Recent FOMC Communications as a Part of Appropriate Monetary Policy[1]

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In this note, I emphasize that recent Federal Open Market Committee communications are consistent with an appropriately accommodative monetary policy strategy. However, I argue that the Committee's communications have provided insufficient detail about how its policy strategy will play out when the recovery is more advanced. I describe how the Committee can reduce residual policy uncertainty, and so better achieve its goals, by providing this missing clarity in future communications.

The views expressed are my own and not necessarily those of any other FOMC participant.

I begin by describing some key aspects of what I see as the appropriate response of asset purchases and the fed funds rate target to the evolution of economic conditions. (By medium-term, I mean one to two years ahead.)

***Asset purchases**: The Committee should continue to buy assets at least until the unemployment rate has fallen below 7 percent, as long as the medium-term outlook for the inflation rate remains below 2.5 percent and longer-term inflation expectations remain well anchored.*

***Federal funds rate:** The Committee should keep its target range for the fed funds rate at its current extraordinarily low level at least until the unemployment rate has fallen below 5.5 percent, as long as the medium-term outlook for the inflation rate remains below 2.5 percent and longer-term inflation expectations remain well anchored.*

In both cases, I am describing thresholds, not triggers. Thus, depending on economic conditions and assessments of policy effectiveness, it may be appropriate for the Committee to buy additional assets even after the unemployment rate falls below 7 percent. And, depending on economic conditions, it may be appropriate for the Committee to keep the fed funds rate extraordinarily low even after the unemployment rate falls below 5.5 percent.

The threshold unemployment rate for the fed funds rate indicates that highly accommodative monetary policy remains appropriate until the unemployment rate falls below 5.5 percent (given that the inflation outlook and inflation expectations satisfy the conditions described above). Why then is the threshold unemployment rate for asset purchases as high as 7 percent? Asset purchases are a relatively novel monetary policy tool, and the benefits and the costs of additional purchases are correspondingly uncertain. Given those uncertainties, I view it as appropriate to allow for the possibility that the Committee may choose to stop using this tool before the economy has fully normalized. As I emphasized above, the 7 percent marker is only a threshold. It may well be that the Committee's overall economic outlook and degree of confidence in an asset purchase tool would lead it to buy additional assets when the unemployment rate is below 7 percent.

I view the above policy strategy as appropriately accommodative.[2] At the same time, I see *no* contradiction between this appropriately accommodative policy strategy and the forward guidance

[2] To be more specific: I see this policy strategy as taking a balanced approach to the mitigation of deviations of inflation from its long-run target of 2 percent and deviations of employment from the FOMC's assessment of its maximum level. Thus, the strategy is consistent with the FOMC's January 2013 statement on its long-run goals and strategies. See Kocherlakota (2013) for details.

announced in last week's FOMC statement and Chairman Bernanke's recent press conference remarks. The FOMC statement expresses the Committee's intention to keep the fed funds rate extraordinarily low at least until the unemployment rate falls below 6.5 percent, as long as the medium-term inflation outlook is below 2.5 percent and inflation expectations remain well anchored. The above policy strategy also calls for the fed funds rate to remain extraordinarily low in these circumstances. In his press conference remarks, Chairman Bernanke made reference to the Committee's expectation that it will keep buying assets through mid-2014, when the unemployment rate is anticipated to be in the vicinity of 7 percent. This expectation is also consistent with the above policy strategy, which specifies that asset purchases should continue at least until the unemployment rate has fallen below 7 percent.

There *is* a difference between FOMC communications, including recent ones, and the policy strategy described above: The latter provides more detail about the likely reaction of monetary policy to key economic eventualities. In my view, the Committee could better achieve its goals by augmenting its communications to provide the missing clarity. For example, the Committee has not described how it will set its fed funds rate target when the unemployment rate has fallen below 6.5 percent but remains above 5.5 percent—a period of time that I currently expect to last about two years. In contrast, the policy strategy that I described above says specifically that the FOMC will keep the fed funds rate extraordinarily low over that time frame (as long as the inflation conditions are satisfied). This additional clarity about *future* policy actions will tend to push downward on a variety of market interest rates and provide needed *current* stimulus to the economy.

To sum up: I have described how recent FOMC communications are consistent with an appropriately accommodative monetary policy strategy. However, these communications do leave the public with large amounts of residual uncertainty about the Committee's likely course of policy choices when the recovery is more advanced. The Committee could better achieve its policy goals if it were to reduce this uncertainty through communicating more information about its likely reactions to additional economic eventualities. I look forward to working with my colleagues to augment our communications in this fashion, and thereby ensuring a faster return to full employment in the context of price stability.

Reference

Kocherlakota, Narayana. 2013. “Evaluating the Appropriateness of U.S. Monetary Policy.” June 1 speech, Istanbul, Turkey.