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The FOMC is Reviewing its Toolbox of Policy Goodies

Philip Chao, March 11, 2019

Members of the Federal Open Market Committee ("FOMC") often start their speeches by referencing a healthy economy with a historically low unemployment rate and inflation (core personal consumption expenditures) running near its 2% long term objective. This infers that the FOMC's extraordinary monetary policy tools of zero interest rate policy, large scale asset purchase programs (quantitative easing) and forward guidance since the Global Financial Crisis have succeeded in bring the economy back to a steady state.

Forward 10-years, these tools are still relied upon to promote maximum employment, stable prices, and moderate long-term interest rates. However, the FOMC is concerned over the effectiveness of its tool kit when the next economic slowdown arrives with Fed Fund rates remain below historical averages, an economy growing at a new normal pace (when compared to the pre-Crisis past) and an inflation rate still falls short of its long-term objective (can't get inflation to symmetry.)

Since the first interest rate hike in December 2015, the FOMC has used forward guidance as the supplemental tool to manage market expectation regarding its path to normalization. On August 24, 2018, Chair Powell stated that the stars (natural rate of unemployment - u*, neutral policy interest rate – r*, and inflation objective - π*) are sometimes far from where they are perceived to be and the relationship between inflation and unemployment are far from certain. Then on October 2, 2018, Chair Powell suggested that no one fully understands the nature of unemployment and inflation relationship (referring to the Phillips Curve) or the role they play in the current context. During the October 3, 2018, interview with PBS's Judy Woodruff, Chair Powell said: "we are long way from neutral at this point probably." Then on November 28, 2018, Chair Powell at the Economic Club of New York stated, "interest rates are still low by historical standards, and they remain just below the broad range of estimates of the level that would be neutral for the economy." The "transparency" regarding FOMC's position pertaining to r* and has been confusing at best[1]. As a consequence, the market reflected the uncertainty. Since then, the new guidance from the FOMC is "patience" and "pause".

Not since the late 1960s have we witness as strong a labor economy. The current unemployment rate of 3.8% has certainly exceeded the FOMC's projections and expectations, even as recent as two years ago. However, the monetary policies have been much less effective in maintaining a steady 2% core PCE.

[1] The Federal Reserve and r* in Three Acts, Philip Chao, 12-3-2018 https://chaoco.com/wp-content/uploads/2018/12/Behind-the-Headline-R-Star-in-Three-Acts-2018-12-03-1.pdf

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The short-tun flattening of the Phillips Curve has posed challenges to inflation expectation. On the one hand, this allows the Federal Reserve to more aggressively support employment during economic downturns, but this could increase the cost, in terms of economic output, of reversing unwelcome increases in longer-run inflation expectations.

The r* globally appear to have fallen and widely expected to persist likely reflect the aging populations, changes in risk-taking behavior, and a slowdown in technology growth. This means that in future economic slowdowns, central bank policy rates will likely retest the effective lower bound (ELB). This lack of policy space (low r*) could challenge central banks from providing monetary support for spending and employment and keep inflation from falling too far.

The Federal Reserve's Statement on Longer-Run Goals and Monetary Policy Strategy since January 24, 2012, states that the FOMC is firmly committed to fulfilling its statutory mandate. FOMC's policy decisions reflect its longer-run goals, its medium-term outlook, and its assessments of the balance of risks, including risks to the financial system that could impede the attainment of FOMC's goals. FOMC affirms its judgment that inflation at the rate of 2% is most consistent over the longer run and would be concerned if inflation were running persistently above or below this objective. By communicating this symmetric inflation goal clearly to the public helps keep longer-term inflation expectations firmly anchored.

On February 22, 2019, Richard Clarida, Vice Chair of the Board of Governors, at the U.S. Monetary Policy Forum[2], stated that a review of the current Federal Reserve's monetary policy framework[3] and an assessment of whether, and in what possible ways, the Federal Reserve can refine its strategy, tools, and communication practices to achieve and maintain these goals consistently and robustly is currently being undertaken.

The FOMC emphasizes on seeking policy settings that bring both inflation and resource utilization back toward their objectives in the medium term and is often referred to as the "flexible inflation targeting approach." The wide-ranging review framework will pose three broad questions.

Question #1: "Can the Federal Reserve best meet its statutory objectives with its existing monetary policy strategy, or should it consider strategies that aim to reverse past misses of the inflation objective?"

Monetary policy today is <u>not</u> adjusted to offset past inflation shortfalls with future overshoots of the inflation target. The ELB on interest rates makes persistent undershoots more likely. Persistent inflation shortfalls carry the risk that longer-term inflation expectations become poorly anchored or become anchored below the stated inflation goal (i.e. worried about persistent disinflation or even deflation.)

[2] https://www.federalreserve.gov/newsevents/speech/clarida20190222a.htm
[3] The Federal Reserve's Framework for Monetary Policy - Recent Changes and New Questions (2013). https://www.imf.org/external/np/res/seminars/2013/arc/pdf/english.pdf

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One approach is to employ "makeup" strategies under which policymakers seek to undo, in part or in whole, past inflation deviations from 2% objective by targeting average inflation over a multiyear period and price-level targeting (seek to stabilize the price level around a constant growth path.) These strategies could be implemented either permanently or as a temporary response to extraordinary circumstances. Since the FOMC has been challenged to keep core PCE at 2% what is the likelihood of targeting for an even higher inflation rate?

Question #2: "Are the existing monetary policy tools adequate to achieve and maintain maximum employment and price stability, or should the toolkit be expanded? And, if so, how?"

The FOMC's primary means of changing the stance of monetary policy is by adjusting its target range for the federal funds rate. When desired effect cannot be achieved or observed when the rates are at the ELB, balance sheet policies and forward guidance became the additional tools. In addition to assessing the efficacy of these existing tools, the FOMC will consider additional tools to ease policy when the ELB is binding. There has been very little transparency on any "additional tools" and the reality is that economic challenges cannot be solved by monetary policies alone and that there may be no more new employable goodies in the tool box.

Question #3: "How can the FOMC's communication of its policy framework and implementation be improved?"

Over the past decade, FOMC has enhanced its communication practices to promote public understanding of its policy goals, strategy, and actions, as well as to foster democratic accountability. These enhancements include the Statement on Longer-Run Goals and Monetary Policy Strategy; post-meeting press conferences; various statements about principles and strategy guiding the Committee's normalization of monetary policy; and quarterly summaries of individual FOMC participants' economic projections, assessments about the appropriate path of the federal funds rate, and judgments of the uncertainty and balance of risks around their projections. The challenge is less about how to be more transparent and increasing public appearances by members of the FOMC to communicate or frame their position, the problem is can FOMC members truly manage or contain the public response. Sometimes saying less can be more effective.

FOMC expects to share its conclusions with the public in the first half 2020. Since we do not expect an economic recession in the U.S. until 2021 and beyond, we are hopeful that any new policy tools or retooling of the existing policy goodies will be ready for prime time.

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