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The Federal Reserve's 2025 Monetary Policy Framework Review

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Overview

Overview of the 2025 Framework Review

Elements of the Review

- *Fed Listens* events
- Flagship research conference
- FOMC discussions supported by staff analytical work

Key Outcome of the Review

- Revised Statement on Longer-Run Goals and Monetary Policy Strategy, released on August 22
- All materials are available on the Federal Reserve Board's website

Fed Listens

- Ten public *Fed Listens* events were held at Reserve Banks from March through June.
- Videos and summaries are available on the Board's website, along with a summary report.
- The events engaged with a wide range of individuals and groups, including representatives of small and large businesses spanning a variety of sectors, employee groups and labor unions, state and local governments, schools and community colleges, workforce development organizations, housing groups, and financial institutions.
- Broad takeaways included:
  - Inflation is a key concern. The high cost of essentials weighs heavily on people's daily economic experiences, even with a solid and stable labor market.
  - In the wake of the pandemic, businesses have had to adapt to control costs and to attract, train, and retain employees. Economic uncertainty looms large, affecting decisionmaking.
  - For many, the most immediate economic concerns were beyond the purview of the Fed.
  - Some noted that Fed communications for general audiences could be improved.

Research Conference

- The 2nd Thomas Laubach Research Conference was held on May 15-16 at the Federal Reserve Board in Washington DC.
- The event was livestreamed, and video recordings and all papers and presentations are available on the Board's website.
- The program included six paper presentations and discussions with prominent academics and researchers, along with a policymaker panel discussion.
- Key topics included the labor market and maximum employment, inflation dynamics and inflation expectations, monetary policy strategy and tools, and monetary policy communications.

FOMC Discussions

January meeting:

- Background and summary of the 2019–2020 Review and the experience of foreign central banks with framework reviews.

March meeting:

- Assessing maximum employment; policy implications of labor market dynamics.

May meeting:

- Lessons about inflation dynamics, including from the international experience, and the implications for policy.

June meeting:

- Assessment of uncertainty and risks and the implications for the conduct and communication of monetary policy.

July meeting:

- Discussion of revisions to the Statement on Longer-Run Goals and Monetary Policy Strategy (consensus statement).

Fed Staff Analytic Work

Staff Papers

1. The Origins, Structure, and Results of the Federal Reserve's 2019-20 Review of Its Monetary Policy Framework
2. Reviews of Foreign Central Banks' Monetary Policy Frameworks: Approaches, Issues, and Outcomes
3. Assessing Maximum Employment
4. Labor Market Dynamics, Monetary Policy Tradeoffs, and a Shortfalls Approach to Pursuing Maximum Employment
5. Retrospective on the Federal Reserve Board Staff's Inflation Forecast Errors since 2019
6. Inflation Since the Pandemic: Lessons and Challenges
7. Pandemic and War Inflation: Lessons from the International Experience
8. Implications of Inflation Dynamics for Monetary Policy Strategies
9. Accounting for Uncertainty and Risks in Monetary Policy
10. Monetary Policy, Uncertainty, and Communications

Assessing Maximum Employment

Overview:

- Reviews key indicators for assessing labor market conditions and the level of maximum employment.
- Examines concepts of maximum employment, focusing on the highest sustainable level of employment while maintaining price stability.

Key Takeaways:

- The unemployment rate remains a key cyclical indicator of labor market performance.
    - It is well understood by the public, time-tested, highly correlated with other indicators, and large cyclical movements relative to trend provide a clear signal of a recession.
- Other indicators help provide a more comprehensive view of the labor market.
    - For example, job vacancies or the employment-to-population ratio.

Labor Market Dynamics, Monetary Policy Tradeoffs, and a Shortfalls Approach to Pursuing Maximum Employment

Overview:

- Discusses monetary policy strategies that mitigate employment shortfalls, rather than deviations, from maximum employment.
- Assesses how such strategies may affect macroeconomic outcomes over time.

Key Takeaways:

- Shortfalls strategies generate modestly greater inflationary pressures than strategies that respond to deviations from maximum employment. Differences in terms of average employment outcomes are relatively small.
- Focusing on employment shortfalls tends to reduce the likelihood of hitting the effective lower bound (ELB) because of the higher average level of inflation.
- In the presence of nonlinearities (such as those due to supply constraints):
  - Shortfalls strategies can give rise to rapid increases in inflation.
  - Policymakers may want to respond forcefully to nascent inflationary pressures

Retrospective on the Federal Reserve Board Staff's Inflation Forecast Errors since 2019

Overview:

- Examines the Board staff inflation forecast during the pandemic and its aftermath.
- Draws lessons for inflation forecasting from that episode.

Key Takeaways:

- The staff missed the magnitude and persistence of the inflation surge.
- Unanticipated supply-demand imbalances were the main cause of the forecast misses.
    - Shocks to supply were unexpectedly persistent (or recurring).
    - The recovery in demand was unexpectedly rapid and unbalanced across sectors.
- In the future, forecasting inflation could benefit from the use of:
    - Alternative measures of economic slack (such as vacancy-to-unemployment ratio).
    - Forecasting frameworks that allow for nonlinearities.
- However, factors that proved useful in forecasting inflation during the pandemic may be less so in more normal times.

Inflation Since the Pandemic: Lessons and Challenges

Overview:

- Reviews the key drivers of inflation over the past five years.

Key Takeaways:

- The pandemic and the recovery from it, including the effects of policy responses, led to large and persistent imbalances between supply and demand across the U.S. economy.
- These imbalances contributed to the high inflation rates experienced during the pandemic and the following recovery.
- Short-term inflation expectations rose rapidly as inflation picked up in 2021 and during the first half of 2022.
- However, longer-term inflation expectations remained well anchored, which likely helped contain the inflationary burst.

Pandemic and War Inflation: Lessons from the International Experience

Overview:

- Examines cross-country experiences during the pandemic and its aftermath.

Key Takeaways:

- Despite different policy frameworks, cross-country experiences have been similar.
  - Inflation surged in most advanced and emerging market economies reflecting:
    - Large demand-supply imbalances.
    - Strong fiscal and monetary policy support.
  - Short-term inflation expectations surged, but longer-term ones moved little.
- These similarities point to the global nature of the experienced high inflation.
  - Idiosyncratic factors and different policy responses played a less critical role.

Implications of Inflation Dynamics for Monetary Policy Strategies

Overview:

- Compares the performance of two policy strategies using macroeconomic models.
  - Flexible average inflation-targeting (FAIT) and flexible inflation-targeting (FIT).
- Describes main qualitative features of optimal policy when the objectives of stabilizing inflation and economic activity conflict.

Key Takeaways:

- When the ELB risk is significant:
  - FAIT can provide better macroeconomic performance than FIT.
  - The performance gap between strategies is largely eliminated when policymakers operating under FIT also use appropriately calibrated explicit forward guidance.
- When the ELB risk is less prevalent, the performance gap between strategies decreases.
- With temporary cost-push shocks, the optimal policy follows a balanced approach.

Accounting for Uncertainty and Risks in Monetary Policy

Overview:

- Reviews the policy-relevant forms and measurement of risks and uncertainties.
- Discusses the main tools to communicate uncertainty and the balance of risks employed by major central banks.

Key Takeaways:

- Central banks use several tools to assess uncertainty and the balance of risks.
  - For example, fan charts, scenario analysis, statistical and econometric modeling.
  - But these tools require choosing models and the data and identifying key risks.
- Central banks can communicate risks and uncertainty using various tools.
  - Qualitative communication is the main tool used by central banks.
    - Policy statements, press conferences, minutes and public speeches.
  - Quantitative communication is also employed but can be difficult.

Monetary Policy, Uncertainty, and Communications

Overview:

- Discusses the design and communication of a robust monetary policy from a risk-management perspective in the context of a broad range of economic conditions.
- Addresses the benefits and costs of using alternative scenarios as a communication tool.

Key Takeaways:

- A robust policy strategy incorporates risk management through the weighing of key risks.
  - When risks are balanced, the baseline outlook may be sufficient to guide policy decisions.
  - When risks are asymmetric, risk-management considerations become important.
- Alternative scenarios can be useful in monetary policy deliberations and external communications.
  - They can illustrate salient risks and how policy might respond if the risks occur.
  - However, using alternative scenarios requires important implementation choices.

Revised Statement on Longer-Run Goals and Monetary Policy Strategy

Statement on Longer-Run Goals and Monetary Policy Strategy

Paragraph 1:

The Federal Open Market Committee (FOMC) is firmly committed to fulfilling its statutory mandate from Congress of promoting maximum employment, stable prices, and moderate long-term interest rates. The Committee seeks to explain its monetary policy decisions to the public as clearly as possible. Such clarity facilitates well-informed decisionmaking by households and businesses, reduces economic and financial uncertainty, increases the effectiveness of monetary policy, and enhances transparency and accountability, which are essential in a democratic society.

Statement on Longer-Run Goals and Monetary Policy Strategy

Paragraph 2:

The Committee's monetary policy strategy is designed to promote maximum employment and stable prices across a broad range of economic conditions. Employment, inflation, and long-term interest rates fluctuate over time in response to economic and financial disturbances. Monetary policy plays an important role in stabilizing the economy in response to these disturbances. The Committee's primary means of adjusting the stance of monetary policy is through changes in the target range for the federal funds rate. ~~The Committee judges that the level of the federal funds rate consistent with maximum employment and price stability over the longer run has declined relative to its historical average. Therefore, the federal funds rate is likely to be constrained by its effective lower bound more frequently than in the past. Owing in part to the proximity of interest rates to the effective lower bound, the Committee judges that downward risks to employment and inflation have increased.~~ The Committee is prepared to use its full range of tools to achieve its maximum employment and price stability goals**, particularly if the federal funds rate is constrained by its effective lower bound**.

Statement on Longer-Run Goals and Monetary Policy Strategy

Paragraph 3:

Durably achieving maximum employment fosters broad-based economic opportunities and benefits for all Americans. The Committee views maximum employment as the highest level of employment that can be achieved on a sustained basis in a context of price stability. The maximum level of employment is ~~a broad-based and inclusive goal that is~~ not directly measurable and changes over time owing largely to nonmonetary factors that affect the structure and dynamics of the labor market. Consequently, it would not be appropriate to specify a fixed goal for employment; rather, the Committee's policy decisions must be informed by assessments of the ~~shortfalls of employment from its~~ maximum level **of employment**, recognizing that such assessments are necessarily uncertain and subject to revision. The Committee considers a wide range of indicators in making these assessments.

Statement on Longer-Run Goals and Monetary Policy Strategy

Paragraph 4:

Price stability is essential for a sound and stable economy and supports the well-being of all Americans. The inflation rate over the longer run is primarily determined by monetary policy, and hence the Committee ~~has the ability to~~ **can** specify a longer-run goal for inflation. The Committee reaffirms its judgment that inflation at the rate of 2 percent, as measured by the annual change in the price index for personal consumption expenditures, is most consistent over the longer run with the Federal Reserve's statutory **maximum employment and price stability** mandate**s**. The Committee judges that longer-term inflation expectations that are well anchored at 2 percent foster price stability and moderate long-term interest rates and enhance the Committee's ability to promote maximum employment in the face of significant economic disturbances. ~~In order to anchor longer-term inflation expectations at this level, the Committee seeks to achieve inflation that averages 2 percent over time, and therefore judges that, following periods when inflation has been running persistently below 2 percent, appropriate monetary policy will likely aim to achieve inflation moderately above 2 percent for some time.~~ **The Committee is prepared to act forcefully to ensure that longer-term inflation expectations remain well anchored.**

Statement on Longer-Run Goals and Monetary Policy Strategy

Paragraph 5:

Monetary policy actions tend to influence economic activity, employment, and prices with a lag. ~~In setting monetary policy, the Committee seeks over time to mitigate shortfalls of employment from the Committee's assessment of its maximum level and deviations of inflation from its longer-run goal.~~ Moreover, sustainably achieving maximum employment and price stability depends on a stable financial system. Therefore, the Committee's policy decisions reflect its longer-run goals, its medium-term outlook, and its assessments of the balance of risks, including risks to the financial system that could impede the attainment of the Committee's goals.

Statement on Longer-Run Goals and Monetary Policy Strategy

Paragraph 6:

The Committee's employment and inflation objectives are generally complementary. However, ~~under circumstances in which~~ **if** the Committee judges that the objectives are not complementary, it ~~takes~~ **follows a balanced approach in promoting them, taking** into account the ~~employment shortfalls and inflation deviations~~ **extent of departures from its goals** and the potentially different time horizons over which employment and inflation are projected to return to levels judged consistent with its mandate. **The Committee recognizes that employment may at times run above real-time assessments of maximum employment without necessarily creating risks to price stability.**

Statement on Longer-Run Goals and Monetary Policy Strategy

Paragraph 7:

The Committee intends to review these principles and to make adjustments as appropriate at its annual organizational meeting each January, and to undertake roughly every 5 years a thorough public review of its monetary policy strategy, tools, and communication practices.

End