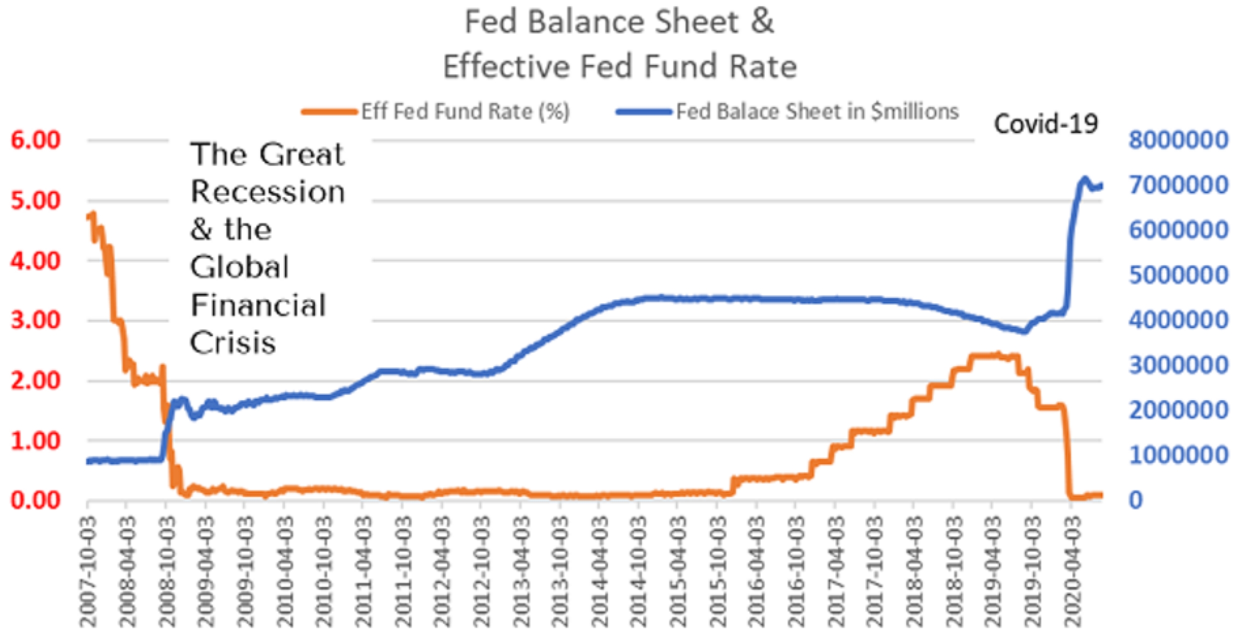
Viewpoints Philip Chao The Fed is Codifying Lower for Much, Much Longer Sep 09, 2020

https://iris.xyz/viewpoints/the-fed-is-codifying-lower-for-much-longer/

The Monetary Policy Toolkit

During the March 15, 2020 Federal Open Market Committee (FOMC or the Committee") meeting, in response to the Covid-19 pandemic, the Federal Fund's target interest rate range was lowered to 0 to ¼ percent. This is the effective lower bound ("ELB"). During the same meeting, the large-scale asset purchase program was reimplemented and the FOMC once again began expanding its balance sheet.



In the Bank of International Settlement October 2019 research paper[1], it reviewed the effectiveness of deploying unconventional monetary policy tools (UMPTs) by global central banks. The paper examined four types of UMPTs: (1) negative interest rate policies, (2) lending operations, (3) asset purchase programs (a.k.a. quantitative easing) and (4) forward guidance.

The paper posited that the use of UMPTs evolved in stages and with some degree of experimentation, broadly pursuing two main objectives: (i) addressing disruptions in the monetary policy transmission chain (DTC events) from monetary policy actions to macroeconomic outcomes[2] and (ii) providing additional monetary stimulus once the main conventional instrument (the policy rate) was constrained by the effective lower bound (ELB) – at or near 0%[3]. Both of these conditions were present in March with the financial markets in freefall as investors, traders, institutions and savers were clamoring for cash and liquidity dried up. As the Fed reached the ELB, UMPTs were released to support the financial markets and to prevent further damage to the general economy.

The paper concluded that, overall, UMPTs historically have demonstrated to be an effective part of central banks' policy toolkits as they have been effective in cushioning DTC scenarios and in averting consequences of ELB. Nonetheless, "*UMPTs are more effective when accompanied by appropriate supervisory, prudential and fiscal policies and embedded in a broader policy framework that avoids placing a disproportionate burden on the central bank.*"

Moving from "*ex ante*" to "*ex post*"

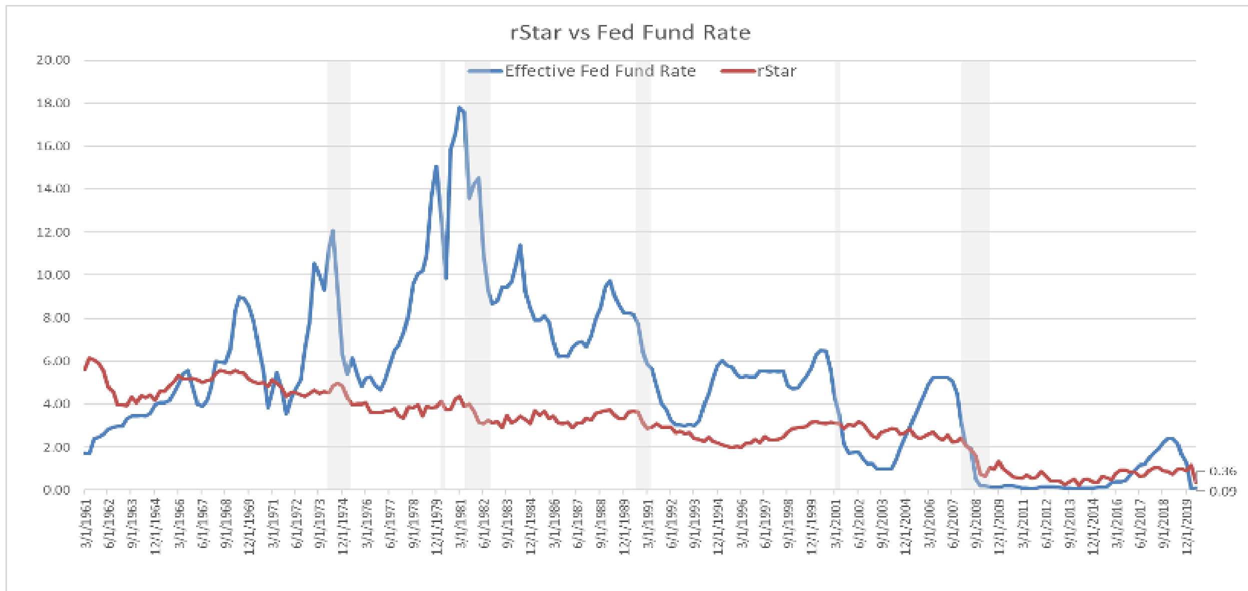
In the annual end of summer economic policy symposium sponsored by the Federal Reserve Bank of Kansas City (virtual for 2020), the theme this year was "Navigating the Decade Ahead: Implications for Monetary Policy." Chair Powell of the Federal Open Market Committee (FOMC or the Committee) used this occasion to announce the amendment to the Statement on Longer-Run Goals and Monetary Policy Strategy.

In January 2012, then–Board Vice Chair Janet Yellen led an effort to codify the FOMC's approach to monetary policy by issuing its first Statement on Longer-Run Goals and Monetary Policy Strategy: "*A central part of this statement was the articulation of a longer-run inflation goal of 2 percent. Because the structure of the labor market is strongly influenced by nonmonetary factors that can change over time, the Committee did not set a numerical objective for maximum employment. However, the statement affirmed the Committee's commitment to fulfilling both of its congressionally mandated goals*" of price stability and full employment. The 2012 "consensus statement" reflected lessons learned from fighting high inflation as well as from experience around the world with flexible inflation targeting.

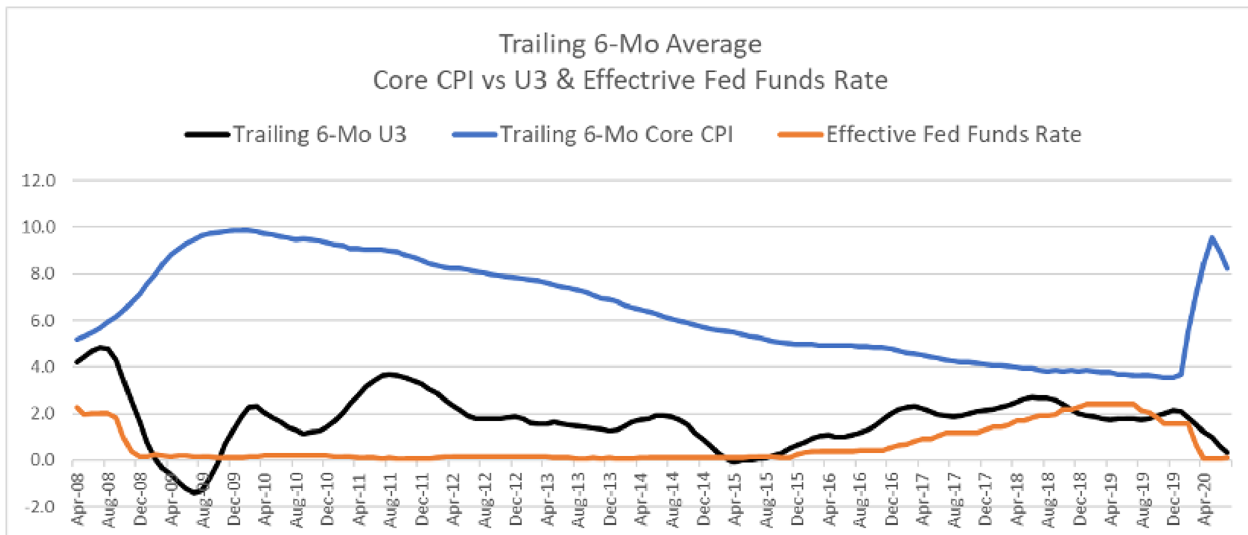
In his prepared statement, Chair Powell stated that there are four key economic developments that motivated the Committee's review since 2019:

- The potential, or longer-run, growth rate of the economy has slowed with a decline in productivity which is a main driver of future standard of living.

The general level of interest rates has fallen both here and globally which is consistent with the fall in the equilibrium real interest rate – ''r-star[4]". This leaves less conventional policy space to cut rates to offset adverse shocks to aggregate demand.



- The unemployment rate, that hovered near 50-year lows for roughly 2 years, was well below most estimates of its sustainable level – u-star[1], and u-star was repeatedly revised lower.
- Inflation forecasts are typically predicated on estimates of "u-star." However, the recent historically strong labor market failed to trigger a corresponding rise in inflation (i.e. a flattening of the Phillips Curve). The relationships between labor market and inflation are now less reliable or understood.



1. Affirm the need for UMPT:

"*Employment, inflation, and long-term interest rates fluctuate over time in response to economic and financial disturbances. Monetary policy plays an important role in stabilizing the economy in response to these disturbances. The Committee's primary means of adjusting the stance of*

monetary policy is through changes in the target range for the federal funds rate. The Committee judges that the level of the federal funds rate consistent with maximum employment and price stability over the longer run has declined relative to its historical average. Therefore, the federal funds rate is likely to be constrained by its effective lower bound more frequently than in the past. Owing in part to the proximity of interest rates to the effective lower bound, the Committee judges that downward risks to employment and inflation have increased. The Committee is prepared to use its full range of tools to achieve its maximum employment and price stability goals."

This is the FOMC's acknowledgment that the Fed Fund's rate is now and expected to remain at the ELB for some time. UMPTs are and will continue to be relied upon to achieve the dual mandates. Although neither of these points are new, now they are hard coded acceptances.

2. Remove proactive monetary action:

"*Moreover, monetary policy actions tend to influence economic activity and prices with a lag. Therefore, the Committee'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 the Committee's goals.*"

Since the effects of any policy change (such as lowering rates) takes time, the FOMC has been taking actions prior to or in anticipation of (*ex ante*) future outcome in meeting their dual mandates. For example, at a sustained historically low unemployment rate, the FOMC would expect a rise in wages which would lead to a rise in aggregate demand and ultimately a rise in inflation (i.e. the relationship expressed in the Phillips Curve). As such, the FOMC would begin to raise interest rates proactively to maintain future price stability.

3. Recognize the unobservable nature of u-star:

"*The maximum level of employment is a broad-based and inclusive goal that is not directly measurable and changes over time owing largely to nonmonetary factors that affect the structure and dynamics of the labor market. Consequently, it would not be appropriate to specify a fixed goal for employment; rather, the Committee's policy decisions must be informed by assessments of the shortfalls of employment from its maximum level, recognizing that such assessments are necessarily uncertain and subject to revision*."

The pre-Covid-19 unemployment rate that hovered near 50-year lows was well below most estimates of its sustainable level, even as the participation rate gradually increased. At the same time, the Phillips Curve relationship of when unemployment rate reaches or breaches u-star with persistence, inflation pressure arises. This relationship failed to materialize in a sustainable way. The FOMC recognizes that u-star is likely unobservable.

4. See the "whites of inflation eyes" – average flexible inflation targeting

In order to anchor longer-term inflation expectations at this level (2%), "*the Committee seeks to achieve inflation that averages 2 percent over time, and therefore judges that, following periods*

when inflation has been running persistently below 2 percent, appropriate monetary policy will likely aim to achieve inflation moderately above 2 percent for some time."

This is the big pivot that many Fed watchers have been expecting. The central bank's foundation for meeting the price stability mandate in the post Volker and Greenspan world is to anchor inflation expectation at 2%. As the prior graph above shows, since the Great Recession and the Global Financial Crisis, core CPI has been undershooting the 2% anchor even with the Effective Fed Funds Rates mostly hoovered at the ELB. This change in policy (the FOMC's reaction function to incoming inflation data) from the flexible inflation-targeting strategy to a flexible average inflation-targeting strategy is the next step to "symmetry":

1. The FOMC is abandoning the *ex ante* effort of projecting a rise in inflation based on the unobservable u-star, among other econometric factors, and will look to take *ex post* interest rate actions. Going forward, the FOMC shall rely on inflation evidence (rather than expectation or projection) or *ex post* data for some time before taking interest rate action.
2. The FOMC's reaction functions to inflation have not been, however, reduced to a mechanical reaction based on a qualifiable set of rules. For example, it is not clear how "periods" of undershooting the 2% target is defined, how long is "for some time" to allow inflation to remain above 2%, or how much above 2% would be deemed "moderately." It is understandable that the FOMC wants to reserve policy flexibility and optionality.
3. Since the FOMC has been seriously challenged in meeting a sustainable 2% inflation over time under an ELB environment and deploying UMPTs, this change in policy means that interest rates will remain lower for much longer.

In Vice Chair Richard Clarida's prepared remarks on August 31 at the Peterson Institute, he further emphasized that "*in economic downturns, the effective lower bound (ELB) will constrain the ability of the FOMC to rely solely on the federal funds rate instrument to offset adverse shocks. This development, in turn, makes it more likely that recessions will impart elevated risks of more persistent downward pressure on inflation and upward pressure on unemployment that the Federal Reserve's monetary policy should, in design and implementation, seek to offset throughout the business cycle and not just in downturns themselves*."

This affirms further that, for as long as there is a low r-star and u-star with a flat Phillips Curve, even during good economic times, we should expect an ultra-accommodative monetary policy. Thus, the famous line by Chair Powell during his June 10, 2020, press conference: "We're not thinking about raising rates, we're not even thinking about thinking about raising rates" is the new normal. This realty of "as far as the eyes can see" low rates has at least three ramifications.

1. Continuing to reward borrowers (financial repression) will eventually create great instability in the economy due to over-leveraging in all sectors – ballooning of government, corporate and household balance sheets.
2. Keeping the "risk free rates" low, all other assets, especially financial assets, will continue their upward trajectory in asset prices and return which further exaggerates income and wealth divide and promotes political instability. This would make monetary financing and universal income the rule rather than the exception.

3. The thirst for yield and return in a low interest rate environment persistently brings underestimation of risk and discounting to risk taking (the Fed provides the back stop). When future systemic shocks happen, such as an unexpected jump in inflation, the corresponding rise in risk free rates would force repricing of assets downward speedily and significantly.

In the meantime, take risk and the Fed has your back!

Related: The Un(settling) Normal

[1] https://www.bis.org/publ/cgfs63.pdf

[2] (1) Money market liquidity stress, (2) bank funding costs that disrupts the bank-lending channel, and (3) sovereign debt and currency anomalies

[3] With interest rates generally running closer to their effective lower bound even in good times, central banks have less scope to support their economies during an economic downturn by simply cutting the interest rate. 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.

[4] This rate is not affected by monetary policy but instead is driven by fundamental factors in the economy, including demographics and productivity growth - the same factors that drive potential economic growth.

[5] The natural rate of unemployment or NAIRU (the non-accelerating inflation rate of unemployment) is the rate of unemployment at which inflation is stable.

[6] https://www.federalreserve.gov/monetarypolicy/guide-to-changes-in-statement-on-longer-run-goals-monetary-policy-strategy.htm

About Us Sponsor Disclaimer Contributors Privacy Subscribe
Iris Media Works LLC © 2020