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Federal Reserve: monetary policy self-assessment

■ The Federal Reserve will conduct a review of its monetary policy framework and the conclusions will be made public in the first half of 2020 ■ Three questions will be addressed: should the monetary policy stance take into account past misses of the inflation objective? Are the tools adequate? How can communication be improved? ■ The initiative should be welcomed because it shows the Fed's efforts for being ready when the next recession hits ■ Facing similar challenges, the ECB is likely to be interested in the outcome of the Fed research.

It had already been announced last November, but the recent communication has shed light on how the Federal Reserve intends to "*conduct a comprehensive review of the strategies, tools, and communications practices we use to pursue our congressionally assigned goals for monetary policy*"[1].

As explained by Fed Vice-Chairman Clarida in a recent speech[2], three questions will be addressed. The first is whether the Federal Reserve can meet its statutory objectives with its existing monetary policy strategy or whether it should take into account past misses of its inflation objective in setting its policy stance. The second question concerns whether the toolkit is adequate or whether it should be expanded. The third question will analyse how the communication by the central bank can be improved. This question echoes the insistence of Chairman Powell to adopt a "plain English" approach in communication so as to make sure that the Fed's thinking and policy are clear for everybody.

Recent research by Reuters has shown that the level of complexity has continued to decline under Powell, a trend that had already started while Janet Yellen was Fed Chair[3]. Interestingly, as another illustration of an effort to being well tuned-in with American society, the Federal Reserve will conduct several town hall style meetings to underpin its strategy review.

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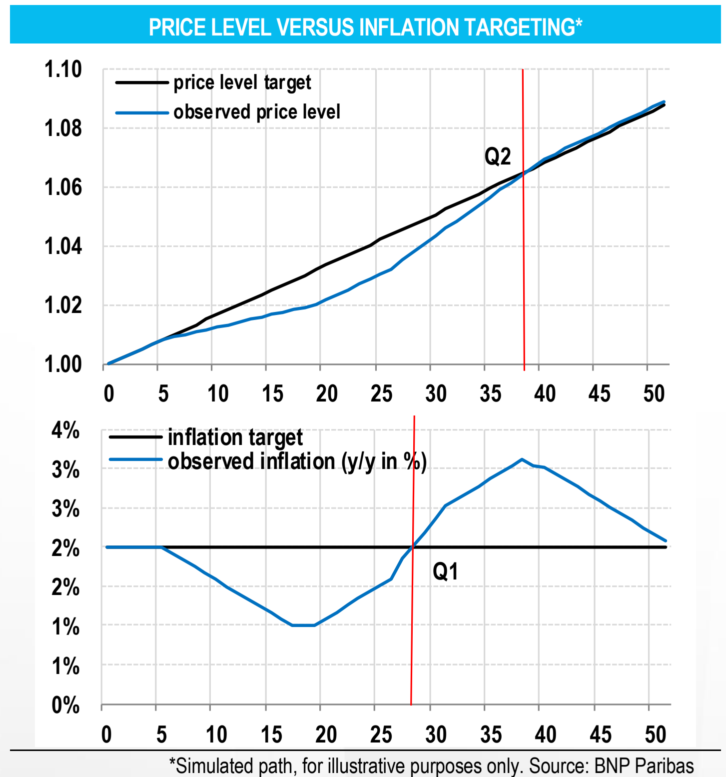
PRICE LEVEL VERSUS INFLATION TARGETING*



*Simulated path, for illustrative purposes only. Source: BNP Paribas

[1] Federal Reserve chairman Powell on the occasion of the presentation of the Semi-annual Monetary Policy Report to the Congress before the Committee on Banking, Housing, and Urban Affairs of the U.S. Senate, 26 February 2019

[2] Richard H. Clarida, *The Federal Reserve's Review of Its Monetary Policy Strategy, Tools, and Communication Practices*, remarks at the 2019 U.S. Monetary Policy Forum, sponsored by the Initiative on Global Markets at the University of Chicago Booth School of Business, 22 February 2019

[3] *You don't need a PhD anymore to read Fed's statements*, Jason Lange, Reuters Business News, 27 February 2019. The author quite rightly observes that reduced complexity may also reflect that the current policy stance is easier to explain

p. 3 Markets Overview
p. 4 Pulse & Calendar
p. 5 Economic scenario

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Communication style is important but, clearly, contents is even more important. So, during the review process, attention of market participants will inevitably focus on the first two questions. The question whether a central bank should take into account inflation misses in setting its policy stance is not new. It boils down to a choice between price level targeting and inflation targeting. Under the latter, prolonged undershooting the inflation target in the past does not per se influence the future stance of monetary policy which, with respect to inflation, only seeks to see it returning to its target. Under price level targeting, the central bank aims for a moving target (the targeted price level increases every year in line with the inflation objective) which implies that an inflation undershoot will need to be made up later by an inflation overshooting: once inflation has been below target for a while, the central bank commits to overshoot its target as long as necessary by keeping a very accomodative policy stance. In the chart, this means that under inflation targeting, the central bank would consider it is "mission accomplished" at T1, whereas under price level targeting, this would only be the case at T2. In a recent blogpost, former Fed chairman Bernanke[4] has, using model-based simulations, demonstrated the merits of such an approach. For it to be effective, it is sufficient that the policy is credible with financial market participants. In that case, the entire yield curve would be "lower for longer" and this would jump start a recovery. As a caveat, if this policy is not credible with households and companies, the inflation overshoot could cause an unanchoring of inflation expectations, making it more difficult to get a grip in inflation.

These issues show the complexity of a price targeting approach. In addition, one wonders what eventually it would entail in terms of risk of financial market bubbles and volatility. "Low rates for longer" means that risky assets (equities, corporate bonds, real estate) would reach higher valuation levels under the belief that monetary policy would remain expansionary as long as the cumulative inflation shortfall hasn't been corrected. One can imagine how markets would react when the price level gap is about to be closed (around T2 in the chart) considering this would fuel expectations of an accelerated policy normalisation, i.e. tightening. Years of quantitative easing have raised concerns about financial stability risks. Prolonged inflation overshooting to correct for the past inflation shortfall could make things even more challenging.

Considering that, in the case of inflation targeting, a persistent undershoot of the 2% inflation target could cause inflation expectations to drift lower, thereby reducing the ability of monetary policy to stimulate activity because nominal interest rates would structurally be lower, Federal Reserve Bank of New York CEO and President, John Williams, has recently said being pleased that the Fed is undertaking a review of its policy framework[5]. Interestingly, he also showed that the cyclically sensitive components of the price index had behaved normally in the current expansion. These components are less subject to measurement errors and non-cyclical factors such as supply shocks, globalisation and changing market structure. This raises an important question however: if one accepts that cyclically sensitive inflation is behaving normally, this would mean that the inertia in overall inflation, despite the disappearance of slack, essentially reflects the role of supply factors. In this case, should monetary policy strive to compensate for these supply factors? Would it be able? Would this entail an overshooting of cyclically sensitive inflation? These questions illustrate the complexity of conducting a monetary policy based on inflation targeting when changes on the supply side have altered the price dynamics in certain sectors, in particular the goods producing ones.

Notwithstanding the questions raised by inflation versus price level targeting, the comprehensive review of strategies, tools and communications practices should be welcomed, if only because it shows that the Federal Reserve wants to be ready when the next recession hits and to be in a position, if necessary and warranted, to adapt its strategy and toolkit. The discussion is interesting from a eurozone perspective as well. After all, the Fed and the ECB share many challenges (low rates, a large balance sheet, inflation undershooting). As European rates are lower, the challenge facing the ECB looks even bigger. It is interesting that the Fed, which has a symmetric objective (implying that it would accept some inflation overshooting), is about to start a reflection on whether it should commit to prolonged overshooting to make up for past inflation misses. The conclusions should be followed in Frankfurt with great interest, all the more so considering that the ECB has an asymmetric inflation objective and hence is reluctant to accept a temporary overshooting.

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[4] Ben Bernanke, *Evaluating lower-for-longer policies: Temporary price-level targeting*, Brookings, 21 February 2019

[5] John C. Williams, Discussion of *'Prospects for Inflation in a High Pressure Economy: Is the Phillips Curve Dead or Is It Just Hibernating?'* by Peter Hooper, Frederic S. Mishkin, and Amir Sufi, Remarks at the U.S. Monetary Policy Forum, New York City, 22 February 2019