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>
</tr>
</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>
</tr>
<tr>
<td>January 2009</td>
<td>Addition of longer-run projections to the SEP</td>
</tr>
<tr>
<td>April 2011</td>
<td>Post-meeting press conferences</td>
</tr>
<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>
</tr>
</tbody>
</table>
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

- $\mu = 5.5; \tilde{f} = 2.5$
- $\mu = 7.0; \tilde{f} = 2.5$
- 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)

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

\[ u = 5.5; \bar{\pi} = 2.5 \]
Figure 4
Welfare Effects of Threshold Policies

Welfare Deteriorating  Welfare Improving

Smoothed Density
0.12
0.10
0.08
0.06
0.04
0.02
0.00

Welfare Improvement (Loss Space)
-60
-40
-20
0
20
40
60

\( u = 7.0, \bar{\pi} = 2.5 \)
\( u = 6.5, \bar{\pi} = 2.5 \)
\( u = 5.5, \bar{\pi} = 2.5 \)
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

Baseline vs. Credible conditions
Alternative Objectives: Possible Benefits

Figure 6
Nominal income level targeting
(Baseline conditions)

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