Central Banks / Global Economy

The Fed: review of its monetary policy strategy, tools and communication practices

Expansión (Spain)

Nathaniel Karp

Just under a year ago, the Federal Reserve (Fed) began a process to review its monetary policy strategy, tools and communication practices. Taking into account the views of the public and subject matter experts, the members of the Federal Open Market Committee (FOMC) plan to carry out an internal analysis in the second half of the year and publish their findings in the first half of 2020.

While the FOMC is satisfied with the current framework, it believes that improvements can be made to enhance the efficiency of monetary policy given the changes that have occurred in recent years.

First, the decline of the natural rate of interest, which leads to lower nominal rates. The former is at 0.5%, similar to the average for the last seven years and significantly below the average of 2.8% between 1991 and 2007. Meanwhile, the federal funds rate is at 2.4%, 180 basis points below the average between 1991 and 2007. In this environment, if an economic downturn occurs, the FOMC will not be able to lower the interest rate as much as it did during other recession periods, and thus the support to employment and spending will be more limited. In addition, it will be more difficult to prevent inflation from falling excessively while the likelihood that the federal funds rate will be near the zero lower bound will be higher.

Second, the response of inflation to the economy's spare capacity has fallen significantly. In fact, although the unemployment rate is currently at its lowest level in 50 years, core inflation is at 1.6%. Given that, inflation has only reached the objective of 2% or above in just six of the past 127 months, there is a high risk that long-term inflation expectations become anchored below the target. This in turn undermines the credibility of the Fed.

In view of the above, the review seeks to answer three questions: Can the Fed best meet its statutory objectives with its existing monetary policy strategy, or should it consider strategies that aim to reverse past misses of the inflation objective? Are the current instruments suitable to meet the mandate or should the toolkit be expanded? How can the FOMC’s communication of its policy framework and implementation be improved?

With regard to the first question, the main alternatives being discussed include raising the inflation target, adopting a multi-year target, moving to an inflation range, adopting a price level target, establishing a nominal GDP target, and amending monetary policy rules. Most of these options would, if inflation were to remain below the target during a given period, lead the Fed to seek higher inflation to compensate for mistakes made in the past.

With regard to the second question, the Fed will analyze the effectiveness of the tools that were deployed during the Great Recession, which included large-scale asset purchases and forward guidance. Additionally, it will consider the desirability of preventing the yields of government bonds from exceeding a certain level. First, the Fed could target short-term bonds and, if necessary, extend its intervention to bonds with longer maturities. It will also examine the potential benefits of negative interest rates, although there is little support for this option.

Finally, the FOMC will explore options for improving its communications by providing more information on the interaction between monetary policy and financial stability, simplifying statements and speeches, providing greater detail on the assumptions behind their forecasts; and being explicit about risks and uncertainty and their potential impact of the expected path of the policy rate.

For the moment, it seems that the adjustments to the framework will be moderate and the adoption of a multi-year or average inflation target could be a preferred option. If necessary, the Fed will resort to purchasing assets, which is considered a better option than other alternatives, although it will continue using forward guidance. In addition, it could seek to increase the transparency of its communications by making changes to the statements and forecasts. In any case, the key question is if the review will happen in time before the next economic downturn occurs.

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ENQUIRIES TO:
BBVA Research: Azul Street. 4. La Vela Building – 4th and 5th floor. 28050 Madrid (Spain).
Tel. +34 91 374 60 00 y +34 91 537 70 00 / Fax (+34) 91 374 25
bbvaresearch@bbva.com www.bbvaresearch.com