



FEDERAL RESERVE BANK
OF PHILADELPHIA

TO: FOMC

FROM: Charles I. Plosser

SUBJECT: Comments Regarding October 15, 2010 Videoconference

Because my ability to connect in to this afternoon's videoconference is not certain, I am circulating my thoughts on the issues to be discussed in advance.

As most of you know, I have been a long-time advocate of our adopting an explicit numerical definition of price stability – or inflation targeting – and for increasing the transparency of our communications with the public. I believe both would improve the effectiveness of our policymaking.

But that being said, I believe it is premature for us to adopt a new framework for monetary policy. I believe that such changes in framework should be done only rarely. The framework is what disciplines our policymaking and limits our ability to change policy in a discretionary manner. It seems to me that we need to know a lot more about the pros and cons of each framework before choosing one. We need to think not only of how the framework might work in the current economic environment, which seems to be to focus of much of the discussion, but how it might work when we need to reverse course. We need better estimates of the potential benefits and costs of each framework. We need to better understand the transmission mechanism of quantitative easing or price-level targeting on the real economy. We need to know what our next steps would be should the framework not perform as we might expect. (If, as the staff memo says, it would take some time to implement changes to the way we report our economic projections, surely it should take time to adopt a new policy framework.)

Let me turn now to the discussion questions.

(1) The first question asks for our views on the three ways of specifying the objectives for monetary policy – qualitative dual mandate, explicit inflation objective, or price-level objective.

I have been in favor of an explicit inflation objective for quite some time. Indeed, setting and announcing such a goal should be the first step in any discussion of changes to our framework. I do not favor price-level targeting at this time. It might make sense if we had full credibility and commitment, but we aren't operating in such a world.

Indeed, I am somewhat troubled by the way the discussion has been framed. We seem to be mixing two separate models with little coherence. The basis for the price-level targeting framework is the Woodford and Eggertsson (WE) model in which the central bank has complete credibility, is operating at the zero bound, and wishes to raise inflation expectations. With complete credibility and commitment, the central bank is able to manipulate the public's expectations of inflation at will. It can raise inflation expectations for a time to reach a desired price level and then allow inflation to revert back to zero or to a particular price path if there is a desired nonzero inflation rate (as in President Evans' earlier memo) or what might correspond to optimal policy in the model. But in the WE framework, as noted by Woodford, quantitative easing plays no role and would be completely ineffective. It is by changing the public's expectations about the likely future path of short-term rates that the central bank can lower long-term interest rates, and not by adjusting the amount of securities in the hands of the private sector (so-called portfolio balance effects). Yet, when we have discussed asset purchases (or quantitative easing) we have emphasized that the effect on longer-term interest rates is through these portfolio balance effects.

If you want to argue that the asset purchases are a commitment device the central bank can use to make credible to the private sector its commitment to a particular kind of future policy, then we would seem to

be combining two separate models. In the price-level targeting framework, we are acting as if we are in a Woodford-Eggertsson world with complete credibility. But we are also discussing doing quantitative easing as if we weren't completely credible. The problem is that in a world without complete commitment or where policymakers have limited credibility, we do not know what optimal policy would look like or what the role or consequences of quantitative easing would be.

If our goal is simply to raise inflation expectations using quantitative easing without a well defined model in which that represents a desirable or optimal policy, then credibility issues and the transmission issue loom large. If we act to raise inflation expectations above our goal (a goal that we have yet to articulate or commit to), are we convinced we would be able to return to a lower inflation rate when we wanted to? Would we be prepared to exit from our large balance sheet at least as rapidly as we expanded it in order to signal our commitment? Unless we are, we should think twice about embarking on such a strategy. This uncertainty regarding the implications for the exit path is one of the important potential costs of engaging in a quantitative easing or a price level targeting program and one that we must assess in advance – before we go down this road.

(2) The second question asks if additional policy accommodation is needed whether I would favor additional asset purchases.

I think the important part of that question is how we go about determining whether additional policy accommodation is needed or not.

At earlier meetings I have said that if we were really worried about deflation then an aggressive quantitative easing might be appropriate as a commitment and credibility mechanism. In the case where

deflation is a serious risk, the benefits of quantitative easing may outweigh the costs. But here too, I am somewhat uncomfortable for the reasons I have just outlined above. That is, what will be our exit strategy and what will we have to do to make that strategy credible at the time? How confident are we that we will be able to affect the public's expectations in the appropriate way? To me, the results in the Cleveland Fed memo suggest how difficult it may be to bring inflation back down after raising inflation expectations. I think we are treading on very dangerous ground here and the consequences could be dire. Trying to effect expectations at this point and with our credibility at least partially suspect may be quite risky and have serious long-term consequences.

These risks seem especially relevant when the magnitude of the benefits to the real economy may be quite minimal. What do we think those benefits would be? I don't believe we know enough about the transmission mechanism of quantitative easing to the real economy. The empirical evidence we have to date suggests the effects would be small. Yes, we can make assumptions of how the level of assets purchased may translate into long-term interest rates – the estimates from our purchases over the last two years have wide error bands. But again as Woodford and Eggertsson point out, this drop in long-term interest rates need not translate into economic stimulus.

Thus, I do not think it is a good idea to engage in further quantitative easing until we have made it clear and explicit that we have, in fact, agreed on an inflation target and that we have more substantial evidence that we need to take aggressive and unusual steps to defend it. I started out my term on the Committee with a desired target of 1 or 1.5 percent and inflation is running in that range – year-over-year PCE inflation is 1.5 percent. It's been running at the low end of this range in 2010, but I'm not concerned since we often see such volatility in the monthly numbers and we have faced large fluctuations in many relative prices. The Committee's longer-run projections are between 1.5 and 2.0, but we have not explicitly agreed on this as our target range. Some on the Committee might even argue we need a higher

inflation target now to avoid the zero bound. It is going to be very difficult to engage in a policy of raising the public's inflation expectations before we have conveyed to them what our normal inflation target is. We risk confusing everyone.

(3) The third question asks whether we prefer large, discrete adjustments or smaller, more continuous adjustments if we engage in further asset purchases.

Should deflation become a significant risk, I have been inclined to favor larger, discrete adjustments, as we would need to affect expectations. We do not understand enough about the transmission mechanism of our asset purchases to the real economy to try to use asset purchases in the same way we do changes in the fed funds rate. Consequently, we shouldn't try to convey to the public that these tools are similar. So I am not disposed toward a gradual approach. How would we determine when it was time to stop, slow, or speed up such a purchase program? What would we need to see in terms of changes in interest rates, output, and employment as we engage in such a quantitative easing policy in order to assess whether it is being effective or not? If we are to re-evaluate at each meeting, what would we look at and how would we know it is working as intended? I, like President Bullard, am in favor of making policy conditional, but the crucial question is – conditional on what? We have only limited evidence on the impact of our previous quantitative purchases on long-term interest rates, and those estimates are not very precise and there is no theory or evidence that mapping them into a funds rate target is a desirable, much less, optimal strategy. It strikes me that a gradualist approach may risk conveying to the public that we know how to fine-tune an asset purchase program to achieve our objectives when, in fact, we don't.

The staff memo's S,s rule assumes the Committee commits to reducing the balance sheet at a rate of 10 percent per quarter once the fed funds rate rises above 25 basis points. This commitment is important. But it isn't clear this 10 percent rate is optimal or desirable and it isn't clear it would be easy to

communicate his type of policy to the public. If large purchases were necessary to impact expectations and make our policy credible, might not we need to act symmetrically? If we are going to consider further asset purchases, I would want us to commit in our statement to reducing the balance sheet conditional on a specific set of outcomes for inflation and unemployment. We need to discuss what those outcomes should be.

(4) The fourth question pertains to the sample policy statements.

We have a fundamental problem with the statements as a transparent communications device. In particular, the statement is now supposed to represent the Committee's views and not just the Chairman's. This works fine when the view among members is similar. But in times when the diversity of views is large, it is difficult to see how the statement can be very transparent yet representative. I would favor the Chairman's doing a press conference in which he could explain the rationales.

My preference would be for us to announce our inflation target separately from our meeting statement. This could be done once a year with the monetary policy testimony or part of the January projections. Similarly, an estimate of the Committee's assessment of the long-term steady-state unemployment rate could be part of that testimony as well. Indeed, because Congress has given the Fed its mandate, the Fed should be careful not to by-step Congress in interpreting the mandate. The FOMC statements need not reiterate the goal each time, but would indicate whether current and projected inflation is inline with our goal, and similarly for unemployment and the long-run unemployment rate.

I would prefer that we include in our projections a range and central tendency for our policy path – say the level of the fed funds rate in the fourth quarter of each year over the forecast horizon. I don't think we have enough information on which to make credible projections of the size of our balance sheet, so I

wouldn't want to include them.

In summary:

I believe there is still a lot of work to be done before launching into a new framework, particularly as it pertains to the use of balance sheet as an instrument of policy. The fact that Congress is unable or unwilling to act on appropriate fiscal policy is not a reason for us to change monetary policy or our framework – we need to assess the costs and the benefits. Without this, we might even be viewed as changing our framework to justify any and all policy actions. In other words, it could be seen as a policy change of convenience, or simply another form of discretion, rather than principle and thus could cause significant damage to our credibility and undermine our effectiveness.