The Federal Reserve’s Current Framework for Monetary Policy: A Review and Assessment

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Humphrey-Hawkins mandate

2012 Statement of Principles
- Symmetric 2% inflation target
- Commitment to maximum employment
Humphrey-Hawkins mandate

Tools to achieve these goals
- Level of Fed funds rate

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Tools to achieve these goals

- Level of Fed funds rate
- Forward guidance about future Fed policy
- Large scale asset purchases (LSAPs)
- Communications and transparency
Backdrop: The Slow Recovery

Unemployment rate, 1980-2019

Dashed line is trend from peak unemployment rate to CBO NAIRU. Shading denotes NBER-dated recessions.
Headwinds to GDP growth:
- Baby boom retirement (demographic LFPR decline)
- Productivity slowdown (TFP)
- Fiscal headwinds, until 2018
Two estimates of the long-term equilibrium real rate of interest ($R^*$) & the yield on 10-year TIPS
Two monetary policy interventions (shocks)
• Level shock: Change level of Fed funds rate
• Slope shock: Change slope of Treasury yield curve (10 year-FF spread)

Key elements of model
• Estimate effect on the unemployment rate of policy change in (a) Fed funds rate and (b) slope by instrumental variables regression
  • The instruments are announcement-window changes in interest rates (Kuttner (2001))
• Estimate response of inflation to the unemployment rate using a hybrid New Keynesian Phillips Curve
(a) **Response of the unemployment gap to unit level and slope shocks**

(b) **New Keynesian Phillips curve**
- Post-2000 data results in flat estimated Phillips curve: Long-run slope ~0.2
- Steeper Phillips curve simulated in paper
Simulation structure

- Posit an historical policy hypothetical
- Compute implied monetary policy shocks
- Compute effects on rates of unemployment and inflation
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Policy simulations

A. Earlier or later liftoff
B. No ZLB
C. Alternative LSAPs/forward guidance policies
D. Inherit higher inflation rates, interest rates, and inflation target
E. Temporary price level target
F. Lower for Longer
Early liftoff

- No change in slope policy (LSAPs or forward guidance)
A. Earlier or later liftoff

B. **No ZLB**

C. Alternative LSAP/forward guidance policies

D. Inherit higher inflation rates, interest rates, and inflation target

E. Temporary price level target

F. Lower for Longer
“Balanced rule” (Taylor (1999) rule), with no ZLB and no LSAPs

- Calibrate slope policy to undo the effects of actual LSAPs
A. Earlier or later liftoff
B. No ZLB
C. Alternative LSAP/forward guidance policies
D. Inherit higher inflation rates, interest rates, and inflation target
E. Temporary price level target
F. Lower for Longer
No LSAPs

- Historical Fed funds path
“Stronger sooner:” flatten yield curve by additional 2pp for 18 months, starting December 2008

- Historical Fed funds path

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counterfactual

actual
A. Earlier or later liftoff
B. No ZLB
C. Alternative LSAP/forward guidance policies
D. Inherit higher inflation rates, interest rates, and inflation target
E. Temporary price level target
F. Lower for Longer
Inherit all nominal rates & inflation target one pp higher ($\pi^* = 3\%$) + No LSAPs

• Funds rate liftoff when either:
  • $U_{gap} \leq 1\%$, or
  • $\pi \geq \pi^* + 0.5$

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counterfactual

actual
Inherit all nominal rates & inflation target one pp higher ($\pi^* = 3\%)$

+ Historical slope policy
  - Same LSAPs, forward guidance policy as actual
  - Funds rate liftoff when either:
    - $Ug_{ap} \leq 1\text{pp}$, or
    - $\pi \geq \pi^* + 0.5$

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counterfactual
 actual
A. Earlier or later liftoff
B. No ZLB
C. Alternative LSAP/forward guidance policies
D. Inherit higher inflation rates, interest rates, and inflation target
E. Temporary price level target
F. Lower for Longer
TPLT with 12 month lookback, implemented by Fed funds + Historical slope policy

- Funds rate at ZLB until price level target hit
- Same LSAPs, forward guidance policy as actual

Performance Under Counterfactuals

- Nominal Fed funds rate
- Real Funds Rate
- Unemployment rate
- Core PCE Inflation rate

- - - - - - - counterfactual
- - - - - - - actual
A. Earlier or later liftoff
B. No ZLB
C. Alternative LSAP/forward guidance policies
D. Inherit higher inflation rates, interest rates, and inflation target
E. Temporary price level target
F. **Lower for Longer**
Taylor (1993) rule with makeup + No LSAPs

- Time-varying $R^*$ (Holston, Laubach, and Williams (2017))
- Funds rate stays at zero until it makes up “below-zero gap”
  - This is the third rule in Feb. 2019 Monetary Policy Report, p. 37

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**counterfactual**

__________ **actual**
Summary

Estimates of R*

Federal Funds Rate

Sources: Holston, Laubach, and Williams (2017), updated, and Del Negro et. al (2017), updated;
TIPS. FRED. Shading denotes NBER-dated recessions.