Considerations for the Federal Reserve's Upcoming Framework Review

Loretta J. Mester
Adjunct Professor of Finance, The Wharton School, University of Pennsylvania
and Former President and Chief Executive Officer, Federal Reserve Bank of Cleveland

Remarks for the Panel on How Should the Fed's Monetary Policy Framework Change?
66th NABE Annual Meeting: "Finding Harmony in the Noise: Transitioning to a New Normal"
National Association for Business Economics (NABE)
Nashville, TN

October 1, 2024

Introduction

I appreciate the opportunity to participate in this panel and I thank the organizers for including me.

The Federal Open Market Committee's (FOMC) monetary policy framework is summarized in its statement on longer-run goals and monetary policy strategy.[1] The FOMC first issued this consensus statement in 2012, and it was the first time the Fed established an explicit, numerical target for inflation. In 2019-2020, the FOMC undertook a review of its monetary policy framework, including its monetary policy strategy, tools, and communication practices. The Fed issued a revised statement in 2020, which has been reaffirmed annually since then. The Fed intends to undertake a thorough public review of its framework roughly every five years, and Chair Jay Powell has indicated that the framework review will commence later this year.[2] The framework has served the FOMC well. But in the spirit of continuous improvement, I offer some considerations for the FOMC as it undertakes its review.

The challenges over the post-pandemic episode of high inflation have put the current framework to a test. It would be useful for the FOMC to start its framework review with a critical assessment of how its current framework performed during this episode and whether adjustments to the framework would have yielded better results.

The economic environment today is considerably different from what it was in the decade leading up to the 2019-2020 review. Back then, the general level of interest rates consistent with sustainable growth and price stability in the U.S. and other advanced economies was lower than it had been in prior decades.[3] There was also a perceived change in inflation dynamics. Resource slack in the labor market and in product markets had become less correlated with actual inflation than in the past, and inflation

[1] See Federal Open Market Committee (January 30, 2024).

[2] See Federal Open Market Committee (June 12, 2024), p. 26 and Powell (2024).

[3] This decline reflected several factors, including the aging of the population, changes in risk preferences, and slower productivity growth.

expectations had played a larger role in determining inflation outcomes. Inflation had been running considerably below target for a long time; the unemployment rate was well below the level most economists thought indicated tight labor markets, which was expected to add to inflation pressures; and the likelihood that the policy rate would need to fall to its effective lower bound seemed higher than it used to be.

In contrast, during the post-pandemic period, inflation persisted well above the 2 percent target; labor market conditions remained tight for a long time; and the policy rate needed to move well above its longer-run neutral rate, which may itself have risen.

Overarching Principle: Robustness

This contrast underscores an overarching principle that should guide any forthcoming changes to the framework. Namely, the monetary policy framework should be effective across a *wide* variety of economic circumstances. It is unwise to over-index on recent history or to one particular scenario, and potential changes to the framework should keep this robustness in mind.

So, let me discuss some potential areas with respect to goals, strategy, communications, and tools that the review might productively consider.

Goals

The 2019-2020 review took the 2 percent inflation target as given. I believe the Committee should reaffirm that target. The recent high-inflation episode would not have been avoided had the target been 3 or 4 percent. Remember, inflation peaked in the 6 to 9 percent range, depending on the measure. Moreover, independent of its level, *changing* the goal could undermine the stability of inflation expectations, which would make it harder for the Fed to achieve price stability.

That said, it would be useful for the Fed to examine changes in the underlying factors that contribute to trend inflation, such as globalization, expectations, automation, and labor market trends.

The Committee should also reconsider adding an operating range around its point goal for inflation.[4] Several central banks use ranges and I think a range around a 2 percent point target could be a helpful communications device. It would help convey the idea that it is normal for inflation to vary, and the FOMC could use the range as a way to add some flexibility in operationalizing the balance between the Fed's maximum employment and price stability goals. For example, in economic downturns, inflation could be lower in the range, and in expansions, inflation could be higher in the range.

Despite recent experience in which supply shocks loomed large, I believe the statement should retain the language that the inflation rate over the longer run is primarily determined by monetary policy. This is what allows the Committee to select its long-run inflation target. While supply shocks played a role in raising the relative prices for goods and some services during the pandemic, inflation began to rise and was persistent until monetary policy was recalibrated to moderate demand to be more aligned with constrained supply. What might have started out as a potentially temporary shock led to more persistent effects on inflation until monetary policy reacted in an appropriate way to reduce the accommodation.[5] So monetary policy continues to be an important determinant of inflation over the longer run.

Regarding the maximum employment goal, I believe the consensus statement should retain the language explaining that it is inappropriate for the FOMC to set a fixed numerical goal for employment, since maximum employment changes over time mainly due to nonmonetary factors affecting the structure and dynamics of the labor market. But the statement should add what the FOMC means by "maximum

---

[4] The FOMC discussed establishing an inflation range during the last review but decided against it.[4] See Federal Open Market Committee (2020).

[5] Benigno and Eggertsson (2024) point out the strength of demand plays an important role is whether supply shocks will have a significant effect on inflation.

employment," namely, that maximum employment is the highest level that is consistent with price stability.[6]

Strategy: Symmetry and Pre-emption

While the inflation target should remain the same, I would like to see two broad changes to the current strategy. First, there should be more emphasis on a *symmetric approach*, which recognizes that inflation can go above target as well as below target and recognizes that the level of employment need not be consistent with stable prices.

The current statement indicates that the likelihood that the fed funds rate will be constrained by its effective lower bound has increased and, therefore, the downside risks to employment and inflation have risen. But the statement should also acknowledge that the risks to inflation and employment can vary over time – there can be upward and downward pressures on each part of the mandate – and that policy will need to balance these risks to achieve the longer-run goals of maximum employment and price stability.

This will require some adjustment to the Fed's flexible average inflation targeting strategy as described in the consensus statement. The current statement addresses the Fed's strategy for when inflation has been running persistently below 2 percent. In this case, the FOMC will aim to achieve inflation moderately above 2 percent for some time. But the statement does not consider the situation in which inflation has been running persistently above 2 percent. This case needs to be incorporated.

Similarly, the FOMC should also revert to taking a more symmetric approach to its employment goal. The 2012 consensus statement discussed how the FOMC would consider "deviations" of employment from maximum employment. The 2020 statement changed this to "shortfalls," which was interpreted as

[6] Eggertsson and Kohn (2023) also makes this suggestion.

an asymmetric approach. The recent high-inflation episode shows that tight labor markets can contribute to inflationary pressures. The statement should revert to "deviations" to acknowledge that the FOMC uses indications from the labor market to help it forecast inflation.

In addition to adding back symmetry, the strategy and consensus statement should reinforce the *forward-looking and pre-emptive nature* of setting appropriate monetary policy. The 2020 revisions did retain language indicating that monetary policy actions tend to influence economic activity, employment, and prices with a lag. But the statement should go farther and explain that this means policy must be forward-looking and based on forecasts of where the economy is headed, even when there is considerable uncertainty around those forecasts. This forward-looking policy approach is consistent with the FOMC's focus (and the consensus statement language) on the importance of keeping inflation expectations reasonably well-anchored.

This brings me to communications.

Communications

Recent research using randomized trials suggests that the general public's belief that the central bank will maintain price stability can be enhanced with effective policy communication.[7] So the review should spend some effort on examining potential improvements to its communication strategy. Currently, the post-meeting FOMC statements do very little to strengthen the public's understanding of the Fed's reaction function. This weakness undermines the FOMC's ability to effectively use explicit forward guidance when it may be needed in extraordinary times.

[7] In a study using randomized information treatments in the six largest euro area countries, Ehrmann, Georgarakos, and Kenny (2024) find that communicating information about the inflation target can increase the central bank's credibility to maintain price stability over the medium term, even in periods in which inflation has risen.

I think the FOMC should issue statements that more clearly explain the linkage between economic developments and policy action or inaction. When members of the public do not understand the rationale for policy decisions, they can be left with the impression that policymakers are acting in a discretionary manner and that lessens credibility. Right now, the post-meeting press conference helps to fill in some of the blanks, but I think it would be better for the Committee to take control of the narrative by using more words to describe the current assessment of economic developments, how they have influenced the outlook, and the risks to that outlook.

Incorporating scenario analysis would also help the public understand there are risks and uncertainty around the forecast.[8] Putting somewhat less weight on the modal outlook and more on potential risks to the outlook would help the public understand that if certain risks are realized, policy may have to deviate from the previously communicated modal path. It would give market participants and the general public a better sense of the contingent, data-dependent nature of policymaking and would raise the central bank's credibility in that a change in policy would not be seen as a breach of promise. And I believe it would actually help the FOMC keep policy better calibrated to alternative paths the economy could take. This could be particularly useful in periods like today when the underlying structural elements of the economy may have changed or there is increased uncertainty.

The Committee should also consider improvements in the Summary of Economic Projections (SEP) that could help the public understand the conditional nature of the monetary policy path in the SEP and the fact that the policy path could change if the economy does not unfold as expected.[9] For example, the SEP should connect the dots, which show the Committee participants' views of the path of appropriate

---

[8] I discussed this recommendation in Mester (2023b). Also, in his review of the Bank of England's forecasting and communications, Bernanke (2024) suggests including analyses of alternative scenarios in both internal discussions and as part of communications to the public. Such alternative scenarios could illuminate salient risks to the outlook when economic conditions evolve differently than expected or the underlying structure of the economy differs from what is assumed in the models.

[9] See Mester (2024) for further discussion.

monetary policy, to their economic forecasts. If the FOMC published the anonymized matrix of economic and policy projections, market participants could see the linkage between each participant's outlook and his or her view of appropriate monetary policy associated with that outlook.

The FOMC might go a step farther and reconsider formulating a FOMC consensus forecast. This was attempted under Chair Ben Bernanke in 2012 and proved to be difficult.[10, 11] In lieu of that, the Committee could publish the Board staff's forecast, which helps coordinate the discussion at the FOMC meeting.

Tools

As in the last review, I anticipate that the Committee will consider its monetary policy tools, and in particular, asset purchases and forward guidance in the upcoming review.

The Fed has used its balance sheet as a monetary policy tool during the last two downturns to add accommodation when the fed funds rate had reached its effective lower bound. In general, the use of large-scale asset purchases, known as quantitative easing, was effective. Some of the fears when the Committee first used this tool during the Great Recession did not come to pass; e.g., there was not a strong rise in inflation due to these purchases. But other concerns did come to fruition: the large level of reserves did limit trading in the fed funds market, which would make it harder to return to a scarce-reserves system should the Committee ever want to do so.[12] In addition, returning to a portfolio of primarily Treasuries, which is the Fed's stated preference, will be very difficult to achieve unless the Fed agrees to sell some of its MBS portfolio. These sales will create losses. While these losses would not

---

[10] See the transcripts of the FOMC meetings from July-August, September, and October 2012. (Federal Open Market Committee, July 31-August 1, 2012; September 12-13, 2012; and October 23-24, 2012).

[11] Hetzel (2017) provides one proposal for how this might be implemented.

[12] It also raises the question of whether the Committee should continue to communicate its policy actions via the fed funds rate or switch to another overnight unsecured interest rate such as the overnight bank funding rate, which included fed funds transactions, and certain domestic and foreign bank transactions.

pose an operational issue for the Fed, they could lead to criticism, which could ultimately affect the Fed's credibility and its independence.

Nonetheless, in a future downturn, asset purchases are likely to be used as a monetary policy tool. The Fed has also purchased assets to address market dysfunction, e.g., in September 2019 and March 2020. I believe the Fed should do a better job of explaining when it is using asset purchases as a monetary policy tool and when it is using purchases to improve the functioning of the financial markets. For example, at the start of the pandemic, the Fed purchased assets to keep markets functioning. After market functioning improved, the Fed continued to buy assets, but these purchases were for monetary policy purposes – to add accommodation. Clearer communication would aid in allowing the Fed to purchase assets to support market functioning even in times when it is appropriate to tighten policy for monetary policy purposes.

Explicit forward guidance is another tool that the Fed has used once the policy rate has reached its effective lower bound. As part of its review, the Fed should consider improving the framework around the use of this tool, addressing the circumstances in which it should be used and in what form. Although several commentators have speculated that the changes the Fed made to its framework in 2020 led it to be somewhat tardy in raising interest rates in 2022, I think the forward guidance in place at the time actually played a larger role.[13] The forward guidance in the FOMC statement at the time said that the Committee "expects it will be appropriate to maintain [the 0-1/4 percent] target range until labor market conditions have reached levels consistent with the Committee's assessments of maximum employment *and* inflation has risen to 2 percent and is on track to moderately exceed 2 percent for some time."[14] [Emphasis added.] This guidance posed a high bar for raising the funds rate from the effective lower bound. Forward

---

[13] Clarida (2023) makes a similar point.

[14] This guidance first appeared in the FOMC post-meeting statement of September 16, 2020, and it remained in the post-meeting statement through the statement of November 3, 2021. See Federal Open Market Committee (September 16, 2020 through November 2, 2021).

guidance with more flexibility (or escape clauses) might have better served the Committee, making it easier to change policy when needed.

Financial Stability

Finally, the review should consider how best to incorporate financial stability considerations into the monetary policy framework. Since monetary policy actions affect financial conditions, they can also affect financial stability risks. For example, a prolonged period of very low interest rates may contribute to financial vulnerabilities by spurring search-for-yield behavior, encouraging higher debt levels, or eroding lending standards. Similarly, a period of rapidly tightening financial conditions raises the risk of increased volatility, market dysfunction, and the potential that a shock could be amplified by known vulnerabilities in the financial system or reveal previously unknown vulnerabilities, including high levels of leverage. The Fed would prefer to address financial stability issues with micro- and macroprudential tools, but its microprudential tools are hard to use in a timely way and its macroprudential tools are limited (comprising the counter-cyclical capital buffer, which the Fed has never raised above zero, and the stress tests). The reality is that, at times, policymakers may be faced with intertemporal tradeoffs between their monetary policy and financial stability policy goals, and these tradeoffs will vary over the business and credit cycles. As part of its framework review, the FOMC should examine how best to incorporate financial stability concerns into monetary policy decisions and articulate some principles it will use to guide how to do so.[15]

Summary

In summary, the FOMC's upcoming review of its monetary policy framework has much to consider. While I have indicated some areas for potential improvements, the current framework has served the FOMC well. It should not be forgotten that the FOMC, under Chair Jay Powell's leadership, has steered

[15] I discuss this in more detail in Mester (2023a). See also Stein (2014), which discusses how best to operationalize the incorporation of financial stability concerns into monetary policymaking.

the economy through the unprecedented time of the COVID-19 pandemic and its aftermath; inflation has come down and looks to be continuing on a path back to the 2 percent goal; and labor markets have moderated but remain healthy. While the work is not done, I am grateful for the progress the Fed has made toward returning the economy to price stability and maximum employment.

References

Benigno, Pierpaolo, and Gauti B. Eggertsson, "Revisiting the Phillips and Beveridge Curves: Insights from the 2020s Inflation Surge," paper prepared for the Jackson Hole Economic Policy Symposium, Federal Reserve Bank of Kansas City, Jackson Hole, WY, August 22-24, 2024. (https://www.kansascityfed.org/documents/10385/Eggertsson_Paper_JH.pdf)

Bernanke, Ben S., "Forecasting for Monetary Policy Making and Communication at the Bank of England: A Review," April 12, 2024. (https://www.bankofengland.co.uk/independent-evaluation-office/forecasting-for-monetary-policy-making-and-communication-at-the-bank-of-england-a-review/forecasting-for-monetary-policy-making-and-communication-at-the-bank-of-england-a-review)

Clarida, Richard H., "U.S. Monetary Policy and the Return to Price Stability," NBER Working Paper 31520, August 2023. (http://www.nber.org/papers/w31520)

Eggertsson, Gauti B., and Don Kohn, "The Inflation Surge of the 2020s: The Role of Monetary Policy," Hutchins Center Working Paper #87, The Brookings Institution, Washington, D.C., August 2023. (https://www.brookings.edu/wp-content/uploads/2023/07/WP87-Eggertsson-Kohn_7.25.pdf)

Ehrmann, Michael, Dimitris Georgarakos, and Geoff Kenny, "Credibility Gains from Central Bank Communication with the Public," January 2024, paper presented at the Federal Reserve Bank of Cleveland Conference: Central Bank Communications: Theory and Practice, May 18, 2024. (https://www.clevelandfed.org/events/2024/ev-20240513-central-bank-communications#agenda)

Federal Open Market Committee, "Minutes of the Federal Open Market Committee, January 28-29, 2020." (https://www.federalreserve.gov/monetarypolicy/files/fomcminutes20200129.pdf)

Federal Open Market Committee, Post-meeting FOMC statements, September 16, 2020 through November 2, 2021. (https://www.federalreserve.gov/monetarypolicy/fomccalendars.htm)

Federal Open Market Committee, "Statement on Longer-Run Goals and Monetary Policy Strategy," reaffirmed effective January 30, 2024. (https://www.federalreserve.gov/monetarypolicy/files/FOMC_LongerRunGoals.pdf)

Federal Open Market Committee, "Transcript of Chair Powell's Press Conference," June 12, 2024. (https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20240612.pdf)

Federal Open Market Committee, "Transcript of the Meeting of the Federal Open Market Committee on July 31-August 1, 2012." (https://www.federalreserve.gov/monetarypolicy/files/FOMC20120801meeting.pdf)

Federal Open Market Committee, "Transcript of the Meeting of the Federal Open Market Committee on September 12-13, 2012." (https://www.federalreserve.gov/monetarypolicy/files/FOMC20120913meeting.pdf)

Federal Open Market Committee, "Transcript of the Meeting of the Federal Open Market Committee on October 23-24, 2012."

(https://www.federalreserve.gov/monetarypolicy/files/FOMC20121024meeting.pdf)

Hetzel, Robert L., "A Proposal to Clarify the Objectives and Strategy of Monetary Policy," Journal of Macroeconomics, 54, Part A, 2017, pp. 72-89.
(https://doi.org/10.1016/j.jmacro.2017.03.004)

Mester, Loretta J., "Monetary Policy in Word and Deed," Shadow Open Market Committee Fall Meeting, New York, NY, October 20, 2023a.
(https://www.clevelandfed.org/collections/speeches/2023/sp-20231020-monetary-policy-in-word-and-deed)

Mester, Loretta J., "Financial System Resilience," Policy Conference 2023, The George G. Kaufman Center for Financial Policy Studies, Quinlan School of Business, Loyola University Chicago, Chicago, IL, November 29, 2023b.
(https://www.clevelandfed.org/collections/speeches/sp-20231129-financial-system-resilience)

Mester, Loretta J., "Forward Guidance and Monetary Policy Communications: Use Your Words and Connect the Dots," The Bank of Japan-Institute for Monetary and Economic Studies Conference Price Dynamics and Monetary Policy Challenges – Lessons Learned and Going Forward, Tokyo, Japan, May 28, 2024.
(https://www.clevelandfed.org/collections/speeches/sp-20240528-forward-guidance-and-monetary-policy-communications)

Powell, Jerome H., "Review and Outlook," remarks at "Reassessing the Effectiveness and Transmission of Monetary Policy," the Federal Reserve Bank of Kansas City's 2024 Jackson Hole Economic Symposium, August 23, 2024.
(https://www.federalreserve.gov/newsevents/speech/powell20240823a.htm)

Stein, Jeremy C., "Incorporating Financial Stability Considerations into a Monetary Policy Framework," International Research Forum on Monetary Policy, sponsored by the European Central Bank, the Federal Reserve Board, the Center for Financial Studies at the Goethe University, and the Georgetown Center for Economic Research at Georgetown University, Washington, D.C., March 21, 2014.
(https://www.federalreserve.gov/newsevents/speech/stein20140321a.htm)