FEDERAL RESERVE BANK OF BOSTON™

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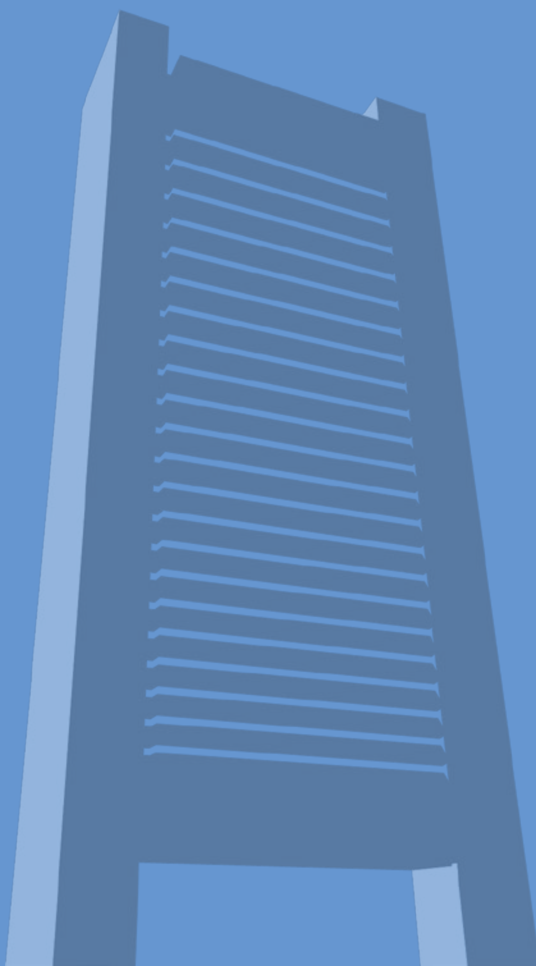
Should the Fed Regularly Evaluate its Monetary Policy Framework?



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Disclaimer:

The views expressed in this presentation are those of the authors, and do not necessarily reflect those of the Board of Governors or the FOMC

Overview

- The Fed has changed key elements of its framework many times
  - Many causes: change in economic structure, poor economic performance, evolution of economic understanding
- The Fed regularly reviews aspects of its framework as part of its internal processes
- The question is whether a more formal – and open – review might improve outcomes
- We will argue that the answer to the titular question is “yes,” although the details of how best to evaluate are uncertain
- We present a “straw person” example of a review process

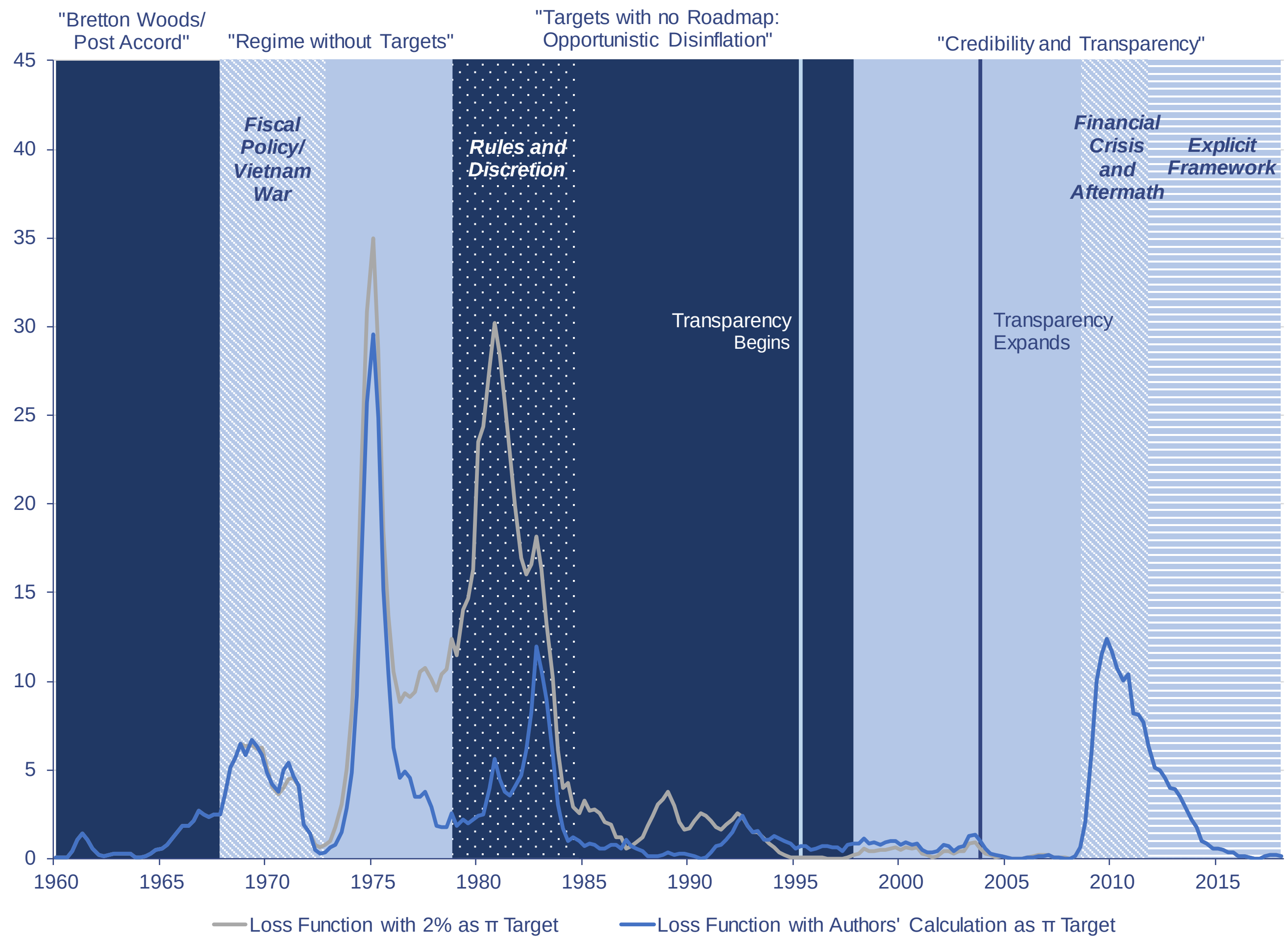
Our Definition of the MP Framework:

The set of tools and processes by which the central bank (CB) attempts to attain its high-level economic goals

Framework Elements	Corollary in Current Framework
Governance	Accountability, Independence
Ultimate Goals	Dual Mandate (Congress)
Loss Function	Symmetric, Balanced Approach
Operating Instrument	Federal Funds Rate (and QE?)
Operational Target	Same as Ultimate Goals
Transparency	Many Enhancements (Explicit Inflation Goal, SEP, Guidance)
Systematic?	Policy is Predictable (Estimated Rules)

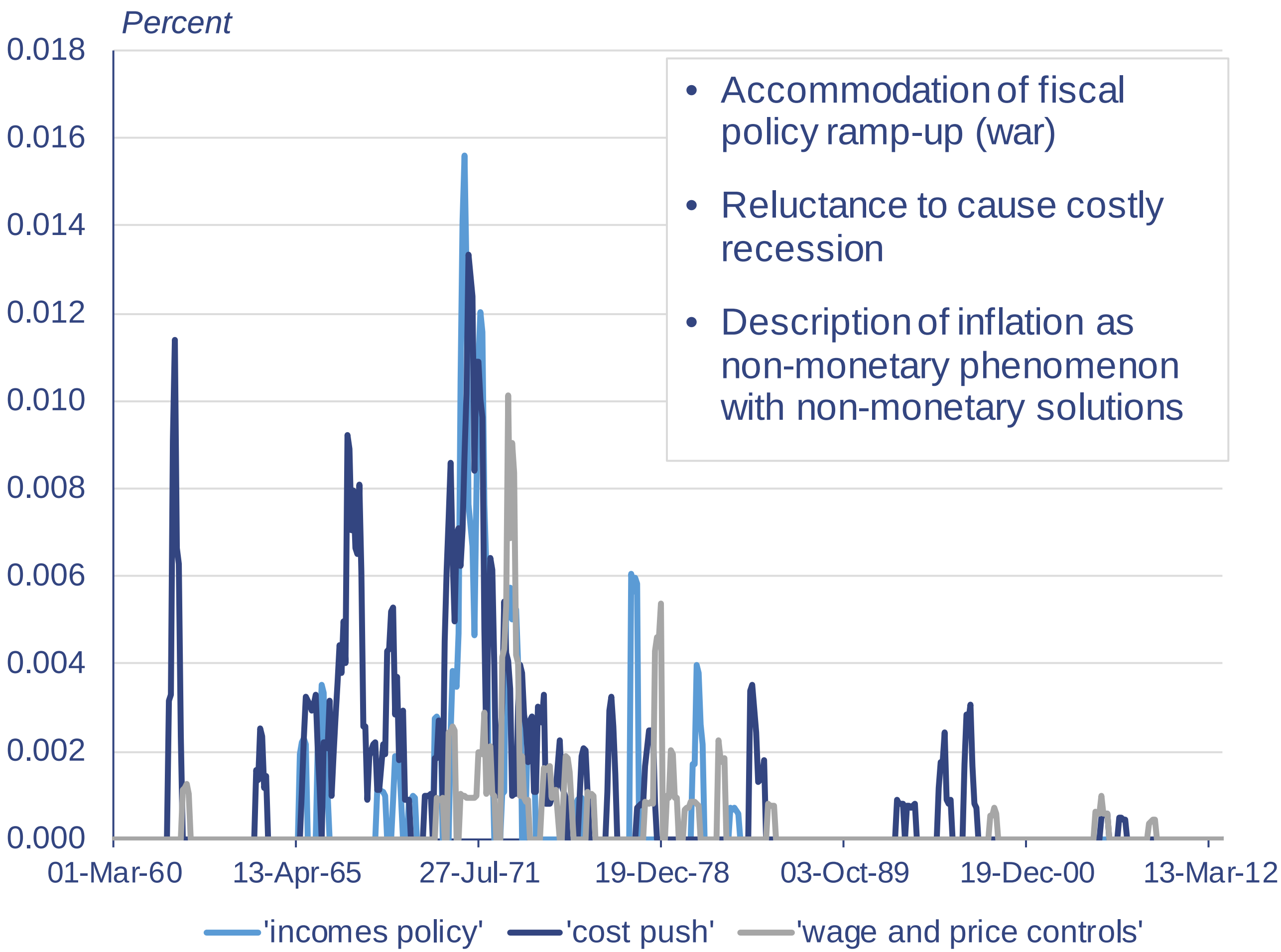
We have been through many changes in our framework, both discrete and evolutionary

Loss Function and Regimes



Source: Authors' calculations, Bureau of Economic Analysis, Bureau of Labor Statistics, Congressional Budget Office, Federal Reserve Board, Haver Analytics

The Evolving Framework: Who's in Control of Inflation (1960s - 70s)?

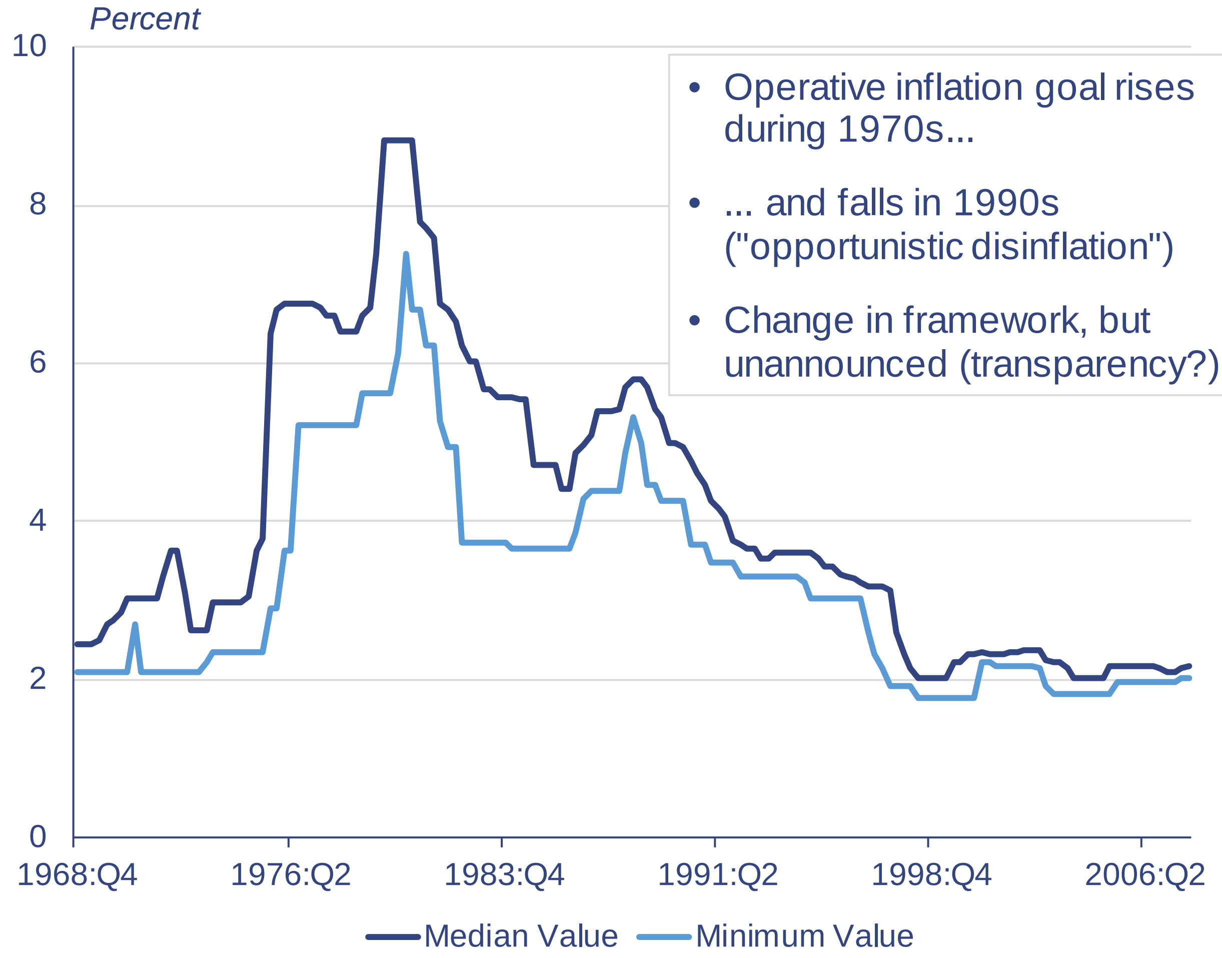


- Accommodation of fiscal policy ramp-up (war)
- Reluctance to cause costly recession
- Description of inflation as non-monetary phenomenon with non-monetary solutions

Note: Four-meeting moving average term counts as a percentage of total words.

Source: FOMC – Transcripts, Memoranda of Discussions, Historical Minutes

The Evolving Framework: Rising and Falling Inflation Goal



- Operative inflation goal rises during 1970s...
- ... and falls in 1990s ("opportunistic disinflation")
- Change in framework, but unannounced (transparency?)

Source: Authors' Calculations, Congressional Budget Office, Federal Reserve Board, Haver Analytics

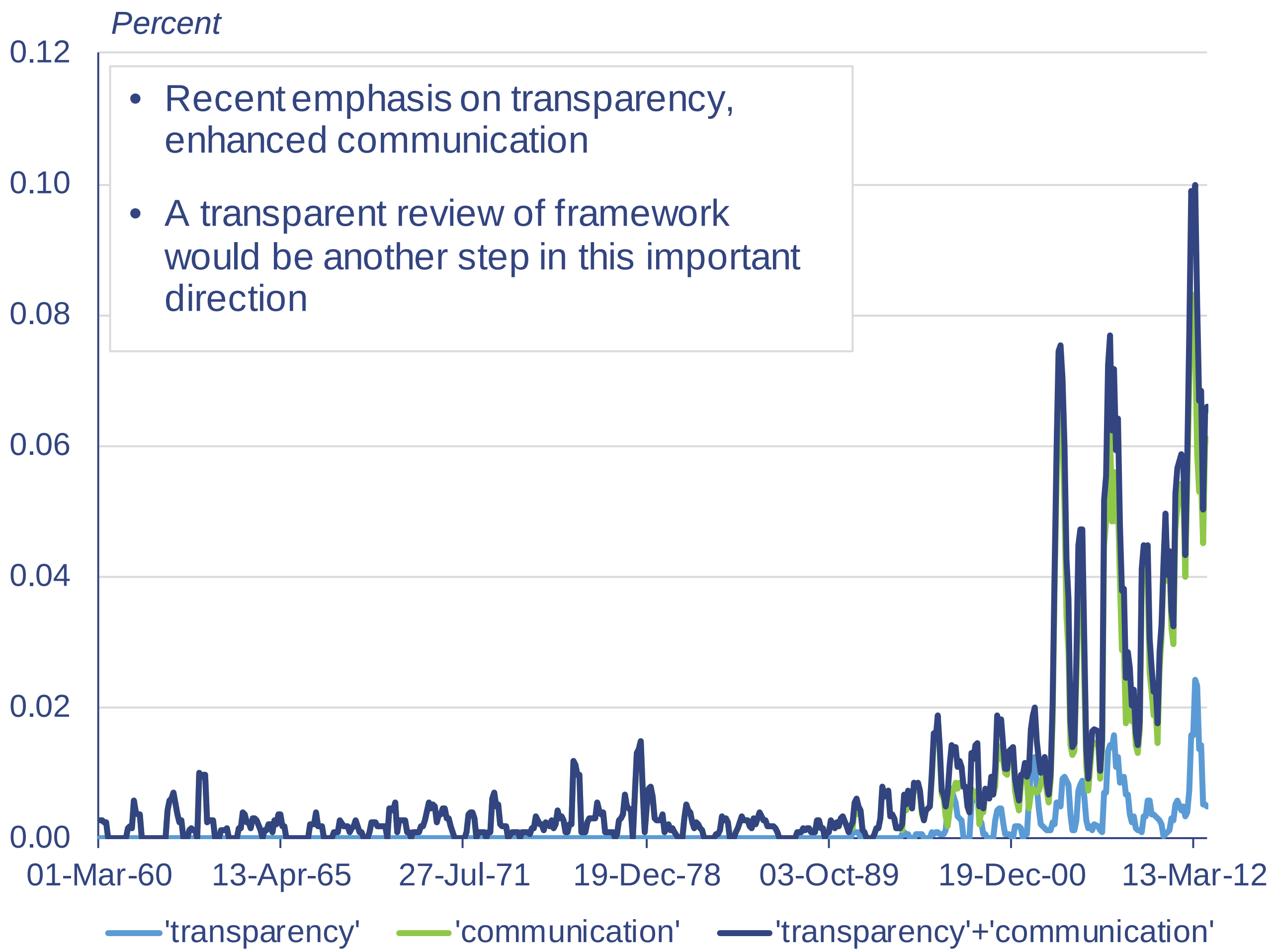
The Evolving Framework: Financial Instability in Policy Discussion

Note: Four-meeting moving average term counts as a percentage of total words.

Source: Peek, Rosengren and Tootell, (2015). "Should U.S. Monetary Policy Have a Ternary Mandate?" prepared for the Federal Reserve Bank of Boston's Annual Economic Conference, October 2015

The Evolving Framework: Improved Transparency and Communication

- Recent emphasis on transparency, enhanced communication
- A transparent review of framework would be another step in this important direction



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Source: FOMC – Transcripts, Memoranda of Discussions, Historical Minutes

Themes from These Episodes

- Changes in framework have often been evolutionary (exception: Volcker 1979)
- The adoption of new frameworks in the face of poor economic performance has sometimes been slow. Examples:
  - The 1970s Great Inflation: accommodation of fiscal policy (Fed dependence), seeking non-MP solutions to inflation, fear of a very high sacrifice ratio (rising inflation target), adverse supply shocks→a decade of poor performance with implicit, shifting frameworks
  - The Great Recession/Financial Crisis ten years on: No agreement to date to change the framework to handle financial instability or the heightened probability of ELB episodes
- The Committee has not always been transparent about changes in its framework
  - Example: Opportunistic disinflation of the mid-1990s

Themes from These Episodes

- Why does this happen? (somewhat speculative)
  - Recognizing weaknesses, changing structure is inherently difficult
  - Once a convention is established, hard to change, especially with a large, consensus-driven Committee
- A process that institutionalizes a periodic step back to devote significant time to evaluate current framework and consider alternatives, may lead to more timely improvements in framework when necessary
- These considerations motivate the need for a regular, formal, transparent review that includes outside perspectives

What Would a Review Look Like?

- Review should normally be at a fixed frequency
  - Suggest every four years – second year of Chair's term
  - Flexibility to review off-schedule when needed
- Agenda for review set by FOMC – changes to framework require vote of FOMC
  - Review would include evaluation of current framework – and consideration of alternatives that might improve on current framework
- Open process – general call for papers
- Costs to regularly evaluating framework?
  - Loss of credibility, uncertainty about inflation goal?
  - Given that we already change frameworks, could also lower the cost by making the process more transparent

How Would Such a Review Differ from Current Practice?

- Review should normally be at a fixed frequency:
  - Annual January review
  - No specific recommendations for alternatives to vote on
- Agenda for review:
  - Minimal agenda for the annual discussion, not set by FOMC. Work largely delegated to subcommittee
- Evaluation of current framework:
  - Not at January meeting. Other work not integrated
- Open process:
  - No

Do We Need a Framework Change Today?

- Key challenges that might motivate a review of the framework
  - Increased probability of hitting the effective lower bound (low real rates, low inflation environment)
    - LSAPs, forward guidance can help, but will they do enough?
  - We are once again hoping to achieve a difficult balance of tightening policy to avoid overshooting without tipping into recession. This has not proven easy, historically
    - Will this time be different?

Conclusions

- The Fed regularly evaluates its framework
  - But a more intensive, inclusive and transparent process might improve the evaluation
- Key episodes suggest that the Fed often moves inertially, in response to revealed weakness in framework
- A formal evaluation of existing framework, and open consideration of alternatives, would <u>institutionalize</u> good practice
- Good news: Evaluation of framework is easier today, because we <u>have</u> a well-articulated framework to compare to. This was not always true (*viz* 1970s)