Reviewing Monetary Policy Frameworks

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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 to 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
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.