

Remarks on the FOMC's Monetary Policy Framework



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Introduction

I will focus my brief remarks on the FOMC's monetary policy framework for determining the appropriate policy to promote our longer-run monetary policy goals.¹ The views I'll present are my own and not necessarily those of the Federal Reserve System or my colleagues on the Federal Open Market Committee.

Recently, some economists and policymakers have recommended that the FOMC evaluate its monetary policy framework. Indeed, a careful reader of the January FOMC minutes, released earlier this week, might have noticed that a few participants suggested such an examination.² The FOMC has not indicated whether or not it will undertake such a review. But let me provide my own thoughts on the rationale for undertaking an assessment, what it might cover, and the timing, that is, the why, what, and when of a review. I'll also briefly discuss some alternative frameworks that should be part of the assessment. But first, some background.

Flexible Inflation Targeting

The Fed's longer-run monetary policy goals are price stability and maximum employment. Congress specified these goals but gave the Fed considerable independence in choosing the framework used to achieve these goals. The FOMC currently uses a flexible inflation-targeting framework. This framework recognizes that, over the longer run, monetary policy can influence only inflation and not the underlying real structural aspects of the economy such as the natural rate of unemployment or maximum employment, but that monetary policy can be used to help offset shorter-run fluctuations in employment from maximum employment.

¹ I view the monetary policy framework as distinct from the operating framework, which is more tactical and is concerned with the tools used to implement appropriate policy choices, e.g., whether to operate with a large amount of reserves as in a floor system or a smaller amount of reserves as in a corridor system to hit the policy interest rate.

² FOMC (February 2018).

The framework is briefly described in the FOMC’s statement on longer-run goals and monetary policy strategy.³ This statement was initially released in January 2012 when the FOMC adopted an explicit numerical inflation goal. This is a symmetric goal of 2 percent, as measured by the year-over-year change in the price index for personal consumption expenditures, or PCE inflation. “Symmetric” means that the 2 percent inflation goal is not a ceiling. The inflation measures will vary from month to month, sometimes above and sometimes below 2 percent, but we aim to keep inflation at 2 percent on average over the longer run.

Why Review the Framework?

The flexible inflation-targeting framework has served the FOMC well and has been effective in promoting our monetary policy goals. So why review the framework? There are a couple of reasons. First, as a matter of good governance, it behooves the Fed to conduct periodic reviews of its assumptions, methods, and models. This is the way the FOMC has operated for some time. For example, as indicated in the minutes, the January FOMC meeting included staff briefings and a discussion of inflation analysis and forecasting models.⁴ It is a standard best practice for a central bank to assess its performance.⁵

Another reason for the FOMC to review its framework derives from the experience of the Great Recession and its aftermath. To fight disinflationary pressures and economic contraction, the policy rate was brought to effectively zero, where it remained for seven years, and unconventional tools, including forward guidance and large-scale asset purchases, were used. Although the recovery was slow in coming, the economic expansion is now firmly in place, labor markets are strong, and inflation is expected to

³ See FOMC (January 30, 2018).

⁴ See FOMC (February 2018).

⁵ For example, the Bank of Canada renews its agreement with the government on its inflation target every five years. The next renewal is in 2021.

return to 2 percent on a sustained basis over the next couple of years. Nonetheless, the post-crisis economic environment is expected to differ in some important ways from the pre-crisis world.

The expected slowdown in population growth and labor force participation rates due to changes in demographics will weigh on long-run economic growth, the natural rate of unemployment, and the longer-term equilibrium interest rate.^{6,7} Real interest rates may potentially remain lower than in past decades. If so, then compared to the past, there would be less room for monetary policymakers to cushion against a negative economic shock, the probability of the policy rate hitting the zero lower bound would be higher, and nontraditional monetary policy tools would need to be used more often. To the extent that these tools are less effective than the traditional interest rate tool or are constrained from being used, the potential would be for longer recessions and longer bouts of low inflation. This raises the legitimate question of whether any changes in our monetary policy framework would be helpful in maintaining macroeconomic stability in this environment.⁸

What Should a Review Cover?

We cannot know whether the FOMC would have been even more successful had it used a different monetary policy framework in the times leading up to and following the financial crisis. But that's the wrong question. The review should focus on evaluating whether changing the framework could make monetary policy even more effective given the current and future economic environment.

⁶ See Mester (2017).

⁷ FOMC participants have been lowering their estimates of the fed funds rate that will be consistent with maximum employment and price stability over the longer run. The median estimate has decreased from 4 percent in March 2014 to 2.8 percent today. (See FOMC (April 2014) and FOMC (January 2018).) Also, empirical estimates of the equilibrium real fed funds rate, so-called r -star, while highly uncertain, are lower than in the past. For a review of the literature on the equilibrium interest rate, see Hamilton, et al. (2015).

⁸ Although I don't discuss them here, other government policies might also be brought to bear to increase the long-term growth rate and equilibrium interest rate, which would give monetary policy more room to act. Such policies would focus on increasing productivity growth and labor force participation.

I remain open-minded on this. At the same time, a change from flexible inflation targeting shouldn't be decided cavalierly. There is little experience with alternative frameworks because the central banks of most advanced economies like the U.S. have used some form of inflation targeting. In my view, the success of the current framework, coupled with the lack of empirical evidence on alternatives, means that the bar should be high for changing to a new framework. It is important to recognize that any framework will have positives and negatives and we are not starting from scratch, there is a framework in place, so transition costs need to be considered.

Two important parts of any framework are communication and credibility. The FOMC has been on a journey over the past couple of decades to make our monetary policy more transparent to the public and Chairman Powell has emphasized that the FOMC will continue on this journey.⁹ When the public has a better understanding of the goals and rationale for monetary policy decisions, they are better able to hold policymakers accountable for their actions. But effective communication also makes monetary policy itself more effective by providing the public with information about the economic outlook and aligning the public's expectations about future policy actions. Thus, an important aspect of any framework is how well it communicates monetary policy to businesses and households that are making economic decisions. If the framework is not well understood, its benefits cannot be captured.

Another important aspect of any monetary policy framework is its credibility. Is the framework credible to the public so that they will formulate expectations about future policy based on the framework? Is it a framework that future Committees will stick with? Of course, one determinant of a framework's credibility is its effectiveness in achieving monetary policy goals. So effectiveness, communication, and credibility, and the interactions among these three need to be part of assessing the framework.

⁹ See Powell (2018).

When Should a Review Commence?

After coming through the financial crisis and Great Recession, the economy has returned to normal and monetary policy, including the policy rate and the balance sheet, is normalizing. The smooth transition to new Fed leadership is also underway. Nothing is broken and a return to a normal economy and normal policymaking gives us an opportunity to look at some longer-run issues. This suggests to me that it may be appropriate later this year to begin an assessment of our current monetary policy framework and alternatives. Such reviews take time and should be thorough. As I mentioned, the FOMC adopted its numerical inflation goal in January 2012, but this came after years of study and discussion going back to at least May 1996, with subsequent discussions in 2005, 2009, and 2011. Even if the FOMC concludes that it is best to stay with its current framework, the review will have served the Committee well and may indicate some ways we can further improve our monetary policy transparency and communication.

Some Alternative Frameworks

I will end my remarks by briefly noting some alternative frameworks that could be assessed as part of a review. I will not have time to discuss their strengths and weaknesses at length, but I can give you a flavor.¹⁰

Higher Inflation Target

One alternative is to keep the flexible inflation-targeting framework but set a higher longer-run inflation target, say, 4 percent instead of 2 percent.¹¹ This would be a familiar arrangement but give the nominal rate more of a cushion from hitting the zero lower bound for any given negative shock. But does the gain from more likely avoiding the zero lower bound when a negative shock hits outweigh the costs of running a higher level of inflation at all times? Will it be easy to raise inflation expectations after having

¹⁰ See Mester (2018) for further discussion of monetary policy frameworks and their strengths and weaknesses.

¹¹ See Blanchard, Dell’Ariccia, and Mauro (2010) for discussion.

successfully anchored them at 2 percent? Is 4 percent inflation seen as consistent with price stability?

These questions will need to be answered.

Price-Level Targeting and Nominal GDP Targeting

Price-level targeting and nominal GDP targeting involve targeting a path for the nominal level rather than a growth rate. Unlike inflation targeting, which lets bygones-be-bygones, these level-targeting frameworks make up for past deviations from the path.¹² For example, when inflation has been running low, price-level targeting builds in a form of forward commitment to higher inflation in the future and a “low for longer” interest rate strategy. In theory, this can move current inflation expectations up, buoying current inflation and limiting the time the economy spends at the zero lower bound.¹³ There is little international experience with these frameworks and there are measurement issues to contend with: the starting point for the path matters, data revisions would be more serious because these frameworks do not let bygones-be-bygones, and to know what inflation will be along the nominal GDP path, one needs a reliable estimate of potential real output growth.^{14,15} There are also credibility issues. Is it credible that policymakers will keep interest rates low to make up for past shortfalls even when demand is growing strongly or that they will tighten policy when demand is weak after a supply shock has raised the price level?

¹² The academic literature suggests that a price-level-targeting framework may approximate optimal monetary policy when policymakers want to minimize fluctuations in the output gap and in inflation around a target, and it can be particularly useful at the zero lower bound by putting upward pressure on inflation expectations and, thereby, downward pressure on the real rate. See Kahn (2009) for an accessible discussion of price-level targeting.

¹³ See Eggertsson and Woodford (2003).

¹⁴ Sweden did price-level targeting for less than two years when it went off the gold standard in 1931. See Kahn (2009).

¹⁵ Figure 1 in Mester (2018) shows four different starting points for the price-level path: the first quarters of 1990, 1995, 2001, and 2007. If the starting point is 1990Q1, the price level is essentially on its path, and if the starting point is 2001Q1, it is near its path. The other two starting points show a larger gap.

Temporary Price-Level Targeting

Former Fed Chairman Ben Bernanke has suggested a temporary price-level-targeting framework, which involves targeting inflation in normal times but switching to price-level targeting once the policy rate has fallen to the zero lower bound.¹⁶ Policymakers would revert to inflation targeting and begin to raise interest rates once the cumulative inflation rate from the time the zero lower bound was hit had risen sustainably back to target. This framework might be easy to communicate because it could be discussed solely in terms of the inflation goal; however, determining and communicating the timing of when to switch back to the inflation-targeting regime could be complex.

Summary

A review of monetary policy frameworks should consider these alternatives, as well as others. The goal would be to assess which framework would make monetary policy the most effective at achieving its goals, given the current and future economic environment, and whether any changes to the current framework could enhance monetary policy communications, credibility, and transparency.

¹⁶ Bernanke (2017).

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