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INSIGHT

The Federal Reserve's Revised Monetary Policy Strategy Statement

September 10, 2020

After a two-year *Review of Monetary Policy Strategy, Tools, and Communications*, the Federal Reserve (Fed) announced on August 27, 2020, revisions to its *Statement on Longer-Run Goals and Monetary Policy Strategy*. This statement, initially published in 2012, explains the Fed's monetary policy strategy for achieving its statutory mandate of maximum employment, stable prices, and moderate long-term interest rates.

The original statement had two key features. First, it set a long-run inflation goal of 2%, the first time the Fed formally specified a numerical goal. Second, it asserted that a similar numerical goal could not be set for maximum employment because of uncertainty surrounding full employment. The 2020 revision retains both features.

Overall, the 2012 statement was concise and did not provide details on how the Fed would react to specific economic situations. The 2020 statement is more detailed, and it marks a shift on how monetary policy will respond to inflation and unemployment in light of recent macroeconomic developments. Specifically, since the 2007-2009 financial crisis, the federal funds rate has been close to zero (see **Figure 1**), and inflation has been mostly below 2% and relatively unresponsive to changes in the unemployment rate. Because the Fed cannot reduce rates below zero, its primary challenge since the crisis has been to provide adequate monetary stimulus to achieve its mandate. The 2020 statement articulates a strategy to provide greater stimulus.

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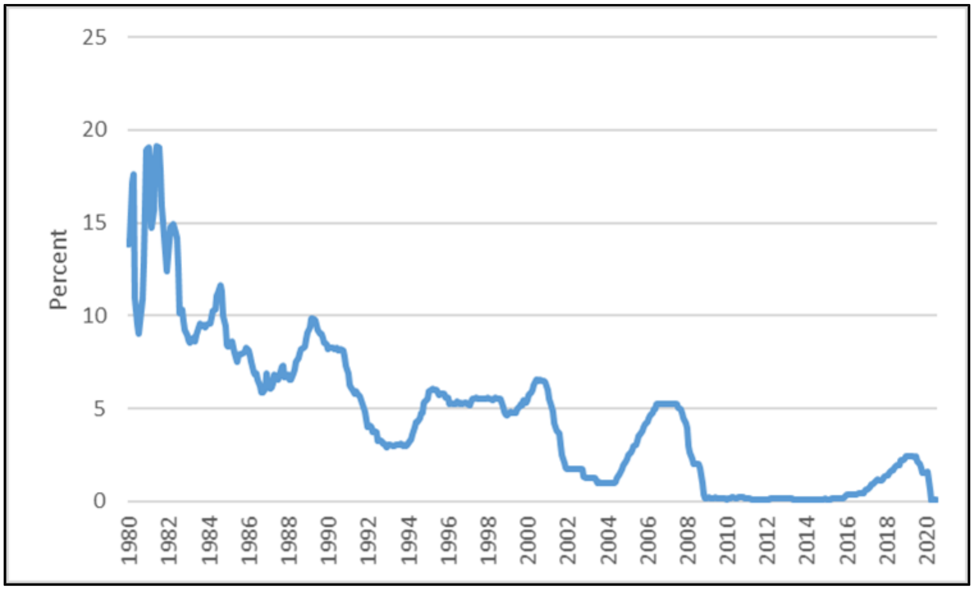
Figure 1. Federal Funds Rate

1980-2020



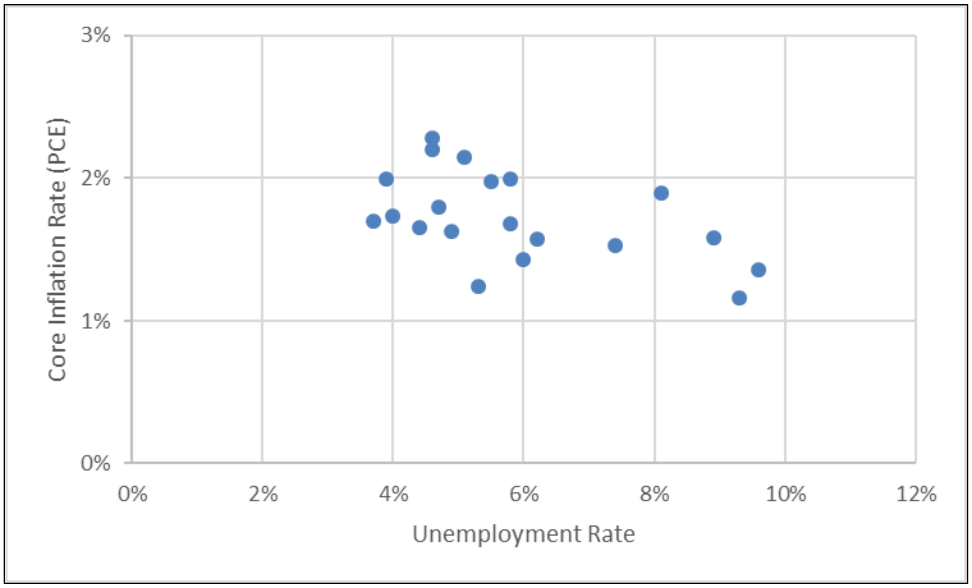
Source: Federal Reserve.

The revision departs from an earlier strategy, adopted in response to excessively high inflation from the late 1960s to the 1980s, to preemptively increase interest rates when unemployment was viewed as too low. This view was based on the "Phillips Curve" relationship that inflation would rise when unemployment fell, and vice versa. The 2020 statement acknowledges that this relationship has been weak in recent decades. As shown in **Figure 2**, over the past 20 years, inflation has remained around 1%-2% every year, whether unemployment was very high or very low.

The statutory mandate does not specify how the Fed should weigh inflation and employment goals. The revised statement drops language about taking a "balanced approach" toward achieving those goals, and argues that monetary policy should only be used in response to unemployment being too high, but not when it is too low. According to the Fed's Vice Chair, a "low unemployment rate by itself ... will not, under our new framework, be a sufficient trigger for policy action." In discussing the statement, Fed officials have stressed the long-term benefits of "hot" labor markets for "groups that are most vulnerable to employment fluctuations," such as minority workers.

Figure 2. Phillips Curve

2000-2019



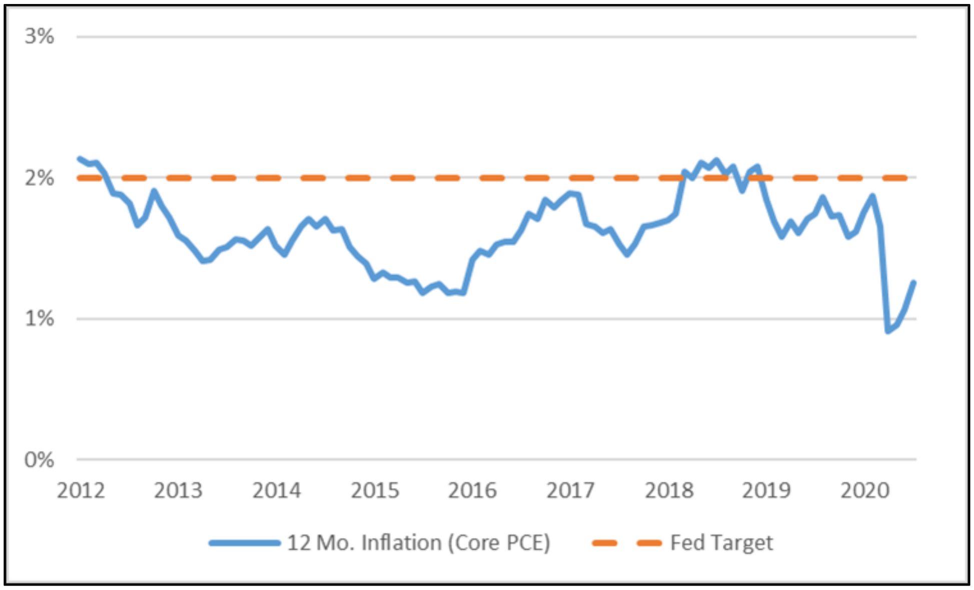
Source: CRS calculations based on data from Bureau of Economic Analysis and Bureau of Labor Statistics.

Note: Each point represents the unemployment and inflation rates for a year between 2000 and 2019.

The 2020 revision also adopts a more aggressive stance toward persistently low inflation. Whereas the Fed's main concern in earlier decades was that inflation might be too high, the Fed's preferred measure of inflation has run below 2% in 91 out of 103 months since it adopted the 2% goal in 2012 (see **Figure 3**). As a result, the Fed is concerned that too-low inflation will feed into expectations, causing it to become self-perpetuating. In response, the 2020 statement explained that the Fed would aim to make up for periods of inflation below 2% with periods of inflation above 2%, so that inflation would average 2% over time. Although the 2012 statement did not rule this strategy out, neither did it describe how such a development would be tackled.

Figure 3. Inflation

2012-2020



Source: CRS calculations based on Bureau of Economic Analysis data

The 2020 statement also notes the importance of maintaining financial stability to achieving its mandate. Whereas previous decades featured only fleeting and isolated incidents of financial instability, financial stability concerns have been central in the 2007-2009 financial crisis and the current pandemic.

Policy Considerations

Overall, the revised statement can be viewed as a more "dovish" approach to monetary policy—less concerned about inflation and the risks of unemployment being too low, and more concerned about providing adequate stimulus. Although some observers have described these changes as a major shift in policy, it could be argued that monetary policy decisions have reflected this thinking for some time. In recent decades, the Fed has not raised preemptively rates when unemployment was high—for example, 1994 was the last time it raised rates when unemployment was above 6%. The Fed reduced interest rates in the second half of 2019 when unemployment was below 4%—below the Fed's own longer-run estimate of unemployment. Likewise, the Fed directly intervened in financial markets with significant resources in both 2008 and 2020 to restore financial stability, which it justified in terms of its mandate.

With unemployment in double digits when the statement was revised, inflation is arguably a less pressing concern. A potential drawback to the new statement is that because it is more specific to current concerns, arguably it could be less useful and possibly unhelpful if future economic conditions change (if inflation became high or became more sensitive to unemployment again in the future, for example). In that case, the statement could be revised again. But if it is believed that the statement makes monetary policy more effective by committing the Fed to a future course of action, then commitment to the strategy matters for economic outcomes.

Another concern some have is that the new policy is more complicated, and some argue that simple policies are more effective and more robust than complicated ones in the face of uncertainty. For example, the new pledge to follow low inflation periods with periods when inflation exceeds 2% may lead to confusion among the public about what interest rate path the Fed will pursue and how high inflation will get. The grounding of low inflation expectations since the 1990s has been viewed by many as one of the

Fed's major successes, and this new policy might muddy the waters. Another challenge to the success of makeup strategies has been the Fed's inability to get inflation to reach its 2% target since 2012. If its policies have not reached 2% inflation, what policy could successfully deliver inflation above 2%?

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