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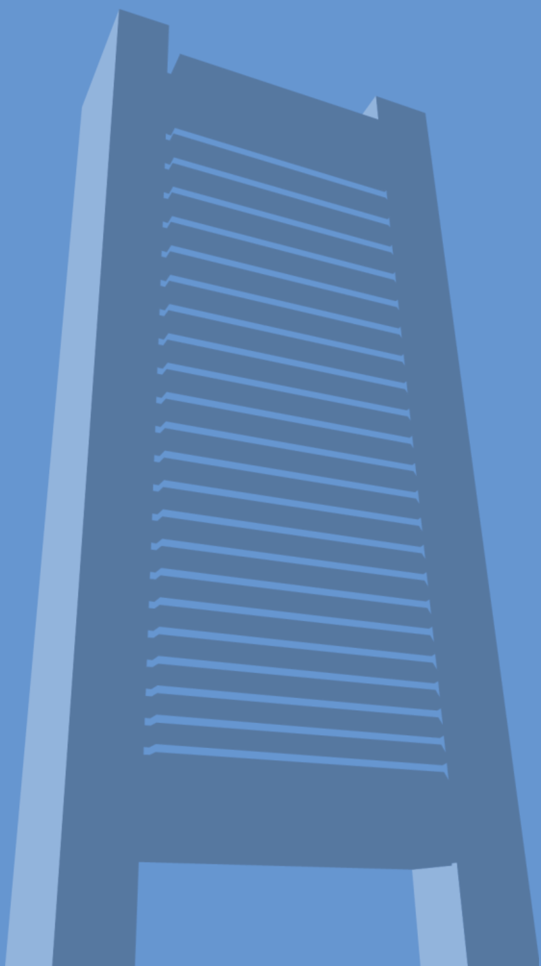

Reviewing Monetary Policy Frameworks

Eric S. Rosengren
President & CEO
Federal Reserve Bank of Boston

January 8, 2018

Brookings Forum on the Federal Reserve's Inflation Target
Hutchins Center on Fiscal & Monetary Policy
Washington, DC

bostonfed.org

United States Monetary Policy Framework

- Dual Mandate – maximum sustainable employment and stable prices
  - Explicitly defined stable prices as 2 percent PCE inflation
  - Maximum employment does not have a numerical target – given that the natural rate can move over time
  - Balanced approach – gives equal weight to deviations from both targets
- Each January the Committee reaffirms the framework
  - Potential to make changes each January – to date changes have been relatively modest
  - No mechanism equivalent to the five-year review done by Bank of Canada with outside comments and a public process

Why Should the Framework Potentially Change, if the Congressional Mandate Does Not?

- The 2 percent inflation target reflected a commonly used target of other central banks, and was consistent with a literature that viewed a 2 percent target as likely to be in the neighborhood of optimal
- That research significantly underestimated the real-world probability of hitting the effective lower bound
- Current characteristics of slow productivity growth, slow population growth, and aging demographics increase the probability of hitting the lower bound
- In fact, the optimal rate of inflation may move around just as does the natural rate of unemployment

Difficulty in Achieving Inflation Targets

- The U.S., Euro Area, and Japan have all fallen short of their inflation targets since the onset of the financial crisis
- Undershooting on inflation has occurred despite aggressive use of less-traditional monetary policy tools in the aftermath of the financial crisis, Great Recession, and very slow recovery

Other Factors Need to be Considered

- Fiscal policy constrained by rising debt-to-GDP ratios
- The potency of nontraditional monetary policy tools in generating robust recoveries is a topic of debate
- The trade-offs between the goals – and even the optimal level of the goals – may be different now than when the FOMC adopted the framework

Periodic Reassessment, Like that of the Bank of Canada, Would be Useful

- Federal Reserve led assessment that includes input from a variety of sources inside and outside the central bank
- Consider whether changed economic fundamentals (such as the equilibrium real interest rate) should alter how best to satisfy mandate
- Consider whether alternative frameworks would better meet the mandate
- Evaluate the costs and benefits of transitioning to a new framework and the longer-run implications

What Would be Reassessed?

- For example, a reassessment might include discussion of whether an inflation range, nominal GDP targeting, or price-level targeting would help the Fed better achieve its Congressionally-mandated goals
- In fact, my own view is that we should be focused on an inflation range, with the potential to move within the range as the optimal inflation rate changes
- This will be the topic of a talk I am giving later this week, when I will have an opportunity discuss the suggestion more fully

Process Should Reflect Unique Central Bank Features

- Appropriately balance the central bank's accountability to Congress for the mandate with its independence to pursue policymaking and technical refinements
- Would need to focus on the structural changes that have reduced the efficacy of the Fed's monetary policy framework, not the injection of short-term partisan political influence
- While any significant change in the framework should involve active consultation with Congress, the review should be focused on the technical framework

Process Should Reflect Unique Central Bank Features (Continued)

- My own personal preference would be to conduct a full review with a specified frequency – possibly longer than the five years used by the Bank of Canada
- However make it possible to call for an earlier review when warranted
- Clearly, however, this is just one approach and there are a variety of other permutations that could be considered by the FOMC

Concluding Observations

- The Bank of Canada provides a process which I view as quite instructive
- In my own view, the costs of hitting the effective lower bound for a prolonged period should cause a reassessment of the 2 percent inflation target
- Having a process that can fully and more transparently examine the monetary policy framework would be a process improvement