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The Federal Reserve's New Monetary Policy Framework: A Robust Evolution

Remarks by

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at the

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Last week, the Federal Reserve reached an important milestone in its ongoing review of its monetary policy strategy, tools, and communication practices with the unanimous approval and release of a new Statement on Longer-Run Goals and Monetary Policy Strategy.<sup>1</sup> In my remarks today, I will discuss our new framework and highlight some important policy implications that flow from the revised statement and our new strategy.<sup>2</sup> I believe that this new statement and strategy represent a critical and robust evolution of our framework that will best equip the Federal Reserve to achieve our dual-mandate objectives on a sustained basis in the world in which we conduct policy today and for the foreseeable future.

I will divide my remarks into four parts. First, I will discuss the factors that motivated the Federal Reserve in November 2018 to announce it would undertake in 2019 the first-ever public review of its monetary policy strategy, tools, and communication practices. Second, I will discuss the review process itself, with particular focus on the economic analysis and public input the Federal Open Market Committee (FOMC) drew on as it contemplated, over the past 18 months, potential changes to its policy framework. Third, I will briefly summarize the flexible inflation-targeting strategy that has been guiding U.S. monetary policy since 2012 in the context of some important changes in the economic landscape that have become evident since 2012.

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<sup>1</sup> The revised statement is available on the Board's website at [https://www.federalreserve.gov/monetarypolicy/files/FOMC\\_LongerRunGoals.pdf](https://www.federalreserve.gov/monetarypolicy/files/FOMC_LongerRunGoals.pdf). Last week, Chair Powell made the review and the revised statement the focus of his speech at "Navigating the Decade Ahead: Implications for Monetary Policy," a symposium sponsored by the Federal Reserve Bank of Kansas City and held in Jackson Hole, Wyoming; see Powell (2020).

<sup>2</sup> The views expressed are my own and not necessarily those of other Federal Reserve Board members or Federal Open Market Committee participants. I would like to thank Etienne Gagnon, Ellen Meade, Jon Faust, and Trevor Reeve for their assistance in preparing these remarks, and Thomas Laubach for sharing with me throughout the review process his many keen insights on monetary policy strategy and communication.

Fourth, I will discuss the major findings of the review as codified in our new Statement on Longer-Run Goals and Monetary Policy Strategy and highlight some important policy implications that flow from them. Finally, I will offer some brief concluding remarks before joining in conversation with my good friend Adam Posen, which, as always, I very much look forward to.

### **Motivation for the Review**

As my FOMC colleagues and I indicated from the outset, the fact that the Federal Reserve System chose to conduct this review does not indicate that we believed we have been poorly served by the framework in place since 2012. Indeed, I would argue that over the past eight years, the framework served us well and supported the Federal Reserve's efforts after the Global Financial Crisis (GFC) first to achieve and then, for several years, to sustain—until cut short this spring by the COVID-19 pandemic—the operation of the economy at or close to both our statutorily assigned goals of maximum employment and price stability in what became the longest economic expansion in U.S. history. Nonetheless, both the U.S. economy—and, equally importantly, our understanding of the economy—have clearly evolved along several crucial dimensions since 2012, and we believed that in 2019 it made sense to step back and assess whether, and in what possible ways, we might refine and rethink our strategy, tools, and communication practices to achieve and sustain our goals as consistently and robustly as possible in the global economy in which we operate today and for the foreseeable future.<sup>3</sup>

Perhaps the most significant change since 2012 in our understanding of the economy is our reassessment of the neutral real interest rate,  $r^*$ , that, over the longer run,

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<sup>3</sup> For a discussion of the elements that motivated the launch of the review and of how the previous policy framework had served us, see Clarida (2019b). See also Powell (2019a).

is consistent with our maximum-employment and price-stability mandates. In January 2012, the median FOMC participant projected a long-run  $r^*$  of 2.25 percent, which, in tandem with the inflation goal of 2 percent, indicated a neutral setting for the federal funds rate of 4.25 percent. However, in the eight years since 2012, members of the Committee—as well as outside forecasters and financial market participants—have repeatedly marked down their estimates of longer-run  $r^*$  and, thus, the neutral nominal policy rate.<sup>4</sup> Indeed, as of the most recent Summary of Economic Projections (SEP) released in June, the median FOMC participant currently projects a longer-run  $r^*$  equal to just 0.5 percent, which implies a neutral setting for the federal funds rate of 2.5 percent. Moreover, as is well appreciated, the decline in neutral policy rates since the GFC is a global phenomenon that is widely expected by forecasters and financial markets to persist for years to come.<sup>5</sup>

The substantial decline in the neutral policy rate since 2012 has critical implications for the design, implementation, and communication of Federal Reserve monetary policy because it leaves the FOMC with less conventional policy space to cut rates to offset adverse shocks to aggregate demand. With a diminished reservoir of conventional policy space, it is much more likely than was appreciated in 2012 that, in

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<sup>4</sup> See Chair Powell’s address in Jackson Hole, Wyoming, last week (Powell, 2020) for an illustration of the revisions to the macroeconomic projections—including for the longer-run neutral federal funds rate—of FOMC participants as well as private and public forecasters. The downward revisions to  $r^*$  over time have been informed, in part, by the general fall in interest rates and by econometric evidence that suggests that this fall is of a permanent rather than a cyclical nature. See, among many contributors, Hamilton and others (2016), Johannsen and Mertens (2018), Laubach and Williams (2016), Del Negro and others (2017), and López-Salido and others (2020). For discussions of the various factors that might have contributed to this fall, see Fischer (2016) and Rachel and Smith (2017).

<sup>5</sup> For evidence on the global nature of the decline in  $r^*$ , see King and Low (2014); Holston, Laubach, and Williams (2017); Wynne and Zhang (2018); and Del Negro and others (2019). For a discussion of global considerations for U.S. monetary policy, see Obstfeld (2020).

economic downturns, the effective lower bound (ELB) will constrain the ability of the FOMC to rely solely on the federal funds rate instrument to offset adverse shocks.<sup>6</sup> This development, in turn, makes it more likely that recessions will impart elevated risks of more persistent downward pressure on inflation and upward pressure on unemployment that the Federal Reserve’s monetary policy should, in design and implementation, seek to offset throughout the business cycle and not just in downturns themselves.<sup>7</sup>

Two other, related developments that have also become more evident than they appeared in 2012 are that price inflation seems less responsive to resource slack, and also, that estimates of resource slack based on historically estimated price Phillips curve relationships are less reliable and subject to more material revision than was once commonly believed.<sup>8</sup> For example, in the face of declining unemployment rates that did not result in excessive cost-push pressure to price inflation, the median of the Committee’s projections of  $u^*$ —the rate of unemployment consistent in the longer run with the 2 percent inflation objective—has been repeatedly revised lower, from

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<sup>6</sup> For assessments of the risk that the federal funds rate will be constrained by the ELB in the future, along with policy strategies that might mitigate that risk, see Kiley and Roberts (2017); Chung and others (2019); Hebden and López-Salido (2018); and Bernanke, Kiley, and Roberts (2019).

<sup>7</sup> For pre-GFC discussions of the macroeconomic consequences of policy rates being constrained by the ELB, see Krugman (1998), Eggertsson and Woodford (2003), and Adam and Billi (2007). For the GFC and its aftermath, using a time-series approach, Eberly, Stock, and Wright (2020) estimate that, in the absence of the ELB constraint, the labor market recovery would have proceeded at a significantly more rapid pace than was observed, whereas core inflation would have been only modestly higher because of inflation’s limited sensitivity to resource slack. Using a DSGE (dynamic stochastic general equilibrium) approach, the mean estimates of Gust and others (2017) suggest that a binding ELB accounted for about 30 percent (roughly 2 percentage points) of the 6 percent contraction in gross domestic product in 2009 relative to the peak in 2007 and was responsible for an even larger fraction of the ensuing slow recovery.

<sup>8</sup> For evidence of a flattening of the slope of the Phillips curve in the United States and abroad, see, among others, Simon, Matheson, and Sandri (2013); Blanchard, Cerutti, and Summers (2015); and Pfajfar and Roberts (2018). The difficulties in assessing shortfalls from maximum employment using measures of the unemployment rate has motivated researchers to explore alternative approaches. See Abraham, Haltiwanger, and Rendell (2020) for an approach based on the job search and matching framework. See also the staff discussion of various concepts of unemployment rate benchmarks by Crump, Nekarda, and Petrosky-Nadeau (2020), which was prepared as background materials for this review.

5.5 percent in January 2012 to 4.1 percent as of the June 2020 SEP.<sup>9</sup> Projections of  $u^*$  by the Congressional Budget Office and professional forecasters show a similar decline during this same period and for the same reason.<sup>10</sup> In the past several years of the previous expansion, declines in the unemployment rate occurred in tandem with a notable and, to me, welcome increase in real wages that was accompanied by an increase in labor's share of national income, but not a surge in price inflation to a pace inconsistent with our price-stability mandate and well-anchored inflation expectations. Indeed, this pattern of mid-cycle declines in unemployment coincident with noninflationary increases in real wages has been evident in the U.S. data since the 1990s.<sup>11</sup>

With regard to inflation expectations, there is broad agreement among academics and policymakers that achieving price stability on a sustainable basis requires that inflation expectations be well anchored at the rate of inflation consistent with the price-stability goal. This is especially true in the world that prevails today, with flat Phillips curves in which the primary determinant of actual inflation is expected inflation.<sup>12</sup> The

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<sup>9</sup> The large degree of uncertainty attached to estimates of  $r^*$ ,  $u^*$ , the slope of the (short-run) Phillips curve, and other key economic objects adds additional risk-management considerations in the conduct of monetary policy, especially in a low  $r^*$  environment in which the federal funds rate is likely to be constrained by the ELB. See Powell (2019b) for a discussion of the implications for monetary policy and my recent remarks in Clarida (2020). See also the model-based analyses of Erceg and others (2018), Ajello and others (2020), and Hebden and others (2020).

<sup>10</sup> See Powell (2020) for an illustration. See also Caldara and others (2020) for a discussion of how repeated surprises in macroeconomic forecasts affect inference about the appropriate stance of policy.

<sup>11</sup> See Clarida (2016, 2019c) and Heise, Karahan, and Şahin (2020) for discussions.

<sup>12</sup> See Yellen (2015) for a discussion of inflation dynamics and monetary policy and Erceg and others (2018) for a quantitative exploration of the monetary policy implications of a flat Phillips curve in an uncertain economic environment. Since the mid-1980s, movements in both realized inflation and measures of longer-term inflation expectations have been somewhat muted, complicating the task of extracting the precise role of inflation expectations as a determinant of realized inflation. Faust and Wright (2013) review the literature on inflation forecasting and present evidence in support of the conclusion that measures of longer-run inflation expectations help predict inflation. Mavroeidis, Plagborg-Møller, and Stock (2014) discuss the challenges of identifying the precise role of expectations in determining actual inflation. Cecchetti and others (2017) suggest that, in a low and stable inflation environment, policymakers should pay attention to a wide array of indicators in determining the implications for monetary policy of movements in realized inflation and measures of inflation expectations.

pre-GFC academic literature derived the important result that a credible inflation-targeting monetary policy strategy that is not constrained by the ELB can deliver, under rational expectations, inflation expectations that themselves are well anchored at the inflation target.<sup>13</sup> In other words, absent a binding ELB constraint, a policy that targets actual inflation in these models delivers long-run inflation expectations well anchored at the target “for free.” But this “copacetic coincidence” no longer holds in a world of low  $r^*$  in which adverse aggregate demand shocks are expected to drive the economy in at least some downturns to the ELB. In this case, which is obviously relevant today, economic analysis indicates that flexible inflation-targeting monetary policy cannot be relied on to deliver inflation expectations that are anchored at the target, but instead will tend to deliver inflation expectations that, in each business cycle, become anchored at a level below the target.<sup>14</sup> This is the crucial insight in my colleague John Williams’ research with Thomas Mertens. Indeed John’s research over the past 20 years on  $r^*$  estimation and monetary policy design at the ELB have been enormously influential, not only in the profession but also at Fed and certainly in my own thinking about how our framework should evolve. This downward bias in inflation expectations under inflation targeting in an ELB world can in turn reduce already scarce policy space—because nominal interest rates reflect both real rates and expected inflation—and it can open up the risk of the downward spiral in both actual and expected inflation that has been observed in some other major economies.

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<sup>13</sup> See Bernanke and others (1999) for a review of the considerations that led to the adoption of inflation-targeting frameworks and the early international experience. See Svensson (1997), Clarida, Galí, and Gertler (1999), and Woodford (2003) for conceptual treatments of inflation targeting, including of rational expectations.

<sup>14</sup> See Mertens and Williams (2019) and Bianchi, Melosi, and Rottner (2019).

Inflation expectations are, of course, not directly observed and must be imperfectly inferred from surveys, financial market data, and econometric models. Each of these sources contains noise as well as signal, and they can and sometimes do give contradictory readings. But, at minimum, the failure of actual PCE (personal consumption expenditures) inflation—core or headline—over the past eight years to reach the 2 percent goal on a sustained basis cannot have contributed favorably to keeping inflation expectations anchored at 2 percent. Indeed, my reading of the evidence is that the various measures of inflation expectations I follow reside at the low end of a range I consider consistent with our 2 percent inflation goal.<sup>15</sup>

### **The Review Process**

With this brief overview of important changes in the economic landscape since 2012, I would now like to discuss the review process itself. In November 2018, the Federal Reserve announced that in 2019 the System would undertake a wide-ranging, public review of its monetary policy strategy, tools, and communication practices. This initiative would be the first-ever *public* review of monetary policy strategy ever undertaken by the Fed. From the outset, it was conceived that the review would build on three pillars: a series of livestreamed *Fed Listens* events hosted by each of the 12 Reserve Banks and the Board, a flagship research conference hosted by the Federal Reserve Bank of Chicago, and a series of 13 rigorous briefings for the Committee by System staff at a succession of five consecutive FOMC meetings commencing in July 2019 and running through January 2020.

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<sup>15</sup> See Clarida (2020).

The *Fed Listens* series built on a long-standing practice at the Reserve Banks and the Board of hosting outreach events that included a wide range of community groups, but, by focusing on a common format in which representatives of these groups were encouraged to tell their stories about our policies' effect on their communities and daily lives, it became a potent vehicle for us to better connect with the people our policies are meant to benefit. Although many people across the System were involved in making *Fed Listens* the success it was, I would be more than remiss if I did not single out Ellen Meade for her indefatigable contributions and attention to detail and organization that were essential to pulling the whole thing off. A report on the *Fed Listens* series is available on the Board's web site.<sup>16</sup>

The second pillar of our review, a research conference hosted by the Federal Reserve Bank of Chicago, brought together some of the world's leading academic experts in monetary economics to present bespoke papers on a range of topics central to the review. These papers and the robust discussion at the conference that they stimulated were an important input to the review process. The proceedings of the Chicago conference are available as a special January 2020 issue of the *International Journal of Central Banking*.<sup>17</sup>

The third important pillar of the review is a collection of 13 memos prepared by System staff and discussed by the Committee at a number of FOMC meetings over the past 18 months. These memos were commissioned by a System steering committee that

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<sup>16</sup> See Board of Governors (2020).

<sup>17</sup> This special issue, which includes five of the seven papers presented at the research conference, is available on the journal's website at <https://www.ijcb.org/journal/ijcb2002.htm>. The conference program, conference drafts, presentations, and video recordings of the sessions can be found on the Board's website at <https://www.federalreserve.gov/conferences/conference-monetary-policy-strategy-tools-communications-20190605.htm>.

included Jeff Fuhrer, Marc Giannoni, and David Altig, with extensive input from Trevor Reeve. Thomas Laubach chaired the steering committee, and I must note that we simply would not be here today discussing this significant evolution of our framework without Thomas and the insights, inspiration, and good judgement that he brought to the project and the review process. A collection of the staff memos prepared for the review is now available on the Board's website.<sup>18</sup>

### **A New Economic Landscape Compels a Framework ReThink**

As I mentioned earlier, the Committee devoted five consecutive FOMC meetings between July 2019 and January 2020 to presentations by the staff and Committee discussions of memos touching on various aspects of the framework review, and it held a lengthy discussion at the July 2020 FOMC meeting about the new Statement on Longer-Run Goals and Monetary Policy Strategy.<sup>19</sup> While it is fair to say that these Committee discussions revealed among the 17 participants a healthy range of views about and priorities for refining our framework and strategy, some common themes did emerge, and these provided the foundation for the revised Statement on Longer-Run Goals and Monetary Policy Strategy that the Committee discussed in July, approved last week, and released on Thursday, August 27.

Broadly, we agreed that the economic landscape has changed in important ways since 2012 and that, as a result, the existing statement and the monetary policy strategy

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<sup>18</sup> An overview of the System staff work in support of the review is presented in Altig and others (2020). Federal Reserve staff analysis on the *Fed Listens* initiative was presented and discussed at the December 2019 FOMC meeting and is part of the *Fed Listens* report.

<sup>19</sup> Summaries of these discussions can be found in the minutes of these FOMC meetings, which are accessible on the Board's website at <https://www.federalreserve.gov/monetarypolicy/fomccalendars.htm>.

that flows from it need as well to evolve along several dimensions.<sup>20</sup> For example, under our previous flexible inflation-targeting framework, the Federal Reserve declared that the 2 percent inflation objective is “symmetric.” This term has been interpreted by many observers to mean that the Committee’s reaction function aimed to be symmetric on either side of the 2 percent inflation goal, and that the FOMC set policy with the (ex ante) aim that the 2 percent goal should represent an inflation ceiling in economic expansions following economic downturns in which inflation falls below target. Regarding the ELB, the previous statement was silent on the global decline in neutral policy rates, the likelihood that the ELB will constrain monetary policy space in economic downturns, and the implications of this constraint for our ability to achieve our dual-mandate goals. As for inflation expectations, the previous statement did discuss expected inflation, but only in the context of mentioning that the announcement of a 2 percent goal helps anchor inflation expectations. While this is certainly true, it does beg the deeper question of how well anchored inflation expectations can be if the 2 percent goal is seen by the public as—and turns out ex post to be—a ceiling. Regarding the maximum-employment leg of the dual mandate, the previous statement’s discussion of minimizing “deviations” of employment from its maximum level does not adequately reflect how the FOMC has actually conducted monetary policy in recent years—before the pandemic—as the actual unemployment rate was declining and, for several years, remained below SEP median

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<sup>20</sup> The FOMC published the statement for the first time alongside its January 2012 postmeeting statement; the document is available on the Board’s website at <https://www.federalreserve.gov/newsevents/pressreleases/monetary20120125c.htm>. This statement has been reaffirmed each year, and was updated in 2016 to include the language on symmetry. The version of the statement that prevailed at the start of the review, which was affirmed in January 2019, can be found on the Board’s website at <https://www.federalreserve.gov/newsevents/pressreleases/monetary20190130b.htm>.

projections of  $u^*$  (although, to be sure, the earlier statement did acknowledge that it can be difficult to estimate the maximum level of employment with precision).<sup>21</sup>

### **The New Statement and Strategy**

Before discussing how our Statement on Longer-Run Goals and Monetary Policy Strategy has evolved, let me highlight some important elements that remain unchanged. First and foremost, our policy framework and strategy remain focused exclusively on meeting the dual mandate assigned to us by the Congress. Second, our statement continues to note that the maximum level of employment that we are mandated to achieve is not directly measurable and changes over time for reasons unrelated to monetary policy. Hence, we continue not to specify a numerical goal for our employment objective as we do for inflation. Third, we continue to state that an inflation rate of 2 percent over the longer run is most consistent with our mandate to promote both maximum employment and price stability. Finally, because the effect of monetary policy on the economy operates with a lag, our strategy remains forward looking. As a result, our policy actions depend on the economic outlook as well as the risks to the outlook, and we continue in the new statement to highlight potential risks to the financial system that could impede the attainment of our dual-mandate goals on a sustained basis.

With respect to the new framework itself, the statement now notes that the neutral level of the federal funds rate has declined relative to its historical average and therefore that the policy rate is more likely than in the past to be constrained by its ELB, and, moreover, that this binding ELB constraint is likely to impart downside risks to inflation and employment that the Committee needs to consider in implementing its monetary

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<sup>21</sup> See my earlier remarks on these aspects in Clarida (2018a, 2018b, 2019a).

policy strategy. In this regard, the statement now highlights that the Committee is prepared to use its full range of tools to achieve its dual-mandate objectives.<sup>22</sup>

Regarding the maximum-employment mandate, the new statement now acknowledges that maximum employment is a “broad-based and inclusive goal” and continues to state that the FOMC considers a wide range of indicators to assess the level of maximum employment consistent with this broad-based goal. However, under our new framework, policy decisions going forward will be based on the FOMC’s estimates of “*shortfalls* of employment from its maximum level”—not “deviations.”<sup>23</sup> This change conveys our judgment that a low unemployment rate by itself, in the absence of evidence that price inflation is running or is likely to run persistently above mandate-consistent levels or pressing financial stability concerns, will not, under our new framework, be a sufficient trigger for policy action.<sup>24</sup> This is a robust evolution in the Federal Reserve’s policy framework and, to me, reflects the reality that econometric models of maximum employment, while essential inputs to monetary policy, can be and have been wrong, and, moreover, that a decision to tighten monetary policy based solely on a model without any other evidence of excessive cost-push pressure that puts the price-stability mandate at risk is difficult to justify, given the significant cost to the economy if the model turns out to be

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<sup>22</sup> FOMC participants discussed the benefits, limitations, and risks associated with policy tools other than the setting of the federal funds rate target at various points during the review. See, notably, the summaries of FOMC participants’ discussions at the July 2019 and October 2019 meetings—available on the Board’s website at <https://www.federalreserve.gov/monetarypolicy/fomccalendars.htm>—which covered, respectively, the performance of these tools during the GFC and its aftermath and issues pertaining to the use of these tools in the future. See also the analyses of Sims and Wu (2020), Caldara and others (2020), Campbell and others (2020), and Carlson and others (2020), prepared for this review.

<sup>23</sup> Italics added for emphasis.

<sup>24</sup> For a discussion of financial stability considerations in the conduct of monetary policy, see Kashyap and Siegert (2020) and Goldberg and others (2020), prepared as part of this review.

wrong and given the ability of monetary policy to respond if the model were eventually to turn out to be right.<sup>25</sup>

With regard to the price-stability mandate, while the new statement maintains our definition that the longer-run goal for inflation is 2 percent, it elevates the importance—and the challenge—of keeping inflation expectations “well anchored *at 2 percent*” (and not just “well anchored”) in a world of low  $r^*$  and an ELB constraint that is binding in downturns.<sup>26</sup> To this end, the new statement conveys the Committee’s judgment that, in order to anchor expectations at 2 percent, it “seeks to achieve inflation that averages 2 percent over time,” and—in the same sentence—that therefore “following periods when inflation has been running persistently below 2 percent, appropriate monetary policy will likely aim to achieve inflation moderately above 2 percent for some time.” This is the second robust evolution of our framework, and it reflects the inherent asymmetry of conducting monetary policy in a low  $r^*$  world with an ELB constraint that binds in economic downturns. As discussed earlier, if policy seeks only to return inflation to 2 percent following a downturn in which the ELB has constrained policy, an inflation-targeting monetary policy will tend to generate inflation that averages less than 2 percent, which, in turn, will tend to put persistent downward pressure on inflation expectations

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<sup>25</sup> As I stated in Clarida (2019a, paragraph 17), “For example, were models to predict a surge in inflation, a decision for preemptive hikes before the surge is evident in actual data would need to be balanced against the cost of the model being wrong.” One major cost of withdrawing policy accommodation prematurely during an economic expansion is that it prevents job opportunities from reaching all communities. A clear takeaway from our *Fed Listens* events is that the strong job market that preceded the pandemic was especially beneficial to members of low- and moderate-income communities. The prolonged economic expansion not only helped create job opportunities for marginalized groups and cement their attachment to the labor force, but, as we heard at these events, it also more generally strengthened families, businesses, and communities. See Aaronson and others (2019) for a discussion of how a strong labor market helped address labor market disparities in the previous economic expansion. See also Feiveson and others (2020) for a discussion of distributional considerations and monetary policy.

<sup>26</sup> Italics added for emphasis.

and, potentially, on available policy space. In order to offset this downward bias, our new framework recognizes that monetary policy during economic expansions needs to “aim to achieve inflation moderately above 2 percent for some time.” In other words, the aim to achieve *symmetric* outcomes for inflation (as would be the case under flexible inflation targeting in the absence of the ELB constraint) requires an *asymmetric* monetary policy reaction function in a low  $r^*$  world with binding ELB constraints in economic downturns.

It is for this reason that while our new statement no longer refers to the 2 percent inflation goal as symmetric, it does now say that the Committee “seeks to achieve inflation that averages 2 percent over time.” To be clear, “inflation that averages 2 percent over time” represents an ex ante aspiration, not a description of a mechanical reaction function—nor is it a commitment to conduct monetary policy tethered to any particular formula or rule.<sup>27</sup> Indeed, as summarized in the minutes of the September 2019 FOMC meeting, the Committee (and, certainly, I) was skeptical about the benefit, credibility, or practicality of adopting a formal numerical price level or average inflation target rule, just as it has been unwilling to implement its existing flexible inflation-targeting strategy via any sort of mechanical rule.<sup>28</sup> So in practice, what, then, is the

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<sup>27</sup> The absence of a commitment to a specific formula or rule should not be interpreted as the absence of a commitment to achieving our mandated goals. To the contrary, the revised statement has strengthened our commitment to achieving these goals in several important ways. Notably, it has clarified that we seek to achieve 2 percent inflation, on average, over time and that, when inflation has been running persistently too low, it is appropriate to aim for inflation outcomes moderately above 2 percent for some time to solidly anchor longer-run inflation expectations at 2 percent. The revised statement also emphasizes our resolve to use our full range of tools to achieve our goals. Clarity about our goals, strategy, and tools fosters greater democratic accountability in the pursuit of our dual mandate. For a discussion of time-consistency issues in monetary policy, see the staff analysis of Duarte and others (2020), prepared for this review.

<sup>28</sup> A summary of the September 2019 FOMC discussion is available on the Board’s website at <https://www.federalreserve.gov/monetarypolicy/fomccalendars.htm>. For the staff analysis presented as background to that discussion, see Arias and others (2020), Duarte and others (2020), and Hebden and others (2020). See also the related staff analysis by Chung and others (2020) on the use of operational inflation ranges.

policy implication of this stated desire “to achieve inflation that averages 2 percent over time”? Again, the implication of our new strategy for monetary policy is stated explicitly in the new statement, and, at the risk of repeating myself, let me restate it verbatim: “... following periods when inflation has been running persistently below 2 percent, appropriate monetary policy will likely aim to achieve inflation moderately above 2 percent for some time.” Full stop. As Chair Powell indicated in his remarks last week, we think of this new strategy as an evolution from flexible inflation targeting to flexible average inflation targeting.<sup>29</sup>

### **Concluding Thoughts**

My remarks today have been focused on our new framework and flexible average inflation targeting strategy. Of course, our review has also explored ways in which we might add to our toolkit and refine our communication practices. With regard to our toolkit, we believe that forward guidance and large-scale asset purchases have been and continue to be effective sources of support to the economy when the federal funds rate is at the ELB, and, of course, both were deployed promptly in our March 2020 policy response to the pandemic. With regard to other monetary policy tools, and as we have made clear previously in the minutes to our October 2019 FOMC meeting, we do not see negative policy rates as an attractive policy option in the U.S. context.<sup>30</sup> As for targeting the yield curve, our general view is that with credible forward guidance and asset purchases, the potential benefits from such an approach may be modest. At the same

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<sup>29</sup> Svensson (2020) argues that “forecast targeting” approaches, by which policymakers set the federal funds rate so as to best stabilize forecasts for inflation and employment around the FOMC’s longer-run goals, outperform policy strategies that respond only to current economic conditions, past economic conditions, or both. In addition, he finds that average inflation targeting offers some advantages over the other strategies that he considers.

<sup>30</sup> The minutes of the FOMC’s October 2019 meeting are available on the Board’s website at <https://www.federalreserve.gov/monetarypolicy/fomccalendars.htm>.

time, the approach brings complications in terms of implementation and communications. Hence, as noted in the minutes from our previous meeting (July 2020), most of my colleagues judged that yield caps and targets were not warranted in the current environment but should remain an option that the Committee could reassess in the future if circumstances changed markedly.<sup>31</sup> Regarding communication practices, our new consensus statement does bring greater clarity and transparency to the way we will conduct policy going forward, and in that regard I note that Michelle Smith is leading our efforts to make immediately and readily available on the web a bounty of content that will be invaluable to those who desire a more granular understanding of the review process. Finally, now that we have ratified our new statement, the Committee can assess possible refinements to our SEP with the aim of reaching a decision on any potential changes by the end of this year.<sup>32</sup>

In closing, let me say that while I was not a member of the Committee in 2012, had I been I would have voted enthusiastically for the January 2012 statement. It was the right statement, and flexible inflation targeting was the right strategy, at that time and for the next eight years. The existing framework served us well by supporting the Federal Reserve's efforts after the GFC first to achieve and then, for several years, to sustain the operation of the economy at or close to both our statutorily assigned goals of maximum employment and price stability. But times change, as has the economic landscape, and

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<sup>31</sup> See the minutes of the FOMC's June 2020 and July 2020 meetings, which can be found on the Board's website at <https://www.federalreserve.gov/monetarypolicy/fomccalendars.htm>.

<sup>32</sup> For a discussion of the importance of clear Federal Reserve communications in an uncertain economic environment, along with possible enhancements, see the paper Cecchetti and Schoenholtz (2019) prepared for the research conference at the Federal Reserve Bank of Chicago.

our framework and strategy need to change as well.<sup>33</sup> My colleagues and I believe that this new framework represents a critical and robust evolution of our monetary policy strategy that will best equip the Federal Reserve to achieve our dual-mandate objectives on a sustained basis in the world in which we conduct policy today and for the foreseeable future. Thank you very much for your time and attention, and I look forward now to my conversation with Adam.

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<sup>33</sup> See Fuhrer and others (2018) for a discussion of the benefits of holding periodic reviews of central banks' monetary policy frameworks.

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In the revised Statement on Longer-Run Goals and Monetary Policy Strategy shown below, underlined bold red text shows additions and ~~struck-through~~ text shows deletions relative to the statement the Committee issued on January 29, 2019. Note that the discussion of the employment and inflation goals has been separated into two paragraphs and their order reversed relative to the January 2019 statement. To improve readability, these changes are not marked with underlined bold red text or struck-through text.

## Statement on Longer-Run Goals and Monetary Policy Strategy

Adopted effective January 24, 2012; as amended effective ~~January 29, 2019~~ August 27, 2020

1. The Federal Open Market Committee (FOMC) is firmly committed to fulfilling its statutory mandate from the Congress of promoting maximum employment, stable prices, and moderate long-term interest rates. The Committee seeks to explain its monetary policy decisions to the public as clearly as possible. Such clarity facilitates well-informed decisionmaking by households and businesses, reduces economic and financial uncertainty, increases the effectiveness of monetary policy, and enhances transparency and accountability, which are essential in a democratic society.

2. Employment, inflation, ~~employment~~, and long-term interest rates fluctuate over time in response to economic and financial disturbances. Monetary policy plays an important role in stabilizing the economy in response to these disturbances. The Committee's primary means of adjusting the stance of monetary policy is through changes in the target range for the federal funds rate. The Committee judges that the level of the federal funds rate consistent with maximum employment and price stability over the longer run has declined relative to its historical average. Therefore, the federal funds rate is likely to be constrained by its effective lower bound more frequently than in the past. Owing in part to the proximity of interest rates to the effective lower bound, the Committee judges that downward risks to employment and inflation have increased. The Committee is prepared to use its full range of tools to achieve its maximum employment and price stability goals. Moreover, monetary policy actions tend to influence economic activity and prices with a lag. Therefore, the Committee's policy decisions reflect its longer run goals, its medium term outlook, and its assessments of the balance of risks, including risks to the financial system that could impede the attainment of the Committee's goals.

3. The maximum level of employment is a broad-based and inclusive goal that is not directly measurable and changes over time owing largely ~~determined by~~ to nonmonetary factors that affect the structure and dynamics of the labor market. ~~These factors may change over time and may not be directly measurable.~~ Consequently, it would not be appropriate to specify a fixed goal for employment; rather, the Committee's policy decisions must be informed by assessments of the shortfalls of employment from its maximum level of ~~employment~~, recognizing that such assessments are necessarily uncertain and subject to revision. The Committee considers a wide range of indicators in making these assessments. ~~Information about Committee participants' estimates of the longer run normal rates of output growth and unemployment is published four times per year in the FOMC's Summary of Economic Projections. For example, in the most recent projections, the median of FOMC participants' estimates of the longer run normal rate of unemployment was 4.4 percent.~~

4. The inflation rate over the longer run is primarily determined by monetary policy, and hence the Committee has the ability to specify a longer-run goal for inflation. The Committee reaffirms its judgment that inflation at the rate of 2 percent, as measured by the annual change in the price index for personal consumption expenditures, is most consistent over the longer run with the Federal Reserve's statutory mandate. The Committee ~~would be concerned if inflation were running persistently above or below this objective. Communicating this symmetric inflation goal clearly to the public helps keep~~ judges that longer-term inflation expectations firmly that are well anchored, thereby at 2 percent fostering price stability and moderate long-term interest rates and enhancing the Committee's ability to promote maximum employment in the face of significant economic disturbances. In order to anchor longer-term inflation expectations at this level, the Committee seeks to achieve inflation that averages

2 percent over time, and therefore judges that, following periods when inflation has been running persistently below 2 percent, appropriate monetary policy will likely aim to achieve inflation moderately above 2 percent for some time.

5. Monetary policy actions tend to influence economic activity, employment, and prices with a lag. In setting monetary policy, the Committee seeks over time to mitigate shortfalls of employment from the Committee's assessment of its maximum level and deviations of inflation from its longer-run goal and deviations of employment from the Committee's assessments of its maximum level. Moreover, sustainably achieving maximum employment and price stability depends on a stable financial system. Therefore, the Committee's policy decisions reflect its longer-run goals, its medium-term outlook, and its assessments of the balance of risks, including risks to the financial system that could impede the attainment of the Committee's goals.

6. ~~These~~ The Committee's employment and inflation objectives are generally complementary. However, under circumstances in which the Committee judges that the objectives are not complementary, it ~~follows a balanced approach in promoting them, taking~~ takes into account the magnitude of the employment shortfalls and inflation deviations and the potentially different time horizons over which employment and inflation are projected to return to levels judged consistent with its mandate.

7. The Committee intends to ~~reaffirm~~ review these principles and to make adjustments as appropriate at its annual organizational meeting each January, and to undertake roughly every five years a thorough public review of its monetary policy strategy, tools, and communication practices.