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Clarida: Reviewing Everything But the 2% Objective and the Dual Mandate

In a speech earlier today, Board Vice Chair Clarida discussed the monetary policy review that the Fed will undertake this year and provided the most comprehensive outline to date of what the review will entail (link to speech). Importantly, he stated that the "Our review this year will take [the Fed's] statutory mandate as given and will also take as given that inflation at a rate of 2 percent is most consistent over the longer run with the congressional mandate." He stressed up front that "The fact that the System is conducting this review does not suggest that we are dissatisfied with the existing policy framework." While that may technically be true, *his own subsequent remarks* certainly suggested he is dissatisfied. His discussion of the issues motivating this review (which were nothing new) suggested that there is concern about the existing framework, particularly with respect to low inflation and inflation expectations. He also mentioned several options the Fed would review, including some, such as price-level targeting and yield-curve targeting, that are sure to raise eyebrows. We believe that his mention of these specific options was in part an attempt to demonstrate how wide-ranging this review will—don't take this to mean that Clarida necessarily has some particular preference for yield curve targeting over other unconventional easing policies, for example. While we don't expect a radical change, such as a move to nominal-income targeting, there are likely to be adjustments to how the Fed communicates and conducts monetary policy as a result of this review.

Vice Chair Clarida highlighted two familiar issues as motivating the review, neither of which was a surprise and both of which are crucially related to a central bank's ability to meet its inflation objective. The first is the apparent decline in r-star. By increasing the likelihood of reaching the effective lower bound (ELB) in future downturns, this "could make it more difficult during downturns for monetary policy to support spending and employment, and *keep inflation from falling too low*" (italics our emphasis). The second is the reduced responsiveness of inflation to resource slack—the flattening of the Phillips curve. He called this a "double-edged sword" because it gives the Fed more scope to ease without risking too-high inflation but also increases the cost of taming too-high inflation. That said, in recent years the bigger problem has clearly been getting inflation and inflation expectations higher, not lower. He concluded, "Thus, a flatter Phillips curve makes it all the more important that longer-run inflation expectations remain anchored at levels consistent with our 2 percent inflation objective."

Clarida confirmed what we have been saying for some time, that there's no appetite for raising the inflation objective: "Our review this year will take [the Fed's] statutory mandate as given and will also take as given that inflation at a rate of 2 percent is most consistent over the longer run with the congressional mandate." The first part of that statement, that the Fed is taking its statutory mandate as given, is less telling than the part about the 2 percent objective. The mandate that it should conduct policy "so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates" leaves a massive amount of room for interpretation. If the current framework is compatible with the Fed's legal mandate, so are many alternative frameworks.

Clarida went on to discuss alternative frameworks, prefacing his discussion with the question, "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*?" (italics our emphasis). He referred to these alternative strategies as "makeup" strategies and specifically mentioned "targeting average

Larry Meyer **202-794-7358** larry@lhmeyer.com
Kevin Burgett **202-794-7352** kevin@lhmeyer.com
Derek Tang, CFA **202-794-7356** derek@lhmeyer.com

inflation over a multiyear period and price-level targeting." This is important because it suggests that he sees options such as these as fully compatible with the Fed's mandate and on the table. He noted that there are many options for tailoring these strategies; for example, they could be implemented either temporarily or permanently. He also discussed problems with such strategies, noting that "one of the most challenging questions is whether the Fed could, in practice, attain the benefits of makeup strategies that are possible in models." One well-known problem is the so-called time consistency problem: "makeup strategies, in general, are not time consistent because when the time comes to push inflation above 2 percent, conditions at that time will not warrant doing so. Because of this time inconsistency, any makeup strategy, to be successful, would have to be understood by the public to represent a credible commitment."

These two strategies, targeting average inflation and price-level targeting, are the same as the ones Williams discussed in a high-profile speech late last year (link to speech)—at least in name. But Williams' description of average inflation targeting didn't make clear that he saw it as needing to be an ex-post "makeup" strategy in the way Clarida described it. Since inflation will always be expected to be below target at points in the future because of the inevitable "bad" times that result in policy being constrained by the ELB, Williams suggested a central bank could balance that out—bringing longer-term inflation expectations closer to the average inflation goal—if it "purposefully aims to achieve an above-target inflation rate in 'good' times when the lower bound is not a constraint." He provided the simple example that if the target is 2 percent but the central bank can only achieve that 80 percent of the time, while the other 20 percent of the time inflation is 1 percent, inflation will average only 1.8 percent. Thus, one would have to aim for higher in "good" times to bring the average inflation rate up to its objective. Williams' description of this strategy could include a strategy whereby the central bank aims to achieve an average inflation rate ex ante by aiming higher in "good times" but still doesn't commit to making up past misses—something Clarida's definition doesn't include. A subtle difference, perhaps, but a crucial one.

The question of whether the FOMC's strategy could be improved was what Clarida discussed in the most depth, but it was only the first of three questions he considered. The second was whether and how the policy toolkit should be expanded. He briefly reviewed the Fed's unconventional policies used during the crisis—both balance sheet policies and forward guidance—concluding that "Overall, the empirical evidence suggests that these added tools helped stem the crisis and support economic recovery by strengthening the labor market and lifting inflation back toward 2 percent. That said, estimates of the effects of these unconventional policies range widely." He went on to say that, "In addition to assessing the efficacy of these existing tools, we will consider additional tools to ease policy." As an example he referred to the BOJ's yield curve targeting, floating the possibility of establishing a temporary ceiling for Treasury yields. As we mentioned above, while provocative, this example seems intended to demonstrate how open-minded the Fed will be in assessing all its options. Indeed, he clarified that "During the crisis and its aftermath, the Federal Reserve reviewed but ultimately found this tool and some others deployed by foreign central banks wanting relative to the alternatives it did pursue."

The final question was about the Fed's communication policy, which includes things like "the Statement on Longer-Run Goals and Monetary Policy Strategy; postmeeting press conferences; various statements about principles and strategy guiding the Committee's normalization of monetary policy; and quarterly summaries of individual FOMC participants' economic projections, assessments about the appropriate path of the federal funds rate, and judgments of the uncertainty and balance of risks around their projections." He didn't give away much at all on possible directions in this area, saying only that, "For example, there might be ways to improve communication about the coordination of policy tools or the interplay between monetary policy and financial stability."

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Larry Meyer
202-794-7358
larry@lhmeyer.com

Kevin Burgett
202-794-7352
kevin@lhmeyer.com

Derek Tang, CFA
202-794-7356
derek@lhmeyer.com

Jacqueline Dolson
202-794-7357
jacqueline@lhmeyer.com

lhmeyer.com

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