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

<table>
<thead>
<tr>
<th>Framework Elements</th>
<th>Corollary in Current Framework</th>
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<tbody>
<tr>
<td>Governance</td>
<td>Accountability, Independence</td>
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<tr>
<td>Ultimate Goals</td>
<td>Dual Mandate (Congress)</td>
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<td>Loss Function</td>
<td>Symmetric, Balanced Approach</td>
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<tr>
<td>Operating Instrument</td>
<td>Federal Funds Rate (and QE?)</td>
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<td>Operational Target</td>
<td>Same as Ultimate Goals</td>
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<td>Transparency</td>
<td>Many Enhancements (Explicit Inflation Goal, SEP, Guidance)</td>
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<tr>
<td>Systematic?</td>
<td>Policy is Predictable (Estimated Rules)</td>
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</table>
We have been through many changes in our framework, both discrete and evolutionary.

Loss Function and Regimes
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

- Two key recent episodes
  - Dot-com stock boom
  - GR/Financial Crisis
- Ongoing discussion
  - No macroprudential tools
  - No authority to use them

Financial Instability Terms Count from Peek, Rosengren, and Tootell (2015)

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

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 institutionalize good practice
- Good news: Evaluation of framework is easier today, because we have a well-articulated framework to compare to. This was not always true (viz 1970s)