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POLICY BRIEF

Assessing the New Powell Monetary Strategy

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In August 2020, in a virtual speech at the annual Economic Policy Symposium in Jackson Hole, WY, Federal Open Market Committee (FOMC) Chair Jerome H. Powell used a revision of the FOMC's "Statement on Longer-Run Goals and Monetary Policy Strategy" to announce a new monetary policy strategy for responding to the recession and the increase in unemployment produced by the COVID-19 pandemic. Powell terms it *flexible-average-inflation targeting* (FAIT) because it allows inflation to rise above and then persist above the FOMC's 2 percent target in order to make up for past undershoots of the target. Unfortunately, this proposal leaves unclear how the FOMC will avoid an uncontrolled overshoot of inflation or eventually eliminate the planned overshoot. Furthermore, there is a danger that abandoning the Volcker–Greenspan policy of preemption could revive the stop-go policy cycle of the 1970s.[1]

The passages from the speech relevant for understanding the new strategy follow. They explain the FOMC's strategy for returning employment to a socially desirable, low, prepandemic level. Powell stated the following:

> [O]ur revised statement emphasizes that maximum employment is a broad-based and inclusive goal. This change reflects our appreciation for the benefits of a strong labor market, particularly for many in low- and moderate-income communities. In addition, our revised statement says that our policy decision will be informed by our "assessments of the *shortfalls* of employment from its maximum level" rather than by "*deviations* from its maximum level" [emphasis in the original] as in our previous statement. This change may appear subtle, but it reflects our view that a robust job market can be sustained without causing an outbreak of inflation.

> In earlier decades when the Phillips curve was steeper, inflation tended to rise noticeably in response to a strengthening labor market. It was sometimes appropriate for the Fed to tighten monetary policy as employment rose toward its estimated maximum level in order to stave off an unwelcome rise in inflation. The change to "shortfalls" clarifies that, going forward, employment can run at or above real-time estimates of its maximum level without causing concern. . . .
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> We have also made important changes with regard to the price-stability side of our mandate. . . . [F]ollowing periods when inflation has been running below 2 percent, appropriate monetary policy will likely aim to achieve inflation moderately above 2 percent for some time.[2]

THE NEW STRATEGY UNDERSTOOD AS ODYSSEAN FORWARD GUIDANCE

FAIT is intended to shape the expectations of financial markets about the criteria the FOMC will use when determining when to raise the federal funds rate off the zero lower bound (ZLB), where it currently rests. Financial markets normally expect the FOMC to raise the funds rate when unemployment declines significantly, and bond rates tend to rise on that expectation. But by changing the language in the FOMC's strategy (from "*deviations* from [the] maximum level [of employment]" to "*shortfalls* of employment from its maximum level"),[3] Powell is committing not to raise the funds rate as the unemployment rate declines unless he also sees a persistent overshoot in the 2 percent inflation target. Jeffrey Campbell and coauthors call this kind of explicit forward guidance "Odyssean forward guidance."[4] The intention is to prevent a "premature" rise in bond rates that would make monetary policy less expansionary.

The particular rate of unemployment that the FOMC tries to achieve before raising the funds rate is called the nonaccelerating inflation rate of unemployment (NAIRU), an estimate of the long-run unemployment rate that is generally understood to represent full employment. Every quarter, in its Summary of Economic Projections (SEP), the FOMC reports its estimate of the NAIRU. Unemployment at or below the NAIRU tends to produce inflation, and under Paul Volcker and Alan Greenspan, the FOMC tried to forestall inflation by raising the funds rate in the event of a sustained decline in unemployment toward the NAIRU. But now attempting to push unemployment below the NAIRU is the express strategy of the FOMC.

The reason is that the NAIRU is not easily predicted. In the recovery from the Great Recession, the unemployment rate fell below the FOMC's median SEP estimate of the NAIRU without adverse inflationary consequences, so the FOMC revised its estimate of the NAIRU downward. Recognizing this challenge, the FOMC intends to use the new strategy to discover the NAIRU by pursuing expansionary monetary policy (presumably, keeping the funds rate at the ZLB) until inflation persists above the long-run target of 2 percent.

One difficulty with this new strategy is shown by America's experience with the stop-go monetary policy of the pre-Volcker era, which Milton Friedman famously documented. Expansionary monetary policy affects inflation with a long lag of almost two years,[5] so requiring evidence that inflation is persisting above 2 percent before raising the funds rate from the ZLB effectively means maintaining expansionary monetary policy for at least the length of the lag. The likelihood of the FOMC doing so is confirmed by other communications such as the SEP from the September 2020 FOMC meeting, which projects the funds rate at basically zero (0.1 percent) through 2023. Another confirming example is Chair Powell's comment in June that the FOMC is not "even thinking about thinking about raising [interest] rates."[6] The long and variable lags that Freidman warned about, however, create the risk that such a policy could produce an uncontrolled overshoot of inflation.

Confidence in the ability of the new strategy to lower the unemployment rate without risking inflation comes from recent experience with inflation and unemployment. In February 2020, the last month before the pandemic, the unemployment rate of 3.5 percent coincided with an inflation rate somewhat below the 2 percent target, leading the FOMC to suppose that the world has changed since the Volcker and Greenspan eras, when the FOMC needed to act preemptively in raising the funds rate as the unemployment rate declined to historically low levels. The Phillips curve, which predicts inflation given the unemployment rate, is flat down to at least the 3.5 percent level that existed before the pandemic. Now it seems the curve is even flatter.

Michael Woodford points out that in the past the FOMC has avoided Odyssean forward guidance: "In the case of forward guidance, it has been tempting for central bankers to believe that they can affect financial conditions simply by offering *forecasts* [emphasis in the original] of likely future policy, while not really tying their hands with regard to future policy decisions."[7] The problem with Odyssean forward guidance is the difficulty in forecasting economic conditions. For example, with a COVID-19 vaccine the economy might recover rapidly, and at the same time inflation might not yet have persisted above the 2 percent level. With the funds rate at the ZLB, the FOMC might then lose credibility for controlled inflation overshoots. Markets could also become concerned about pressure from the political system not to raise interest rates barring a significant overshoot in inflation.

WHAT HAPPENS AFTER ODYSSEUS UNTIES HIMSELF FROM THE MAST?

As stated earlier, the new strategy commits the FOMC to an extended period of monetary stimulus through commitment to a persistent inflation overshoot of the 2 percent target, regardless of whether unemployment reaches its prepandemic rate of 3.5 percent. But what happens when the FOMC finally does decide that the inflation overshoot is sufficient? Such is not clear. Powell uses the adjective "flexible" to characterize the FOMC's new monetary policy strategy. As connoted by the term, with achievement of the inflation overshoot, discretion then replaces firm commitment, so the FOMC may choose to pursue contractionary monetary policy, but there is no guarantee that it will.

As part of the inflation overshoot strategy, it remains unclear how the FOMC will control the expectation of inflation by the public. The issue of controlling inflationary expectations will become important when the FOMC tries to restore 2 percent inflation after having achieved the desired inflation overshoot. It will need to slow economic growth without causing a recession—the proverbial but elusive soft landing. By achieving credibility for price stability, the Greenspan FOMC made it possible for the FOMC to lower the funds rate aggressively without reviving inflationary expectations. Once the public sees inflation rising, however, the FOMC could lose that credibility. That loss of credibility would then render difficult the ability of the FOMC to reverse a contractionary monetary policy and replace it with an expansionary monetary policy of lowering the funds rate or of using its unconventional tools of forward guidance and quantitative easing.

In the Great Inflation, lasting from the mid-1960s through the early 1980s, the FOMC raised inflation, but not in a controlled, desirable way. FAIT offers little guidance for how the FOMC can avoid this outcome and restore inflation to 2 percent. Furthermore, the FOMC offers no evidence of past success in raising inflation in a controlled way. In the past, increases in inflation have always been unintended outcomes of expansionary monetary policy.

Just like in the first half of the 1960s, the expectation of near price stability is firmly embedded in the public's behavior. The lesson from the expansionary monetary policy that followed the first half of the 1960s is that with the embedded expectation of price stability, expansionary monetary policy can drive the unemployment rate well below its sustainable level. But in the 1960s, the ultimate cost of doing so was inflation. Inflation arose with a long lag of almost two years after the overshoot in employment past its sustainable level. America exploited a valuable resource (expectations of price stability) for very transitory gains in employment. These employment gains were reversed when inflation had to be addressed in the early 1980s.

Again, at present, the FOMC wants to raise inflation. Earlier, it did so in three waves starting in 1966, 1972, and 1977. However, these increases in inflation were unintended. If they offer a lesson for the present relevant to raising inflation in a controlled way, it is the importance of maintaining control of the expectations of price setters about inflation. Unfortunately, economists and policymakers know little about managing expectations. That ignorance suggests caution.[8]

CONCLUSION

The newly announced strategy commits the FOMC to expansionary monetary policy to lower the unemployment rate to its lowest sustainable level as indicated by a persistence of inflation above the long-run 2 percent target. The announced strategy, however, leaves vague how the FOMC will then return inflation to the 2 percent target. One possible way to ensure the long-run discipline required to maintain price stability would be to accompany the policy with a long-run path for the price level.

Ben Bernanke has suggested price-level targeting when the funds rate is at the ZLB.[9] He mentions two advantages relevant to FAIT. First, price-level targeting allows the FOMC to make up for periods of low inflation: if inflation has been below the 2 percent target, then the FOMC will try to maintain inflation above the 2 percent target for a commensurate period. Second, it also ensures long-run price stability.[10] Price-level targeting consequently serves the same function as FAIT while guarding against an uncontrolled overshoot in inflation. If credible, a price-level path would anchor long-run expectations of inflation.

As of the time of the writing of this brief, with the pandemic raging, attention is focused on the need to restore employment. However, a vaccine will make possible a return to a normal economy. The FOMC needs to make its new strategy symmetrical by explaining how it will ensure long-run price stability as well as maximum employment.

ABOUT THE AUTHOR

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NOTES

1. For other papers on the new policy, see Robert L. Hetzel, "COVID-19 and the Fed's Credit Policy" (Mercatus Working Paper, Mercatus Center at George Mason University, Arlington, VA, July 2020); Robert L. Hetzel, "COVID-19 and the Fed's Monetary Policy" (Mercatus Working Paper, Mercatus Center at George Mason University, Arlington, VA, October 2020); Robert L. Hetzel, "A Rule to Preserve Monetary Stability" (Mercatus Policy Brief, Mercatus Center at George Mason University, Arlington, VA, October 2020).

2. Jerome H. Powell, "New Economic Challenges and the Fed's Monetary Policy Review" (remarks, "Navigating the Decade Ahead: Implications for Monetary Policy," Jackson Hole, WY, August 27, 2020), 11–12.

3. Powell, "New Economic Challenges," 11.

4. Jeffrey R. Campbell et al., "Macroeconomic Effects of Federal Reserve Forward Guidance," *Brookings Papers on Economic Activity* (Spring 2012): 1–80.

5. Milton Friedman, "The Quantity Theory of Money," in *The New Palgrave: Money*, ed. John Eatwell, Murray Milgate, and Peter Newman (New York: Macmillan Press, 1989): 30–31.

6. Board of Governors of the Federal Reserve, *Transcript of Chair Powell's Press Conference*, June 10, 2020, 10.

7. Michael Woodford, "Methods of Policy Accommodation at the Interest-Rate Lower Bound" (working paper, 2012), 3.

8. For commentary on these earlier experiences, see Robert L. Hetzel, *The Monetary Policy of the Federal Reserve: A History* (Cambridge: Cambridge University Press, 2008); Robert L. Hetzel, *The Great Recession: Market Failure or Policy Failure?* (Cambridge: Cambridge University Press, 2012).

9. Ben S. Bernanke, "Monetary Policy in a New Era" (paper presentation, "Rethinking Macroeconomic Policy," Peterson Institute for International Economics, Washington, DC, October 2, 2017). Bernanke mentions the following as advocating

price-level targeting: Víto Gaspar, Frank Smets, and David Vestin, "Is Time Ripe for Price Level Path Stability?" (working paper series no. 818, European Central Bank, Frankfurt, Germany, October 2007); Lars E. O. Svensson, "Price-Level Targeting versus Inflation Targeting: A Free Lunch?," *Journal of Money, Credit and Banking* 31, no. 3 (1999): 277–95; John C. Williams, "Preparing for the Next Storm: Reassessing Frameworks & Strategies in a Low R-Star World" (remarks, Shadow Open Market Committee, New York, May 5, 2017); Alexander L. Wolman, "Real Implications of the Zero Bound on Nominal Interest Rates," *Journal of Money, Credit and Banking* 37, no. 2 (2005): 273–96; Scott Sumner, "Monetary Policy Rules in Light of the Great Recession," *Journal of Macroeconomics* 54 (2017): 90–99. Wolman was the first to draw attention to the desirable makeup feature of price-level targeting. In the language of Sumner, price-level targeting would apply a "guardrail" to FAIT. Sumner suggested the relevance of price-level targeting to this author.

10. Bernanke, "Monetary Policy in a New Era," 23.