategy may prove highly risky. The Fed policymakers are essentially saying that they are worried about their credibility on the downside, but are denying or ignoring the possibility that their credibility could be tested on the upside as well. They do so without any explanation or evidence why such asymmetry is desirable or justified. The Fed needs to be

[6] Of course, this is not the only possible explanation for falling inflation expectations. A neo-Fisherian view of the nominal interest rate might suggest that over the longer run a monetary policy that keeps interest rates very low for a prolonged period may drive the economy into an equilibrium with a much lower inflation rate and thus much lower inflation expectations.

[7] See Reifschneider and Williams (2000) for example. There are other suggestions for addressing the ELB issues including raising the inflation target (although it seems that the proposed new framework has an element of this embedded in it) or the use of negative rates as employed by several other countries.

[8] For example, see Plosser (2019) for further discussion.

[9] Such an approach, sometimes referred to a temporary price level targeting regime, has been suggested by Bernanke (2017).

more transparent and more careful not to over-promise, whether it is in terms of its ability to fine-tune inflation or inflation expectations, the real economy or labor markets.

In any case, the success of the Fed's new strategy framework depends on its credible management of inflationary expectations, yet the Fed has never explained why its monetary policies have fallen short, if only modestly, of its 2 percent target. Why did nearly 8 years of a near-zero Federal funds rate target and trillions of dollars of quantitative easing fail to boost inflation to 2 percent? What is the Fed's strategy for actually achieving its make-up strategy? Would several trillion dollars more of asset purchases and excess bank reserves raise inflation? Would it take 10 years of a zero funds rate target to ensure a rise in inflation?

The Fed's review was lacking a thorough assessment of its tools and operating regime and how they should be integrated into its new framework. The Fed has made major changes to its operating framework since 2009. It pays interest on reserves to member banks and its large scale asset purchases have decimated the traditional federal funds market and ballooned the Fed's balance sheet, but continues to argue that the funds rate is its primary instrument. It has also changed capital requirements, leverage ratios and other regulations. These elements of the Fed's monetary policy framework and tools deserve close attention alongside the Fed's focus on expectations and credibility.

Broadening the Employment Mandate

The Fed's January 2012 consensus statement emphasized that the maximum employment objective cannot be defined by a numeric target, and that employment is affected by an array of non-monetary factors. The Fed's view on this has not changed: Powell has emphasized the important roles of education and skills training, health, and fiscal policy on employment. We would add the impact of labor regulations and other factors on employment. Yet the Fed's new framework involves two important changes that broaden its economic objectives and expands the scope for monetary policy considerations further beyond its capabilities.

First, the Fed emphasizes that it will assess the employment mandate in terms of the "shortfall" from maximum employment. Second, the Fed has broadened its mandate to "maximum inclusive employment", a term that has been emphasized by Chair Powell and other Fed policymakers. In practice, the Fed has most often communicated its assessment of the labor market in terms of the unemployment rate relative to some perspective on the unobservable normal or "natural" rate (so-called U*) and the trend in wages. This approach, for better or, mostly, worse, had a long history and meshed with the Fed's reliance on the Phillips Curve as the central link between monetary policy, inflation and the labor market. (More on this below.)

"Shortfall" introduces asymmetry into the Fed's employment mandate. The focus on shortfall suggests that the Fed places a higher priority on employment that is shy of some unmeasurable maximum, which suggests a tilt toward monetary ease. The problem is that it will always be easy to argue, and some surely will, that employment could always be higher. The Fed has not offered much guidance as to how it will assess labor markets as they pertain to monetary policy actions. Maximum employment is determined by demographics and productivity, and labor regulations, health and pension policies that influence the supply and demand for labor. How will the Fed interpret trends in employment-topopulation ratios, participation rates and demographics? What is the mechanism by which monetary policy can shape those outcomes? These raise both strategic and communication challenges for the Fed.

The revised policy framework interprets maximum employment mandate to mean "maximum inclusive employment." Promoting an inclusive labor market for all citizens is an important and desirable feature of an efficient market economy. Lifting permanent employment of under-privileged and minority citizens would enhance economic performance and lift potential growth. Yet monetary policy is not an appropriate or effective policy tool for achieving such an objective. The Fed acknowledges its limited scope in maximizing inclusive employment. From a monetary policy standpoint, it is therefore inappropriate for the Fed to acknowledge the array of non-monetary factors that determine maximum employment—and the special challenges that face the under-privileged—and then to proceed to incorporate explicitly them into its policy framework. Doing so gives the impression that the Fed's monetary policy can effectively address these laudable objectives. This may seem smart politically, and Members of Congress applaud the Fed's reference to maximum inclusive employment, but it seems unwise in terms of misleading what monetary policy is capable of achieving and the realities of economic policymaking.

The result of the Fed broadening and elevating the employment mandate is to deepen the quagmire that the dual mandate imposes on the Fed. The statement is inviting the public and the politicians to hold it accountable for goals it cannot achieve. This risks undermining its credibility and its political independence. The Fed should provide guidance to Congress on the capabilities and limitations of monetary policy, and the important role of other policy tools. The Fed's new policy statement further blurs those lines of responsibility.

Abandoning the Phillips Curve?

For years, as the unemployment rate came down but inflation did not rise. The Fed's standard response was the Phillips Curve was flatter than had been presumed. This was an *ex post* rationale for why inflation stayed low, but did not provide any insight into the true sources of inflation or the inflation process. The Phillips Curve was an empirical finding that described the 1960s, but it is flawed analytically and it has not been a reliable predictor of inflation in the last fifty years. In recent decades, as the Fed has grudgingly acknowledged the unreliability the Phillips curve as a predictor of inflation or the mechanism it uses to implement stabilization policy. Yet, its only response has been to heightened the role of inflationary expectations in the inflation process.

It is wise that Fed Chair Powell and other members have finally acknowledged that the Phillips Curve framework is flawed. But while taking this step, the Fed has not replaced the Phillips Curve with any framework or model for predicting inflation. This was reinforced by Fed Vice Chair Clarida, who recently discussed the unreliability of the Phillips Curve and the inaccuracy of macro models based on it, but did he not offer any new line of thought about what causes inflation or how to predict it. The Fed has clearly described the important role of expectations, but has not mentioned nominal GDP or excess aggregate demand as sources of inflation, nor has it mentioned money supply.

The Fed's acknowledgment that the Phillips Curve is flat has led to the change in its new Strategy statement that now emphasizes "shortfalls of employment from the Committee's assessment of its maximum level" rather than "deviations", with important implications for monetary policy. Clarida stated that a robust jobs markets and low unemployment "in the absence of evidence that price inflation is running or is likely to run persistently above mandated-consistent levels…will not, under out new framework, be a sufficient trigger for policy action". According to Clarida, "This is a robust evolution in the Federal Reserve's policy framework". While the precise wording about inflation leaves flexibility for interpretation, this seems to imply, and financial market participants and commentators have widely perceived, that the Fed has raised the hurdle for preemptive monetary tightening. If so, such a shift would replace a decades-long framework of "leaning against the wind," and seemingly runs counter to the assigned importance of managing inflationary expectations. But the missing link is the absence of any clear framework or model for forecasting inflation. It also would seem to ignore the Fed's recognition that monetary policy works with lags and the evidence that once established can becostly to bring down. Downgrading its pre-emptive monetary tightening tool without a clear understanding of the inflation process and lags between monetary policy and inflation seems risky.

Communications

The lack of clarity in the Fed's new policy framework, with asymmetric and undefined goals for both employment and inflation, will generate communications problems. Conveying the Fed's assessment of inflationary expectations, which play a heightened role, will be difficult. The Fed will be looking to markets for indicators of expectations, while the markets will be seeking advice from the Fed. This new strategy further heightens the Fed's unhealthy relationship with financial markets.[10] Some of the difficulties in communications have already begun to arise. While the FOMC voted unanimously in support of the new Strategy Statement, two members dissented at the September meeting, both expressing different interpretations of the Fed's forward guidance and flexibility under the new strategy. During the post-meeting meeting press conference, Chair Powell's response to journalists' questions about inflation, economic and labor market conditions echoed the Fed's old Phillips Curve framework. In the absence of an alternative explanation of the inflation process, the Fed's communications will be muddled.

The new strategy also adds complications and uncertainties to the Fed's quarterly economic projections. The Fed states clearly that its projections are not forecasts, rather compilations of projections of FOMC members based on each member's assumption that "appropriate" monetary policies will be followed. But markets and the public widely view them as forecasts. In any case, these quarterly updates are widely viewed as important communication tools and forward guidance. In September's updated quarterly economic projections, the median FOMC member forecast inflation to rise gradually to 2 percent and stop there. We do not know what appropriate monetary policy this was based on. But we do know the Fed favors inflation above 2 percent for some time. Does this mean the Fed members question the Fed's credibility to accomplish its make up strategy, or does it imply the Fed is following an inappropriate strategy for doing so? Such communications issues may force the Fed to reconsider and modify its quarterly projections.

[10] See Levy (2019).

Concluding Observations

The Fed's new framework has broadened its interpretations of its inflation and employment mandates, but does not establish a credible strategy for how its monetary policy tools will achieve them. The result will be a step away from a more predictable and systematic approach to monetary policy toward highly discretionary policy environment. The framework seems to be focused on monetary policy that may be appropriate for the near term as the economy recovers to its pre-pandemic level rather than the longer run. It introduces unnecessary complexities that are open to flexible interpretations and lack of clarity. This will create new challenges in communications. Attempts to achieve its broader employment mandate may expose the Fed to further political interference that may undermine its independence. Maintaining the new strategy's asymmetric objectives after the economy returns to normal will raise the risk of an undesired rise in inflation and create problems in managing inflationary expectations. We expect these shortcomings will force the Fed to revise its longer-run strategy sooner rather than later.

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