The Fed’s Strategic Approach to Monetary Policy Needs a Reboot

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Hoover Monetary Policy Conference: Getting Global Monetary Policy on Track

May 2-3, 2024

Suggestions for Improving the Fed's Flawed 2020 Strategic Framework

- The original 2012 strategic plan was balanced and clear
- Fed's excessive worries about low inflation, the risk of collapsing inflationary expectations and effective lower bound ***pre-determined*** the 2019 strategic review and new 2020 framework
- The result: an overly complex and asymmetric FAIT favoring higher inflation, higher priority on a broader employment mandate and dropped preemptive tightening as a tool to manage inflationary expectations
- ***Opened door for greater discretion in conducting policy***
- A month after adoption, we wrote a paper identifying the flaws of the new strategic framework and said it was only a matter of time before it collapsed ("The Murky Future of Monetary Policy" 2020, 2022)

Excessive worries about low inflation and ELB

- Inflation remained low after the financial crisis despite zero rates and QEs
- The Fed's *ex post* rationale was flatter-than-presumed Phillips Curve
- The lengthy expansion successfully lowered unemployment rate, but Fed worries mounted about the ELB, stemming from low inflation, risk of falling inflationary expectations and estimates of a secular decline in r*
- Fed worries were unsubstantiated by data and driven by asymmetric fears
- Inflation in 2016-2019: CPI, 2%; PCE 1.6% while inflationary expectations remained anchored to 2% and Fed projected rise of PCE inflation to 2%
- No evidence that low inflation was harming economic performance

The Pre-determined 2019 Strategic Review

- Fed's mind was set: a make up strategy to offset prior inflation misses; new tools to achieve mandate (read: introduce flexibility to 2% target); "opportunistic reinflation" to pump up employment
- As the review process began, Fed Vice Chair for Monetary Policy Rich Clarida outlined what the process would involve and what it would conclude
- At Fed's June 2019 review symposium, in Chair Powell's introductory remarks, 9 of 19 paragraphs referred to the ELB
- Panels of community leaders articulated benefits of further improvement in labor markets and research confirmed that further monetary easing would lift employment and inflationary expectations

The New Strategic Framework and Its Flaws

- FAIT: asymmetric and overly complex without numeric guidelines, favoring higher inflation; no makeup strategy following period of above 2% inflation
- Maximum inclusive employment mandate broadened mandate that was already unquantifiable and determined by non-monetary factors and further beyond scope of the Fed
- Shift to “Shortfalls” from mandate rather than ”deviations” combined with Fed’s assessment that Phillips Curve is flat nixes preemptive tightening
- Heavy reliance on managing inflationary expectations—and doing so through forward guidance

The New Strategy’s Track Record

- The NSF contributed to the Fed’s mistakes and high inflation
- Fed’s bad forecasts and failure to acknowledge persistence of inflation was based on presumption that inflation would stay low, reflecting the same preconceived worries that led to the NSF
- Failure to raise rates when inflation expectations became unanchored
- Fed’s reliance on forward guidance without raising rates failed to manage inflationary expectations
- Fed loses credibility and reveals misunderstanding of inflation process and the important role of aggregate demand

The Upcoming Strategic Review: Suggestions

- The Fed is adrift and needs to step back (before it steps forward) and review its objectives and the basic issues of inflation and monetary policy. We have five basic suggestions:
- **1) Conduct more thoughtful and thorough review of the inflation process and dynamics and how they relate to monetary policy tools**
- A time-varying Phillips Curve is an inadequate basis for understanding inflation; if it is unreliable as Fed has acknowledged, the Fed must consider a reliable framework
- Analyze key factors affecting aggregate demand: fiscal policy, the monetary transmission channels (influences by IOER, capital and liquidity requirements, asset purchases and balance sheet), macro conditions
- More focus on NGDP and money

Suggestions

- **2) Clarify interpretation of the Fed’s mandate**
- Correct asymmetries and complexity of the FAIT
- Consider returning to clear 2 percent target of 2012 strategy
- Add numeric range around target (0.5 percent?) to provide guidance on how Fed will respond to deviations
- Other alternatives: explore symmetric price level targeting
- Restore “deviations” (drop “shortfalls”) around maximum employment

Suggestions

- **3) Consider systematic rules as guidelines for the conduct of MP**
- Would avoid past major policy mistakes that resulted from discretion
- Would improve clarity, transparency and understanding of MP
- Fed includes estimates of alternative rules in its semi-annual Monetary Policy Report to Congress…don't dismiss them
- **4) Abandon forward guidance as an *independent* tool of MP**
- It is ineffective in absence of support of traditional monetary policy tools; complicates communications and risks Fed's credibility
- References to systematic rules would help communicate an understandable reaction function and appropriate forward guidance

Suggestions

- **5) Clarify and improve the quarterly Summary of Economic Projections**
- If FOMC's projections are conditional on appropriate monetary policy, why do participants' estimates of appropriate rate so frequently fail to achieve desired outcomes?
- Why is there so little dispersion of estimates?
- SEPs should include information on balance sheet
- With such a poor track record of projections, the Fed should consider an annual exercise that includes alterative projections to enhance risk management
- **Concluding remark: we encourage the Fed to consider our suggestions when it undertakes its strategic review**