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The Monetary Policy Rescuer: A Long-Run Nominal Interest Rate Target

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Abstract

Is U.S. monetary policy aging? To find the answer we develop a framework to quantify the magnitude of monetary stimulus offered during a recession. The proposed framework estimates that, over the last 30 years, the FOMC offered larger incentives and for a longer duration in a recession relative to the past cycle. Therefore, our work suggests that monetary policy is aging. To de-age monetary policy we propose 4% as a long-run target for the nominal FFR. Some of the major benefits of our proposed framework include: helping market participants gauge whether the current stance is accommodative/restrictive; anchoring policy watchers' expectations in the sense that analysts would expect the FFR to stay close to its target; and reduce the risk that the FFR would hit and stay at the zero lower bound for an extended period of time.

Introduction

This paper proposes a framework to quantify the magnitude of monetary stimulus offered during a recession. That is, whether the FOMC needs to cut the fed funds rate (FFR) by 500bps to combat a recession? Or the magnitude of the stimulus is larger/smaller for a recession compared to other recessions. The analysis estimates that, in each recession since the mid-1980s, the FOMC offered larger incentives to stimulate the economy in a recession compared to the past cycle. In addition, those incentives were offered for a longer duration relative to the past cycle. Furthermore, each recession in our analysis drained the FOMC's resources and left the Committee with 'less ammunition' to combat the next recession. Therefore, our work suggests that monetary policy is aging.

To de-age monetary policy, our work proposes that the FOMC may need to declare a commitment to an explicit long-run nominal policy rate target. One major reason of the diminishing effectiveness of monetary policy is the lack of an explicit long-run FFR target. Due to the absence of a long-run FFR target, market participants are unable to gauge whether the current policy stance is accommodative or restrictive and by what magnitude? One supposed benchmark is the equilibrium interest rate, or r-star. However, there are at least half a dozen different measures of the r-star which makes it very difficult to evaluate monetary policy accommodation. Additionally, we are not just looking for a benchmark to evaluate policy stance but also an expectations anchor. That is, an anchor in the sense market participants expect that the FFR would return to the target in the medium to long-run. We propose 4% as a long-run target for the nominal FFR and believe a long-run target may change the current declining FFR trend and, thereby, boost the effectiveness of the monetary policy.

Is Monetary Policy Dying?

The FFR is a key tool of U.S. monetary policy. The FFR can be seen as an incentive/discount as well as a disincentive/penalty. Typically, the FOMC reduces FFR during recessions/slowdowns to stimulate the economy. Conversely, during expansions, the FOMC tends to raise the FFR to prevent the economy from overheating. Therefore, monetary policy affects the economy through discount/penalty channels.

Our proposed framework analyzes the effectiveness of the incentive/disincentive channel and thereby the aging of the monetary policy. The first step determines the peak and trough in the FFR for each business cycle. The second phase incorporates the pace/duration of monetary policy changes in relation to the FFR peak/trough. The peaks/troughs are important factors which shed light on the potential incentives/disincentives channels. That is, a lower peak in the FFR, compared to the previous cycle's peak, would suggest the FOMC has fewer incentives to offer in the current cycle given the zero lower bound of the nominal FFR. By the same token, a lower trough relative to the past cycle would suggest a longer time is needed to rebuild the ammunition box, all else equal. Additionally, a faster rate cut would utilize available incentives quickly and longer duration of the easing period may reduce available resources to fight the next recession.

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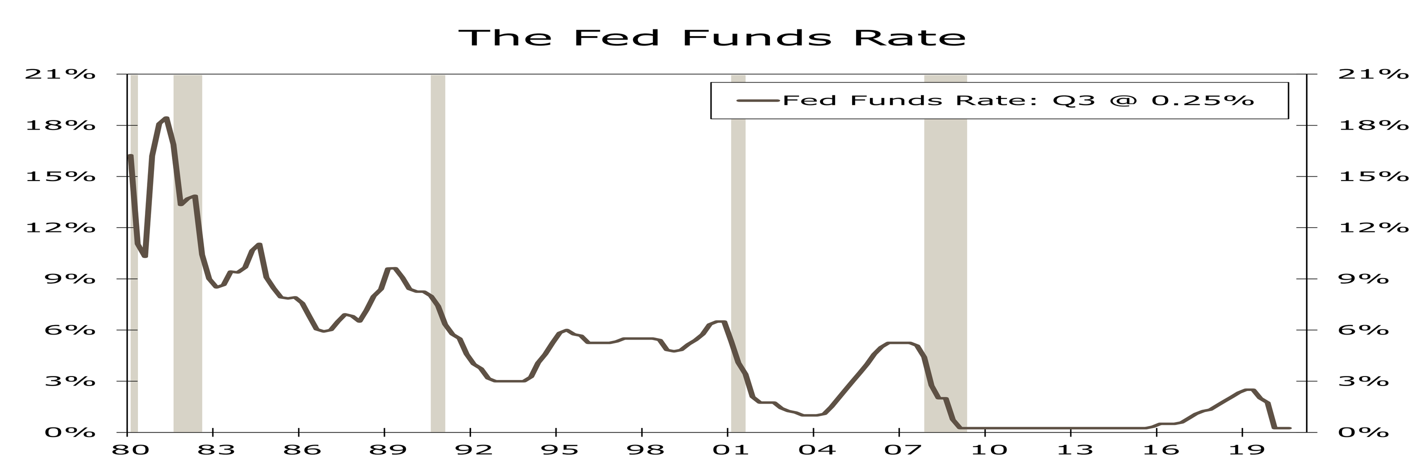
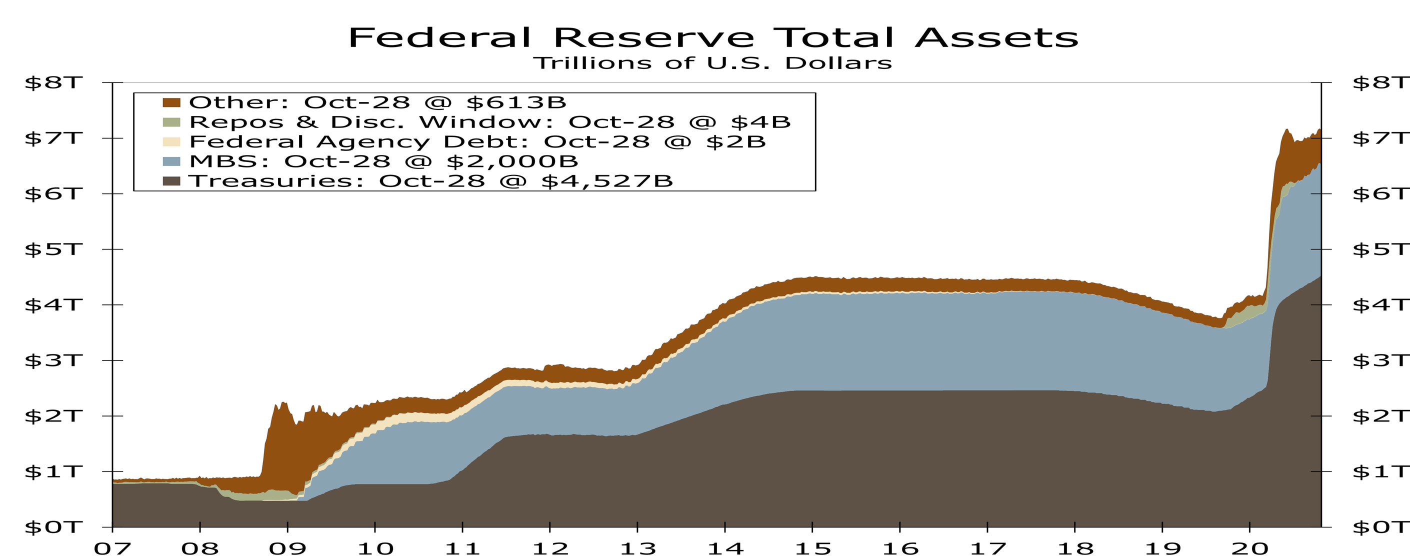
De-Aging Monetary Policy

We propose 4% as a long-run target for the nominal FFR. Some of the major benefits of our proposed framework include: helping market participants gauge whether the current stance is accommodative/restrictive and its magnitude; anchoring policy watchers' expectations in the sense that analysts would expect the FFR to stay close to its target; reduce the risk that the FFR would hit and stay at the zero lower bound for an extended period of time; reduce changes in the Fed's balance sheet by providing enough room to cut rates in the case of a slowdown/recession; and, with the inflation target rate set at 2%, ensure that the real FFR will be positive when the FOMC meets its interest rate and inflation targets. Therefore, a long-run target may change the current declining FFR trend and, thereby, boost the effectiveness of the monetary policy.

Results





Recession	level change during recession	percentage change	number of Rate Cuts	Change from previous peak	% Change from previous Peak	Months of Easying**	Pre-recession Peak	Recession Trough	Post-recession Trough
July 1990 - Mar 1991	2.50%	30.30%	16	6.75%	69.20%	44	9.75%	6.00%	3.00%
Mar 2001 - Nov 2001	3.75%	68.20%	12	5.50%	84.60%	42	6.50%	2.00%	1.00%
Dec 2007 - Jun 2009	4.25%	94.44%	8	5.00%	95.20%	100	5.25%	0.25%	0.25%***
Feb 2020--*	1.50%	85.70%	2	2.25%	90.00%	N/A	2.50%	0.25%	0.25%***

*NBER did not announce a Trough for the 2020 recession, yet ** Rate cuts plus rate on hold *** The FOMC started QE

Conclusions

Our study develops a new framework to quantify the magnitude of monetary stimulus offered during a recession. The framework suggests that monetary policy is aging in the sense it offers larger incentives and those incentives remain in place for longer duration to stimulate the economy in each of the last three business cycles. The analysis proposes that in order to de-age (and to revive the effectiveness of) monetary policy, the FOMC may need to declare a commitment to an explicit long-run nominal policy rate target. We suggest 4% as a long-run target for the nominal FFR. Studies show that the FOMC may be already trying to influence market participants' expectations through the meeting's statements and SEP/dot-plot chart, but those tools lack explicit commitment by the FOMC to maintain a certain level of the FFR. Therefore, we suggest that by declaring a long-run FFR target would show an explicit commitment by the FOMC to maintain the rate close to the target in the medium to long-run. Put differently, a long-run target may change the current declining FFR trend and, thereby, boost the effectiveness of the monetary policy and the FOMC (and other central banks) should entertain the idea of declaring an explicit long-run policy rate target.