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Monetary Policymaking in Today's Environment: Finding "Policy Space" in a Low-Rate World

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Recent Economic Results Relatively Positive

- Fed's dual mandate – maximum employment and stable prices
  - Unemployment is 3.8 percent – good news for many including graduating seniors – tight labor markets
  - Real GDP likely a little above 2 percent – fast enough to tighten labor markets somewhat further
  - Inflation – Core PCE – averaged 1.8 percent over the past year – a little below the Fed's 2 percent inflation target
- Inflation has been somewhat lower than expected – a pattern that has persisted for most of the recovery
  - Slow recovery in aftermath of Great Recession
  - Japan and Europe are undershooting their inflation targets by a larger extent
  - Inflation below target is one reason to be patient in determining future rate adjustments

Why is Undershooting Inflation a Problem?

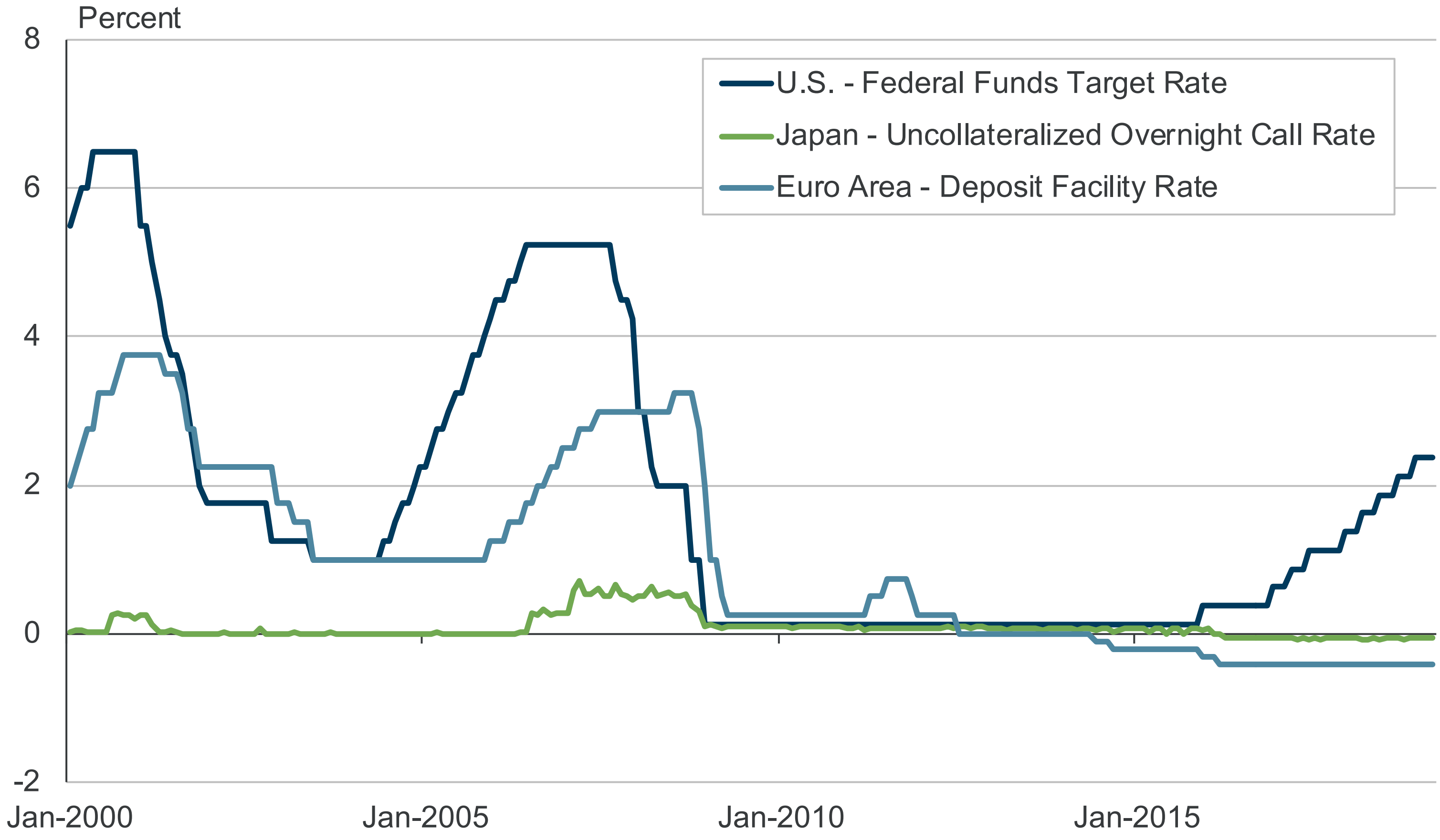
- Persistent misses on the target can cause inflation expectations to decline
  - Japan is a leading example of allowing expectations to drift down
  - Japan has shown that expectations below target are difficult to alter
- Low inflation, particularly when real interest rates are low, provides little room for traditional monetary policy
  - Federal funds rate is effectively 2.4 percent
  - In response to most recessions, the Fed typically lowers the federal funds rate 5-6 percentage points

Having Adequate Monetary Policy “Space”

- To have flexibility to lower interest rates in a downturn, need monetary policy space
- Important to keep inflation expectations anchored at 2 percent
- A major topic of the Federal Reserve – a review of the monetary policy framework
  - What are the tools and processes that best attain economic goals?
  - Can the Fed better reinforce its 2 percent inflation target?

Figure 1: Overnight/Policy Rates for the Euro Area, Japan, and the U.S.

January 2000 - March 2019

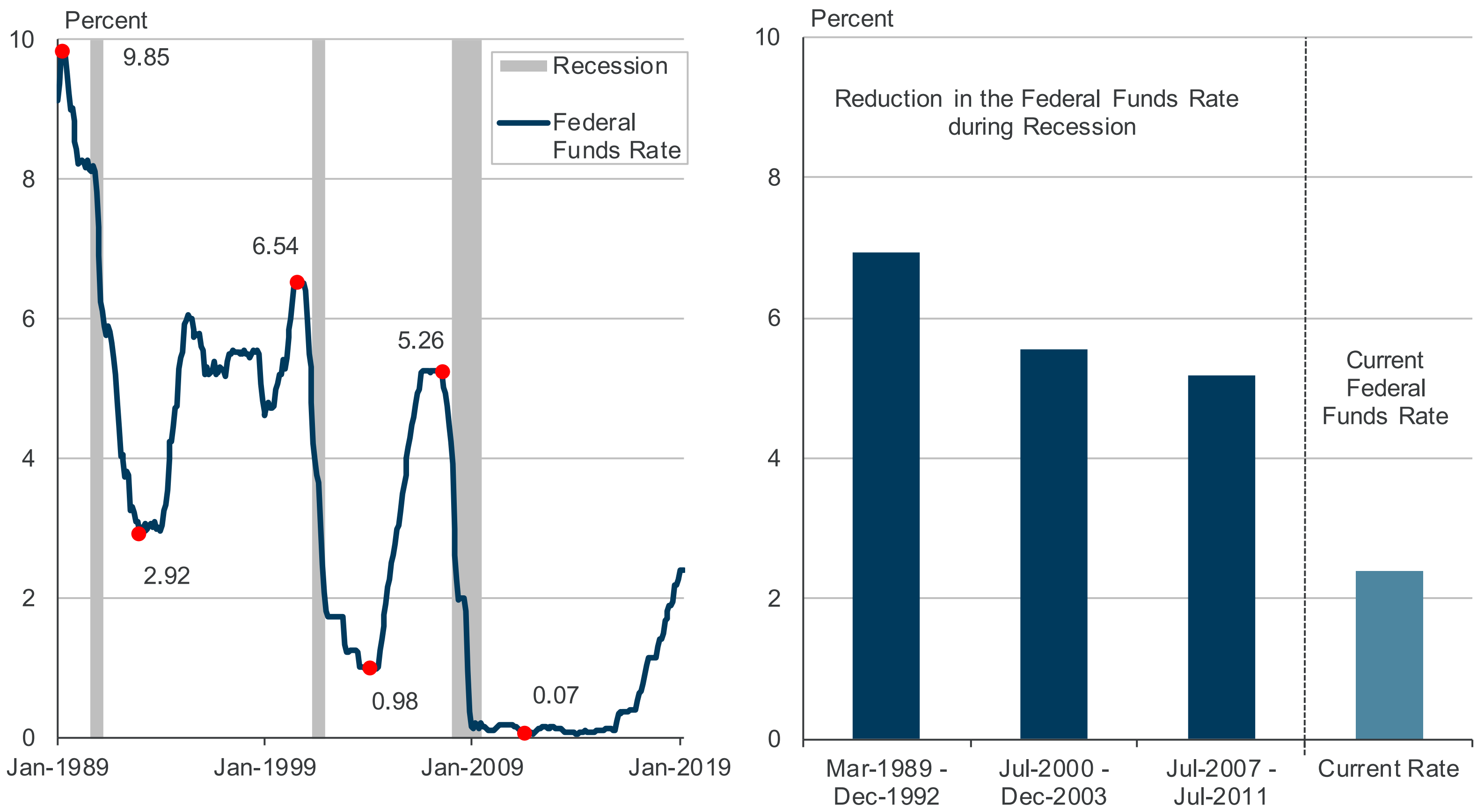


Note: Rates are as of end of period. U.S. target rate is the midpoint of the target range, beginning in 2008.

Source: Bank of Japan, European Central Bank, Federal Reserve Board, Haver Analytics

Figure 2: Change in the Federal Funds Rate from Rate Peak to Rate Trough during the Last 3 Recessions

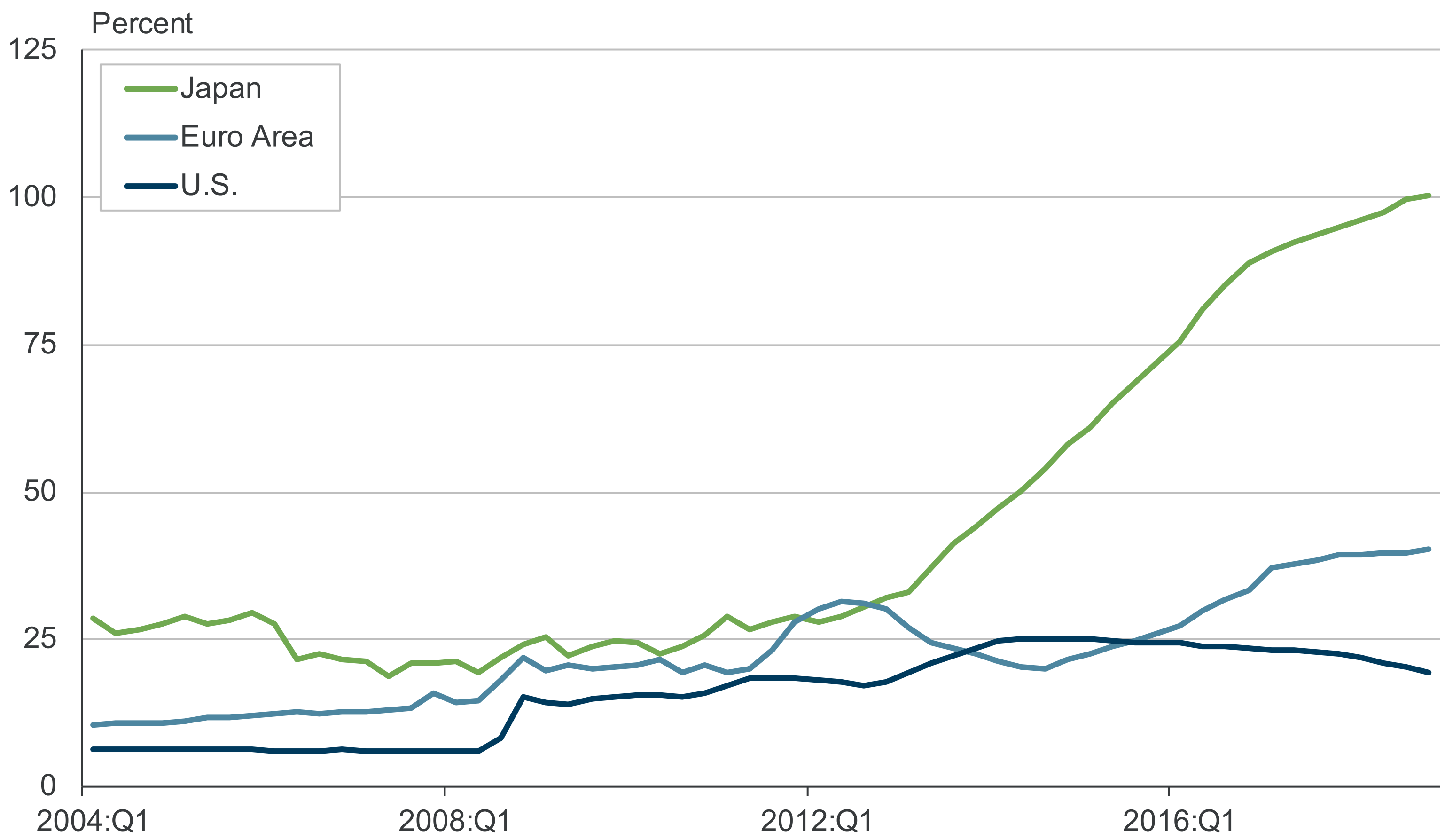
January 1989 - March 2019



Source: Federal Reserve Board, NBER, Haver Analytics

Figure 3: Central Bank Assets Relative to GDP

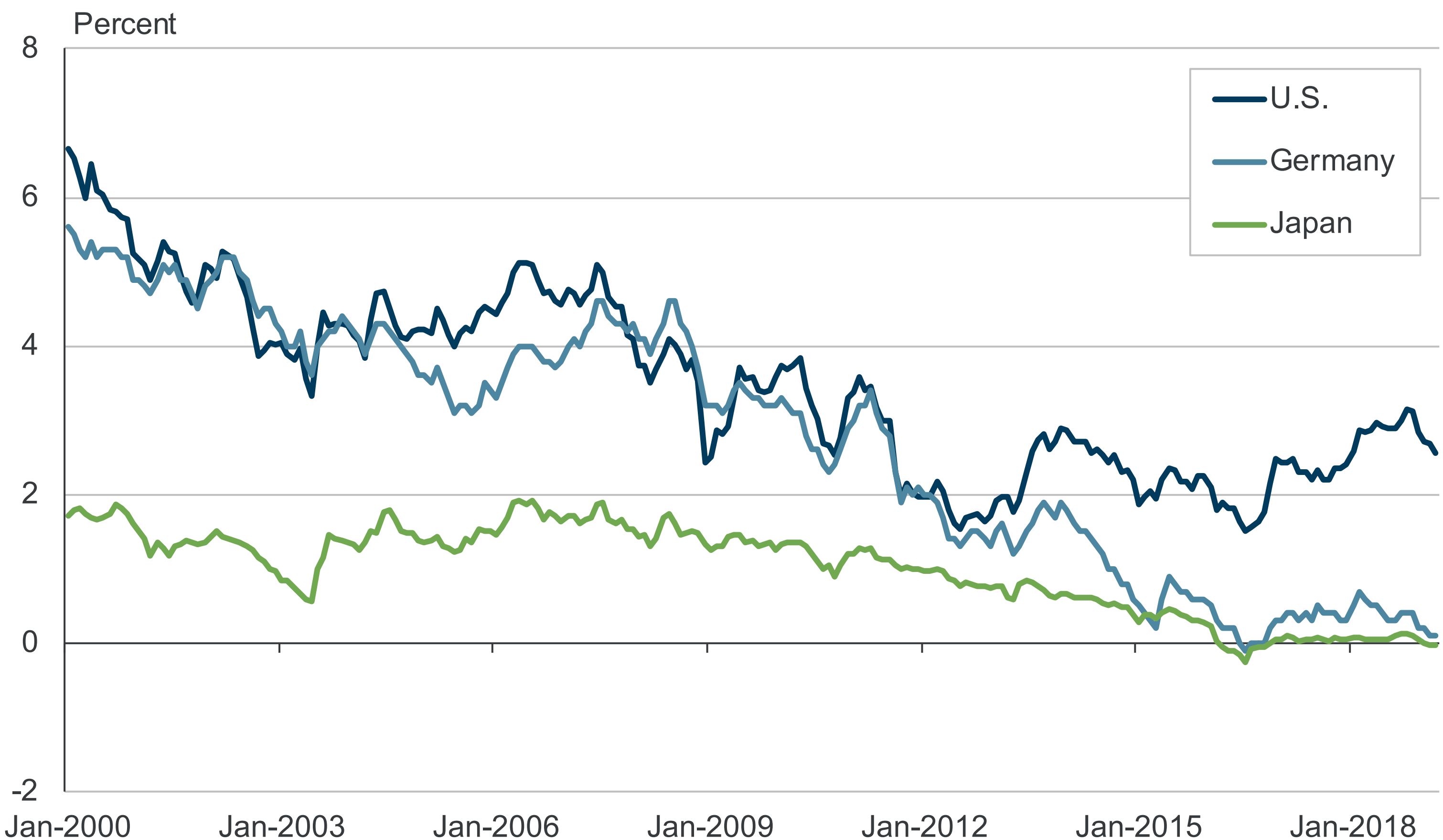
2004:Q1 - 2018:Q4



Source: Bank of Japan, Cabinet Office of Japan; European Central Bank, Eurostat; Federal Reserve Board, BEA; Haver Analytics

Figure 4: Ten-Year Government Bond Yields

January 2000 - March 2019



Source: Deutsche Bundesbank, Federal Reserve Board, Japan's Ministry of Finance, Haver Analytics

Limited Policy Space

- Short-term interest rates are quite low in many developed economies, raising important issues about how to best conduct monetary policy
  - Japan and the Euro Area have no significant space to reduce short-term rates
  - The U.S. has some limited space, but probably not enough to react to a slowdown by only lowering short-term rates
- Long-term government bond yields are also quite low in Europe and Japan – limiting the effectiveness of another policy tool – Quantitative Easing (QE)
- Central banks in many developed countries have little monetary policy space with which to operate should a downturn occur
  - Note that a recession is not my modal forecast
  - However, we should be prepared for a hypothetical next recession

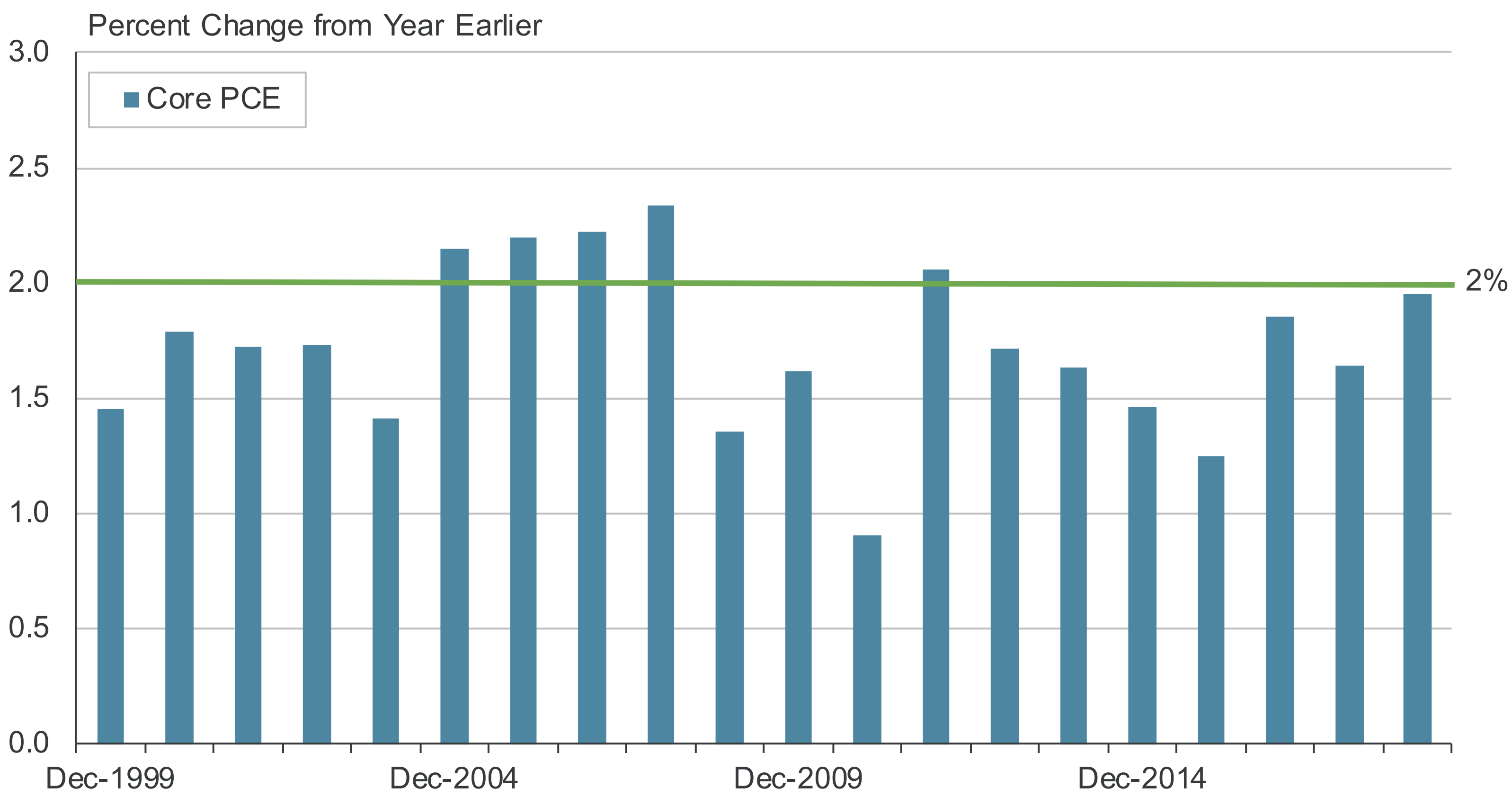
Figure 5: Components of Nominal Interest Rate

Note: Core PCE excludes food and energy. The proxy for Core PCE inflation expectations is the median forecast for core PCE inflation for 2019 measured on a fourth-quarter to fourth-quarter basis from the most recent Survey of Professional Forecasters.

Source: Federal Reserve Board; Federal Reserve Bank of Philadelphia, Survey of Professional Forecasters, March 22, 2019; Haver Analytics

Figure 6: Inflation Rate: Change in Core Personal Consumption Expenditures (PCE) Price Index

December 1999 - December 2018

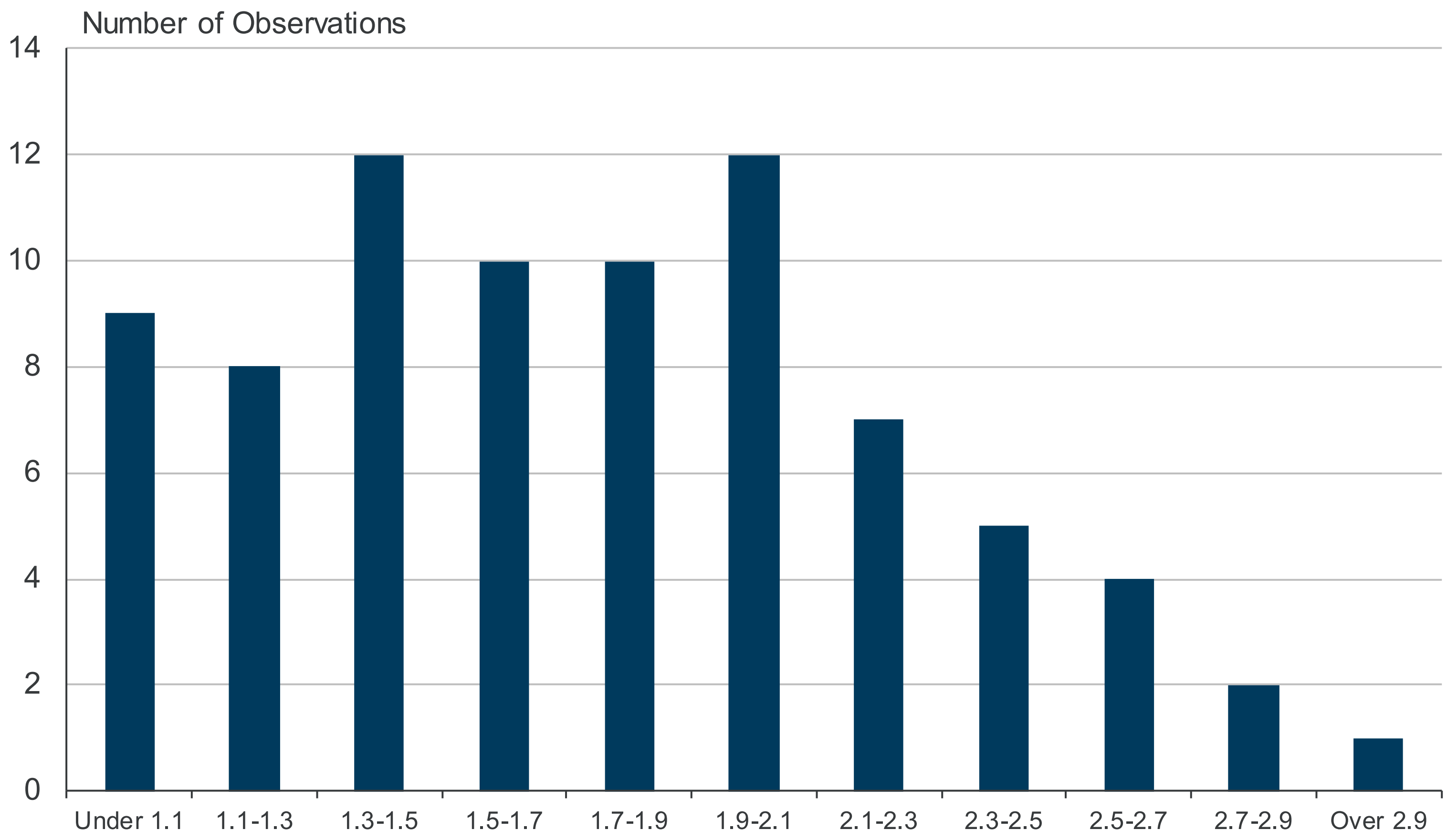


Note: Core PCE excludes food and energy.

Source: BEA, Haver Analytics

Figure 7: Distribution of Quarterly Percent Changes in Core Personal Consumption Expenditures (PCE) Price Index over 20 Years

1999:Q1 - 2018:Q4



Note: Core PCE excludes food and energy.

Source: BEA, Haver Analytics

Are We Reaching a Symmetric 2 Percent Inflation Target?

- Hard to argue that the target has been symmetric
  - Observations of inflation have tended to undershoot target
  - Would expect observations to be more symmetric around 2 percent
  - The 2 percent goal has acted more like a ceiling
- Provides a key reason to hold rates steady
- Symmetric 2 percent inflation target has been elusive over the past 20 years
- Should we alter the monetary policy framework to get more policy space?
  - If inflation expectations slip, we will have less policy space
  - Would a change in the framework improve the Fed's ability to reach its 2 percent goal?

Figure 8: Symmetric Inflation over the Business Cycle

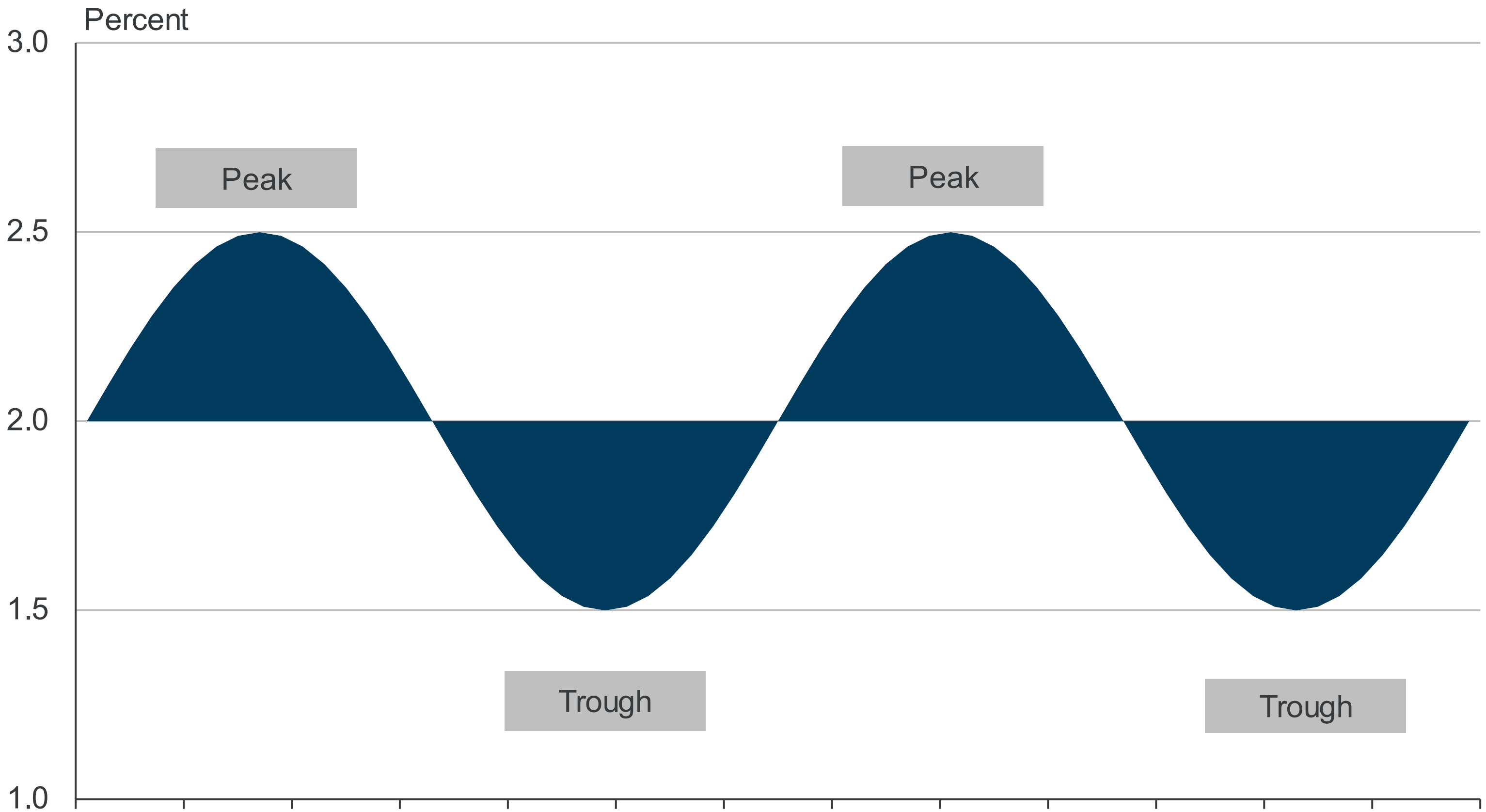
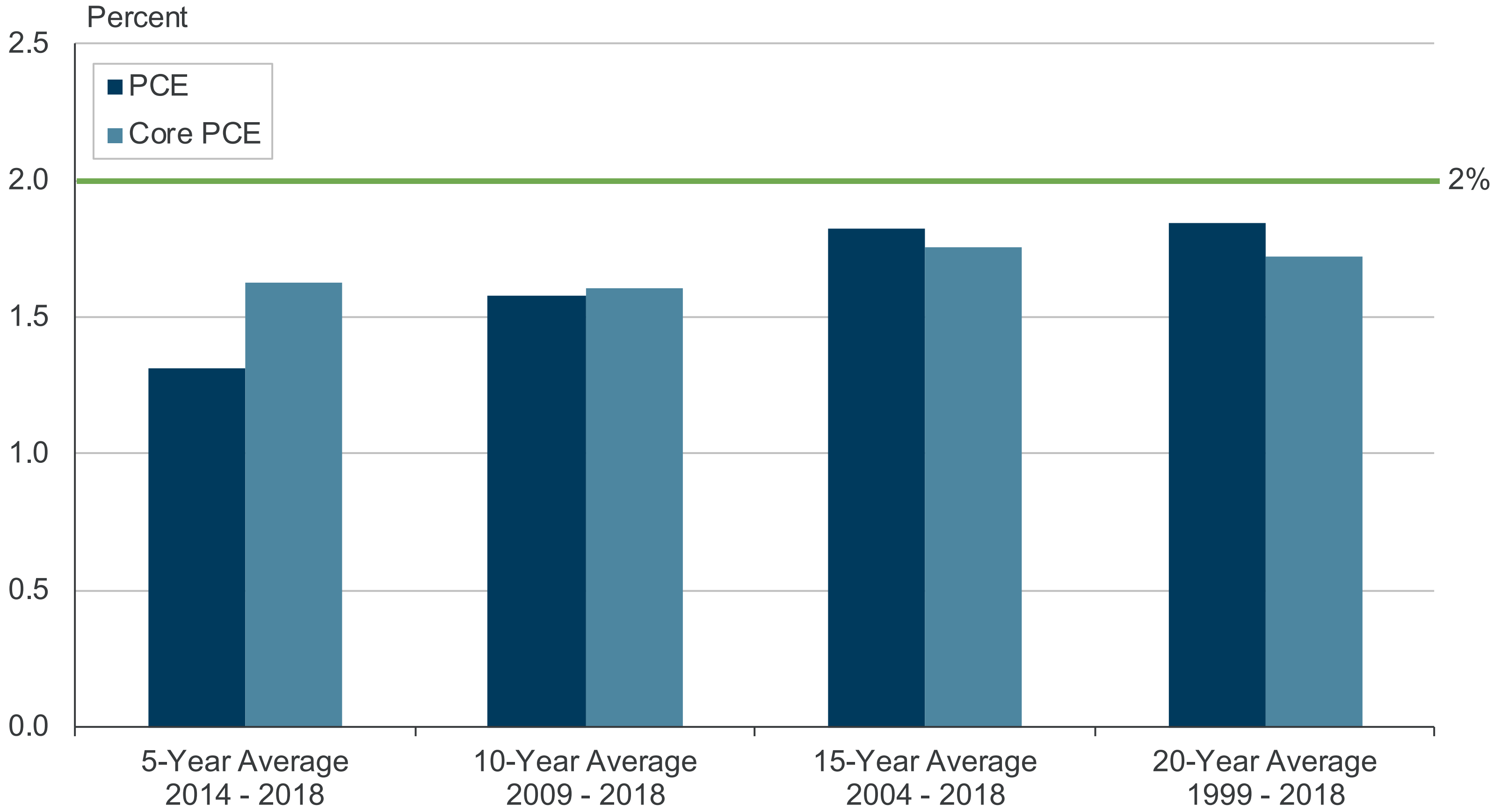


Figure 9: Average Inflation Rate: Change in Personal Consumption Expenditures (PCE) Price Indices

1999 - 2018

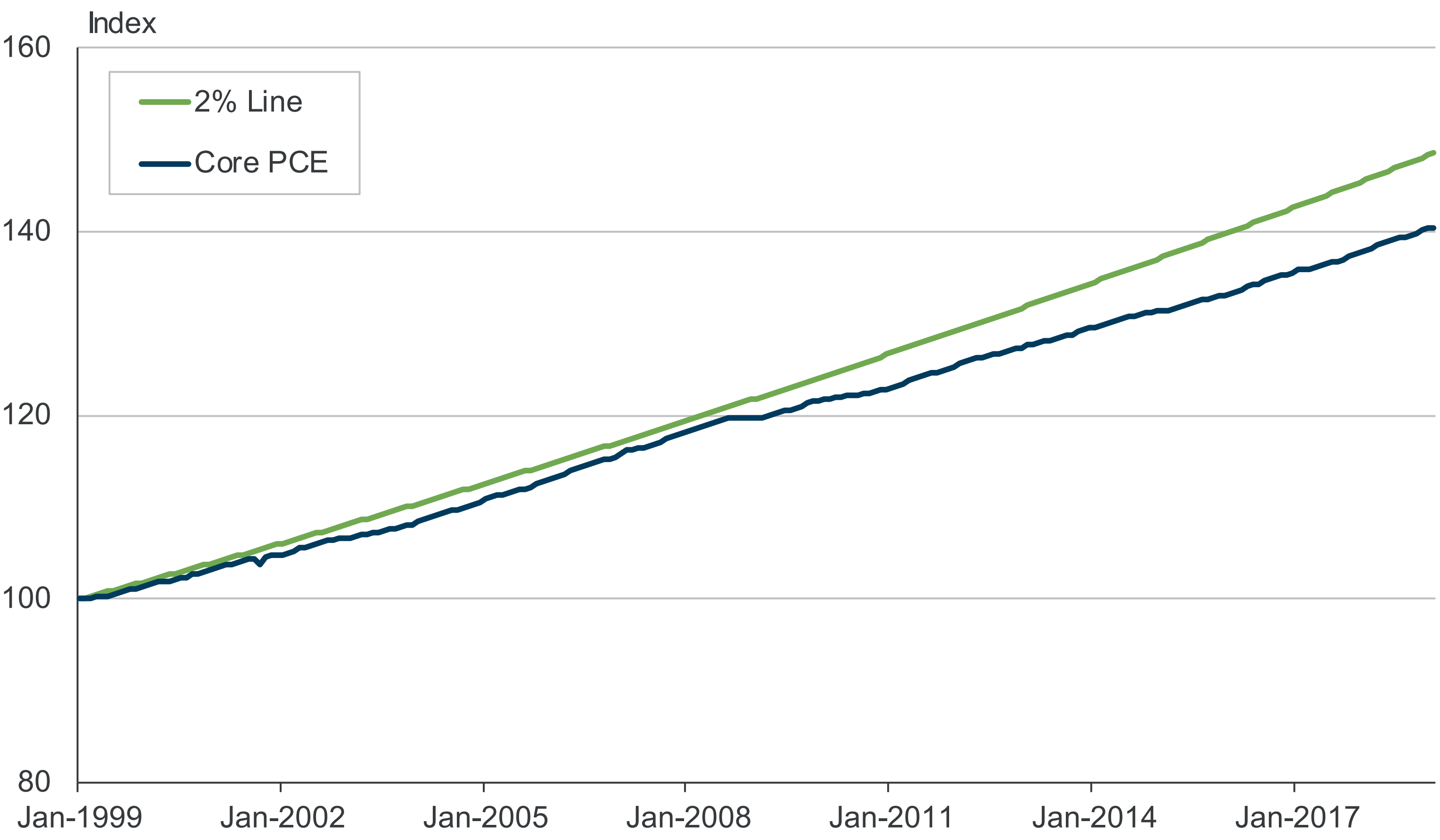


Note: Core PCE excludes food and energy.

Source: BEA, Haver Analytics

Figure 10: Core PCE Inflation Rate and Price Level Target of 2 Percent

January 1999 - January 2019



Note: Core PCE excludes food and energy. Index level January 1999=100.

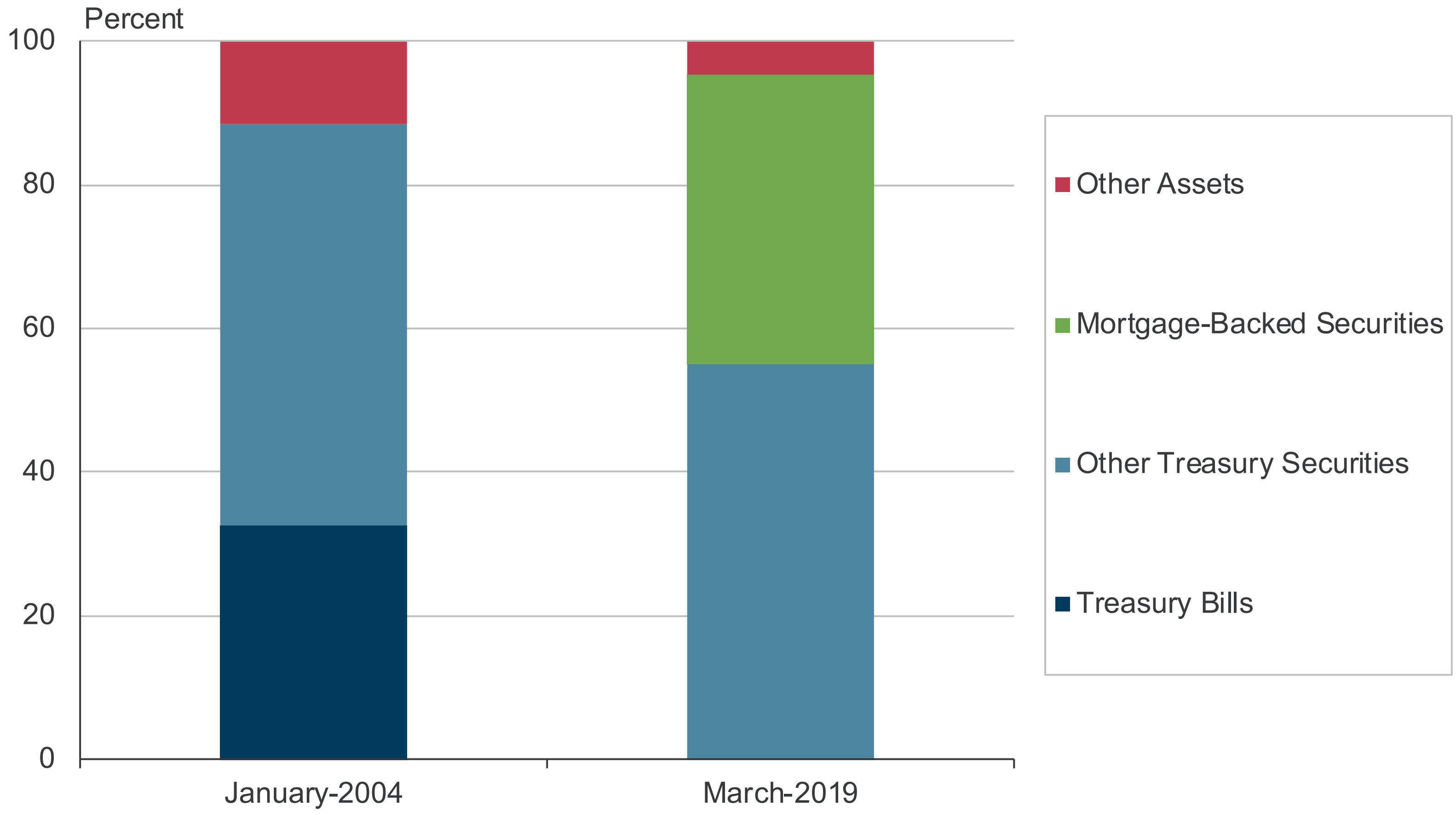
Source: BEA, Haver Analytics

Framework Changes Could Reinforce 2 Percent Target

- Inflation range – for example, 1.5 to 2.5 percent
  - Hard to precisely hit inflation target
  - Likely undershoot in recessions – particularly with low interest rates and greater likelihood of reaching the effective lower bound
- Inflation average
  - Details matter – over what period, future or just past?
  - If recession lowers inflation below target, expectation that Federal Reserve will generate higher-than-target inflation in the future
- Price level target
  - Harder to explain
  - Will likely engender a more symmetric outcome
- I have a mild personal preference for an inflation range

Figure 11: Federal Reserve System Asset Composition

January 2004 and March 2019



Source: Federal Reserve Board, Haver Analytics

Concluding Observations

- Challenges of a low interest rate environment
  - Problem in many developed economies
  - Provides limited policy space
- Good time to evaluate monetary policy framework
  - Consider whether alternative frameworks might better achieve outcomes
  - Providing policy space is important for action in hypothetical future economic downturns