The Fed's Risky Experiment: Why the New Framework is So Troubling and Might There be a Better Way

Charles Plosser

November 10, 2021

Economic Policy Working Group
Hoover Institution

Introduction

- Background papers Levy and Plosser (2020), Ireland and Levy (2021), and Plosser (2021).
- Review the original (2012) “Statement of Long-Run Goals and Monetary Policy Strategy” and a little of the history that gave rise to its development.
- Review the new version (2020) with an emphasis on key changes.
- Explain why the new framework is problematic and likely to result in policy becoming less predictable and more discretionary, thus less successful.
- Briefly discuss what might have been a better approach given the uncertainties.

The Fed’s Long-run Goals and Strategy Statement (2012)

- The purpose of the initial statement was to enhance transparency and accountability by clarifying the Fed’s interpretation of its statutory mandates.
  - It publicly established a numeric inflation target of 2 percent.
  - It also explained why a numeric employment target was not feasible.
- It also noted that the inflation and employment aspects of its mandate were generally compatible, but if in conflict, it would follow a “balanced approach” to achieving both mandates.
- The result was to establish the Fed as an inflation targeting central bank while retaining its commitment to “promoting maximum employment, stable prices and moderate long-term interest rates.”

The Fed's Long-run Goals and Strategy Statement (2020) I

- This was not a simple update from the prior statement. It laid the foundations for a significant re-orientation of the Fed's policy framework.

- It altered the Fed's interpretation of its mandates in significant ways that had important ramifications for the conduct of policy.

- The Fed's new statement and the framework it has implemented, were intended to address its concerns over the ELB, the inflation experience following the financial crisis, and to enhance and prioritize the employment mandate.

The Fed’s Long-term Goals and Strategy Statement (2020) II

- Reinterpretation of the inflation mandate
  - Dropped inflation targeting and moved to an asymmetric “flexible” average inflation target (AFAIT). Each of the descriptors is an important qualifier.
  - Rather than adding clarity or transparency about the Fed’s inflation goal it adds confusion and greater opportunities for discretion.
- Reinterpretation of the employment mandate.
  - Added “inclusive” as a new distributional dimension to its interpretation of the employment mandate and moving away from the prior emphasis on the unemployment rate to maximum inclusive employment
  - This broadens the implicit goal of the mandate and affords more dimensions to rationalize policy choices and thus increases discretion. It also opens the door for greater political pressure and interference, undermining Fed independence.

Rationale For Change

- The Fed was criticized by the markets for “undershooting” its inflation target. The average PCE inflation rate from 2010-2019 was 1.5 percent.
- It was also surprised that inflation was not pushed up despite $4 trillion in QE over 6 years, a zero funds rate for nearly 7 years, and a low unemployment rate.
- The conclusions by the Fed were
    - ELB depressed inflationary expectations restraining inflation and risked further downward pressure.
    - The Phillips curve had become very “flat” due to structural change.

Did the Fed Learn the Right Lessons?

- Was ELB the real culprit or did the Fed lack creditability? Expectations are not observed directly so depressed expectations my not have been the culprit. Could the Fed have identified the wrong problem?
- In that regard there were many other factors or potential explanations that could have impacted the transmission mechanism of monetary policy to inflation.
    - The financial shock itself altered the public's confidence in the banking system
    - New regulations raised capital requirements, created new liquidity rules, and placed greater restrictions on banking activity
    - The Fed began paying IOR.
    - Massive amounts of QE flooded the banking system with reserves eviscerating the fed funds market.

The New Approach to Inflation

- The approach to inflation in the revised framework has two key elements centered around addressing the ELB. Its stated objective is to anchor longer-run inflation expectations at 2 percent.
- The first element is the adoption of the AFAIT. This is an attempt to implement an approach similar to that suggested by Reifschneider and Williams, Woodford and others. I will call the “lower for longer” approach for convenience.
    - It relies on the Fed shaping expectations of inflation higher during periods when the lower bound is binding and having them return to target at some point in the future.
    - So credibility and commitment are essential to the approach. Without that, it it doesn’t work, even in theory.
- The second element is a change in its view of inflation dynamics implied by its new views on the links between measures of “slack” and inflation.

Untangling the AFAIT

- The descriptors are revealing of the challenges to making this complex strategy work
  - AIT – average inflation targeting vs inflation targeting vs price level targeting
  - Asymmetric - below target inflation will prompt intentional overshooting to offset the shortfall. Above target realization will not prompt such action. Why would, or could, you set a target that is inconsistent with your implementation?
  - Flexible – offsetting shortfalls from target but not overshoots means you can't be expected to achieve the target on average. "Average" must have another meaning and so it becomes a "flexible average." More accurately, this might be better described as a lower bound for average inflation. This builds an inflationary bias into the regime.

Can AFAIT Work?

- The Fed's ability to manage expectations up and down in a particular, yet credible, way is what makes this idea work.
  - Will the public understand this? The Fed offers no quantitative guidance that provides any help to the public or the market in forming expectations. How to measure the undershoot, how much overshooting is permissible and for how long? What do "moderately" or "some time" mean. It many take many cycles and years for the public to deduce the reaction function. Without metrics of any kind its hard to determine just what is the Fed's "commitment" at any point in time. How is the public to gage its success?
  - Does the Fed have sufficient credibility? It argues that its credibility to target 2 percent inflation was not sufficient to counter the damage caused by ELB. Why does it believe that this new, more complex approach, will be any more credible than the simple IT approach?

Inflation Dynamics/Phillips Curve

- The "old" Phillips curve (Fed) view of inflation dynamics and stabilization policy: Monetary policy accommodation impacts the real economy by stimulating economic activity, raising employment and reducing "slack." The decline in "slack" or the "output gap" causes price pressures to accumulate that gradually gives rise to inflation.

- The "new" view of inflation dynamic seems quite different. It is summarized in the following quote from Powell's 2020 address at the Jackson Hole conference and codified in the September 2020 FOMC statement.

The “New” View of Monetary Policy

- The “new” view: (Powell (2020)):

  ..”going forward, employment can run at or above real-time estimates of its maximum level without causing concern, unless accompanied by signs of unwanted increases in inflation or the emergence of other risks…. . Of course, when employment is below its maximum level, as is clearly the case now, we will actively seek to minimize that shortfall by using our tools to support economic growth and job creation.”

- This view has been codified by the Fed and is reflected in speeches and its FOMC statements since September 2020.

  “The Committee decided to keep the target range of the federal funds rate at 0 to ¼ percent and expects it will be appropriate to maintain this target range until labor market conditions have reach 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.”

The “New” View of Monetary Policy

- The “new” view is that accommodative monetary policy does not risk inflation as long as employment is below its maximum inclusive level.
- Moreover, even at maximum inclusive employment, the Fed indicates that it will only seek to control inflation once it is clearly evident and it will not act pre-emptively.
- The Fed likely thinks this “new” approach with its asymmetry for higher inflation is a form of commitment to higher inflation. This poses it own risks.
- The revised interpretation of the employment mandate and the conditioning of addressing inflation only after achieving maximum employment clearly signals that employment has become the dominant focus of the Fed and monetary policy.
- Put differently, the strategy seems to take the view that inflation is some exogenous process that the Fed reacts to rather than is responsible for. But at the same time the tells us it will control expectations but does not explain how it relates to its tools.

What Does the Fed Think Causes Inflation?

- As I mentioned, the “old” view of the Fed is that monetary policy influences real variables in a way that impacts “output gaps” or “unemployment gaps” which in turn influence inflation.
- Inflation is also influenced by expectations, which is why the Fed and other central banks stress the importance of credible commitments to an inflation goal of some kind.
- The Fed’s view that the Phillips curve is flat, a zero coefficient on the gap variable in a forecasting equation of inflation, leaves inflation largely determined by expectations.
- Thus, the Fed is emphasizing the anchoring of inflation expectations, but it has not given us a view of how it will use its tools to deliver the outcomes and expectations it seeks.

A Troublesome and Risky Strategy I

- The Fed's new monetary policy strategy is a significant departure from past practices.
- It implies a remarkable restructuring of its priorities in ways that will invite more political interference and undermine independence.
- The AFAIT is a complicated approach, intended to manage time varying inflation and time varying inflation expectations, all to address the ELB. How does it intend to do that?
    - It offers no real quantitative guidance that helps establish those expectations or how its tools will be used to achieve its price stability mandate.
    - Trying to control expectations in this manner risks losing control of them to the upside as well as the downside, posing serious risk.
    - In the absence of a Phillips curve, how does the Fed think it can control the path of inflation and achieve its goals using its available tools.

A Troublesome and Risky Strategy II

- The Fed has stated its desire to anchor inflation expectations at 2 percent, yet it offers an approach to monetary policy that is inconsistent with such a goal. How is this going to enhance credibility?
- The signal that it will not act on inflation based on forecasts but respond to outcomes only after maximum inclusive employment is achieved is a risky policy. Why would you choose to ignore inflation or signals of inflation to achieve a "goal" that is unobservable and hard to define. particularly when it comes to keeping expectations well anchored.
- The current situation, rising inflation before maximum inclusive employment, does not seem to have been in the playbook. Credibility will suffer.

Might There be a Better Approach? I

- My thoughts on an alternative approach are shaped by two guiding principles
  - Preserving and strengthening institutional arrangements and policy strategies that support the political independence of monetary policy.
  - In a democracy, independence demands that monetary policy be transparent, credible, and well understood by the public in order to ensure accountability and improve effectiveness. Clearly articulated and robust systematic policies are supportive of this effort.
- The Statement on Longer-Run Goals Monetary Policy Strategy of 2012 was an important initial step in support of these principles.

Might There be a Better Approach? II

- The 2012 statement was not perfect and could have been improved, but the significant re-orientation of monetary policy following the 2020 statement and strategy was counter-productive.
- The “new” approach took a step back. It hides an increase in discretionary policy in a lot of words and complexity that weakens the Fed’s commitment and credibility.

Might There be a Better Approach? II

- What might an alternative look like
  - A symmetric AIT with more quantitative metrics or a recommitment to inflation targeting (IT). A symmetric AIT would address the challenges of the ELB in a much simpler more understandable framework. Asymmetry adds complexity that undermines credibility and poses a clear inflationary bias. The goal should be to not weaken the commitment by allowing greater interpretation of what's was acceptable behavior for inflation but to strengthen it.
  - A discussion of the role of the balance sheet in monetary policy. This would be difficult for the Fed but, given the history and the new floor system it has adopted, greater clarity and transparency should be provided. Is the balance sheet a tool of monetary policy, financial stability, or credit allocation. The Fed has used for each at differ times. How and when should it be used and scaled?

Might There be a More Credible and Feasible Strategy? III

- What might an alternative look like (cont'd)
  - No change in the interpretation of the employment mandate. Inclusiveness is a desirable goal for the labor market but not one that monetary policy plays a determinative role. Longer expansions would be welcome, but the Fed is not necessarily able to deliver. Clear, transparent and predictable monetary policy would be the most valuable contribution of monetary policy, reducing the need for sharp policy reversals Expanding the Fed's "to do" list invites more discretion, more policy uncertainty, and greater political interference.
  - Strengthen and clarify the language around "balanced approach." The effort would focus on ways to clarify the Fed's reaction function to make policy more systematic.