The Federal Reserve’s Framework for Monetary Policy – Recent Changes and New Questions

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Outline

• Changes to the Federal Reserve’s monetary policy framework
  ° Greater clarity regarding objectives and strategy
  ° Nontraditional policy tools

• Additional questions
  ° Value of alternative objectives?
  ° Monetary policy and financial stability?
**Greater Clarity Regarding Objectives and Strategy**

<table>
<thead>
<tr>
<th>Date</th>
<th>Innovation</th>
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</thead>
<tbody>
<tr>
<td>December 2005</td>
<td>Minutes publication lag reduced to three weeks</td>
</tr>
<tr>
<td>November 2007</td>
<td>Summary of Economic Projections (SEP)</td>
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<td>January 2009</td>
<td>Addition of longer-run projections to the SEP</td>
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<td>April 2011</td>
<td>Post-meeting press conferences</td>
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<tr>
<td>January 2012</td>
<td>Addition of federal funds rate to the SEP</td>
</tr>
<tr>
<td>January 2012</td>
<td>Statement on Longer-Run Goals and Policy Strategy</td>
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Figure 1
Number of Words in FOMC Press Releases
(Average per release, by year)
Nontraditional Policy Tools

- Forward guidance
- Large-scale asset purchases
Forward Guidance

- Qualitative forward guidance
- Date-based forward guidance
- State-based forward guidance
  - In current circumstances, thresholds can help improve economic outcomes relative to simple rules
Figure 2
Implications of alternative unemployment threshold values
(Inertial Taylor rule; Baseline conditions)

Federal funds rate
Core PCE inflation (4Q)
Civilian unemployment rate

\[ \mu = 5.5; \bar{\mu} = 2.5 \]
\[ \mu = 7.0; \bar{\mu} = 2.5 \]
Optimal (commitment)
Without thresholds
Figure 3
Probability of liftoff from the effective lower bound by calendar date
(Stochastic simulations under inertial Taylor (1999) rule, with and without thresholds)

\[ \underline{u} = 7.0; \; \bar{\pi} = 2.5 \]

\[ \underline{u} = 5.5; \; \bar{\pi} = 2.5 \]
Figure 3’
Probability of liftoff from the effective lower bound by calendar date (Stochastic simulations under inertial Taylor (1999) rule, with and without thresholds)

$u = 6.5; \bar{\pi} = 2.5$

$u = 6.5; \bar{\pi} = 2.0$

With threshold
Without threshold
Figure 4
Welfare Effects of Threshold Policies

- Welfare Deteriorating
- Welfare Improving

Smoothed Density

Welfare Improvement (Loss Space)

- $u=7.0, \bar{\pi}=2.5$
- $u=6.5, \bar{\pi}=2.5$
- $u=5.5, \bar{\pi}=2.5$
Figure 4
Welfare Effects of Threshold Policies

Welfare Deteriorating → Welfare Improving

Smoothed Density

Welfare Improvement (Loss Space)

$u=6.5, \pi=1.5$

$u=6.5, \pi=2.0$

$u=6.5, \pi=2.5$
Strong Assumptions:

• Rational expectations
• Thresholds understood
• Credibility
• Model uncertainty
Large-scale Asset Purchases

• Simple, static model

  ° Benefits of purchases depend on their efficacy and the economic outlook

  ° Costs are increasing in purchases
Large-scale Asset Purchases (contd.)

• Model suggests that:

  ° Purchases need to take account of efficacy and costs
  ° Uncertainty makes it difficult to be clear about the economic outcomes that will guide purchases
  ° Policymakers may learn over time about the efficacy and costs of purchases
Additional Questions:

1. Alternative objectives?
   - Different inflation goal
   - Nominal income target

2. Monetary policy and financial stability
Alternative Objectives: Possible Benefits

**Figure 5**
Increase in Inflation target with policy credibility
(Inertial Taylor rule; Baseline conditions)

- **Federal funds rate**
- **Core PCE inflation (4Q)**
- **Civilian unemployment rate**

- Credible
- Baseline
Alternative Objectives: Possible Benefits

Figure 5'
Increase in inflation target with and without policy credibility
(Inertial Taylor rule; Baseline conditions)

Federal funds rate

Core PCE inflation (4Q)

Civilian unemployment rate

- Incredible
- Credible
- Baseline
Alternative Objectives: Possible Benefits

Figure 6
Nominal income level targeting (Baseline conditions)

Federal funds rate
Core PCE inflation (4Q)
Civilian unemployment rate

Nominal income level targeting
Inertial Taylor rule
Alternative Objectives: Possible Benefits

Figure 6'
Effects of expectations on policy outcomes
(Nominal income level targeting with and without complete information)

Federal funds rate

Core PCE Inflation (4Q)

Civilian unemployment rate
Alternative Objectives: Possible Problems

• Credibility of the change
• Confusion about the goals of policy
• Data revisions
• Alternative model features
• Model uncertainty
Monetary Policy and Financial Stability

- To the extent possible, use regulatory and supervisory tools to limit systemic risks

- Need to balance potential benefits of using monetary policy against possible costs
  - Deviations could be in either direction

- Careful monitoring of financial developments
  - Improved data collection
Concluding Remarks

• Greatly improved communications regarding objectives
• Use of threshold-based forward guidance
• Communications regarding asset purchases
• Alternative objectives may be costly
• Need for additional work on the integration of monetary policy and financial stability
• Need to remain humble