Considerations for a Post-Pandemic Monetary Policy Framework

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Features of Good Monetary Policy

- Raise interest rates to fight inflation
- Lower interest rates to fight economic distress
  - 500bp of FF-Capacity is a typical norm (Yellen 2016)
- Recognize risks from ELB when neutral rates are low
  - 300bp with QE and Threshold FG may work (Reifscheider 2016)
- Be mindful of unusual inflation risks emanating from supply shocks and challenges

2020 LR Framework

- Federal funds rate is primary policy instrument
  - Explicitly mentioned the risk of Effective Lower Bound
  - Other available policy tools mentioned

- Re-affirm 2 percent PCE Inflation objective, with addition to average 2 percent over time
  - Strengthened inflation expectations anchoring
  - State-contingent FAIT introduced; language is flexible

- Maximum employment mandate narrowed to focus on employment shortfalls (only)
  - Is low unemployment undesirable owing to intrinsic labor market dysfunction or Phillips Curve inflation risks?

Sturdy Framework

- September 2020 FAIT guidance reinforced commitment to symmetry around 2 percent inflation
  - Unexpected supply disruptions in 2021-22
  - Strategy v. Tactical Implementation issues; learnings

- Aggressive FOMC tightening from March 2022-July 2023 was aligned with 2020 LR framework price stability commitments

- Which states-of-the-world were uncovered?

Was 2020 Framework an over-reaction?

- Humility? Introduce relevant strategic features that were absent or challenging to implement under 2012 Framework

- Over-reaction? Introduce features that handicap the implementation of "Good Monetary Policy"

- Candidates for over-reaction:
  - Focusing on employment shortfalls sounds the deathknell of pre-emptive monetary policies
  - Introducing two asymmetric features --- FAIT and shortfalls only --- will lead to asymmetric, excess inflation above 2 percent

Employment shortfalls – build a better inflation forecast

- Federal Reserve Act's mandate includes supporting maximum employment: is this u(t)-u*(t) risks?
  - On low unemployment risks, 99 percent of FOMC discussions are about *implied inflation risks*; not dysfunctional labor markets
- Can't any Fed critics write down an explicit inflation model?
  - Criticizing Phillips Curve inflation forecasts seems odd if one faults a new focus on employment shortfalls
  - Martingale statistical forecast is not a model
  - Basing pre-emption simply on a low unemployment rate is simplistic
- Put more focus on identifying intrinsic inflation risks when unemployment is low

FAIT and Shortfalls – bias-correcting for Conservative Central Bankers

- Rogoff (1985) – Conservative Central Bankers can offset Barro-Gordon discretionary inflation bias
  - My casual empiricism sees very strong conservatism
- FAIT and shortfalls attempt to offset CCB asymmetries
  - Question: Why is overshooting pi* controversial in the first place?
- Example 1: Strong discomfort with inflation above pi*
  - State-contingent FAIT encourages averaging away undershoots
  - Shortfalls encourages greater focus on inflation risks, not bias
- Example 2: CCB end up less confident of QE/FG tools after material time spent at ELB
  - Asymmetric instrument confidence leads to low inflation bias

Everything starts with pi* = 2

- State the case for why 2 is best
  - Consider a *Reverse Trichet*: inflation should be above but close to 2 percent

- If pi* is not symmetric around 2, be honest and state that 2 percent is merely aspirational, a ceiling for inflation. Let the dual mandate and inflation expectation chips fall where they may.
  - BIS/G30/Rajan argue for (1) a cushion between low inflation and the 2 percent goal (to keep R better for financial stability), and (2) strongly fighting risks of rising inflation (pre-emption).

- Communications and FG – Own it and be explicit
  - Eschew FG? The Fed's 2024 insistence that they needed confidence before it would be appropriate to reduce FF was FG.
  - Introducing "confidence" in January 2024 was hugely convenient; not as much at the uncertain endgame. Need to own FG entry and exit.