Summary of Audience Q&A
Session #1: "The Federal Reserve's Current Framework for Monetary Policy: A Review and an Assessment"

Date: June 4, 2019

Moderator: Yuriy Gorodnichenko (University of California, Berkeley)

Presenters: Janice Eberly (Northwestern University), James Stock (Harvard University), and Jonathan Wright (Johns Hopkins University)

Discussant: John Taylor (Stanford University)

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Following the presentation of "The Federal Reserve's Current Framework for Monetary Policy: A Review and an Assessment" by Janice Eberly, Jim Stock, and Jonathan Wright, and discussion by John Taylor, the authors responded to clarify specific points raised by the discussant regarding the effects of shocks to the level of the FOMC's short-term policy interest rate (the federal funds rate). The authors began by noting that the chart of the impulse response function presented by the discussant was not the same as any of those presented in their paper, which involved the combination of a SVAR-IV model and a New Keynesian Phillips curve. The authors noted that issues such as the "price puzzle" and invertibility in SVAR estimation and results are technical challenges familiar to researchers in empirical macroeconomics. These issues make it difficult for researchers to get accurate estimates of variable responses to innovations in the the federal funds rate. The invertibility issue can be effectively side-stepped by using the SVAR-IV and Local Projection IV techniques as demonstrated in the paper and in the appendix, respectively. The authors noted that these two techniques generated comparable results. Further, the authors explained that the use of the New Keynesian Phillips curve model with shocks from the SVAR-IV allowed the authors to control the influence of the shocks on the outcome variables directly.

Proceeding to other comments by the discussant, the authors agreed with the suggestion on the importance of using more than one model to assess the effects of monetary policy, especially unconventional policies. Regarding the choice of sample period, the authors provided further explanation of their focus on the short period since 2012—the FOMC first articulated its current monetary policy framework with an explicit 2 percent inflation objective in January 2012. In order to respect the implications of the Lucas critique (1976), the authors wanted to examine a period over which there was one policy regime in place to avoid complications associated with changes in expectations. As to the choice of counterfactual simulations, the authors chose experiments that seemed comparable to policy choices that policymakers may have considered during the period.

The authors started the empirical analysis in 2009 for the simulations and counterfactuals, a decision taken largely because the implementation of policies in 2008-09 was very important for data generated in 2012 and after. Relatedly, the authors emphasized that the persistence of effects associated with large-scale asset purchases (LSAPs) is hard to identify, but related effects on mortgage origination as found in subsequent research on the housing market after the crisis seem to indicate persistence; however, precisely how persistent is hard to measure. The authors agreed that observed productivity outcomes could reflect policy, as suggested in the discussion, but the effects were likely not related to monetary policy directly (aside from the monetary policy role of providing a stable macroeconomic environment, which is a long-term effect of policy).

From the audience, Peter Hooper (Deutsche Bank) noted that productivity has typically risen after labor markets tighten with a lag of a year or two. As labor markets tighten, wage growth picks up via the wage Phillips curve—this effect was notable in the 1950s and 1960s but has been less apparent recently. He wondered if monetary policy could allow labor markets to tighten further. Bill Dudley (Princeton University) asked why the authors had focused on a higher level of the inflation objective as a means to provide the Fed with more room to ease using traditional interest rate policy in a downturn, as opposed to other economic policies—fiscal policy, for example—that could help moderate a downturn. He noted that numerous other initiatives could enhance the effectiveness of fiscal policy in combatting recession. Larry Meyer (Monetary Policy Analytics) stated the employment goal of the Fed as maximum "sustainable" employment and was critical of the terminology used in the paper combining LSAPs and forward guidance as "slope policies." He thought LSAPs were better referred to as open market operations on long-term rates.

The authors responded to this collection of audience comments. Professor Eberly pointed out that in model counterfactual results the unemployment rate rose to 8 percent even with aggressive monetary policy intervention. In that case, there was ample scope for effective fiscal initiatives to lower unemployment. In support of that point, Professor Wright noted that analysis from a variety of estimated models (including the one in the paper) indicate that numerous policies are helpful in response to a downturn, but no one individual policy is sufficient to offset contractions in general. Regarding productivity, Professor Stock noted that productivity is cyclical, but that cyclicality was hidden within substantial noise prior to the last recession. Any policy that stabilizes a recession helps reduce the cyclical components of productivity. Furthermore, the secular slowdown in productivity that started before the 2008-09 recession and subsequent policy interventions make detecting the source of productivity changes—whether cyclical or trend—a challenge. As to their treatment of slope policies, the authors stated that it was their deliberate intention to combine forward guidance and LSAPs because of the difficulty of identifying them separately.

Neel Kashkari (President, Federal Reserve Bank of Minneapolis) raised the example of the Bank of Japan (BoJ) and its current policy of targeting the term structure of interest rates. Professor Taylor commented that the BoJ has been successful at achieving its target 10-year interest rate but that it is not clear how that policy has affected short-term interest rates and the term structure or whether the BoJ's actions have achieved its goals. He suggested that the BoJ's actions have

not had much effect because the initial impact effects disappear quickly. In response, Professor Wright highlighted that in one scenario in their paper, a simulation controlling the yield curve, they set the 10-year yield at 2 percent, comparable to the BoJ's policy. That experiment had effects on key variables similar to the results of the "stronger sooner" counterfactual.

Jared Bernstein (Center on Budget and Policy Priorities) asked whether the authors had considered policies implemented by other central banks such as negative interest rates or buying of alternative assets. David Nelms (Board of Directors, Federal Reserve Bank of Chicago) asked whether the initiation of stronger LSAPs earlier in the downturn would have been associated with unintended negative consequences, like asset bubbles. He inferred "advocacy" of this approach from the paper's results. In response to these questions, Professor Eberly reiterated that their results should not be construed as advocacy in support of a particular policy and were not intended to second-guess Fed policy decisions. The notable findings of a "stronger sooner" LSAP policy likely resulted from the significant effects that the purchases of "on the run" mortgage-backed securities had in calming that uncertain market. Professor Wright suggested that policymakers could implement a "stronger sooner" policy through forward guidance, noting that forward guidance policy became more potent after 2011 when dates and thresholds were introduced. He also commented that the relevant counterfactual showed negligible effects of negative interest rates on key variables.

With respect to LSAPs and other unconventional policies, James Bullard (President, Federal Reserve Bank of St. Louis) noted that markets and policymakers have learned from their experience. The next time these policies are employed, expectations could act to magnify their economic impact. Ben Friedman (Harvard University) claimed that there is a lack of rigorous research aimed at determining the appropriate target for the inflation rate and suggested that the economics profession and the Fed should encourage research aimed toward assessing the optimal target for inflation along with the costs and benefits of a higher inflation target.

In response to these additional points, Professor Stock pointed to a growing literature on inflation targets, including a historical perspective on the costs of higher inflation and the associated price-resetting costs, price dispersion costs, and the potential trade-offs of a higher inflation target in the presence of a declining equilibrium real interest rate (r*). On learning from the LSAP initiatives, Professor Eberly agreed that experience provides market participants with a better sense of what to expect in the future. She noted that when markets are disrupted, LSAPs would likely have greater impact.

The discussion then turned to communications. Brian Sack (D.E. Shaw) asked whether the authors thought Fed communications about LSAPs could help market participants form expectations about how policymakers might use asset purchases in the next downturn. Chris Erceg (International Monetary Fund) asked if combining LSAPs with forward guidance appropriately might lower long-term interest rates but reduce the volume of assets that the Fed would have to buy. In response to Mr. Sack, Professor Wright suggested that targeting a yield curve in a "policy rule" might succeed. In response to Mr. Erceg, Professor Wright noted that forward guidance is likely to be more effective for influencing interest rates at shorter horizons.

Professor Taylor commented that "rules" for LSAPs and forward guidance would not work because the effects of the LSAPs are unconfirmed, and a rule aims at outcomes. He noted that policy rules for short-term interest rates arose following years of observation and analysis. In Reifschneider and Williams (2000), after the policy rate hits the zero lower bound, policymakers keep the policy rate at zero to make up for the extra accommodation a standard Taylor rule that was unconstrained by the zero bound would have prescribed. Forward guidance about how long the funds rate will remain at the zero lower bound informs expectations and affects the term structure.

Professor Stock noted that the key issue for evaluating rules with regard to LSAPs is that it is difficult for the Fed to affect long-term rates—that is, to affect the yield curve. The analysis in the paper indicates that LSAPs and forward guidance affected both the level and expectations of interest rates through the entire yield curve. In the absence of these two tools, the Fed would face serious constraints on its ability to implement countercyclical policy in the presence of the zero lower bound.

With regard to the efficacy of the Reifschneider-Williams rule, the authors suggested the model specification that underlies the impulse responses in the paper may have been unable to capture the structural elements of this particular rule and its potential beneficial effects. Still, they questioned whether an extended stay at the zero lower bound can be effective without employing LSAPs.

References

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David Reifschneider and John C. Williams (2000), "Three Lessons for Monetary Policy in a Low-Inflation Era," *Journal of Money, Credit and Banking*, vol. 32 (November), pp. 936-66.