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GRISWOLD CENTER FOR ECONOMIC POLICY STUDIES (GCEPS) POLICY BRIEF
Evaluating the Federal Reserve's Long-Term Monetary Policy Framework: In Theory and in Practice

The Federal Reserve has made significant changes in how it proposes to conduct monetary policy. In the Fed's new long-term monetary policy framework, which was announced last year, the Federal Open Market Committee (FOMC) now seeks to minimize shortfalls in employment from the maximum level consistent with its inflation objectives and to achieve a 2% average annual rate of inflation over time. Previously, the employment objective had been symmetric, with FOMC seeking to minimize deviations from the maximum, sustainable level of employment consistent with its inflation objective, and the FOMC simply targeted 2 percent inflation all the time, regardless of past misses relative to that target.

The FOMC has operationalized the new long-term framework by setting three conditions that have to be met before the FOMC will raise its federal funds rate target from the zero lower bound: 1) The FOMC judges that employment is at the maximum sustainable level consistent with its inflation objective; 2) Inflation has reached 2 percent; and 3) the FOMC is confident that inflation will climb above 2 percent for some time in the future.

This brief assesses these shifts to the long-term monetary policy framework and the execution of monetary policy. What are the motivations behind these changes? What are the implications of these changes for the timing and magnitude of future monetary policy adjustments? And, how will these changes influence the nation's business cycle and the likelihood of future recessions? I conclude that while changes to the long-term framework were appropriate, how the Fed has operationalized the new frame work is more problematic. The conditions set for liftoff imply that the FOMC will be slow to raise rates and will have to raise rates by more, increasing the risk of recession.

Good Reasons for Change in the Long-Term Framework

Fed officials were well-justified to alter the long-term monetary policy framework. Under the old regime, if inflation persistently fell short of 2 percent and the Fed ignored these misses and treated them as bygones, inflation expectations could drift lower and fall below 2 percent. Such a decline in inflation expectations, in turn, could put downward pressure on actual inflation, making it more difficult for the FOMC to reach its 2 percent objective.

This risk was exacerbated by the effective floor on short-term interest rates at the zero lower bound. If the US economy fell into a recession, this could constrain the ability of Fed officials to deliver sufficient monetary policy stimulation to push the economy back towards full employment and 2 percent inflation. This, in turn, could cause inflation and inflation expectations to fall further, effectively tightening monetary policy and making it even more difficult to make monetary policy accommodative.

Moreover, both cyclical and secular trends in the macroeconomic environment were increasing the likelihood of such an outcome. On the cyclical side, the slow recovery from the Great Financial Crisis resulted in a chronic output gap and downward pressure on inflation. Inflation fell consistently below the Fed's 2 percent inflation objective through the onset of the pandemic.

The persistent shortfalls below the Fed's 2 percent objective, in turn, were causing inflation expectations to soften. This was apparent in both measures of inflation calculated from the yield differential between nominal Treasuries and Treasury Inflation Protected securities and in household surveys of inflation expectations. In recent years, both moved below the range that had been consistent with 2% inflation expectations.

Because inflation expectations are an important driver of actual inflation outcomes, the decline in inflation expectations was making it more difficult for Fed officials to push inflation up back to 2%.

On the secular side, the level of inflation-adjusted short-term rates consistent with a neutral monetary policy—so-called r*—had been falling. While it is not completely clear what was driving this—hangover from the GFC versus shifts in demographic and productivity trends, it was apparent that the neutral rate was now much lower than in the past. This was important because it meant that the cyclical peak in short-term rates would likely be considerably lower as well. Of course, this was precisely what occurred during the last business cycle, with the federal funds rate reaching a peak of only 2 ¼-2 ½%, far lower than in earlier business cycles.

As a result, there would be much less scope for cutting interest rates when the economy next fell into a recession. Where the risk of being pinned at the zero lower bound had once appeared to be mostly theoretical and improbable in practice, now the prospect of an early return to the zero lower bound was more likely than not. And, with the coronavirus pandemic, that's how things played out.

Recognizing this flaw in the Fed's monetary policy framework, Fed officials properly altered the inflation objective in order to keep inflation expectations better anchored. The notion is straightforward: If we successfully average 2 percent inflation over time, then it seems likely that inflation expectations will stay anchored around 2 percent.

Discussions of the new regime, however, miss a subtle point. The goal is to keep inflation expectations well-anchored at 2 percent, with the 2% average inflation regime just a means to this end. In particular, if the announcement of this shift in objective is fully credible, Fed officials might not have to make up for past shortfalls, but simply average 2 percent inflation in the future.

Early evidence strongly suggests that Fed officials will not have to make up the accumulated shortfall of inflation relative to 2% generated over the past decade in order to achieve their objective. Inflation expectations measured either by Treasury breakevens or household expectations have drifted up a bit over the past year and are now broadly consistent with the Fed's objective.

But Operationalized in a Way that Makes Interest Rates More Volatile and Raises Recession Risk

In contrast, the way in which Fed officials have operationalized the long-term monetary policy framework is more problematic because it means that the FOMC will be very slow to remove monetary policy accommodation. As a consequence, the FOMC will have to tighten more and this will increase the risk of recession in the future.

The new operational regime stands in sharp contrast to the old one. Under the old regime, the FOMC attempted to push short-term interest rates up so they would reach a neutral setting at about the same time the economy reached 2 percent inflation and full employment. In principle, if this were done well, the economy could then operate close to the Fed's employment and inflation objectives indefinitely.

In contrast, under the new regime, short-term rates aren't adjusted at all until Fed officials are confident that the economy has pushed the labor market past full employment. This means that monetary policy will still be very accommodative (short-term rates at zero) at a time that monetary policy should be tight.

It is important to emphasize that the new long-term monetary policy framework does not require Fed policymakers to start the tightening process so late. They could have set a less extreme standard. For example, they might have committed instead to begin tightening after substantial progress toward their goals was achieved or when they became confident that they would achieve their goals in the future.

Because the FOMC will be much slower (relative to the performance of the economy) to tighten monetary policy, when the FOMC finally moves, the Committee will have to do more. Short-term rates will need to be increased more because inflation will be higher when Fed officials start to tighten and because monetary policy will have to made tight in order to push the unemployment rate up and inflation back down towards the Fed's 2% objective.

As a result, the risk of recession will go up. That's because it is extraordinarily difficult for the Federal Reserve to engineer "soft landings from below". As Claudia Sahm has pointed out, every time the unemployment rate has risen by 0.5 percentage point or more, the result has been a full blown recession and a much larger rise in the unemployment rate.[1]

So why did the FOMC commit itself to being "late"? As I see it, the new regime was attractive in two important respects. First, by committing the FOMC to be "loose for long", that pushed back the expected timing of lift-off, pushed down long-term interest rates, and made financial conditions more accommodative. At a time that monetary policy was constrained by the zero lower bound for short-term rates and the economy was far from full employment, a high threshold for liftoff was a means of providing additional monetary policy accommodation.

Second, Fed officials were uncertain about what level of short-term interest rates were consistent with a neutral monetary policy and what level of employment was consistent with the Fed's 2 percent average inflation objective. During the recovery from the Great Financial Crisis, Fed officials had been surprised by the decline in the neutral short-term interest rate, r*, and how

[1] See Claudia Sahm, "Direct Stimulus Payments to Individuals," The Brookings Institute, May 16, 2019

little inflation consequence there was from a very low rate of unemployment. The new regime would essentially remove such guesswork. The Fed would keep short-term interest rates near zero until the labor market became sufficiently tight to generate higher inflation.

The shift also allowed Fed officials to underscore their commitment to get those who are less advantaged and less attached to the labor market employed. From a political economy perspective, this was particularly attractive in an environment in which the negative economic consequences of the pandemic were falling disproportionately on lower income households and the benefits of the Fed's monetary ease was mostly accruing to the more affluent—homeowners with mortgages or those with large portfolios of financial assets. It has helped to facilitate the focus of Fed officials on the large shortfall of employment from its pre-pandemic level in their commentary about monetary policy.

Regardless of the FOMC's motivation, the new regime is likely to become less attractive as the economy makes its way back to full employment. What was an attractive means of adding stimulus at the zero lower bound, will become much less attractive when monetary policy is still very easy at a time that economic conditions suggest it should be tight. In economists' parlance, the current regime suffers from a time inconsistency problem. What you promise to do, you won't actually want to do, in fact, when the time comes for the promise to be met. Of course, the FOMC could subsequently amend its conditions for lift-off to allow it to occur earlier. But, if it did so, its credibility would be questioned and this would compromise the power of forward guidance to provide additional monetary policy accommodation. There is no simple way out of the dilemma that the FOMC has created for itself.

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