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Economic Research Note

US: What's the latest with the Fed's framework review?

- **The Fed's monetary policy framework review should be completed in less than six months**
- **The review of communications and tools appears unlikely to produce any important changes**
- **The review of strategies, however, could pave the way for the Fed to move to flexible inflation averaging**
- **Whether such a change of strategies will impact monetary policy in 2020 is a tougher call**

Fed officials continue to reiterate that the first ever policy framework review is likely to be concluded by the end of the first half of the year. This review focused on three areas for consideration: strategies, tools, and communications. We believe the first of these—strategies—is the most meaningful for the conduct of monetary policy. Our longstanding expectation is that the strategy review would result in a shift from flexible inflation targeting—the current strategy—to a fuzzy version of average inflation targeting (see our notes here and here).

We believe recent Fed communications are consistent with expectations. For example, last month Fed Governor Brainard gave a speech endorsing this strategy, which she dubbed "flexible inflation averaging." Whether the completion of the review will have any implications for the conduct of monetary policy this year is an open question that we discuss later in this note. Before doing that, we briefly take stock of the framework review and of the motivation for flexible inflation averaging.

A time to reflect

The framework review was first announced in November 2018. A primary motivation for the review has been the decline in the neutral rate of interest, which means that the Fed will likely be constrained by the effective lower bound on nominal interest rates the next time the economy enters recession. At the outset, it was made clear that raising the inflation target wouldn't be considered and that negative interest rates were prejudged to be inappropriate for the US. Issues related to the implementation framework—e.g., the optimal level of reserves, the appropriate short-term interest rate to target, the long-run composition of the Fed's portfolio of securities—are being considered on a separate track and are outside the purview of the framework review.

As mentioned above, the review is focusing on strategies, tools, and communications. We take up these topics in reverse order starting with communications, the review topic about which Fed officials have said the least. Chair Powell mentioned that one of the important communication devices to be reviewed is the dot plot. When the Fed was still at near-zero interest rates, the dot plot was useful in underscoring the strong consensus on the Committee supporting a low-for-long policy. After liftoff, the purpose of the dot plot is less clear. Even so, Fed officials seem to have a strange attachment to the dot plot and appear to believe that discarding it would be a step back in transparency. Thus, we don't expect much to come out of the review of communications.

The tools that the Fed are examining are the ones used at the effective lower bound—asset purchases and enhanced forward guidance—as well as one tool they didn't use, yield curve targeting. The conclusions reached so far would not surprise observers of the Fed in recent years: Fed officials believe the asset purchases and forward guidance worked in providing meaningful stimulus when short-term interest rates were constrained by the lower bound, and they did so without noticeable adverse side effects. The opinions on yield curve targeting have been mixed.

It's not clear what to make of the review of the toolkit as it has merely reinforced the findings of the econometric studies of these tools. A cynic might view this as the Fed's self-congratulatory look back on the past decade. However, many Fed officials have also caveated these findings by noting that long-term interest rates are likely to be very low going into the next recession, thereby limiting the ability of asset purchases and forward guidance to lower them further and thereby provide material support to the economy.

From AIT to FIA…

Unlike the review of tools and communications, the review of strategies has the potential to change how policy is conducted and the future decisions of the FOMC. The strategy review has been delimited to a consideration of whether it would be useful to adopt a "makeup" strategy and, if so, which one. As the name suggests, a makeup approach to monetary policy seeks to make up past deviations of inflation from the 2% target. This is in contrast to the current strategy, in which "bygones are bygones," past inflation developments don't matter for the setting of current policy.

A principal motivation for considering makeup strategies is that an extended period of below-target inflation—like the one we have been experiencing—could lower inflation expectations. This, in turn, should lower nominal neutral interest rates. The lower the nominal neutral interest rate, the closer it is to the effective lower bound, implying that the Fed will have less scope to cut interest rates in the next downturn. In short: Japanification.

Makeup strategies seek to prevent this from happening. If a period of below-target inflation is followed by a period of above-target inflation, then inflation expectations are less likely to drift lower after an adverse shock to the economy, thereby short-circuiting the Japanification loop. Makeup strategies come in several forms, such as price level targeting, temporary price-level targeting, average inflation targeting, and nominal income targeting. We discuss the differences and similarities of these strategies in the note linked here. As we also observed in that note, average inflation targeting is the least revolutionary change relative to the current strategy.

We believe the Fed is leaning in this direction. The expected vague or flexible nature of such an average inflation target is meant to be realistic about situations where a mechanistic approach would risk de-anchoring inflation expectations to the upside or fostering financial instability. As mentioned earlier, Governor Brainard explicitly stated her preference for this policy, and several other Fed officials have spoken approvingly of such an approach. If this comes to pass, the change could be as simple as altering the phrase in the Statement on Longer-Run Goals and Monetary Policy Strategy that reads "The Committee reaffirms its judgement that inflation at the rate of 2 percent . . . is most consistent with the Federal Reserve's statutory mandate" by adding the phrase "on average" or "on average over the business cycle."

…and back to what people care about

Upon adoption, would this have any immediate implication for monetary policy? Let's examine the case for and against.

The case for action rests on the idea that if the Fed changes its strategy it should align that strategy with the proper policy. If the current setting of policy (a funds rate target of 1.5-1.75%) is appropriate for the current policy strategy (flexible inflation targeting), then it's unlikely that the same policy setting would also be appropriate for a different strategy (flexible inflation averaging).

Moreover, a change in strategy may require a change in actions to be viewed as credible by the public. For example, shortly after the Bank of Japan raised the inflation target to 2% (obviously, not a perfect parallel to adopting flexible inflation averaging) they implemented qualitative and quantitative monetary easing (or QQE). One might scoff at holding up the BoJ as a paragon, but a recent Fed study found that BoJ's target increase (followed up with action) was a success in economic activity terms and a partial success in inflation terms.

The case against action rests on the belief that monetary policy is already accommodative and so over time should foster above-trend economic growth that will gradually exert upward pressure on inflation. In particular, the policy target range of 1.5-1.75% is below the median Committee participant's estimate of the neutral rate, which is 2.5%. While this isn't stimulative enough to push the estimate of inflation above 2.0% in the median inflation forecast in the FOMC's Summary of Economic Projections, by 2022 it does push the central tendency of the core inflation forecast to 2.0-2.2%, thereby indicating a sense that the current policy setting could eventually engender a modest inflation overshoot consistent with flexible inflation averaging.

An additional reason that some FOMC participants have for not acting (but which will not be discussed in the Board Room) is the desire to duck and cover during an election year. This may be particularly true in a year in which economic activity—which is what most people really care about—appears to be doing fine. Additional stimulus to foster an overshoot could be delivered after the election. After all, even the BoJ did not roll out QQE until three months after raising their inflation target.

As we have weighed the merits of these arguments, we judged that the case for action was stronger. However, the recent communications from the FOMC indicate that most on the Committee are *very* comfortable with keeping policy on hold, and so we recognize there is a strong risk that policy rates are unchanged over the course of 2020.

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