PIIE PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS

Rebuilding the Global Economy

A series outlining policy priorities and solutions

MEMORANDUM ON

US MONETARY POLICY PRIORITIES IN THE NEAR AND MEDIUM TERMS

To: The Vice Chair of the Federal Reserve Board
From: David Wilcox
November 2020

Background: The US economy has partially recovered from a historically deep downturn, but there is still a long way to go before the recovery will be complete.[1] The overall unemployment rate remained at 6.9 percent in October 2020, and the number of jobs was still 10 million below its February level. The consequences of the economic downturn have fallen disproportionately on women, people of color, and the lower rungs of the income ladder. As of late November 2020, fiscal policymakers still appear gridlocked over when to enact additional support for the economy, how substantial that support should be, and what form it should take.

Even with the recent good news on potential vaccines, the economic recovery likely will remain incomplete through the end of 2021 at the very least, and perhaps significantly longer. Left unattended, an incomplete recovery could inflict serious damage—including but not limited to hunger, eviction from homes, and diminished attachment from the labor market—on the groups noted above who are suffering the worst of the consequences.

The Federal Reserve has played a crucial role thus far in helping to stave off even worse outcomes. Earlier in 2020, the Federal Open Market Committee (FOMC) quickly cut the short-term interest rate under its control essentially to zero and began to purchase longer-term Treasury and mortgage-backed securities in historically large quantities. In addition, the Fed established a range of emergency facilities using the authority granted to it under Section 13(3) of the Federal Reserve Act and expanded its provision of dollar liquidity to other central banks. These steps were successful in quelling the turmoil that erupted in financial markets when the pandemic crisis began.

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1 The NBER Business Cycle Dating Committee has determined that economic activity peaked in February 2020—and thus that a recession began. They have not yet designated the month in which the recession ended. If the economy continues to gradually recover, they will probably decide that the trough occurred in April, thus making the recession the shortest on record at only two months in duration. (The shortest recession currently recognized by the NBER is the one in 1980, at six months.) If COVID-19 continues to intensify in its effect over the next few months, the economy could weaken again, and the Dating Committee could be confronted with a difficult decision as to whether what had happened was two discontinuous recessions, or one longer one interrupted by the fastest GDP growth recorded since the modern era of GDP measurement began in 1947.

As necessary and effective as these steps were, they represent the bulk of what the Fed is statutorily authorized to do in fighting recessions. The bulk, but not all. Because the consequences are so enormous, it is incumbent upon the Fed to use its tools to the utmost to deliver the best possible outcomes. Even so, the reality is that fiscal policy will have to shoulder the bulk of the responsibility from here forward to ensure that we, as a society, shield the most vulnerable from ongoing harm and speed the attainment of a full recovery.

Also, the Federal Reserve has recently concluded its "Review of Monetary Policy Strategy, Tools, and Communications," which refines the Fed's interpretation of the instructions given to it by Congress in the Federal Reserve Act. The revised framework helpfully includes a new set of thresholds governing the conditions that the FOMC expects to see before it will lift the federal funds rate above the effective lower bound. You and your colleagues should do everything you can to make this commitment credible, understood, and have an easing effect on policy now through communications.

In this context, there are three important steps for you to consider, each of which could help rebuild the global economy. The first step should be considered in the near term; the other two can go on the longer-term agenda but still deserve focused attention.

KEY PRIORITIES

PRIORITY 1: Strengthen the FOMC's forward guidance about large-scale asset purchases

One piece of seemingly unfinished business from the Framework Review pertains to the guidance included in each post-meeting statement regarding future purchases of longer-term assets. Currently, the statement says that "over coming months the Federal Reserve will increase its holdings of Treasury securities and agency mortgage-backed securities at least at the current pace to sustain smooth market functioning and help foster accommodative financial conditions."

Longer-term interest rates are low, but they are not as low as the federal funds rate, suggesting there could be room for the FOMC to provide additional impetus to aggregate demand by driving long rates lower. (As of this writing, the yield on 10year Treasury notes is in the neighborhood of 0.9 percent.) The FOMC could provide more impetus by announcing economic thresholds that it expects will have to be met before it will stop increasing the size of its portfolio. For simplicity, these thresholds could take exactly the same form as the ones already announced for the federal funds rate; or they could be closely related.[2] By making clear that it will scale the cumulative amount of its bond purchases according to the length of time that elapses before its inflation and employment objectives are reached, the FOMC could bolster public confidence in its determination to achieve a complete recovery as rapidly as possible.

2 David Reifschneider and I advocated an approach along these lines in a PIIE working paper.

PRIORITY 2: Reconsider the inflation objective in light of changed economic circumstances

The Fed came into the most recent recession with too little room to fight even a typically sized recession—let alone a historically severe one—using its conventional tool, cuts in the federal funds rate.[3] The Fed found itself in this predicament despite having fostered a highly favorable macroeconomic environment, with the unemployment rate at a 50-year low and core inflation running only about ¼ percentage point below the 2 percent target. The diminishment of the Fed's recession-fighting capability reflected the worldwide decline in the normal structure of interest rates. Many other central banks around the globe are in the same predicament.

One step the Fed conspicuously did *not* take in modifying its Statement of Longer-Run Goals was to boost the inflation target from its current level of 2 percent. Adopting a modestly higher target would eventually help the Fed to recoup a portion of its lost ability to fight recessions.[4] Even a slight increase in the inflation objective would be difficult for any central bank to undertake unilaterally. However, you could work on two aspects of the problem. First, a coordinated move involving several globally important central banks (e.g., the European Central Bank, the Bank of Japan, and the Bank of England) all moving in concert could be easier than any bank moving alone, as my PIIE colleague Adam Posen argued. Second, the Fed and other central banks could build a rhetorical bridge to a higher inflation objective by saying that their first priority is to restore inflation to the current 2 percent objective, and once that is attained, they will revisit the question of what the optimal level of the inflation target is, in light of the further decline in the neutral rate since the 2 percent objective was adopted in 2012.

PRIORITY 3: Build out the macroprudential toolkit

Monetary policy will be stretched to the limit in coming years in terms of its ability to fight recessions. A danger is that financial stability concerns will become more acute even before central banks should curtail the amount of support for aggregate demand they are providing. The macroprudential policy toolkit is very sparse in the United States. To allow monetary policy to fight recessions to the fullest extent possible, potential financial stability concerns must be addressable using other policy tools. The precise specification of these other tools, and the identity of who should wield them, will require careful study. That program of study should get under way now. This agenda item will ultimately require extensive coordination with Congress, as well as the other regulatory agencies, depending on where the authority to exercise the new tools is lodged.

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3 On the eve of the COVID-19-induced collapse, the target range for the federal funds rate extended from 1½ percent to 1¾ percent. In response to a typical post–World War II recession, usual behavior (following the so-called balanced approach rule) would have the Fed cut the funds rate by about 5 percentage points, assuming the zero lower bound on interest rates posed no impediment. A historically severe recession obviously would call for a much larger rate response in the absence of a lower bound.

4 There is no prospect of recouping *all* of the lost policy space by this means, and you and your colleagues should not try to do so, because the gap to be closed is too big.

OTHER PRIORITIES

Beyond the top priorities listed above, other issues will need your focused attention. Especially with the ongoing relevance of the effective lower bound on the funds rate being abundantly clear, the Fed and other central banks need to devote increased attention to the question of whether other monetary policy tools can be developed, with better distributional consequences than the current set of tools. More broadly, you should invest time and energy in promoting the broad rethink of the Fed's responsibility for helping to close the yawning economic inequalities that persist in our society. Related to the adoption of "average inflation targeting" under the new framework for monetary policy, the Fed will need to clarify the extent to which you and your colleagues are willing to tolerate some greater risk of higher inflation for the sake of promoting a tighter labor market and hence a more equitable distribution of economic resources. These issues are complex; if easy solutions were available, they would have been implemented already. There are not, but that does not mean that you should not pursue them.