A new approach to US monetary policy

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In the aftermath of the US election of 2020, Washington seems destined to face continuing political gridlock, though likely with a new Democratic administration in place. Yet one place that will clearly remain unfettered in adopting a substantive new approach to macro policy in the years ahead is the Federal Reserve. The need for a new approach to monetary policy is found in the struggles that the Fed and other major central banks have faced in recent decades to come even close to achieving their inflation objectives. Over the twelve years since the global financial crisis, inflation has averaged nearly one-half of a percentage point below the Federal Reserve's two per cent objective and even further below the ECB's target. While the covid crisis has only widened these gaps, it has not always been so. Prior to the 1980s, inflation ran far above desired levels for a time, especially in the US. Indeed, it was the Fed's success in quelling excessive inflation during the Volcker years that ultimately contributed to the current condition of insufficient price pressures.

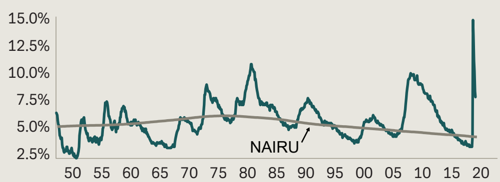
Following a year-long review of its policy objectives and strategy, this summer the Fed announced fundamental changes in its approach to monetary policy aimed at resolving problems with how too-low inflation can limit monetary policy's effectiveness. This shift, which entails the Fed only responding to "shortfalls" on its employment objective and aiming for an overshoot of two per cent inflation for some time, has already pushed the Fed to adopt a more aggressive commitment to keeping rates at zero for an extended period. More importantly down the road, as the economy recovers from the covid shock, the Fed will be taking a new, less pre-emptive, approach to exiting from its current ultra-stimulative stance, a shift that we endorse.

In our view, this pivot is overall well placed to deliver better outcomes for the labour market and economy than the past several decades of overly-preemptive policy. However, it also carries risks – some of which are unique to the post-covid world -- that will require deft management by the Fed in the coming years. The ECB and other major central banks currently engaged in their own policy introspection would therefore be wise to pay close heed to the Fed's experience with this new approach.

Why change?

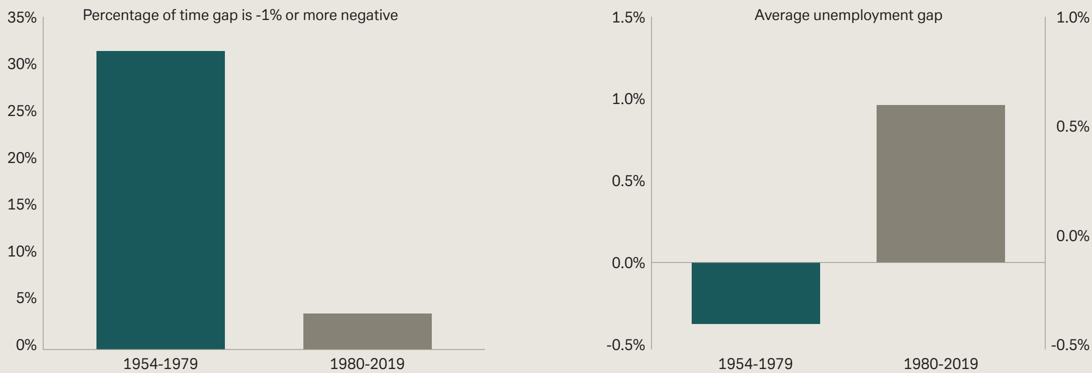
Before we describe just what the Fed's new exit approach will be, it is important to understand what was wrong with the previous one. Since the Great Inflation of the 1960s and 70s, the Fed has taken a decidedly pre-emptive approach to tightening monetary policy during economic expansions. That period led to lingering fears of incipient inflation just beyond the horizon, which have ingrained a policy bias in favour of avoiding tight labour markets. For example, since 1980, US unemployment has averaged more than three-quarters of a percentage point above the level believed to trigger inflation pressures, often referred to as the natural rate (see the following chart). Very tight labour markets (with unemployment more than one percentage point below the natural rate) have occurred less than five per cent of the time. It has not always been the case. Central bankers used to tolerate tighter labour markets: during the 1950s, 60s, and 70s, unemployment averaged nearly one-half of a percentage point below the natural rate, and labour markets were "very tight" nearly one-third of the time.

Unemployment has generally run above the natural rate since 1980



Source: BLS, CBO, Haver Analytics, Deutsche Bank

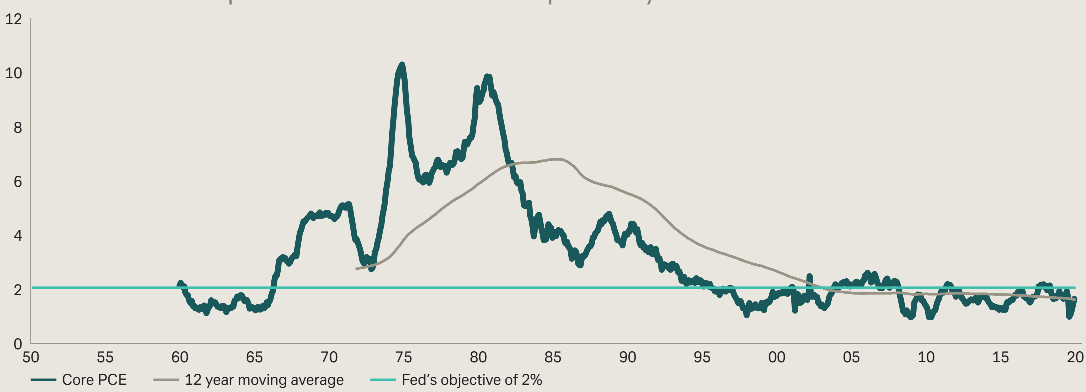
Incidence of tight labor markets down sharply since 1980



Source: Deutsche Bank

While excessive tightness in the labour market was a key factor leading to the Great Inflation, the shift in the direction of pre-emptive policy was overdone. As evidence, since the global financial crisis, US inflation has averaged one-half of a percentage point below the Fed's two per cent target. Central bank success in slaying inflation and stabilising inflation expectations at relatively low levels has also contributed to a flattening of the so-called Phillips curve, the relationship between unemployment and inflation. With inflation much less responsive to movements in unemployment than it was in the past, unemployment may be able to go significantly lower than previously thought.

Inflation has underperformed for most of the past 25 years



Source: BEA, Haver Analytics, Deutsche Bank

The Fed's policy review was also motivated by a second realisation – monetary policy has become increasingly constrained by the zero lower bound (ZLB) on interest rates. The relentless march lower in central bank policy rates has been due to two factors. First, the persistent inflation shortfall has bled into inflation expectations, reducing the Fed's scope to lower real rates. Second, the level of the policy rate that is neither stimulative nor contractionary – often referred to as r-star – has fallen dramatically over time, due to structural factors, such as demographics, and market features, such as the safety premium of holding US treasury securities. The Fed's hope is that achieving higher inflation will help to better anchor inflation expectations at a higher level and give the Fed more scope to lower rates before being constrained by the ZLB.

The Fed's new approach

The Fed's new approach to monetary policy was laid out in some detail in a speech (and a number of accompanying staff papers) that Chair Powell delivered at the Fed's Jackson Hole conference in late August.[1] It features three key modifications.

First, the Fed expanded its definition of the maximum level of employment it strives to achieve to being "broad based and inclusive." Implicitly, this refinement recognises, for example, that black unemployment runs well above overall unemployment. Concerns about these persistent inequalities, which featured prominently during meetings between Fed leadership and community stakeholders during the review, is a reason to push harder than in the past to reduce overall unemployment.

Second, the Fed said that going forward it will adjust policy only in response to "shortfalls" in employment from estimates of its maximum level. This is an explicit shift to an asymmetric employment objective: policy can remain easy so long as employment falls short of maximum, and there is no requirement to tighten policy simply because unemployment is low.

Third, the Fed is moving to a form of inflation averaging that will call for overshooting its two per cent objective to make up for past misses to the downside. While the Fed has said it will be flexible rather than formulaic in its approach, it has made it clear that it will not be tightening policy until it sees inflation on the way to overshooting two per cent, an important shift from the past when the "whites of the eyes" of inflation were all that was needed to tighten policy.

Bringing these three changes together, the Fed can be much less pre-emptive and more reactive in setting monetary policy, especially when exiting a very easy policy stance as the economy is recovering, as is currently the case following the covid crisis. In some sense, this marks a return to the pre-Volcker conduct of monetary policy at the Fed, but with the benefit of the lessons from that episode.

Benefits from the new approach

The potential benefits from this new approach are clear. If successful, the Fed should be able to simultaneously achieve better labour market outcomes and provide more monetary policy space by engineering higher inflation, which will re-anchor inflation expectations around the two per cent objective.

A simple calculation is illustrative. If the Fed aimed to push the unemployment rate one percentage point lower than otherwise, this could create $100bn of additional income.[2] To offset this in terms of real income, inflation would have to rise by a bit more than half a percentage point. The typical Phillips curve relationship suggests that inflation rises initially by only about 0.1 percentage points in response to a one percentage point fall in unemployment.[3] As such, a significant increase in the sensitivity of inflation to unemployment (i.e., a dramatic steepening of the Phillips curve) would be needed to eliminate the welfare benefits of this trade-off. This simple calculation is further supported by the empirical fact that wage growth remains far more sensitive to labour market outcomes. As such, we can be reasonably confident that a lower unemployment rate will, on balance, be associated with improved real incomes.

The gains of this approach are not constrained to the short-run. Indeed, our research has demonstrated that labour market slack and wage growth are important drivers of the medium-term cycle in productivity growth[4]. That is, by making labour scarcer and more expensive on average over time, the Fed can help to incentivise firms to invest in capital and more efficiently use inputs, ultimately to the benefit of longer-run growth prospects. These improvements could be quantitatively important: A sustained one percentage point drop in the unemployment rate could lift the trend growth of productivity by around a quarter to a half a percentage point.

Risks in the new approach

The preceding discussion is not to say this new approach is without downside. While a return to the high-inflation 1970s is unlikely, an unexpected rise in inflation cannot be ruled out. One lesson we have taken from the past decade is that the relationship between macroeconomic variables and inflation is fickle. Consequently,

[1] See Powell, Jerome H. (August 27, 2020), "New economic challenges and the Fed's monetary policy review." At "Navigating the decade ahead: Implications for monetary policy", an economic policy symposium sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming.

[2] Pre-covid, a 1 percentage point fall in the unemployment rate would mean 1.5 million additional jobs. Using a median household income of about $70,000, this translates into $105bn of additional income. While it may be optimistic to assume all new jobs are paid the median income level, this calculation does not account for the fact that wage growth for all employees will rise as the labor market tightens.

[3] Over the longer-run, this rises to only 0.2pp.

[4] See Luzzetti, Matthew and Avik Chattopadhyay (October 10, 2018), "Chicken or the egg: Are firmer wages a precursor to a productivity pickup?" Deutsche Bank US Economic Perspectives.

we should not blindly assume that the conditions that have delivered too low inflation over the past decade will continue to do so over the next ten years. This point of caution is particularly warranted in the current environment, where key conditions have in fact changed. On the inflationary side, covid has required massive fiscal stimulus that has lifted debt levels and led to a sharp rise in the Fed's balance sheet, all at the time when the Fed has shifted its bias towards running a hotter economy that delivers higher inflation. On the disinflationary side, covid has introduced substantial slack into the economy and raised precautionary savings motives.

Fed officials are cognisant of these risks, noting that they will aim for only a "moderate" overshoot, one that is not large or permanent, to use Powell's words. The Chair also emphasised in his Jackson Hole speech that the commitment to accommodation is limited by "signs of unwanted increases in inflation or emergence of other risks that could impede the attainment of our goals."

What level of inflation would be unwanted? Our perception based on what the current FOMC leadership and membership has said is that they do not want to see inflation running persistently above 2.5 per cent. The fact that a flat Phillips curve requires even higher unemployment to bring inflation lower, prospects for nonlinearities in the Phillips curve that could bring unexpectedly-higher inflation, and difficulty understanding how inflation expectations are determined, all contribute to the Fed's aim to inflation well above two per cent.[5]

Wherever you stand on this inflation debate, the inability of monetary policy to fine-tune inflation suggests to us that central bankers should be humble in predicting inflation outcomes in normal economic conditions, let alone in a post-covid world.

Powell's Jackson Hole caveat also referred to "the emergence of other risks." These refer primarily to financial stability concerns, something the Chair has noted have been the consequence of periods of economic overheating in recent decades. This observation is consistent with a secular stagnation view of the world, in which achieving maximum employment requires extraordinarily easy monetary policy, which can incentivise excessive risk taking. While we take the Fed at its word that it will depend primarily on macro-prudential policies to deal with these risks, the reality is that these tools are somewhat limited in the US. For this reason, the Fed has left financial stability concerns as an escape clause from achieving two per cent average inflation. While this is sensible, it is also unfortunate that the blunt tool of monetary policy could be used inefficiently to counteract financial stability risks.

For this framework review to be truly transformative, we therefore believe it requires two conditions. First, the Fed will have to be nimble in handling the trade-off of committing to dovish policy outcomes into the future to credibly commit to this policy shift versus being too slow to respond to a regime shift in the inflation process. Second, it could well require more active use of the Fed's current macroprudential tools, such as the countercyclical capital buffer, or an expansion of the central bank's toolkit.

Conclusion

In sum, the benefits of the Fed's new, less pre-emptive approach to exiting policy stimulus and greater acceptance of inflation overshoots will be potentially considerable in terms of gains in jobs, income, income distribution, and productivity growth. The change does carry risks, but those risks are manageable, so long as the Fed holds to moderate overshoots of inflation and strengthens the use of its macroprudential toolkit. Looking beyond the US, the ECB and Bank of Japan have struggled even more than the Fed in falling short of their inflation objectives in recent decades. Both would be well placed to follow the Fed's example. Indeed, neither is officially fettered by having employment as an objective in their mandate, and both appear to be open to inflation overshoots if not informal inflation averaging.[6] The key challenge, of course is encouraging inflation to high enough levels to achieve some degree of overshoot of the inflation target. Any sense that an overshoot of inflation will be tolerated should be helpful.

[5] See Hooper, Peter, Frederic Mishkin, and Amir Sufi (February 2019), "Prospects for inflation with a high-pressure economy." Presented at the 2019 US Monetary Policy Forum.

[6] For the Sintra conference last year, Draghi wrote, "What matters for our policy calibration is our medium-term policy aim: an inflation rate below, but close to, 2%. That aim is symmetric, which means that, if we are to deliver that value of inflation in the medium term inflation has to be above that level at some time in the future." See https://www.ecb.europa.eu/press/key/date/2019/html/ecb.sp190618~ec4cd2443b.en.html. In September 2016, the BoJ announced a commitment to continue expanding the monetary base until actual inflation exceeds its target of 2%. See https://www.boj.or.jp/en/mopo/outline/qqe.htm/.