Restoring Symmetry and Simplicity in the Fed's Strategic Framework

Mickey D. Levy and Charles I. Plosser
Shadow Open Market Committee

April 7, 2025

Suggestions for Improving the Fed's Flawed 2020 Strategic Framework

- The Fed's current strategic review provides the opportunity to correct the flaws in the 2020 Plan and help the Fed achieve its dual mandate
- **Critical need**: restore symmetry and simplicity to its framework and make it robust over time and easy to communicate
- **Obvious changes**: replace the FAIT with the symmetrical 2% inflation target, probably like the Fed's original 2012 strategic plan; reinstate preemptive tightening; and improve its SEPs and communications
- **Additional focus**: conduct a thoughtful reassessment of the sources of inflation and the role monetary policy plays in it

Fed Worries about Low Inflation and the ELB were Excessive

- Inflation remained low after the financial crisis despite zero rates and QEs; the Fed's *ex post* rationale: flatter-than-presumed Phillips Curve
- The Fed's estimates of a secular decline in r* raised concerns
- Fed worries about too low inflation and a sharp decline in inflationary expectations and the ELB mounted
- These worries were excessive and unsubstantiated by data and driven by asymmetric fears
- Inflation in 2016-2019: CPI, 2.1%; PCE 1.7%; inflationary expectations remained anchored to 2% and Fed projected inflation to rise to 2%
- No evidence that low inflation was harming economic performance

Fed’s Asymmetric Worries Pre-determined the 2019 Review and 2020 Strategy

- Why was Fed so worried about an uncontrollable collapse in inflationary expectations if it was so confident in its forward guidance to manage them?
- The resulting asymmetries in the 2020 framework and dropping of preemptive tightening were problematic on many dimensions
- A month after the Fed’s adoption, we wrote a paper discussing these concerns and said it was only a matter of time before problems would emerge (“The Murky Future of Monetary Policy” 2020, 2022)

The New Strategic Framework and Its Flaws

- Fed’s asymmetric interpretation of its dual mandate contributed to overly an overly complex strategic framework
- Its asymmetric worries about too-low inflation also seems to have contributed to the Fed’s misperception that inflation would stay low, regardless of the monetary policies pursued by the Fed, and its “transitory” assessment of the rising inflation

The New Strategy's Track Record

- The 2020 Strategic Framework was not the source of the Fed's mistakes and high inflation, but was consistent with them
- The Fed virtually ignored the unprecedented fiscal stimulus, 40% surge in M2 and robust acceleration of aggregate demand, even as concerns about Covid dissipated
  - Relying on discretionary judgment proved to be a mistake
- The Fed didn't respond to unanchored inflation expectations
- Fed's reliance on forward guidance without raising rates failed to manage inflationary expectations

The Upcoming Strategic Review: Suggestions

- We have five basic suggestions:
- **1) Conduct more thoughtful and thorough review of the inflation process and dynamics and how they relate to monetary policy tools**
- If the Phillips Curve is time-varying and an unreliable predictor of inflation, as Fed has acknowledged, the Fed must explore other frameworks
- Focus more on aggregate demand & NGDP and outsized shifts in money
- Analyze key factors affecting aggregate demand: fiscal policy, the monetary transmission channels (influences by IOER, capital and liquidity requirements, asset purchases and balance sheet), the wealth effect, etc.

Suggestions

- **2) Clarify interpretation of the Fed's mandate**
- Correct asymmetries and complexity of the FAIT
- Reinstate a clear 2 percent target like 2012 strategy
- Other alternatives: explore symmetric price level targeting
- Restore "deviations" (drop "shortfalls") around maximum employment

Suggestions

- **3) Consider systematic rules as guidelines for the conduct of MP**
- Not rigidly, but as a guideline to avoid prior discretionary mistakes
- Would improve clarity, transparency and understanding of MP and establish a basis for effective forward guidance
- Fed includes estimates of alternative rules in its semi-annual Monetary Policy Report to Congress…don't ignore them
- **4) Abandon forward guidance as an *independent* tool of MP**
- It is ineffective in the absence of support of traditional monetary policy tools; complicates communications and risks Fed's credibility

Suggestions

- **5) Improve the quarterly Summary of Economic Projections (SEPs)**
- SEPs should include Taylor Rule estimate (dot) that would be consistent with achieving the median FOMC economic & inflation projections
- SEPs should include information on balance sheet
- Each FOMC participant's dot should be anonymously linked to their individual projections to address current aggregation problem
- The Fed should conduct an annual exercise that includes alterative projections to enhance risk management: ask FOMC members to estimate FFR for alternative economic scenarios, or ask them project economic and inflation outcomes under different FFR estimates