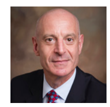
Fed Considering Policy Changes

Failure to meet 2% inflation target among other challenges under scrutiny

May 2019

KEY INSIGHTS

- The Fed has launched a comprehensive review of its policy framework, with a primary goal being improved strategies for hitting its 2% inflation target.
- The Fed will also assess the use of its balance sheet, which may result in a skew toward Treasury bills.
- Efforts are also underway to provide clearer public guidance about the direction of the federal funds rate.



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Seeking to better meet inflation targets and achieve other objectives, the Fed has launched a comprehensive review of its policy framework—including its strategy, tools, and communications. The review has begun with a series of town hall-style "Fed listens" sessions during the first half of this year, and a staff-only research conference follows in June. Later in 2019, the policymaking Federal Open Market Committee (FOMC) will review the findings from these events and receive briefings on additional staff research. The FOMC plans to make public its findings during the first half of 2020.

Three key questions are at the heart of the Fed's review. Within each, particular issues are likely to receive attention before the comprehensive review is complete.

Q: "Can the Federal Reserve best meet its statutory objectives with its existing monetary policy strategy, or should it consider strategies that aim to reverse past misses of the inflation objective?"

Policymakers have previewed that changes to the policy framework will be evolutionary, not revolutionary. Most importantly, the FOMC is not considering a numerical change to its inflation objective: 2% annual growth in the personal consumption expenditures (PCE) price index. Rather, policymakers are considering ways to guide inflation closer and more quickly to that objective.

Indeed, inflation has been persistently below 2% in recent years, with the PCE price index rising at a 1.4% annual rate (1.6% excluding food and energy) since the FOMC adopted the 2% inflation objective in January 2012. Persistent downside misses can weigh on inflation expectations, making the objective even harder to reach.

This challenge takes on greater urgency in the context of low neutral interest

2%

The FOMC's inflation objective for annual growth in the PCE price index.

rates, a global phenomenon that the FOMC expects to persist. All else being equal, a fall in neutral rates increases the likelihood that a central bank's policy rate will reach its effective lower bound (ELB)—in most cases, 0%—in future economic downturns. When policy rates reach zero, central banks struggle to provide other forms of stimulus sufficient to prevent sustained and substantial undershoots of inflation targets.

Inflation "makeup" strategies, including price level targeting or multiyear inflation averaging, could be deployed permanently or as a temporary response to extraordinary circumstances, such as policy rates arriving at the ELB. Such "lower for longer" strategies would aim to hasten inflation's return to 2% by lifting inflation expectations and by encouraging spending, which would add to cost-push inflation.

Inflation Overshoot Carries Own Risks

There are risks to such policies, however. The higher inflation might not be welcomed by households and businesses when it arrives, and the overshoot could become costly to contain if the public is not confident that it will be temporary. On the flip side, a central bank might find it increasingly uncomfortable to maintain rates at the ELB in the face of persistent above-target inflation and, potentially, an overheating economy.

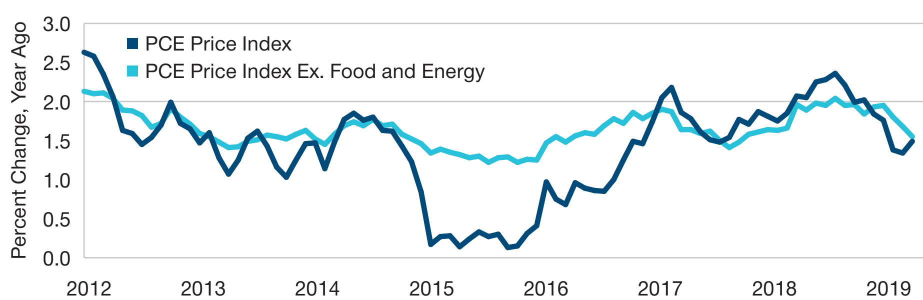
This latter possibility points up a fundamental obstacle to the Fed adopting an inflation makeup strategy. The Fed is charged by Congress to pursue full employment *and* price stability; it cannot commit to an inflation outcome without regard for the evolution of the labor market.

These constraints on adopting binding inflation makeup strategies do not mean that the Fed is without options for improving performance relative to its 2% objective. One option would be to change the characterization of that objective as set out in the FOMC's "Statement of Longer-Run Goals and Monetary Policy Strategy." As currently formulated, "the Committee judges 2% inflation in PCE price index to be the most consistent over the longer run" with its price stability mandate, and "would be concerned if inflation were running persistently above or below this objective. Communicating this symmetric inflation goal clearly...helps keep longer-term inflation expectations firmly anchored."

The limitations of this formulation have been laid bare in this era of low neutral rates, where central banks have been limited demonstrably in their ability to prevent persistent undershoots. Applying a qualitatively symmetric inflation objective to an environment in which undershoots tend to be greater

(Fig. 1) Inflation Target Has Proved Elusive

Persistent Shortfall Since Adoption of 2% Objective
March 31, 2019



Source: Bureau of Economic Analysis, Haver Analytics

More immediately, the FOMC could signal a willingness to allow a modest cyclical inflation overshoot now that the economy is generating underlying wage and other cost pressures.

than overshoots increases the risk of below-objective inflation over time, suppressing inflation expectations and hampering achievement of stated inflation objectives (2%, in the U.S. case) over the medium term.

Focus May Become 2% Average Inflation

Restating the 2% inflation objective in terms of an average over the medium term—and accepting an explicit full-cycle range of, say, 1.5% to 2.5%—might strengthen the anchor for inflation expectations at 2%. Such an adjustment could come as soon as January, with the FOMC's annual review of its statement of goals and strategy.

More immediately, the FOMC could signal a willingness to allow a modest cyclical inflation overshoot now that the economy is generating underlying wage and other cost pressures. Yet in the March 20 Summary of Economic Projections (SEP), only six of 17 FOMC participants forecast inflation above 2.0% (2.1%–2.2%) in 2020 or 2021. By 2021, in particular, policymakers' forecasts could include a makeup overshoot if it were desired, since these forecasts are based on the assumption of "appropriate" monetary policy.

Q: "Are the existing monetary policy tools adequate to achieve and maintain maximum employment and price stability, or should the toolkit be expanded?"

After the traditional policy rate tool, the federal funds rate, was cut to zero in 2008, the Fed provided forward interest rate guidance and deployed balance sheet policies—asset purchases, the Maturity Extension Program, and adjusting reinvestment of principal payments. The framework review will include an assessment of these tools and consideration of additional ones for easing at the ELB used by other central banks (but not the Fed) during the postcrisis period.

At this point, it seems safe to expect that when policy rates next reach the ELB, forward guidance will be more aggressive at the outset to maximize the lower-for-longer signal. When the FOMC cut the funds rate to the ELB (0% to 0.25%) in December 2008, it stated simply that "weak economic conditions are likely to warrant exceptionally low levels of the federal funds rate for some time." It was not until August 2011 that the Committee adopted stronger date-based guidance, and only in December 2012 did the FOMC shift to the data-dependent guidance, citing thresholds for the unemployment rate and forecast inflation.

On March 20, the FOMC outlined the glide path for completing the reduction in the overall size of its balance sheet, guided by a judgment that the minimum level of reserve balances consistent with the efficient conduct of monetary policy is in the range of USD 1 trillion to USD 1.5 trillion. The Fed will slow the pace of asset runoff by reducing the cap on monthly redemptions of the Fed's holdings of U.S. Treasury securities (UST) from USD 30 billion to USD 15 billion beginning in May and cease the net reduction of total securities holdings at the end of September.

From that point, the overall size of the balance sheet may be held constant for a time, allowing reserve balances to decline gradually to offset growth in the Fed's other liabilities (mainly currency in circulation). Once the FOMC judges that reserve balances have fallen to the lowest level consistent with efficient policy implementation, it will resume UST purchases to keep pace with growth of the Federal Reserve's non-reserve liabilities and maintain an appropriate level of reserves in the system.

Open Questions About The Fed's Balance Sheet

This broad outline leaves open two questions about the long-term

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composition of the balance sheet: the maturity composition of its UST portfolio and the timing with which the Fed exchanges its nearly USD 1.6 trillion portfolio of mortgage-backed securities (MBS) for UST.

Policymakers seem to be debating two alternatives for the maturity distribution of the Fed's UST holdings. One is to mirror the structure of total marketable debt outstanding, which would minimize the Fed's footprint in pricing the Treasury yield curve. The other is a portfolio with a very short maturity, which would maximize the Fed's options for altering the maturity structure at the ELB without having to expand the balance sheet or sell assets outright.

Either way, the transition to a shorter-maturity UST portfolio is likely to occur only gradually—over a period of three to five years. Returning to a UST-only portfolio may take substantially longer. Principal payments on the Fed's MBS portfolio are averaging roughly USD 14 billion per month; at this pace, it could take upward of 10 years to jettison all MBS holdings. The possibility that the policymakers will next reach the ELB still holding a sizable MBS portfolio could introduce political, if not also substantive, constraints into the design of any new asset purchase programs.

Q: "How can the FOMC's communication of its policy framework and implementation be improved?"

The FOMC's communications practices have evolved generally toward greater transparency and, in the postcrisis period, clearer forward guidance on the likely direction of interest rates. The introduction of the quarterly Summary of Economic Projections (SEP) in 2007 was an important innovation, to which the FOMC added participants' policy rate forecasts in 2012.

This quarterly interest rate "dot plot" has recently come under policymakers' scrutiny, however. As long as policy was clearly accommodative, and the economy was growing steadily enough to warrant progress toward a neutral policy stance, the dot plot dovetailed with the FOMC's rate guidance conveyed in the post-meeting policy statement. Nonetheless, market participants have persistently struggled to distinguish between the median rate forecast and the Committee's collective judgment about the likely course of policy. In particular, the former was treated as something of a foregone conclusion while both are, in fact, *conditional* views based on the evolution of the economy.

The conflict between the dispositive FOMC statement guidance and the background information in the dot plot came to a head on January 30, when the directionally agnostic statement that "the Committee will be patient as it determines what future adjustments to the…federal funds rate may be appropriate" seemed at odds with the median December 19, 2018, forecast calling for two rate hikes in 2019.

Dot Plot Has Created Confusion

To some extent, this cognitive dissonance was relieved by the sharp downward shift in participants' rate forecasts for this year in the March 20 SEP. But "normal" policymaking—keeping the economy at full employment, growing at potential, and with inflation near 2%, all from a starting point of a neutral policy stance—is agnostic as to the direction of the next rate move. It also seems inconsistent with ascribing sufficient conviction to multiyear interest rate forecasts to make them useful for communication with the public.

In his discussion of the March 20 SEP at that day's press conference, Chair Powell found it necessary to note what those projections are—as well as what they are not: "We always emphasize that the interest rate projections in the SEP are not a committee decision, they're not a committee plan...the FOMC statement, rather than the dot plot, is the device that the Committee uses to express its opinions about the likely path of rates."

Yet it is not just the balance of risks to the baseline outlook that drives a wedge between the Committee's interest rate guidance and the median of participants' interest rate forecasts. It is also that, even if the economy conforms to the baseline outlook, the supporting path of policy rates may be different than implied in the numerical forecasts in the SEP.

With policy now thought to be vaguely neutral, and particularly as the expansion progresses and if the Fed raises rates again later this year or early in 2020, the direction of rates will become increasingly uncertain, and the dot plot may become an outright impediment to transparency.

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