Central Banks

Fedwatch: Powell shifts focus from “stars” to transparency and inclusiveness in the new paradigm

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As we expected, the Federal Reserve (Fed) announced the adoption of a flexible average inflation targeting, with unanimous support, as part of the revision to the Statement on Longer-Run Goals and Monetary Policy Strategy. The announcement was made during Chair Powell’s speech at the Jackson Hole Symposium earlier today, where he highlighted that “the federal funds rate consistent with maximum employment and price stability over the longer run has declined relative to its historical average” and therefore “the Committee judges that downward risks to employment and inflation have increased.”

The changes follow a series of Fed Listens events, a flagship research conference, and internal discussions and are part of a broader program to enhance Fed’s transparency and accountability. In fact, Powell stated that “public faith in large institutions around the world is under pressure” and “institutions like the Fed have to aggressively seek transparency and accountability to preserve our democratic legitimacy.”

There are four major economic trends since the Great Financial Crisis that drove the Fed to reassess its monetary policy framework. First, the decline in the longer-run growth rate of the economy due to slower population growth, the aging of the labor force and the decline in productivity growth. Second, the lower level of the neutral interest rate that has been driven by the fall in the equilibrium real interest rate, which in turn reflects weaker demographics and lower productivity growth. With nominal interest rates closer to the effective lower bound, the Fed faces a more constrained environment to support the economy during downturns.

Third, the significant and prolonged improvement in labor market conditions that led to unemployment rates well below the expected sustainable level. These conditions helped individuals that had been left behind to find jobs, thereby revitalizing their communities and increasing the productive capacity of the economy. Fourth, the persistent failure to achieve the 2% inflation objective due to both the flattening of the Phillips Curve, which implies a more muted response of inflation to labor market tightness, and persistently lower levels of inflation expectations, which hold down actual inflation.

Under the new framework, the committee altered its guidance on inflation from the previous 2% target to a flexible form of average inflation targeting “that averages 2 percent over time” and that if inflation persistently falls short of this goal policy the committee “will likely aim to achieve inflation moderately above 2 percent for some time.”

Chair Powell explained that after reviewing the different inflation makeup alternatives, the Fed decided that the flexible option was better than a formulaic approach: “we are not tying ourselves to a particular mathematical formula that defines the average. Thus, our approach could be viewed as a flexible form of average inflation targeting”. Moreover, Powell indicated that inflation overshoots were likely to be moderate and temporary: “Therefore, following periods when inflation has been running below 2 percent, appropriate monetary policy will likely aim to achieve inflation moderately above 2 percent for some time."

Given the emphasis the Chairman and other Fed officials have placed on low- and moderate-income communities, it was also not surprising that the policy goals included a broadening of the employment objective citing that maximum employment is "a broad-based and inclusive goal that is not directly measurable and changes over time owing." In particular, the revised statement indicates that policy decisions will be based on the Fed's "assessments of the shortfalls of employment from its maximum level" rather than by "deviations from its maximum level" as in the prior objectives.

On the one hand, this exhibits the difficulties in measuring maximum employment and the natural rate of unemployment and that "specifying a numerical goal for employment is unwise". On the other hand, it reflects the Fed's intention to stress the importance of expanding the benefits of a strong labor market for low- and moderate-income communities, which tends to occur late in the business cycle.

Thus, as long as tight labor markets can be sustained without price pressures, the Fed will allow employment to "run at or above real-time estimates of its maximum level". Whenever employment is below the maximum level, as is the case in the current environment, the Fed will try to "minimize that shortfall by using our tools to support economic growth and job creation."

During the Q&A session, Powell mentioned that the effects of the pandemic on the labor market have fallen to a large extent on low-wage workers, minorities and women, and that the "single most important thing we can do here is to support a strong labor market." However, Powell stated that "there are better tools to dealing directly with distributional issues" held by elected officials and the executive branch, and the responsibility should be borne by "all government, all society".

In any case, Powell highlighted that millions of people will struggle to find jobs and need support: "We are looking at a long tail of probably a couple of years at least, of relatively high unemployment as people who worked in those industries will struggle to find work, and again we need to support them." In addition, Powell defended the Main Street Lending Facility as a way for loans to reach SMEs and stated that they have put more effort into this facility than "everything else we've done." Nonetheless, he acknowledged that "It is going to take more than that, it is going to take more direct aid, I think, to smaller businesses and I think that is an area where fiscal policy can really do things that it is very hard for us to do."

Ultimately, achieving these revised policy objectives will also be guided by financial conditions and the committee's "longer-run goals, its medium-term outlook, and its assessments of the balance of risks, including risks to the financial system." In this sense, the Fed will continue using existing and new tools to deal with the macroeconomic challenges of low interest rates, low inflation, slow growth, a flat Phillips curve and relatively low productivity. As Powell indicated: "Time is going to tell, and what we do going forward is really going to decide the effectiveness of the changes we made".

With inflation and inflation expectations below target and labor markets recovering slowly, policy rates will remain at the effective lower bound for a prolonged period. Thus, under the new framework, as long as price pressures remain under control, the Fed will keep interest rates low even if employment has reached its maximum level. That is, the Fed will allow labor markets to run “hot” to achieve more inclusive growth. Nonetheless, the duration of the low interest rate environment will depend on how effective the changes are to bring back up inflation and inflation expectations.

The Fed will undertake a policy review every five years. Whether this is to reaffirm the current plan or come up with a new one, only time will tell. If inflation and inflation expectations return to 2% persistently, the Fed will be able to raise rates and scale down other tools that are supporting the recovery. However, if inflation remains below target and the Fed realizes that the changes have not had the expected effect, they will go back to the drawing board to design a new game plan.

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