An Opportunity to Improve the Fed's Strategic Framework

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The current strategic review provides the Fed an important opportunity to look back and learn from history and modify its strategic plan in ways that can better guide monetary policy toward achieving its dual mandate. The nearly five years of experience with the 2020 Strategic Plan strongly suggests that the Fed's goal should be to restore symmetry to its interpretation of its inflation and employment mandate, simplify its framework, and make it robust over time and easy to communicate. In addition, following the high inflation of the 2020s, the Fed should use the strategic review to initiate a thoughtful reassessment of the sources of inflation and the models it relies on to predict inflation.

The 2012 strategic plan established a symmetrical framework with 2% inflation and maximum employment as the Fed's objectives. Between 2012-2019, employment gains contributed to a 50-year low in the unemployment rate. PCE inflation persisted modestly below the Fed's objective while inflationary expectations remained relatively well anchored. The Fed became increasingly concerned that if inflation remained below 2%, there was a risk that inflationary expectations may fall sharply. Combined with its estimates that the natural rate of interest had declined, the Fed's mounting concerns about the risks of falling inflationary expectations and the constraints of the effective lower bound became the impetus for the Fed's strategic review in 2019. The Fed's mounting worries seemed excessive since during the years 2016-2019 CPI inflation averaged 2.1% and the PCE inflation averaged 1.7% and nominal GDP growth had averaged a healthy 4.4%, and the unemployment rate had fallen to an average of 3.8% in 2018-2019.

The Fed's 2019-2020 review and strategic plan. The focus of the review and the Fed's strategic plan of 2020 were direct products of these concerns. The 2020 plan established asymmetric interpretations of its inflation and employment mandate, shifting its priority towards employment and favoring higher inflation. The intention of its new Flexible Average Inflation Targeting (FAIT) scheme, which explicitly advocated above 2% inflation, was to allow the economy to "run hot" and stimulate higher employment. Based on its acknowledgement that the Phillips Curve was flat, the Fed also declared that high employment would no longer be assumed as a precursor to inflation, and it discarded its long-held practice of pre-emptive tightening. Instead, the Fed placed a much higher reliance on forward guidance to manage inflationary expectations. These modifications and asymmetries fundamentally changed the balanced framework the Fed had established for conducting monetary policy in 2012.

The strategy was overly complex. The FAIT lacked any numeric guidelines, was not well understood and proved difficult to implement. The Fed's efforts to manage inflationary expectations through forward guidance proved ineffective absent actual policy changes. Even if one accepts this refocusing of monetary policy, it is dubious that the Fed has the credibility and sufficient knowledge of the economy to effectively execute the fine-tuning required by the strategy.

Immediately after the Fed rolled out its new strategic plan, we published an article, "The Murky Future of Monetary Policy" that described the problems that the new asymmetries had introduced. At the time, the economy was rebounding sharply from its Covid contraction despite government lockdowns. In the next 1 ½ years, the government enacted unprecedented deficit spending exceeding 25% of GDP and the Fed maintained zero interest rates and undertook massive asset purchases, including roughly one-half of the amount new U.S. Treasury debt. This generated a surge in excessive aggregate demand amid pandemic-related supply constraints, and inflation soared.

During the high inflation period, the Fed rarely referred to its new strategic framework, but its acceptance of higher inflation and prioritizing employment were consistent with its 2020 strategic plan. The Fed's incorrect projections of inflation and reliance on "transitory" explanations of inflation likely stemmed from its perception that inflation would stay low, just as it did following the Great Financial Crisis, when the Fed maintained zero interest rates and engaged in large-scale asset purchases. The Fed's discretionary judgment that the high inflation would quickly fall to 2% and its estimates of the Federal funds rate that would reduce inflation to 2% proved incorrect.

The Fed's delayed aggressive tightening slowed aggregate demand and lowered inflation, but inflation has remained sticky and above the Fed's 2% longer-run goal. While the Fed has emphasized the significant reduction of inflation, consumers lament the cumulative 24% rise in the general price level since before the pandemic.

Obvious improvements. In its strategic review, several changes are obvious. Replacing the FAIT with a symmetrical inflation target, probably like the original strategic plan of 2012, is logical and necessary. The upside and downside risks around 2% inflation are clear, and this change would be a necessary step toward restoring symmetry and simplicity and making it easy to communicate. An associated formal reinstatement of preemptive tightening would support efforts to manage inflationary expectations. On the employment goal, the Fed should restore its focus on deviations from maximum employment rather than shortfalls.

As an operational improvement, the Fed needs to step back from relying on forward guidance as an independent monetary policy tool to manage inflationary expectations. The 2020-early 2022 experience showed that inflationary expectations rose despite the Fed's forward guidance, and they did not recede until the Fed supported its forward guidance with rate increases.

In its basic strategy, the Fed needs to highlight the importance of price stability as its best contribution for healthy economic growth and maximum employment. That basic premise was at the heart of the successful monetary policy regimes of Paul Volcker and Alan Greenspan.

Research on the sources of inflation. The Fed should use this strategic review to launch research that aims to develop a better understanding of the inflation process and the role monetary policy plays in it. The Fed has acknowledged the unreliability of the Phillips Curve in predicting inflation. However, its research and the commentary of Fed members continue to focus on wage and price setting behavior, with a Phillips Curve looming in the background. A rethinking of the sources of inflation should pay more attention to nominal spending and the role the Fed's monetary policy plays in generating aggregate demand. Research that focuses on monetary policy influences of nominal GDP, including investigations into money supply and the monetary transmission channels and how they are influenced by capital requirements and IOER would be instructive. Such research may identify minor blips in M2 growth as unimportant, but highlight the importance of outsized shifts, such as the 40% jump that occurred in 2020-2021.

Using rules to guide discretion. While the Fed relies on discretion in setting monetary policy, it has been shown that adopting simple rules, like the Taylor Rule, would have avoided past major policy errors, including the inflation of the 2020s. The Fed's review should consider how rules can be used as guidelines to complement the Fed's decision-making. Rather than dismissing rules as a rigid, undesirable formulas that dictate money policy, the Fed should think about how rules may be used to augment its discretionary approach to monetary policy, and how the additional information can improve policy outcomes.

Improving the Fed's Summary of Economic Projections. The Fed's quarterly economic projections and "dot plots" of the FOMC members' estimates of the appropriate Fed funds rate that would achieve their projections fall far short of their objective of informing the public and providing guidance on the conduct of monetary policy. Part of the problem is the Fed estimates of the appropriate policy interest rates to achieve the FOMC members' economic and inflation projections have proved misleading all-to-frequently.

Referencing the Taylor Rule estimate of the appropriate policy rate that would achieve the FOMC member projections would be a valuable addition to the SEPs. It would build on the Fed's current practice of including estimates of different rules in its semi-annual Monetary Policy Report to Congress. In most years, a Taylor Rule dot would be within the central tendency of the FOMC members' dots, but on those rare occasions that the Taylor Rule is an outlier, it would be very informative to the Fed and the public.

The SEPs could be enhanced in several other valuable ways. Anonymously linking (through color code) each FOMC member's interest rate estimate with his or her economic and inflation projection would improve the understanding of the Fed's reaction when outcomes deviate from the FOMC members' expectations. Second, the SEPs should include information on the Fed's balance sheet, which the Fed identifies as an important policy tool. This would enhance understanding of monetary policy. Third, the Fed should use the SEPs to conduct an annual risk management exercise in which Fed members are asked to provide policy rate estimates for different economic and inflation scenarios, or conversely, provide economic and projections under several alternative policy rates.

We all benefit from an independent central bank that credibly pursues its mandate of price stability and maximum employment. We suggest that the Fed take this opportunity to simplify its monetary policy and return to a more balanced and systematic approach that is likely to be robust in variety of circumstances and is easier to communicate.

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