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# Fed Thoughts: Bringing the Tablets Down from the Virtual Mountaintop

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For all the words spilt over the Federal Reserve's (Fed) recent change in its longer-run monetary policy strategy, one might think that Fed Chair Powell brought the new mission statement on a stone tablet down from a virtual mountaintop of Jackson Hole. Powell characterizes it as "a robust updating of our monetary policy framework," his vice chair Rich Clarida considers it "an important milestone," and Governor Lael Brainard believes it "breaks important ground" (on page 13 here, page 1 here, and page 1, here, respectively).

This note, previewing the meeting of the Federal Open Market Committee (FOMC) to be held on September 15-16, performs the biblical exegesis of the event by answering four questions:

1. Why do Fed officials believe the change was important?

2. What did they do?

3. How has the Fed's strategic vision changed?

4. When is the next change?

The synopsis is that Fed officials act as if it was important and built on their legislative instructions to promote maximum employment and stable prices. However, the mission statement is ambiguous about, and asymmetric in, its treatment of those goals and fits to the near term, not the longer term. They want, and in the medium term will probably get, higher inflation. Having specified their goals, FOMC participants will next define their policy setting in terms of the path of the economic outlook relative to those goals. This may map both the policy rate (for sure) and asset purchases (perhaps) into a rule, possibly as early as the upcoming meeting.

## Why is This a Big Deal?

On one level, from outside the Fed it is hard to imagine how so many people could work so hard for so long on its review of longer-run strategy merely to insert the word "average" in its annual statement. On another level, the affirmation by the FOMC of a revised "Statement of Longer-Run Goals and Monetary Policy Strategy" (found here) was an important accomplishment for Fed Chair Powell and his colleagues, at least to them given their earlier quotes. There are three other important tells.

First, officials took pains to showcase their announcement at the Federal Reserve Bank of Kansas City Economic Symposium, this time held virtually rather than in Jackson Hole proper. There was radio silence among Fed governors and Bank presidents, who normally front-run changes in communications strategy to appear in the intellectual vanguard of the institution. While the annual statement is only one page, Fed Chair Jay Powell took 22 pages in his Jackson Hole remarks to explain it (with four pages of references and four pages of charts). Many Fed speakers followed on his heels.

Second, central bankers tend to travel in packs, flocking to such retreats as Jackson Hole and Basel (Bank for International Settlements) to compare notes. Innovations in policy strategy come incrementally, first tried out at smaller institutions before being embraced by the larger ones. This time, the Fed was the first mover. That is, the Fed apparently viewed the move as sufficiently important that they were willing to be the nail sticking out among the otherwise smooth edifice of central banks.

Third, quite tellingly, Fed Chair Powell sometimes refers to the FOMC's "Statement on Longer-Run Goals and Monetary Policy" as its Constitutional document. A lawyer does not throw around such a term loosely. The statement, normally ratified at the first meeting annually since 2012, represents the Fed's interpretation of the goals assigned to it, just as Congress was assigned the power "to coin money" in the Constitution. Guiding monetary policy by this mission statement is the quid pro quo for the power to conduct monetary policy. Perhaps not biblical, but this was a change to the Fed's constitution and therefore important to officialdom.

## What Did They Do?

The new Fed strategy rests on four pillars.

1. The FOMC strongly endorses its dual mandate of maximum employment and price stability. This, in part, provides the assurance that their attention to inflation is not at the cost of concerns about unemployment.

2. The numerical goal of 2 percent inflation consistent with price stability in the long run requires them "...to achieve inflation that averages 2 percent over time..." They judge this as making it more likely that longer-term inflation expectations will remain well-anchored at 2 percent. It also allows the Fed to compensate subsequently for misses from its inflation goal. The statement reads "...following periods when inflation has been running persistently below 2 percent, appropriate monetary policy will likely aim to achieve inflation moderately above 2 percent for some time." This introduces an element of price-level targeting, implying that prior monetary policy performance is indicative of future behavior. Monetary theorists adore such a rule because it allows policy makers to lower policy rates aggressively amidst a downturn while making it more likely inflation expectations remain anchored. However, the statement only spells out one side of the pursuit of 2 percent inflation on average—that they will tolerate an overshoot given that they have undershot the mark for so long.

3. Fed Chair Powell and his committee emphasized that there is no single metric for maximum employment. This recognizes that policy makers were repeatedly surprised during the economic expansion about how low the unemployment rate could get. It also reflects the increased pressure on the Fed to be sensitive to the distribution of income and the labor market conditions of minorities. This continues the transition in the Fed's conduct and policy communication begun in earnest by former Fed Chair Janet Yellen. But Powell has doubled down because his committee is one-sided in its concern for "shortfalls" from maximum employment, not "deviations" as in prior statements—another one-sided goal.

4. The Fed warned that it is likely to use tools other than the policy rate, and more often than previously. The logic is that in an environment of significant resource slack, slow trend growth, and elevated uncertainty, the natural real rate of interest is likely low and the policy rate is likely to be constrained more often by its effective lower bound. If so, more will be needed more often.

## How Has the Fed's Strategic Vision Changed?

The new long-run strategy departs fundamentally from its prevailing orthodoxy, so much so that it is hard to understand why "longer-run" remains in the title. In fact, it is asymmetric, ambiguous, and fit to the moment. All combine to undermine the Fed's credibility about containing inflation at 2 percent on average over the longer run.

## Asymmetric

As noted, both Fed goals point in one direction—the one justifying sustained policy accommodation. Rather than a concern about "deviations" from maximum employment in prior statements, the Fed now informs policy decisions "by assessments of the shortfalls of employment from its maximum level." That is, unemployment rates can never get too low. A key prediction of monetary theory since the early 1980s is that a central bank set on attaining unemployment rates below their natural rates will tolerate above-goal inflation.[1]

Similarly, average inflation targeting is supposed to be symmetric—when inflation runs below 2 percent expect a subsequent overshoot, and when inflation runs above 2 percent expect a subsequent undershoot. The Fed, however, only mentioned the former, not the latter, highlighting one of the criticisms of the approach. Inflation below goal will be used to justify policy accommodation, but a central bank is unlikely to intentionally go below 2 percent to offset inflation that had run above goal. Because of the asymmetric application of letting bygones be bygones, inflation and inflation expectations will likely average above 2 percent to the detriment of central bank credibility. There is an obvious precedent for this concern, which is another throwback to the 1980s. In that decade, the Fed routinely rebased the growth paths for its targeted monetary aggregates when they were above goal—known then as base drift.

## Ambiguous

The Fed bought itself room for more discretion by being ambiguous about its goals. Maximum employment is "not directly measurable and changes over time" and will be assessed against "a wide range of indicators." How big is a shortfall? How long is the look-back when "the Committee seeks inflation that averages 2 percent over time"? If it is a thirty-year average, then they can pack up and go home because inflation is at their goal. If, instead, it matches Jay Powell's tenure as governor (since May 2012) or chair (since February 2018), then they have about 0.6 or 0.9 percentage points, respectively, to make up. The way they get the average back to goal is to overshoot 2 percent, but by how much and for how long? Ambiguity allows more discretion and is usually associated with an inflation bias (in the same textbook model).

## Fit to the Moment

Asymmetry and ambiguity are convenient for Fed officials right now by underscoring their intent to keep policy accommodative for a long time to come. However, it lays bare the odd nature of the entire exercise. The committee is specifying the instructions that it believes the Congress wants maintained over the longer run, as in M.C. Escher's lithograph of drawing hands creating themselves. But the FOMC reorganizes itself every year on a rotation, governors and Bank presidents come and go, and the chair has a term of four years. This FOMC is attempting to define the longer-run goals of it and its successors, even though its successors could always vote differently later.[2] Indeed, the Fed has promised to reassess the process every five years.

The idea back in 2012 was that the FOMC could affirm a statement at the beginning of each year that was timeless in conveying the setting of policy over the longer run. By reaffirming the same statement over time, the force of precedent would bind future FOMCs. This latest version puts more in play and is therefore less credible.

# When Is the Next Change?

Soon. The Federal Reserve is digging a firebreak to ensure that market participants do not get ahead of themselves and come to expect a removal of policy accommodation sooner than policy makers think appropriate. And what they think is that it will be a long time before they let off the gas.

They can do this by tying their hands regarding future action to either the calendar or the outlook. They clearly prefer the latter, an outcome-based policy rule. Specifying the longer-term policy goal is the logical precondition for framing an outcome-based interest rate rule as it will relate their forecast to their goals. There is no pressing need to act immediately because Fed Chair Powell seems to have convinced market participants that tightening is a far-distant event. They will want, however, to have the rule in place before that a change in those expectations becomes a risk.

The Fed has been disciplined in their rollout of the long-run strategy document so we should expect them to be similarly disciplined about a rule. From the minutes we know the clock is ticking. In our view, the safe bet is they will have it in place by the end of the year. That implies either an announcement in September or December. Given that there is an election in between, they probably will opt for an announcement before, not later. In principle, an outcome-based rule could bind both sets of policy instruments—the policy rate and the size of the balance sheet—as was discussed in the latest set of minutes. There is much more enthusiasm for the former than the latter, but both cannot be ruled out.

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Vincent is Mellon's Chief Economist and Macro Strategist. In this role, he is responsible for developing views on the global economy and making relative value recommendations across global bond markets, currencies and sectors.

Previously, Vincent served as the Chief US Economist and a managing director at Morgan Stanley. For the prior four years, he was a resident scholar at the American Enterprise Institute (AEI). Vincent also worked in several roles at the Federal Reserve over 24 years, including Director of the Division of Monetary Affairs and Secretary and Economist of the Federal Open Market Committee (FOMC). His responsibilities at the Federal Reserve included directing research and analysis of monetary policy strategies and the conduct of policy through open market operations, discount window lending and reserve requirements. Prior to these roles, he was the principal liaison with the domestic desk at the Federal Reserve Bank of New York and was responsible for preparing a document outlining policy alternatives for each FOMC meeting. He was Deputy Director in the Division of International Finance and Associate Economist of the FOMC and spent five years at the Federal Reserve Bank of New York in both the domestic and international research departments.

His academic publications primarily concern the conduct of policy and issues related to the monetary transmission mechanism as well as an analysis of alternative auction techniques and Treasury debt management. After an undergraduate training at Fordham University, he received graduate degrees in economics at Columbia University.

## Endnotes

[1] The textbook example of monetary policy design—based on Robert Barro and David Gordon, "A Positive Theory of Monetary Policy in a Natural Rate Model," Journal of Political Economy (August 1983)—produces the result that inflation exceeds its goal in proportion to the gap between the natural rate of unemployment and the central bank's target.

[2] In the law, this is known as entrenchment. In which legislature passes a law that constrains future legislatures. Entrenchment is usually the basis for a Constitutional challenge.

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