William Dudley and Carolyn Wilkins

The Federal Reserve Monetary Policy Framework Review: A Comprehensive Approach to Improve Robustness

On Thursday, May 1, William Dudley and Carolyn Wilkins joined Markus' Academy for a conversation on the Group of Thirty's recent report on "The Federal Reserve Monetary Policy Framework Review: A Comprehensive Approach to Improve Robustness." Dudley is currently a Senior Advisor at the Griswold Center for Economic Policy Studies at Princeton University and previously served as the President and CEO of the Federal Reserve Bank of New York. Wilkins is an external member of the Financial Policy Committee at the Bank of England and a visiting senior research scholar at the Griswold Center for Economic Policy Studies at Princeton University.

A few highlights from the discussion.[1]

- **A summary in three bullets**
  - The Fed's 2020 Framework was designed for a low inflation world, and it turned out to be poorly suited for the rapid demand recovery and supply shocks we saw after Covid
  - The new framework should be robust to risks on both sides of the dual mandate. The report has 6 main proposals, including ending flexible average inflation targeting, a more balanced approach to the dual mandate, and developing a comprehensive cost-benefit framework for QE/QT
  - Doing the review well is important for the credibility of the central bank, and credibility is important for independence. Not making any changes would entail not admitting that there were any shortcomings with the prior framework. It is good that central banks know there are lessons to learn

- **[0:00] Markus' introduction**
  - Government debt is at a historic peacetime high, raising risks of monetization and inflation; central bank independence remains the only safeguard
  - Recent turmoil and liquidity incidents in government bond markets have forced large central bank interventions. However, in an inflationary environment financial stability and monetary policy goals may conflict
  - Large central bank losses from paying interest on reserves have created quasi-fiscal costs. This link between monetary and fiscal policy may pose risks to central bank independence
  - One of the effects of QE is to remove duration risk from the private sector (placing it at the central bank); this may require more aggressive rate hikes to tighten policy effectively. The optimal "preparatory" QE rule should account

[1] Summary partly based on the Executive Summary of the G30 Report. Produced by Pablo Balsinde (PhD student, Stockholm School of Economics)

for this amplification effect on rate increases (Alexandrov and Brunnermeier, 2025)

- [6:13] **Shortcomings of the 2020 Framework**
    - The purpose of the Fed's 2025 monetary policy framework review is to re-examine the 2020 framework in light of post-Covid lessons
    - The 2020 framework had two key features. First, it introduced Flexible Average Inflation Targeting (FAIT), which promised temporary overshoots of 2% inflation after past periods of inflation undershoots. The idea was to avoid being stuck at the ZLB, and to re-anchor expectations away from it
    - The FAIT was asymmetric in that periods with inflation above 2% would not be compensated with periods of below-2% inflation
    - Second, it set its employment objectives to minimize "shortfalls" from maximum employment, rather than having a two-sided test focused on any "deviation" from maximum employment. It effectively had the Fed push the economy to maximal employment until tightening was necessary. The idea was to prevent inflation expectations from being anchored below 2%
    - However, the flexible inflation targeting reinforced a bias for the Fed to tighten monetary policy too late. In early 2022 it still had 0% rates while inflation exceeded 5%
    - The Fed's failure to tighten preemptively in 2021 can also be attributed to a series of bad forecasts—the recovery was much stronger, the labor market much tighter, and inflation much higher than the Fed had anticipated
    - The sequencing guidance, where the Fed said they could not raise rates until QE was tapered off and finished, also postponed the first rate hike
    - QE also had the unintended consequence of ballooning bank balance-sheets. Investors deposited the proceeds from selling assets to the Fed at banks, and with these deposits banks bought long-term fixed rate assets. This became a problem as the deposits were volatile and short-term in nature, while the assets lost value after the rate hikes, leading to several regional bank failures
    - QE also produced unanticipated losses for the Fed: as it raised rates, interest payments to commercial bank reserves exceeded its earnings from assets. The Fed had accumulated $224bn in losses as of March 2025
    - The losses were a consequence of the maturity mismatch in the Fed's balance sheet, and not due to the shift from a corridor to a floor system of reserves
    - The Fed also had some communication gaps: the specifics of FAIT were unclear, there was no guidance on how the inflation-employment trade-off would be managed, and the lack of scenario-based forecasts in the Fed's Summary of Economic Projections led to an excessive focus by the market on the median projection and its "dot plot"

- [30:10] **6 recommendations from the report**
    - 1. End FAIT. It was ambiguous and was ill-suited to a period of upward shocks to inflation. A return to a symmetric 2% inflation target would restore clarity and anchor expectations while supporting timely action in the face of both inflationary and disinflationary shocks

- 2. Change the employment objective back to seeking the maximum level of employment consistent with its 2% inflation objective. This would restore a more balanced approach to the dual mandate. Excessively tight labor markets can pose an inflation risk even before price inflation is visible
- 3. Explain trade-offs explicitly when inflation and employment objectives are in conflict
- 4. Develop a comprehensive framework for QE/QT tightening that includes a means for systematically evaluating a program's costs and benefits. Ideally these analyses would be published before launching asset purchases
- These analyses would assess risks to financial stability and potential losses to the Fed, and would distinguish between asset purchases to support market functioning and purchases to provide monetary policy stimulus
- The QE framework would also have pre-defined criteria for tapering or ending QE, in this way avoiding rigid sequencing (requiring QE to end before rate hikes), and would explain the desired long term size and composition of the Fed's assets and liabilities
- 5. Publish staff forecasts at the conclusion of each FOMC meeting with alternative scenarios for the paths of interest rates and the economy
- 6. Develop a forward-guidance playbook that distinguishes between calendar-based and economic condition-based guidance. When rates are at the effective lower bound, forward guidance becomes more important, though public understanding is often limited

- [52:18] **Additional proposals**
  - The report agrees with the Fed's decision of maintaining the 2% inflation target; raising it could hurt its credibility by signalling an inability to achieve the existing target
  - While beyond the scope of the Fed's 2025 framework review, the report makes several other suggestions:
  - 1. Make the interest on reserves (IOR) the main policy rate. The federal funds rate market is increasingly idiosyncratic. It basically consists of GSEs selling reserves (which they cannot earn interest on) to foreign banks (which can earn interest). We have seen that the IOR is a sufficient tool to control money market rates
  - Removing a FFR target would allow for removing things like the reverse repo facility, which was introduced in 2013 to set a floor to prevent the FFR from trading outside the target range
  - 2. Fix the supplemental leverage ratio (SLR) by exempting reserves from the ratio, which is justified since reserves have no risk. This leverage ratio on bank capital can create a conflict between regulation and monetary policy, as QE expands bank assets and makes the SLR binding
  - The main counterargument is the slippery slope: exempting reserves could lead to pressure to exclude other assets, like T-bills, to help primary dealers support the Treasury market in times of stress. However, from a monetary policy standpoint, only reserves warrant exemption
  - 3. Better integrate monetary policy with bank supervision and financial stability. If there is no financial stability monetary policy becomes ineffective

Timestamps:
[0:00] Markus' introduction
[6:13] Shortcomings of the 2020 Framework
[30:10] 6 recommendations from the report
[52:18] Additional proposals