BY TIM SABLIK

The Fed's New Framework

With a revised strategy, the Fed responds to challenges facing central banks today

Most people know that the Fed makes periodic changes to monetary policy by changing interest rates. What is perhaps less well known is that since 2012 the Fed's approach to monetary policy has been guided by a public strategy document that defines the Fed's longer-run goals. The Fed has made minor updates to this framework over the years, but in August 2020, it unveiled a major revision of its policy strategy.

The original 2012 statement on longer-run goals outlined how the Federal Open Market Committee (FOMC), the Fed's policymaking body, would seek to achieve its dual mandate from Congress of maintaining maximum employment and stable prices. The FOMC announced as its goal an inflation rate of 2 percent, measured by the personal consumption expenditures (PCE) price index. It declined to set a specific target for maximum employment, noting that the maximum level of employment the economy can sustain changes over time and is largely driven by nonmonetary factors.

The Fed's new framework sets a goal for inflation that averages 2 percent over time, meaning that the FOMC will now allow periods of higher inflation to make up for periods of inflation below target. On employment, the Fed's framework now emphasizes that full employment is a "broad-based and inclusive goal." Additionally, the FOMC pledges to respond specifically to shortfalls from maximum employment rather than "deviations" as in the 2012 statement, which implied that too much employment could be as problematic as too little.

These revisions, which the FOMC reaffirmed this January, were the culmination of a year-and-a-half long public review of monetary policy conducted by the Fed. But the story of the Fed's policy framework stretches back further than that, reflecting changes in the challenges facing central banks over the decades.

Fed Chair Jerome Powell delivers opening remarks at a Fed Listens event in Chicago on June 4, 2019.

COURTESY OF THE FEDERAL RESERVE BOARD OF GOVERNORS.

CHOOSING A TARGET

When Congress established the Fed's dual mandate in 1977, the FOMC was much less vocal about how it conducted monetary policy to achieve those goals.

"The FOMC didn't announce its decisions when they were made; they let the markets try to figure them out based on the Fed's actions," says Andrew Levin, a professor of economics at Dartmouth University who served as an economist at the Fed Board of Governors for two decades. "That was standard practice among most central banks until the 1980s and 1990s."

By that time, economists and policymakers had come to view central bank secrecy as counterproductive. Publicly announcing monetary policy decisions would eliminate any potential confusion in the markets, ensuring smoother implementation of policy changes. Additionally, research suggested that announcing a long-term goal for inflation would help anchor the public's expectations for inflation, making it easier to maintain stable prices over the long run.

By the 1990s, central banks in several developed countries such as New Zealand, Canada, and the United Kingdom adopted inflation targets. The Fed waited until 2012 to formally announce an inflation goal, but by then U.S. monetary policymakers were convinced of the benefits of communicating more openly with the public. These communication strategies grew out of the experiences of high inflation in the 1970s. But what central banks did not anticipate was that starting in the late 2000s, they would actually face the opposite problem: inflation that was too low rather than too high.

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Hints of this challenge first emerged in Japan. After booming in the 1980s, the country suffered a serious recession in the early 1990s. Afterward, economic growth slowed and the Bank of Japan cut interest rates to effectively zero, where they have largely stayed since.

"Economists first thought this was just an issue for Japan," says Levin. "But then in the early 2000s, the United States had a recession where interest rates got very low. And economists started thinking very seriously about how it's not easy for central banks to reduce nominal interest rates below zero."

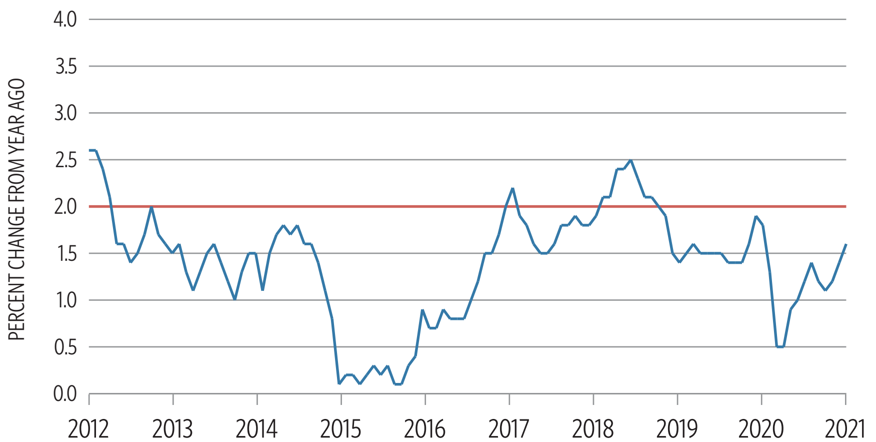
The Great Recession of 2007-2009 saw nominal rates fall to zero in several developed economies. In the United States, the Fed lowered its interest rate target to effectively zero in late 2008 and didn't raise rates until the end of 2015. The Fed had only raised interest rates back up to 2.5 percent at the end of 2018 before it started cutting them again. The COVID-19 pandemic prompted policymakers to drop rates back to zero.

Many economists have attributed the increased prevalence of near-zero policy rates to a global decline in the natural rate of interest — the rate at which monetary policy is neither expansionary nor contractionary. (See "The Fault in R-Star," *Econ Focus*, Fourth Quarter 2018.) A lower natural rate means the peak interest rate will be lower during economic expansions. When interest rates are near zero, policymakers can't lower rates much further because individuals would just choose to hold cash instead of negative interest-bearing bonds. (See "Subzero Interest," *Econ Focus*, First Quarter 2016.) This can constrain conventional monetary accommodation, resulting in monetary policy that is tighter than central bankers would prefer and slowing economic recovery.

This also poses a problem for the inflation-targeting strategies that many central banks adopted. In a frequently cited 2003 paper, Gauti Eggertsson of Brown University and Michael Woodford of Columbia University observed that "the definition of a policy prescription in terms of an inflation target presumes that there is in fact some level of the nominal interest rate that can allow the target to be hit (or at least projected to be hit, on average). But, some argue, if the zero interest rate bound is reached under circumstances of deflation, it will not be possible to hit any higher inflation target, because further interest rate decreases are not possible."

Aiming at a Target

Inflation since the introduction of the Fed's 2 percent goal



NOTE: Based on Personal Consumption Expenditures chain-type price index.
SOURCE: U.S. Bureau of Economic Analysis

If a central bank consistently fails to meet its inflation target while interest rates remain at zero, the public might start to question the credibility of that target. Indeed, observers both inside and outside of the Fed have voiced this concern since the FOMC announced its long-run inflation goal of 2 percent. Except for a few brief periods, inflation has persistently run slightly below the Fed's target since 2012. (See chart.)

A DIFFERENT APPROACH

The apparent decline in the natural rate of interest was one of the motivations for the Fed to undertake a review of its monetary policy framework. When the Fed first unveiled its inflation goal in 2012, the median estimate of the neutral fed funds rate among FOMC members was 4.25 percent — 2 percent inflation plus a natural rate of 2.25 percent. Since then, it has fallen to 2.5 percent.

"With interest rates generally running closer to their effective lower bound even in good times, the Fed has less scope to support the economy during an economic downturn by simply cutting the federal funds rate," Fed Chair Jerome Powell said in a speech announcing the Fed's new policy framework on Aug. 27, 2020. "The result can be worse economic outcomes in terms of both employment and price stability, with the costs of such outcomes likely falling hardest on those least able to bear them."

A lower neutral rate means that the Fed is more likely to face the constraint of the zero lower bound during a downturn. In the years leading up to the 2020 framework revision, Fed officials began to explore different solutions to this problem.

"Broadly speaking, one can point to two approaches: raising the inflation target without changing the policy rule or changing the policy rule without changing the target," says Jordi Galí of the Center for Research in

International Economics, Universitat Pompeu Fabra, and the Barcelona Graduate School of Economics.

Galí acknowledges that the first approach may seem counterintuitive when the Fed has consistently fallen short of its 2 percent inflation target. How could it be expected to achieve an even higher target? In his research, Galí argues the Fed could opportunistically announce a higher target once inflation surpasses 2 percent and then hold steady at the new target. In a world with a low natural rate of interest, an inflation target of 4 percent, for example, would provide monetary policymakers with more room to cut rates during downturns before hitting the zero lower bound. This benefit would need to be weighed against the costs of higher inflation, however.

Ultimately, the Fed chose to keep its 2 percent inflation target but adopt a new strategy: flexible average inflation targeting. Under this approach, the Fed would allow inflation moderately above 2 percent following periods where inflation is below 2 percent. In theory, this should help boost inflation expectations for the future and give the Fed more room to be accommodative.

Under the Fed's old 2012 framework, as the economy strengthened, the Fed responded by raising its policy rates. This was consistent with economic theory: In a world with stable inflation and inflation expectations, the natural rate of interest and thus the nominal interest rate should move with the economy. So, as economic activity heated up and unemployment reached historic lows in 2017-2019, the Fed gradually raised rates. But inflation still remained below target. This puzzle prompted the other major revision to the Fed's policy framework regarding its full employment mandate.

THE PHILLIPS CURVE FALLS FLAT

At the center of the change are evolving views about the Phillips curve. In the decades since New Zealand-born economist Alban William Phillips described it in 1958 — the result of what he called a "quick and dirty" analysis over a weekend — the Phillips curve has served as one guidepost for monetary policymakers. It posits a link between employment and inflation. When employment is running above the economy's long-run potential, inflation should rise, as a tight labor market puts upward pressure on wages and prices. Conversely, when there is a lot of slack in the labor market, inflation pressures should be more muted.

There are problems with using the Phillips curve as a guide for policy in practice, however. It is difficult to know the labor market's full potential, and that value changes over time. In the late 1990s, for example, unemployment fell to historically low levels, but inflation remained low despite the Fed holding steady on rates. Evidently, the natural rate of unemployment in the economy had fallen since the prior expansion. Conversely, the 1970s saw both unemployment and inflation rise at the same time — a phenomenon dubbed "stagflation."

After a slow recovery from the Great Recession, unemployment in 2019 fell to levels not seen in 50 years. This was beyond most estimates of the economy's full potential, and many observers expected inflation to start rising as well. But wage and price inflation remained muted. Labor force participation among prime-age workers (ages 25-54) increased as more people reentered the workforce, defying earlier predictions of a long-term decline due to the baby boomers aging into retirement. Economists and policymakers increasingly speculated that the Phillips curve relationship between employment and inflation had flattened.

In a recent paper with Luca Gambetti of Universitat Autònoma de Barcelona, Galí presented evidence of what he called "a growing disconnect between wage inflation and unemployment." Like the falling natural rate of interest, this presented a potential problem for inflation targeting.

"An outright decoupling of inflation from indicators of economic slack would call into question the inflation targeting framework widely adopted by central banks over the past decades, since that framework hinges critically on the existence of a positive relation between inflation and the level of economic activity," Gambetti and Galí wrote.

A flatter Phillips curve would mean a weaker signal for when the Fed should begin raising rates to prevent an overshoot of inflation. But Fed officials also saw an opportunity in this development. Low unemployment levels weren't placing much upward pressure on prices, but the tight labor market was proving beneficial for workers. As part of the review of its monetary policy framework, the Fed held a series of "Fed Listens" events in 2019. In these sessions, the Fed invited members of the public to share their economic experiences. One consistent takeaway was that minorities, including blacks and Hispanics who historically have suffered higher unemployment rates than whites, were finding more opportunities for employment and advancement as the recovery gained momentum. This prompted a renewed discussion among economists and policymakers about the potential benefits of running an economy "hot" — that is, allowing employment to rise beyond current estimates of its long-run sustainable level.

San Francisco Fed President Mary Daly, along with several current and former Fed co-authors, explored this idea in a 2019 paper. They found evidence that minorities, including black and Hispanic workers, experienced greater employment losses during downturns than whites. These groups also benefited more from employment gains when the labor market was already strong. Essentially, less advantaged groups were typically the first to suffer during recessions and the last to recover during economic expansions. In light of the low inflation of recent years, some Fed policymakers

have argued that the central bank can exercise more patience before tightening, allowing more time for the labor market to strengthen and benefit less advantaged groups.

"For nearly four decades, monetary policy was guided by a strong presumption that accommodation should be reduced preemptively when the unemployment rate nears its normal rate in anticipation that high inflation would otherwise soon follow," Fed Governor Lael Brainard said in a recent lecture to a Harvard College Principles of Economics class.

This view was perhaps most famously expressed by former Fed Chair William McChesney Martin Jr. in 1955 when he described the Fed as a "chaperone who has ordered the punch bowl removed just when the party was really warming up." While the Fed's new policy framework does not prescribe a particular response to achieving the central bank's goals, the FOMC has signaled a greater willingness to keep rates low as long as inflation is below target.

"Our new monetary policy framework recognizes that removing accommodation preemptively as headline unemployment reaches low levels in anticipation of inflationary pressures that may not materialize may result in an unwarranted loss of opportunity for many Americans," Brainard said in her presentation.

LOOKING TO THE NEXT RECOVERY

What does the Fed's new framework mean for monetary policy during the post-COVID-19 recovery? For now, the FOMC has said the prescription is clear: continued accommodation. Unemployment is still above pre-pandemic levels; inflation, while it has increased, remains below 2 percent. But how will the Fed respond under the new framework when its objectives conflict?

"We believe that conducting a review at regular intervals is a good institutional practice."

"Inevitably, there are going to be times when inflation is picking up, but employment is still below target," says Levin. Under the 2012 framework, the FOMC pledged to take a "balanced approach" when considering trade-offs between full employment and price stability. Levin notes the 2020 revision removes that language, leaving some questions about how the FOMC will respond to conflicts between its objectives.

Chair Powell and other members of the FOMC have so far stressed that as long as unemployment remains elevated, the Fed will not move to tighten policy unless inflation is consistently above target for an extended period. According to their latest projections, most Fed officials don't expect this to happen until 2023 or later. But the Fed's new framework is a step into uncharted territory, from economic theory to the real world of policy.

"Some policies work very well in our computer simulations but may be harder to implement in practice since they require the central bank to steer inflation along a desired path with a degree of precision that may not be available to policymakers," says Galí. "This certainly poses a risk to their credibility, but so does doing nothing."

One thing is certain: This latest revision to the Fed's monetary policy framework won't be the last. In its new statement on longer-run goals, the Fed also committed to undertaking a public review of its monetary policy strategy, tools, and communication practices every five years.

"We believe that conducting a review at regular intervals is a good institutional practice, providing valuable feedback and enhancing transparency and accountability," Chair Powell said in his speech unveiling the new framework. "And with the ever-changing economy, future reviews will allow us to take a step back, reflect on what we have learned, and adapt our practices as we strive to achieve our dual-mandate goals." **EF**

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