
**What Does the New Long-Run Monetary Policy
Framework Imply for the Path Ahead?**

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The views expressed today are my own and not necessarily those of the
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Introduction

Thank you very much for inviting me to offer my views on the economy and monetary policy. It's a real honor to be the kickoff speaker at this year's NABE (National Association for Business Economics) Annual Meeting. It's not every day you get to be the opening act for all of the rock stars you have later in the program. I've got my amp all set to go up to 11. And before I get started, there is the usual disclaimer that these are my own views and not necessarily those of the Federal Reserve System or the Federal Open Market Committee (FOMC).

As 2020 opened, the fundamentals for the U.S. economy were solid, with unemployment at 3.5 percent and strong consumer spending. Monetary policy had been repositioned, moving from a tightening cycle to being on hold because of 18 months of rising uncertainties related to difficult and erratic foreign trade negotiations and their effect on business sentiment and spending. Then the Covid-19 virus hit and activity plummeted, as we and much of the rest of the world locked down in order to fight the pandemic. Unemployment soared, and inflation fell.

Today, the economy is forging its way back, in spite of virus flare-ups and a horrific death toll of over 200,000 in the U.S. The performance of the economy has been

surprisingly more resilient than I would have expected under these health circumstances. Much can be attributed to the fact that large portions of the business sector have successfully adapted to operating safely in the current environment and that individuals have taken to wearing masks and social distancing in response to the outbreaks. Still, the U.S. economy has a long way to go. The unemployment rate is just under 8 percent; about 12-1/2 million people are unemployed; and inflation continues to be well below our 2 percent goal.

My forecast is very much in line with the latest Summary of Economic Projections (SEP) median.¹ Now that the reopening surge is behind us and given the extent of the lost ground we need to make up, I don't expect activity will return to its pre-pandemic level until late in 2021. My outlook has the unemployment rate moving down steadily, but it is still 2023 before it reaches 4 percent. I expect inflation to slowly improve, reaching 2 percent on a persistent basis in 2023 and then moderately overshooting 2 percent over the following few years.

My forecast assumes that additional federal fiscal policy actions are coming. I expect such support will play an enormously powerful role for providing adequate emergency relief until the Covid-19 health crisis is better contained. Still-struggling households and businesses need more aid, and help for state and local governments is especially important. Without adequate fiscal support before too long, I am concerned that

¹ Federal Open Market Committee (2020a).

recessionary dynamics will gain more traction and lead to a slower trajectory back to maximum employment.

Of course, monetary policy also has an important role to play in these unusual and uncertain times. The Federal Reserve is prepared to use its full range of tools in order to support the U.S. economy's attainment of maximum employment and inflation that averages 2 percent over time. A key element of this support will be the effective execution of the FOMC's new long-run monetary policy framework that Chair Powell announced in August and that is articulated in the Committee's revised "Consensus statement on longer-run goals and monetary policy strategy."² The recent September FOMC statement followed through on the new strategic principles, in part by providing strong, outcome-based forward guidance about the future path for interest rates.³ These commitments reaffirm the Federal Reserve's resolve to provide the monetary accommodation needed to achieve our policy goals in as timely a fashion as possible.

Today I would like to discuss some of my views on the messages in our new long-run framework and the September policy statement. I also will explore how the new consensus statement might have affected what some commentators have described as the Fed's mistaken decisions to raise rates as soon and as high as we did over the 2015–18 rate cycle. I hope to be more informative on alternative policy considerations than simply defensive, but I'll let the listener be the judge.

² See Federal Open Market Committee (2020d) for the revised statement. See Federal Open Market Committee (2020c) for a comparison of this revised statement with the previous version from January 2019.

³ Federal Open Market Committee (2020b).

The revised long-run strategy statement

Let me start with a few comments about the new long-run strategy statement. This group of experts is familiar with the revised statement, so I'll just emphasize a couple of points. To me, the biggest impetus for updating our monetary policy strategy was the undeniable realization that the effective lower bound (ELB) on the federal funds rate was not just an anomaly we stumbled into during the Great Financial Crisis, but a persistent threat to the achievement of our dual mandate goals.

The research here is clear. For all the well-known structural reasons, the long-run equilibrium real fed funds rate is much lower now than it was in the 1980s and '90s. This means even average business cycle shocks will drive the funds rate to its lower bound (let alone the kind of shock we received in March).

Research also shows that under traditional monetary policy strategies, the proximity of the ELB will impart a downward bias to inflation and inflation expectations relative to our 2 percent target. And this bias is always present; it's not just an occasional risk associated with a large negative shock. The ELB will also impede the achievement of our maximum employment mandate.

These facts imply a couple of things. First, a systematic adjustment to monetary policy strategy is needed to offset the bias. Second, at times this bias-adjustment will require generating inflation above 2 percent in order to center inflation and inflation expectations at target. I am happy to say that the new monetary policy strategy delivers on these two fundamental principles with its flexible inflation averaging goal and explicit

recognition for the need, at times, for policy to purposely aim for inflation rates higher than 2 percent.

The new framework also emphasizes that our maximum employment mandate is a broad-based and inclusive goal and that monetary policy will seek to eliminate shortfalls from maximum employment. Recall that the old strategy sought to minimize deviations—both positive and negative—from maximum employment, not just shortfalls.

This was an important refinement. Our Fed Listens events were full of discussions with community leaders and others who emphasized the benefits of a strong job market.⁴

The most telling one for me was a dialogue with Maurice Jones, head of LISC (Local Initiatives Support Corporation). He was asked if he was concerned about the risk that a period of exceptionally strong labor markets could lead to macroeconomic imbalances and a subsequent recession. Jones was dismissive of this hypothetical danger, noting that in the communities where his organization works, it always feels like a recession. Maximum employment means bringing as many people as possible into the labor force and finding them productive jobs.

Furthermore, we are all aware of the great uncertainty surrounding linkages between unemployment and inflation pressures. Recently, inflation was running below target despite a historically low 3-1/2 percent unemployment rate. This highlights the challenge for interpreting the influence of lower-for-longer rates on inflation through a simple Phillips curve mechanism. Importantly, even when labor markets appear to be tight, we

⁴ Details on these events are available online, <https://www.federalreserve.gov/monetarypolicy/review-of-monetary-policy-strategy-tools-and-communications-fed-listens-events.htm>.

can't definitely say that a lower-for-longer interest rate policy is accommodative if inflation is underrunning our 2 percent on average objective. Now, let's be clear. You don't have to abandon the expectations- and supply-shock-augmented Phillips curve; but we must recognize that the relationship is multidimensional and large uncertainties surround its predictions.

The new strategy statement does not include specific operational details for how to achieve those goals. I think that is a feature, not a bug. I have long thought that no specific formulaic monetary policy rule will be robust to all of the changes in the economic environment that inevitably will occur. That is, for example, one reason I support the statement's flexible approach to average inflation targeting. The strategy statement is, instead, a commitment to a goals-based policy approach—a philosophy that I have supported throughout my tenure on the FOMC. The precise policy tools and their settings may vary with economic conditions, but the ultimate policy goals remain the same.

The long-run framework and forward guidance

The new long-run framework envisions that forward guidance will be an important part of the FOMC toolkit. Whenever the FOMC employs forward guidance during a long period of low or zero rates, a natural first question is: What does this mean for when the Fed will first raise rates? This was true in August 2003 and throughout the 2012–15 ELB period, for example. Our new long-run strategy statement highlights a number of important features for consideration when deciding on liftoff, and our September FOMC statement then tackled the question head-on.

The September statement indicates we will maintain the current 0 to 1/4 percent target range until we have reached our employment mandate and inflation has reached 2 percent and is on track to moderately exceed 2 percent for some time. This overshooting after a period of sub-2 percent inflation is straight out of the new long-run strategy. I want to emphasize “for some time,” as year-over-year inflation readings could temporarily be above 2 percent next spring as the large drops in prices this year fall out of the annual calculations.

The statement also recognizes that our work on inflation might not be complete at the time of liftoff, and so it also indicates that we will maintain accommodative monetary conditions until our inflation averaging goal has been met. This latter criterion is more nuanced, since it relies on comparing the actual funds rate to some concept of a neutral fed funds rate.⁵ Historically, communicating to the public that an upward march in policy rates is still accommodative has often been met with substantial skepticism and disbelief.

These challenges will be compounded by the fact that short-run r^* today likely is depressed below its long-run value, but should move up to long-run r^* as the economy recovers.⁶ Describing the stance of policy against a moving and unobservable benchmark is another complicated communications challenge. So, all in all, I envision substantial communications work ahead. But it can be done.

⁵ The neutral, or equilibrium, federal funds rate is the funds rate associated with a neutral monetary policy (policy that is neither expansionary nor contractionary).

⁶ The equilibrium (or natural) real interest rate, or the rate consistent with full employment of the economy’s productive resources, is often referred to as real r^* .

Putting this all together, I view the September 2020 forward guidance as a coherent, multipronged policy reaction function—one that should help us deliver on our policy goals.

A review of monetary policy from 2015 through 2018

When it comes to implementing a new strategy, like buying a new car, it makes sense to take it for a test drive. I'd now like to turn to thinking about our new framework and forward guidance through the lens of a recent U.S. experience, specifically, the 2015–18 liftoff and policy rate increases following the post-financial-crisis stay at the effective lower bound. The ultimate success of monetary policy during this period is subject to debate: While we did ultimately experience strong labor markets, we achieved 2 percent inflation for only a brief period in 2018—and in the end that success proved fleeting.

Of course, back then our monetary policy framework was focused on deviations of employment from its maximum level, not shortfalls. It also had a symmetric 2 percent inflation objective, with no sense of inflation averaging. Indeed, when former Chair Janet Yellen was asked at a recent Brookings conference if the December 2015 funds rate liftoff was a mistake because inflation never overshot 2 percent, she replied that it wasn't and that overshooting 2 percent wasn't the FOMC's objective back then.⁷

Still, the inflation experience over this period did not deliver on the old symmetric inflation objective. Furthermore, our struggles over this period influenced my thinking about the new framework a good deal, as I am sure it did others'. So it is worthwhile to

⁷ Brookings Institution (2020, pp. 26–27).

reconsider this rate cycle and how it may have evolved differently under our new long-run strategy.

Let's first review the history. In December 2015 the Fed increased the fed funds rate for the first time after eight years at the ELB. At the time, the unemployment rate was about 5 percent and the median FOMC participant's projection was for it to be 4-3/4 percent over the next three years—a couple of tenths below what was generally thought *at the time* to be its long-run normal rate. Core PCE inflation was only 1-1/4 percent, but was projected to move up steadily and reach 2 percent by 2018.⁸ Underlying this forecast, the SEP median had a 25 basis point rate hike just about every other FOMC meeting for the next three years, reaching close to the then-assumed 3-1/2 percent neutral rate by the end of 2018. So we were looking at a forecast and policy path pretty much fine-tuned to the old framework—don't push unemployment too low, and gradually asymptote in to 2 percent inflation.

Of course, the year 2016 had numerous twists and turns. Heightened uncertainty over growth in China, Brexit, and U.S. politics weighed on the economy, and the FOMC held off on early-year policy moves. Still, by the end of the year the economy had regained its footing. Business sentiment was boosted by expectations of deregulation; tax cuts were on the table and were eventually enacted in late 2017; and equity markets surged. Inflation moved up to 1-3/4 percent. Against this backdrop, the FOMC began to raise

⁸ See Federal Open Market Committee (2015). While our objective is stated in terms of overall inflation according to the Price Index for Personal Consumption Expenditures (PCE), core inflation—which strips out the volatile food and energy components—is a better gauge of sustained inflationary pressures and of where inflation is headed in the future.

rates steadily, increasing the fed funds rate in December 2016 and three more times in 2017.

The tightening continued through 2018 as labor markets improved, with the unemployment rate falling below 4 percent; fiscal policy was massively accommodative; and core PCE ran near 2 percent during much of the year. Any standard monetary policy reaction function had rates returning to neutral and then beyond to avoid further inflation. At the December 2018 FOMC meeting, the target range was raised to 2-1/4 to 2-1/2 percent—close to the 2-3/4 percent rate that was the new, downwardly revised neutral fed funds rate setting in the SEP median.⁹ Furthermore, the post-meeting policy statement indicated that the Committee judged that further gradual increases in the funds rate would be consistent with its policy goals.¹⁰

But no one knew then that U.S.–China trade negotiations and tariff wars would weigh on business sentiment and the economy as much as they did. As we moved into 2019, it became apparent that the outlook for growth had become fragile. Furthermore, core inflation dropped sharply to 1-1/2 percent early in the year and only partially recovered, before plunging with the pandemic. Monetary policy had to reset—first by changing forward guidance to communicate patience on future rate adjustments and then by cutting rates three times in the second half of the year.

⁹ Federal Open Market Committee (2018a).

¹⁰ Federal Open Market Committee (2018b).

Lessons learned

So what are some of the lessons that I take from this experience?

Lesson number 1: Following a prolonged period of underrunning 2 percent inflation, tightening on an inflation forecast comes with asymmetric risks; namely, the costs are larger when uncertainties are resolved adversely.

During this tightening cycle, the consequences of trade war mischief were not apparent until late in the game. In my opinion, in 2017 or early 2018, the administration pursuing a trade policy that negated much of the tax stimulus was just not in the cards. Still, after years of underrunning 2 percent inflation, the costs of a downside surprise with weaker growth and yet another failure to attain sustained 2 percent inflation were significantly larger than if the economy had unexpectedly gained momentum. In such situations, having policy give stronger weight to downside risks ex ante seems crucial. The proximity of the ELB comes into play here as well—in our workhorse models, it is optimal to run looser policy the closer you are to the ELB because of the limits that the ELB imposes on monetary responses to downside shocks.

Lesson number 2: Again, in the context of having underrun 2 percent for several years, something more dramatic than what was in the 2015–18 dot plots and forward guidance was likely needed to boost inflation sustainably. Those didn't do the trick.

Perhaps, as we have just indicated with the September 2020 forward guidance, the FOMC back in 2016 could have waited until inflation actually got to 2 percent before beginning to remove accommodation rather than tightening on a forecast. This would

have made an inflation overshoot more likely; and indeed, ex post, an overshoot probably would have been a desirable outcome. To be sure, some FOMC participants eventually began to advocate for overshooting, but this was not until later in the cycle.¹¹

Of course, actually pulling this off—whether back then or now—depends on the risk appetite of the Committee to overrun 2 percent. Can tightening wait until we see the whites of inflation’s eyes, or will the Committee want to raise rates earlier based on just a strong inflation forecast? The new long-run strategy statement provides the latitude to wait, and our September forward guidance says that we expect to do so. But as inflation approaches 2 percent, if our policy-risk appetite is low, we may have to fight the temptation to raise rates early. I’ll have more on this in a minute.

Lesson number 3: To end with an old message of mine, in the presence of a low r^* and looming ELB, the successful achievement of our inflation goal requires that the FOMC be “in it to win it” and follow through on averaging 2 percent inflation over some period of time. Our new long-run strategy definitely gives the FOMC plenty of runway to pursue such a policy effort.

A hypothetical

So what would have been different in 2015–18 under the new framework?

Well, from the start, policy would not have been designed to just asymptote in to 2 percent inflation. From the beginning of the Great Recession in December 2007 to the

¹¹ See Evans (2017) and Federal Open Market Committee (2018c, 2018d).

December 2015 FOMC meeting—that’s an eight-year period—core PCE inflation averaged about 1-1/2 percent. Under the new framework, there would have been a strategic emphasis on producing inflation above 2 percent for a time in order to offset this shortfall. It’s highly likely that this strategy would have forestalled raising rates in 2015 and 2016; whether inflation would have persistently reached 2 percent and justified a rate increase sometime in 2017 under this counterfactual is open to debate.

Next, there would have been no concern with the unemployment rate falling below the Committee’s view of its long-run normal level if it wasn’t producing undesired inflationary pressure. The Committee would have not felt any employment-related constraint on pursuing inflation overshooting.

And finally, a looser policy would have made the real economy more resilient to the headwinds that hit in 2018 and 2019. It is likely that under the alternative policy, those just-at-2-percent-inflation numbers in 2018 would have been turned into a meaningful overshoot, providing a buffer to keep inflation from falling as much below target as it did with the disinflationary shock in 2019.

The new framework in the current environment

Let’s return to today. Under the new framework, we are explicitly trying to average 2 percent inflation. Some additional perspective likely is useful here. For example, think about how long and how much inflation will need to run above 2 percent for us to achieve this average. For the sake of argument, here are a couple of simple calculations.

Forget the many years of underrunning 2 percent since 2008, and let's just start averaging beginning with the price level in the first quarter of 2020. Core PCE inflation in the SEP is projected to be 1-1/12 percent this year and then gradually rise to 2 percent in 2023.¹² Suppose it hits 2-1/4 percent in 2024 and then stays there. In this scenario, cumulative average core inflation starting from the first quarter of 2020 does not reach 2 percent until mid-2026. That is a long time. If you can produce 2-1/2 percent inflation in 2024, you can get there about a year quicker. Some, though, might view 2-1/2 percent inflation as an excessive overshoot. And don't forget, that is under a positive economic outlook such as in the SEP, which in my submission depends on strong fiscal and public health support.

Now, we are not going to follow a strict numerical formula to determine liftoff or how long to keep policy accommodative after liftoff. Still, these simple calculations illustrate that we likely have a lot of work ahead of us. And it's crucial that we acknowledge the magnitude of the job up front to help lessen the temptation to back off the overshoot too early in the process.

Some final thoughts

Let me conclude with two observations on how I view the policy situation today given our new framework and these lessons from history.

First, now is not the time to employ a plan to tighten preemptively on the basis of a forecast. And our current forward guidance regarding liftoff rejects this tactic. The

¹² Federal Open Market Committee (2020a).

guidance is pretty straightforward: Inflation should be at 2 percent and confidently on track for overshooting before we liftoff from the ELB.

Now, to some extent this decision—and certainly the contours of the path after liftoff—may still revolve around the risk appetite of the Committee to wait until its goals are clearly in the data as opposed to being on track for achievement according to a well-thought-out, but still uncertain forecast. Of course, forecasts always are in play—that is the nature of the game, given the fact that monetary policy works with a lag. But forecasts come with obvious risks, and moving policy on them should be done with careful risk-management calculus in mind. Also, we can't allow ELB fatigue to influence our decisions—simply saying the federal funds rate has been at zero for a long time is not a good argument for increasing rates.

Second, only in Lake Wobegone is everyone above average. In the real world, successful achievement of inflation expectations that are truly reflective of our 2 percent objective means the FOMC needs to follow through on averaging 2 percent inflation. This will require actual overshooting, and we can't be timid about doing so. To reduce employment shortfalls and average 2 percent inflation over time, the FOMC needs to have an "in it to win it" attitude toward our inflation objective.

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