Challenges Around the Fed's Monetary Policy Framework and Its Implementation

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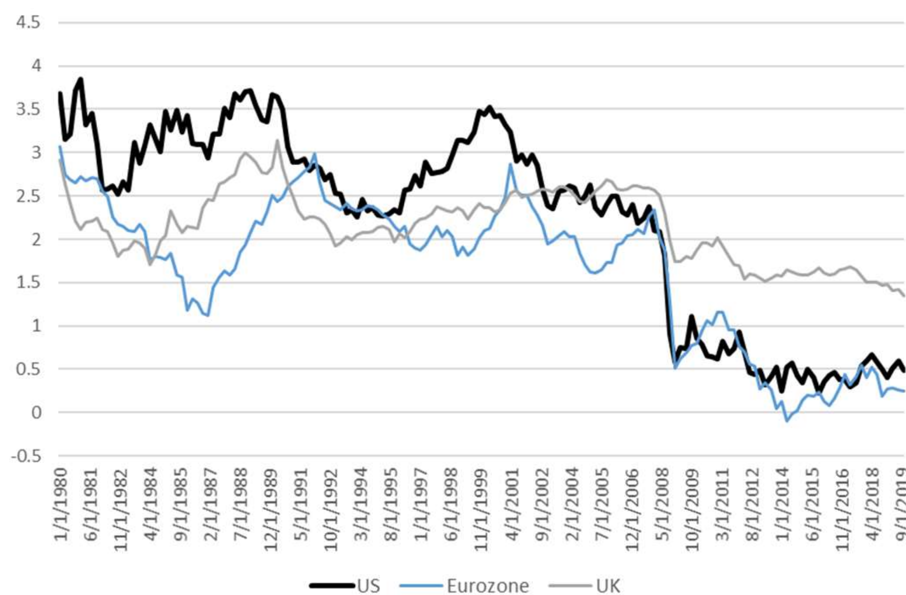
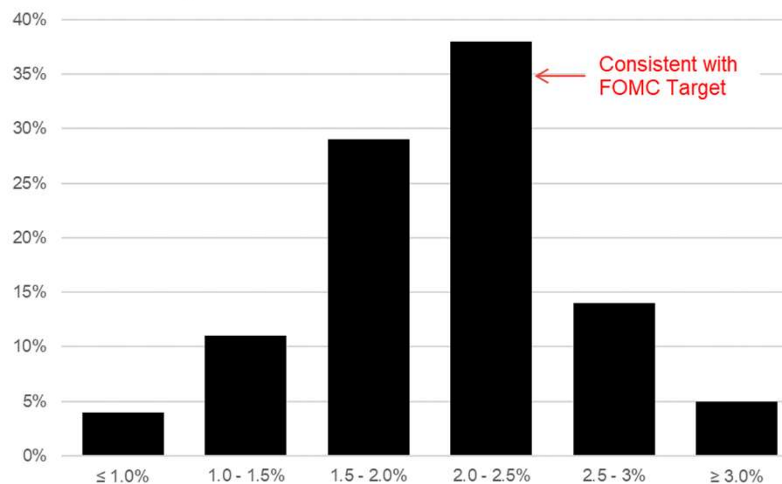
The Fed’s Policy Framework Review

- In the fall of 2018, the Federal Reserve announced a review of its monetary policy tools, framework, and communications
- The results of the review were announced by Chair Powell at the Jackson Hole symposium in August 2020
- A revised “Statement on Longer-run Goals and Monetary Policy Strategy” was released at that time
- The implementation of that framework took place through changes to the FOMC statement in September and December 2020 and through subsequent policy decisions

Context for the Policy Framework Review



Note: Holston-Laubach-Williams one-sided estimates made in 2019Q4.
Source: FRBNY.



Note: Responses on the distribution of outcomes from Primary Dealer Survey in December 2019.
Source: FRBNY.

Key Components of the New Policy Framework

- Focus on "shortfalls" from maximum employment
  - "In setting monetary policy, the Committee seeks over time to mitigate shortfalls of employment from the Committee's assessment of its maximum level"
  - This language replaced "deviations" from full employment
- Adoption of Flexible Average Inflation Targeting (FAIT)
  - The FOMC "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 a make-up strategy of the type that appears effective in models
  - The amount of intended inflation overshooting was not specified

The Implementation of the Policy Framework

- Guidance on the path for the federal funds rate
  - In September 2020, the FOMC indicated that it "expects it will be appropriate to maintain this target range [0 to ¼ percent] until labor market conditions have reached levels consistent with the Committee's assessments of maximum employment and inflation has risen to 2 percent and is on track to moderately exceed 2 percent for some time."

- Large-scale asset purchases
  - FOMC bought $4.5 trillion in assets in total
  - After very rapid purchases for several months beginning in March 2020, the Fed settled into a pace of purchasing $80bn of Treasuries and $40bn of MBS per month
  - Net purchases continued until March 2022

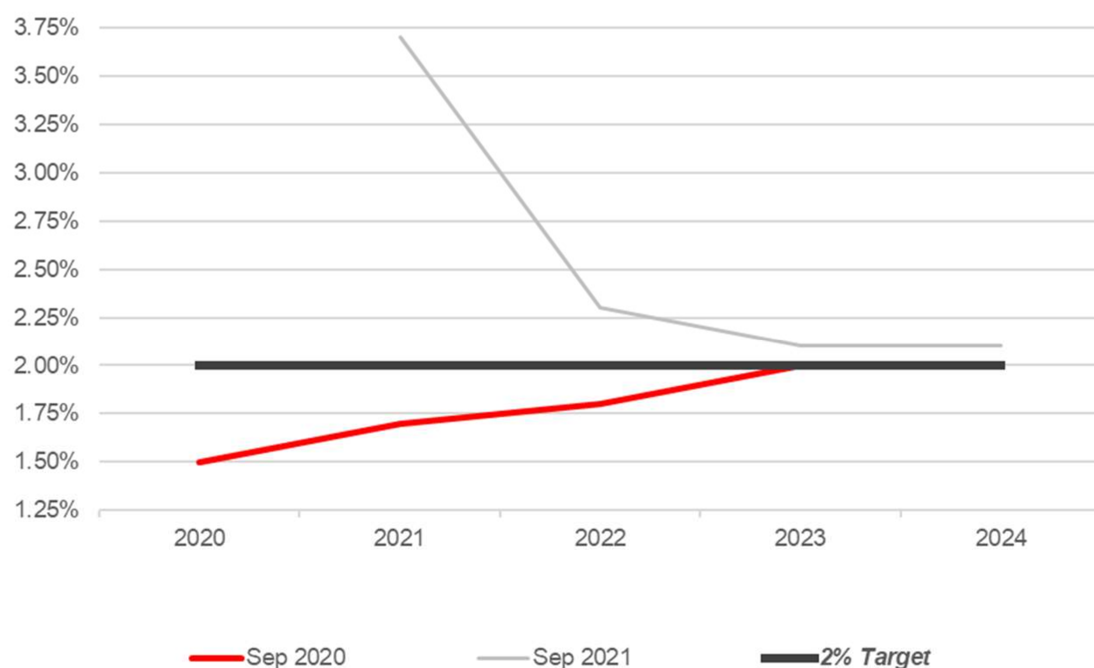
Our Own Review of the Policy Framework

- The Fed’s new policy framework was aimed too narrowly at the specific set of economic circumstances it had faced
- The implementation of the policy framework needed more careful calibration and communication by the FOMC

Focusing on Shortfalls Could Hamper Preemptive Policy

- The focus on shortfalls appears to apply to the Fed's policy reaction function (not just the objective function)
  - Framework statement: "The Committee's policy decisions must be informed by assessments of the shortfalls of employment from its maximum level"
  - Chair Powell (2021): "This means that we will not tighten monetary policy solely in response to a strong labor market."
- Not responding to actual or expected labor market tightness could be problematic in some situations
  - Clarida (2020) notes that lags in the effects of policy mean that policymakers must be forward looking
  - Kiley (2024) shows that poor economic performance can result if policymakers only respond to employment shortfalls

FAIT May be Less Effective than Hoped

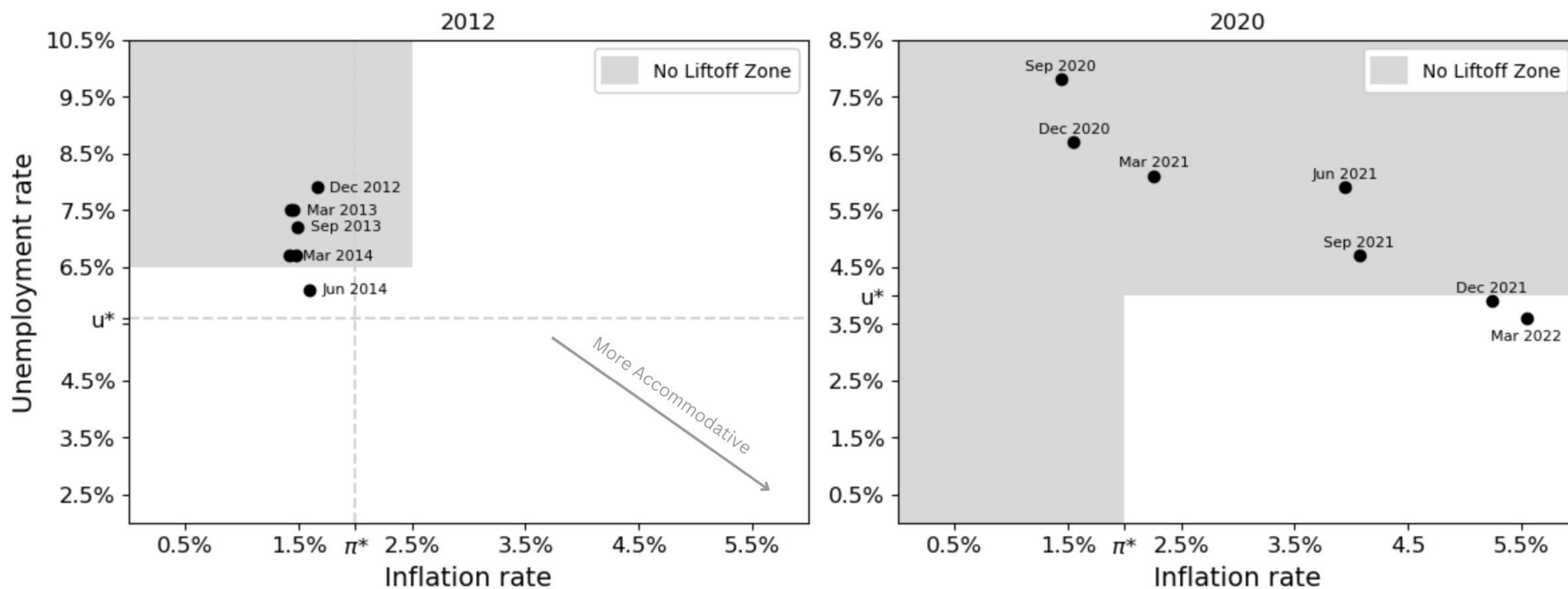


- When inflation was below target, the FOMC never indicated the extent of inflation overshooting that it intended

- When inflation moved above target, FAIT seemed to confuse some observers

- Chair Powell (2021): "The inflation that we got was not at all the inflation we were looking for or talking about in the framework."

Policy Guidance Needs to be Appropriately Conditioned



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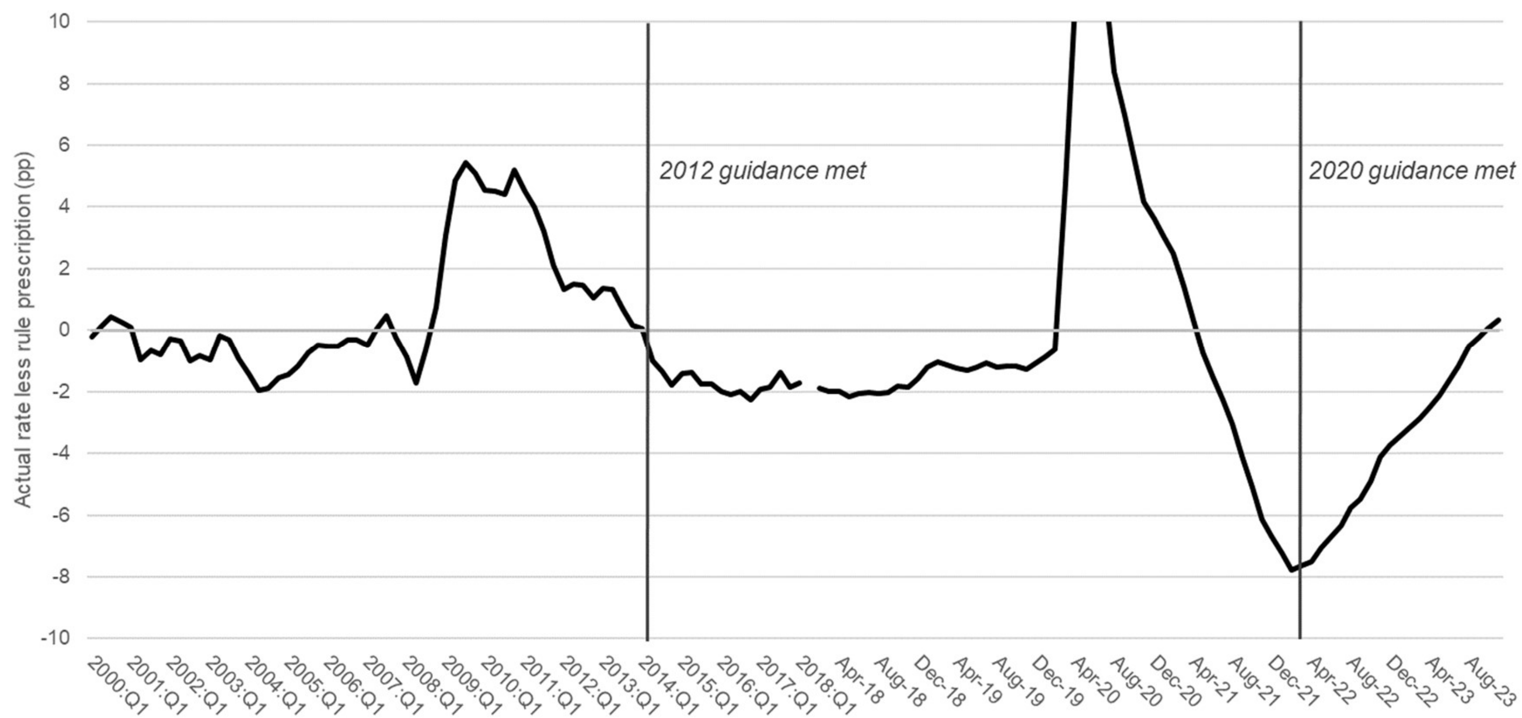


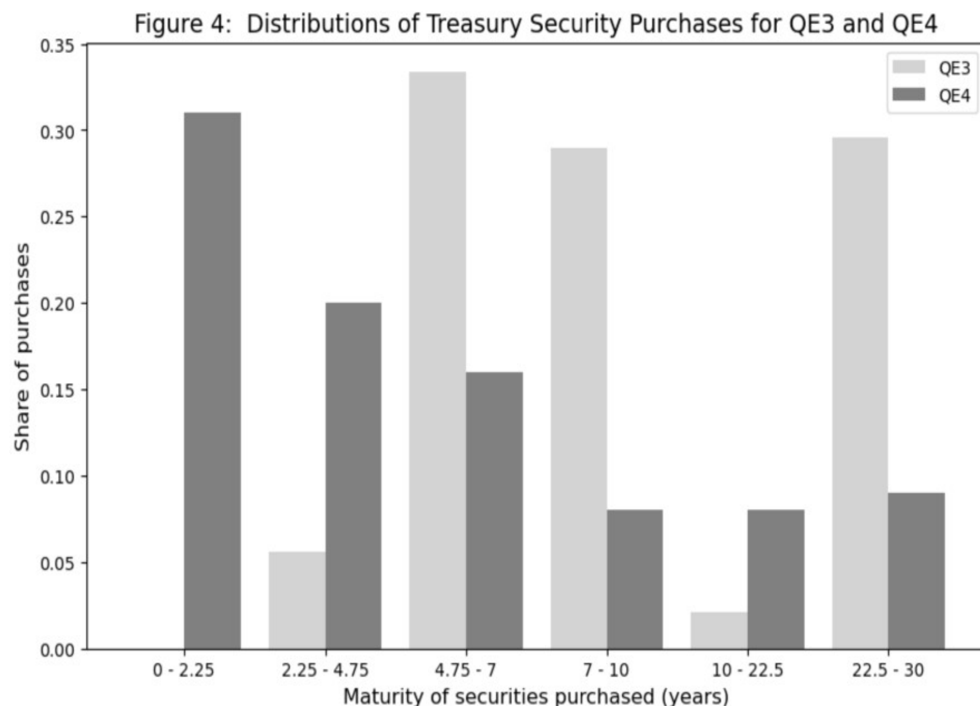
QE Needs More Careful Calibration

- QE4 was notably larger than earlier QE programs
  - Totaled 15% of GDP in terms of ten-year equivalents
- These asset holdings represent a meaningful amount of additional policy accommodation
  - Estimates in the literature would map the asset holdings into the equivalent of 2 to 3 percentage points of easing with the federal funds rate
- It would be surprising if an effective policy rule would have called for that much accommodation over the second half of 2021 and into 2022
  - The balanced approach rule moved to a positive policy rate prescription by mid-2021
  - The housing market did not need the additional stimulus from MBS purchases

QE Needs Better Communication

- FOMC did provide guidance on asset purchases from late 2020, but the guidance was vague
  - "The Federal Reserve will continue to increase its holdings of Treasury securities by at least $80 billion per month and of agency mortgage-backed securities by at least $40 billion per month until substantial further progress has been made toward the Committee's maximum employment and price stability goals."
  - Not much additional clarification from other FOMC communications
  - Balance sheet not included in the SEP
- FOMC's communications left ambiguity in purpose of asset purchases
  - From September 2020 to March 2022, the stated purpose was "to sustain smooth market functioning and help foster accommodative financial conditions"
  - But the right structure of QE would be different across those two purposes

Choosing the Appropriate Structure of QE



Note: The figure shows the share of Fed purchases in the indicated maturity ranges. The figure excludes Treasury inflation-indexed securities, which accounted for 3% of purchases during QE3 and 8% during QE4.
Source: Federal Reserve.

- QE4 was skewed towards short- and intermediate-term securities
- That likely reflected its market functioning purpose
- But this distribution was likely not optimal for QE aimed at general policy accommodation

Suggested Changes to the Framework

- Make the framework more “constitutional”
  - Drop the indication that policy depends on shortfalls from maximum employment
  - Move from FAIT back to more traditional inflation targeting
  - Emphasize a commitment to use the policy instruments aggressively to achieve the mandate and focus on anchoring longer-run inflation expectations at the target
- Improve the implementation of the framework
  - Ensure that conditioning of policy guidance on economic outcomes does not result in such large deviations from normal policy benchmarks that they risk highly costly economic outcomes
  - Be clear on the calibration and path of asset purchases and more clearly separate monetary-policy QE and market-functioning QE
- Framework reviews would then focus on evaluating the implementation of the framework rather than on regularly updating the framework