The Federal Reserve's New Monetary Policy Strategy

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Introduction

I thank Paul Mizen and the Money Macro and Finance Society for the opportunity to speak at your 6th Annual Conference. In my brief remarks today, I will give an overview of the changes to our monetary policy strategy that the Federal Open Market Committee, the monetary policymaking body within the Federal Reserve, recently announced and discuss their implications for monetary policy going forward. As always, the views I will present are my own and not necessarily those of the Federal Reserve System or of my colleagues on the Federal Open Market Committee.

Revised Statement on Long-Run Goals and Monetary Policy Strategy

In early 2019, the FOMC began a review of our framework for setting monetary policy – the strategy, tools, and communications we use in setting policy in pursuit of the monetary policy goals given to us by the U.S. Congress. These goals are maximum employment, price stability, and moderate long-term interest rates. When prices are stable and the economy is at full employment, long-term interest rates are typically at moderate levels. So it is often said that the U.S. Congress has given the Fed a dual mandate of price stability and maximum employment. The framework review was informed by our experience during and after the Great Recession, by economic theory and empirical analysis, and by consultations with academic researchers and practitioners at research conferences. It was also informed by conversations with the public at large, through a series of Fed Listens events held across the country.[1] The main conclusions of the review are captured in our revised Statement on Longer-Run Goals and Monetary Policy Strategy, which the FOMC approved this August.

The framework review was undertaken in light of changes in the economic environment that have emerged since the FOMC's first strategy statement was published in 2012. One change with important implications for monetary policy is the decline in the U.S. and other advanced economies in the general

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[1] The revised Statement on Longer-Run Goals and Monetary Policy Strategy, as well as other materials pertaining to the review, is available at https://www.federalreserve.gov/monetarypolicy/review-of-monetary-policy-strategy-tools-and-communications.htm.

level of interest rates consistent with sustainable growth and price stability. This decline reflects several factors, including the aging of the population, changes in risk preferences, and slower productivity growth. It means that the level of the federal funds rate, the policy rate in the U.S., consistent with maximum employment and price stability is now lower than it has been in the past. This means that during economic downturns, it is now more likely that the fed funds rate will be constrained by its effective lower bound, and the FOMC will have less policy space to support the economy using its traditional policy tool. This constraint, being understood by households, businesses, and financial markets, imparts a downward bias to inflation and inflation expectations, and so increases the downside risks to achieving our policy goals.

Another change in the economic environment with implications for monetary policy pertains to inflation dynamics. Resource slack in the labor market and in product markets has become less correlated with actual inflation than in the past, and inflation expectations now play a larger role in determining inflation outcomes. This means it is even more important that inflation expectations remain well anchored at levels consistent with our longer-run inflation goal. If expectations move below these levels, then it is more likely that inflation will run below our goal, which would then result in even less policy space in a low-interest-rate environment.

These changes in the economic environment warranted asking ourselves whether there were revisions to our monetary policy strategy that would make it more effective in promoting our policy goals. The review led us to conclude that the answer was yes. And we made changes to our approach to both the inflation goal and the employment goal, which are summarized in our revised strategy statement.

Revised Strategy Statement: Inflation Goal

Regarding our approach to inflation, the first thing I want to note is something that did not change. The FOMC has reaffirmed the explicit inflation target first announced in 2012, namely, that a longer-run

inflation rate of 2 percent is most consistent with our statutory mandate. But our strategy statement is now more explicit about how we will go about achieving this inflation goal. In particular, after periods in which inflation has been running persistently below 2 percent, we will likely aim to have inflation run moderately above 2 percent for some time. Doing so will help anchor inflation expectations, a main determinant of actual inflation, at levels consistent with 2 percent inflation.

This new language is a stronger statement than we have made in the past as we have struggled to effectively convey that the longer-run goal of 2 percent should not be interpreted as a ceiling. In the past, many of us on the FOMC have indicated that we would be comfortable with inflation running above 2 percent for a time after it has run low for some time – a type of opportunistic reinflation. But now we are going to be deliberate rather than opportunistic. As the revised strategy indicates, after inflation has been running persistently below 2 percent, not only will we tolerate serendipitous shocks that move inflation above 2 percent, but we will likely set policy with the intention of moving inflation moderately above 2 percent for some time. The implication is that monetary policy will be somewhat more accommodative than in the past when inflation has been running persistently low in order to reach our longer-run inflation goal.

Revised Strategy Statement: Employment Goal

Regarding our employment goal, I view the changes we made in the strategy statement as an acknowledgment of the uncertainty around assessments of the level of maximum employment and a clarification to our approach to achieving this goal. This is consistent with something I have advocated for some time: that policy communications should acknowledge uncertainty.[2] In the recent expansion, we saw that employment growth could be stronger and the unemployment rate lower without generating inflation than one would have thought possible based on past decades of experience. Over the expansion,

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[2] See, e.g., Loretta J. Mester, "Acknowledging Uncertainty," remarks at the Shadow Open Market Committee Fall Meeting, New York, NY, October 7, 2016. (https://www.clevelandfed.org/newsroom-and-events/speeches/sp-20161007-acknowledging-uncertainty.aspx)

it took time to learn about these structural changes in the economy, and as the FOMC learned, its assessments of the longer-run unemployment rate came down significantly over time. Unfortunately, this time-to-learn, combined with the previous strategy statement's references to "deviations" of employment from maximum employment, has been misinterpreted by some as suggesting that the FOMC, at times, takes deliberate policy action to bring employment down independently of our inflation goal. This is not the case. The benefits of a strong labor market in fostering economic inclusion are clear.

Changes in the economy underscore the difficulties in using the Phillips curve model to forecast inflation or to assess maximum employment in real time. The revised strategy statement clarifies that in the absence of inflationary pressures or risks to financial stability, strong employment is not a concern and monetary policy will not react to it. This approach is consistent with the recent behavior of the FOMC. Estimates of simple monetary policy rules by the Cleveland Fed staff indicate that FOMC participants put less weight on the unemployment rate in determining the appropriate policy path in the last two years of the most recent economic expansion than they did earlier in the expansion.[3]

An Area for Further Work: Systematic Policymaking and Communications

The new strategy statement will guide FOMC monetary policy decisions both during and beyond the pandemic. But bringing the new strategy to bear in our policymaking is a work in progress. So I will end my remarks by discussing two areas for further work: first, systematic policymaking and communications, and second, the nexus between financial stability and monetary policy.

[3] See Edward S. Knotek II, "Changing Policy Rule Parameters Implied by the Median SEP Paths," Federal Reserve Bank of Cleveland *Economic Commentary* Number 2019-06, April 15, 2019. (https://www.clevelandfed.org/newsroom-and-events/publications/economic-commentary/2019-economic-commentaries/ec-201906-changing-policy-rule-parameters)

Our September FOMC statement was the first to incorporate the new strategy.[4] The statement indicated that because inflation has been running persistently low, we will be aiming to achieve inflation moderately above 2 percent for some time and that we expect to maintain the current funds rate target range of 0 to 1/4 percent until labor market conditions have reached levels consistent with our assessment of maximum employment and inflation has risen to 2 percent and is on track to moderately exceed 2 percent for some time. As of September, the forecasts of FOMC participants, as indicated in the Summary of Economic Projections, showed that the majority thought it would not be appropriate to raise rates until after 2023.[5] However, importantly, the guidance is based on the state of the economy and not on calendar dates. The economy could evolve so that the stipulated inflation and employment conditions are achieved earlier or later than currently projected, in which case, the anticipated policy path would appropriately adjust.

I strongly believe that clear policy communications are an important part of effective monetary policymaking. 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. Clear 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. When households, businesses, and investors have a better sense of how monetary policy is likely to change conditional on the outlook, they can make better economic and financial decisions.

Even though the September statement incorporated some aspects of the new strategy, Fed watchers and others have asked for more context about what indicators the FOMC would be using to assess whether labor market conditions are consistent with maximum employment, and how far above 2 percent would the FOMC aim for inflation to be and for how long. While the context has changed, similar kinds of

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[4] The September FOMC meeting statement is available at https://www.federalreserve.gov/newsevents/pressreleases/monetary20200916a.htm.

[5] The September Summary of Economic Projections is available at https://www.federalreserve.gov/monetarypolicy/fomcminutes20200916ep.htm.

questions about how the FOMC assessed whether or not its goals had been met were asked when we operated under the previous strategy as well. Work still needs to be done to ensure that our policy decisions are systematically guided by our outlook and risks around the outlook and that our policy communications convey a good sense of the FOMC's reaction function, especially now under the new strategy.

The revised strategy leans heavily on the relationship between inflation expectations, inflation, and the ability of monetary policy to influence both, but there is still much to learn about inflation dynamics and inflation expectations. The benefits of the move to a type of make-up strategy for inflation – that is, running policy to achieve inflation somewhat above 2 percent for a time after it has run persistently low – depend on our ability to communicate that we have shifted to and will pursue this new strategy and our ability to explain clearly how the new strategy differs from the old.

Recent research from the Cleveland Fed's Center for Inflation Research suggests that we may have further to go on this score. Center researchers used the Cleveland Fed's daily national survey of consumers to examine the effect of Chair Jay Powell's announcement of the new strategy on households' understanding of monetary policy and their expectations of inflation.[6] They obtained four interesting results.

First, while there was a surge in news coverage about monetary policy around the time of the Chair's speech, there was only a small increase in the number of respondents who reported having heard news about monetary policy; most people did not recall anything.

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[6] Olivier Coibion, Yuriy Gorodnichenko, Edward S. Knotek II, and Raphael Schoenle, "Average Inflation Targeting and Household Expectations," Federal Reserve Bank of Cleveland Working Paper 20-26, September 18, 2020. (https://doi.org/10.26509/frbc-wp-202026)

Second, among the small group who had heard news, there was a sense that something had changed, but little recognition of what had changed in the approach to monetary policy.

Third, there is considerable confusion about our goals: when presented with a list of options, more respondents said that the Fed sets monetary policy with the aim of maintaining a strong dollar or keeping interest rates low to reduce the government's cost of borrowing than said we set policy to promote maximum employment and price stability.

Fourth, when some individuals were selected at random and given information about average inflation targeting, their expectations about future inflation over the next five years were no different than those of individuals who were, instead, given information about traditional inflation targeting.

Of course, it is important to remember that some of the gains from the new strategy will likely come from the expectations and actions of sophisticated financial market participants who closely follow monetary policy, thereby helping policy to transmit throughout the economy. It is also true that the survey was taken over only a short period following the announcement, and as anyone who has ever taught or been a student knows, it takes time to master new material. Still, the results do suggest that more work needs to be done on policy communications to ensure that households will understand the policy strategy and then incorporate it into their expectations and actions.

Another Area for Further Work: Financial Stability and Monetary Policy

A second area that needs further work is understanding the nexus between monetary policy and financial stability. Our revised strategy statement explicitly acknowledges that sustainably achieving maximum employment and price stability depends on a stable financial system. As part of its framework review, the FOMC considered the interactions between financial stability and monetary policy, particularly in the

current environment of low neutral interest rates.[7] While monetary policy that leads to a stable macroeconomy encourages financial stability, it is also possible that in an environment with low neutral rates, a persistently accommodative monetary policy could, in some cases, increase the vulnerabilities of the financial system by encouraging higher levels of borrowing and financial leverage, increased valuation pressures, and search-for-yield behavior. How best to approach the nexus between monetary policy and financial stability in a low-interest-rate world deserves more consideration.

As indicated in the minutes of the January 2020 FOMC meeting, in discussing the framework, most FOMC participants agreed that supervisory, regulatory, and macroprudential tools, including the countercyclical capital buffer and stress tests, should be the primary way to address financial stability risks rather than using monetary policy. But in the U.S., there are few countercyclical tools and they are not designed to address vulnerabilities outside of the banking system. Therefore, there may be certain circumstances where monetary policy may need to be adjusted in order to mitigate risks to financial stability. But when and how to do that needs further study. In addition, more study is needed of the tradeoffs and complementarities among our three sets of relevant policies: monetary policy, macroprudential policy, and microprudential policy, which includes tools, such as capital and liquidity requirements, that work throughout the business and financial cycles. As our framework review did with monetary policy, the implications of a low-interest-rate world for both macroprudential policy and microprudential policy should be considered.

[7] See a summary of the discussion in the minutes to the January 2020 FOMC meeting at https://www.federalreserve.gov/monetarypolicy/fomcminutes20200129.htm.