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# ***"Reviewing Monetary Policy Frameworks"***


Eric S. Rosengren
President & Chief Executive Officer
Federal Reserve Bank of Boston


*Remarks at a Forum on the Federal Reserve's Inflation Target – the Hutchins Center on Fiscal and Monetary Policy, the Brookings Institution*

Washington, D.C.
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Good afternoon. It is a pleasure to be here at Brookings. I'd like to thank David Wessel of the Hutchins Center for inviting me to participate in this forum. It is also my pleasure to be here with John David Murray of the Bank of Canada, to provide some observations in response to his comments.[1]

At the outset, let me note as I always do that the views I express are my own, not necessarily those of my colleagues on the Federal Reserve Board or the Federal Open Market Committee (FOMC).

The monetary policy framework adopted by the Federal Reserve is rooted squarely in our "dual mandate" from Congress, which directs the Fed to seek maximum sustainable employment and stable prices.[2] And in the spirit of today's conference, I want to pose a couple of questions that tee up my remarks. Given that the Congressional mandate has not changed, why might it be beneficial to evaluate the Fed's monetary policy framework periodically? And relatedly, why is the framework not as durable as the Congressional mandate?

Importantly, the Congressional mandate is quite broad. It was not until 2012 that the Federal Reserve explicitly defined the stable-prices component of the mandate in numerical terms, as a 2 percent inflation target tied to total PCE inflation.[3] The second half of the mandate, maximum employment, was not assigned a numerical target given that the Fed does not, of course, set the natural rate of unemployment – and estimates of the natural rate have changed considerably over time, with changes in demographic and labor-market characteristics.

Since 2012, the FOMC has voted at the beginning of each year on a statement of longer-run goals and monetary policy strategy, which provides a long-run goal for inflation (the 2 percent target) and broadly defines a monetary policy strategy. Currently, the strategy involves a so-called balanced approach: the Committee gives equal weight to deviations of employment from an estimate of full employment, and to deviations of inflation from the 2 percent target.

In light of this, one could argue that the U.S. version of the Bank of Canada's five-year review actually occurs at a *yearly* frequency at the Federal Reserve. However, the Federal Reserve's annual reaffirmation of the longer-run inflation goal and monetary policy strategy has not regularly involved the extensive discussion, and incorporation of outside comments, that are part of the Bank of Canada's process.

From my perspective, it is possible that the absence of more involved debate regarding the Federal Reserve's inflation goal and monetary policy strategy reflects the fact that the FOMC is broadly comfortable with the status quo framework for achieving monetary policy goals and our mandate. Still, with this in mind, I would suggest that there are several compelling arguments for a more robust periodic review of the Federal Reserve's monetary policy framework.

First, admittedly the choice of 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. However, much of that literature was based on pre-crisis research that estimated that the effective lower bound for the policy interest rate would rarely be hit, and that interest rates would remain at the effective lower bound only briefly. That research appears to have significantly underestimated the real-world probability of hitting the effective lower bound. Moreover, the probability of hitting the effective lower bound is higher in an economy with a low equilibrium real interest rate, as would be associated with our current characteristics of slow productivity growth, slow population growth, and aging demographics. In fact, the optimal rate of inflation may move around just as does the natural rate of unemployment.

Second, the ability to achieve an inflation target over a reasonable amount of time has come into question as the U.S., Euro Area, and Japan have all fallen short of their inflation targets, regularly and quite consistently, since the onset of the financial crisis. Notably, undershooting on inflation has occurred despite aggressive use of less-traditional monetary tools designed to make policy more accommodative in the aftermath of the financial crisis, Great Recession, and very slow recovery.[4]

Third, U.S. policymakers must take into account complicating factors. . With fiscal policy constrained by rising debt-to-GDP ratios, and questions about the potency of nontraditional monetary policy tools in generating robust recoveries, 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.

In light of all this, in my view it may be a good time to consider putting in place a periodic Federal Reserve led assessment of the U.S. monetary policy framework that would include input from a variety of sources inside and outside the central bank. Such a periodic re-evaluation could consider whether changed economic fundamentals (such as the equilibrium real interest rate) should alter how best to satisfy the Congressional mandate given to the central bank.

Furthermore, a periodic reassessment could involve consideration of whether alternative frameworks would better meet the mandate, and evaluate the costs and benefits of transitioning to the new framework – as well as the longer-run implications. For example, in recognition of the challenges the Federal Reserve has experienced with our current framework, 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 discuss the suggestion more fully.

Similar to the Bank of Canada, a U.S. review could include research papers by Fed economists, as well as input from academics and other macro-policy institutions. This type of periodic exercise could reinforce the Federal Reserve's commitment to attaining the

Congressional mandates, while providing a more public and transparent forum for evaluating our performance in attaining these goals.

Finally, I would note that a number of process details could influence the efficacy of such a review process. The Bank of Canada has a full review every five years. One does not want to evaluate a monetary policy framework too frequently, given that changes in underlying economic fundamentals are relatively infrequent and take time to fully assess. At the same time, it is important to make changes if the existing framework is no longer consist with how the economy has evolved.

It would also be extremely important to design a review process that appropriately balances the central bank's accountability to Congress for the mandate with its independence to pursue policymaking and technical refinements. Reviews 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 – as was the case when the Fed formally adopted its numerical price objective in 2012 – the review should be focused on the technical framework that the central bank employs to achieve the Congressional mandate's goals and would need to be seen as such.

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 – but to make it possible to call for an earlier review when warranted. Given the unpredictability of changes in the optimal targets, providing the option to call for a special review would be important. This would allow for a re-examination when needed – specifically when most participants view economic events as justifying a full re-examination of the framework. Clearly, however, this is just one approach and there are a variety of other permutations that could be considered by the FOMC.

In summary and conclusion, the Bank of Canada provides a process which I view as quite instructive. My own view is that the costs of hitting the effective lower bound, and staying there for a prolonged period, should cause a reassessment of whether a specific 2 percent inflation target is still warranted. The optimal inflation rate is unlikely to be 2 percent if economic fundamentals cause the central bank's policy rate to regularly hit the effective lower bound during economic downturns. As a result, having a process that can fully and more transparently examine the monetary policy framework would be a process improvement, and would allow the Federal Reserve to systematically examine and alter its framework when needed.

Thank you.

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[1] As John Murray illustrated in his presentation, the Bank of Canada has a process for revisiting its inflation target and monetary policy framework that has been in place for quite some time. This process occurs at a regular five-year frequency, it seeks comments from academics and the general public and, though not legislated, it features the explicit involvement of the government. See http://www.bankofcanada.ca/core-functions/monetary-policy/.

[2] The dual mandate is derived from The Federal Reserve Reform Act of 1977. Among the changes made to the Federal Reserve Act was a directive to "maintain long-run growth of the monetary and credit aggregates commensurate with the economy's long-run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices and moderate long-term interest rates." The shorthand for this is the goal of maximum employment consistent with stable prices.

[3] In order to provide more clarity about how the Federal Reserve implemented the dual mandate, the FOMC issued the Statement on Longer-Run Goals and Monetary Policy Strategy, which is important for clarifying to the public what monetary policy is about, and also for providing FOMC members with a common framework when conducting policy. FOMC members will have different opinions about economic conditions and where the economy is headed. Still, according to the strategy document, the way these differences are translated into different policy recommendations should be consistent across FOMC members, in that members agree to share the same inflation goal and assign the same penalty to deviations of inflation and unemployment from their longer-run values.
The statement became effective January 24, 2012, and was subsequently amended, effective January 31, 2017. See https://www.federalreserve.gov/faqs/statement-on-longer-run-goals-monetary-policy-strategy-fomc.htm.

[4] As already mentioned, the statement on longer-run goals and monetary policy strategy specifies a balanced approach on stabilizing inflation around the inflation target and the unemployment rate around its natural level. It

could be useful to periodically assess the extent to which such an approach is followed in practice, and the reasons that may lead to deviations from such a strategy.