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Analysis of the New Changes in Monetary Policy under Powell and the Current Situation in the U.S.

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Abstract: When Powell assumed office on February 5, 2018, his main monetary idea was to adopt a risk management strategy based on the core components of the traditional Fed policy in order to stabilize the market economy. The 2% inflation target was changed to an average inflation control of 2% over a period of time, meaning that the inflation rate may exceed 2% over time; in addition, the unemployment rate was repositioned to adopt the principle of employment maximization and no longer specify a target. However, as a result of its previous policy, the U.S. stock market equity index experienced a significant year-long decline. When this policy is implemented, the U.S. economy experienced a significant boost after the epidemic's impact on February 2020. There were numerous negative effects, though, and in 2022 the U.S.'s inflation rate shot up quickly and is now a startling 9%. Is the current state a result of the new monetary policy framework's introduction? Is there another reason? Using the time period from Powell's inauguration in 2018 to June 2022, this paper will examine the causes of the change between the old and new U.S. frameworks as well as the current state of the country's economy under the new framework.

Keywords: monetary policy, Fed, new monetary policy framework, Powell

1. Introduction

Throughout the world, in every market economy, there is a monetary policy that is adapted to the system. Monetary policy is like an invisible hand that adjusts the flow of money in the market to maintain the healthy and stable operation of the economy in each market so that the supply and demand in the market can reach a balance in the expected direction, thus stabilizing market prices and enhancing employment. This feature of monetary policy is widely recognized by countries around the world, and the United States is no exception. Therefore, the Federal Reserve—the maker of monetary policy in the U.S.—has made maintaining price stability and full employment two of its major missions [1].

Monetary policy, as an important policy of the state apparatus, can promote the stable and healthy development of the economy when properly implemented, but may cause economic stagnation if not properly implemented, which may lead to a series of economic crises. Taking the 2008 subprime mortgage crisis in the United States as an example, in the monetary policy from 2002 to 2005, the Federal Reserve adopted an excessively loose monetary policy federal funds rate at a low level for a long time, to a certain extent to guide the economy of individual "speculation fever in real estate". In addition, the Fed's lack of supervision of banks also made subprime loans at the time of lack of control, thus causing the economic crisis in 2008. After the economic crisis, the Federal Reserve adopted quantitative easing to get the U.S. economy out of the subprime crisis in 2008. This initiative not only brought down the benchmark interest rate but also contributed to the boom in the stock market at the time, allowing the U.S. economy to recover in a smooth and healthy direction [2]. This shows that monetary policy plays a tremendous role in the country's economy.

After Powell came to power in 2018, he has made a new construction of the traditional Fed monetary framework based on the current economic situation, starting with two major indicators, namely the unemployment rate and inflation rate, for policy reform, thus embarking on a new framework of Fed monetary policy. This article analyzes the transformation of the new framework on the basis of previous studies and develops on the basis of previous studies to analyze and draw insights from the current economic dilemma faced by the United States.

The study of this thesis could help to fill the gap in the current academic field regarding the research on the inflationary spike triggered by 2022 under the new monetary policy framework of the United States and help to provide some useful reference and assistance to other central banks on how to formulate reasonable strategies in the face of the epidemic.

2. Powell's Policy in the Early Days after Taking Office

The introduction of any policy is inseparable from the social situation at the time, so at different times, have different goals, and at the same time, develop different policies. During Bernanke's time, the United States was suffering from a serious subprime mortgage crisis and the U.S. economy was under downward pressure. Under this premise, Bernanke adopted the monetary policy of quantitative easing. After 2008, the implementation of several rounds of QE enabled the Federal Reserve to buy a large number of Treasury bonds and a large number of MBS purchases to inject a lot of liquidity into the market. After Bernanke left office, the new chairman of the Federal Reserve, Yellen, took power. Since that time, the U.S. economy has been in the post-crisis recovery period of development. Yellen did not use large-scale QE like Bernanke, but only through the manipulation of interest rates to regulate the economic operation. From 2015 to 2018, the flat rate was hiked many times to promote the recovery of the U.S. economy.

After Powell came to power, facing the status quo of obvious economic development, the unemployment rate declined year by year; the U.S. GDP has been running smoothly in recent years; the inflation rate remained close to 2% for a long time; and the overall rise in the market value of the stock market. After analyzing all the realistic data at that time, Powell believed that the economy should have a new direction at that moment. He believes that the biggest problem to deal with after taking office is not the problem of inflation, not the problem of unemployment, and not the problem of stock prices, but the low interest rates and quantitative easing policies used in the previous period that led to a large amount of capital flowing to high-risk areas, and how to solve the aftermath of this is the most important part of the next work.

In 2018, the Federal Reserve projected the level of the neutral interest rate in the United States to be roughly 3% in 2019 [3]. This is a big gap between the federal funds rate, which was close to 1.5% when he took office. Based on this, Powell began to formulate some new policies after he took office. However, Powell's rate hikes did not return the U.S. to its pre-crisis economic operating model as he had predicted. But instead, the sudden increase in the federal funds rate led to a shift in liquidity from the stock market and a large amount of liquidity flowed out of the stock market, which led to a sharp decline in the prices of the major U.S. stocks.

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Figure 1: Interest rate of United States [4].

3. Reasons for Policy Changes

In the face of significant stock market movements in the latter half of 2018 due to rising interest rates, the Fed began to look for the root of the problem, and in the course of his analysis, Powell argued that perhaps the monetary policy of the past few years had failed to cope with a new era as time changed.

3.1. Interest Rates Do Little to Moderate the Unemployment Rate

To solve the current problem, it is most important to analyze the unusual aspects of the implementation of monetary policy in the past. Before Powell took office, the Fed had raised interest rates several times between 2015 and 2017. But the multiple rate hikes did not lead to a rise in unemployment as the Fed had envisioned, but instead the unemployment rate fell again and again, as if this had become a monetary policy oddity [4].

The contribution of the federal funds rate to the unemployment rate is negligible. This conclusion has also been confirmed after Powell took office. The unemployment rate generally showed a downward trend after Powell raised interest rates four times in a row after taking office in 2018. It is thus clear that the regulation of the unemployment rate by interest rates under the original monetary policy framework has failed in the current situation, and the feasibility of the original monetary framework deserves further discussion and research.

3.2. Aging Issues Lead to Insufficient Potential Economic Growth

By 2011, the elderly population over 65 years of age in the United States accounted for 13.25% of the total population, and by 2018 it accounted for 15.81% of the total population. The increasing aging problem in the U.S. has decreased the long-term economic growth rate in the U.S., which in turn has affected the potential growth rate of the economy [5], making the potential growth rate of the economy less robust.

The decline in the potential growth rate of the economy means that the natural rate of interest, which had maintained the balance of supply and demand, will need to be adjusted downward to reach the new balance of supply and demand. In January 2012, the Federal Reserve forecasted long-term interest rates at 2.25%, and since then the Fed's valuation of interest rates has continued to fall, reaching as low as 0.5% by June 2020 [6]. In this case, interest rates have been very limited for economic regulation. Once the economy faces downward pressure, relying on interest rate regulation to boost the economy is almost minimal. In other words, using downward interest rates to promote economic development has no room.

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3.3. Low Inflation Becomes the "New Normal"

A look at inflation data from 2013 to 2018 shows that inflation has been below the Fed's 2% inflation target for most of the time. The Fed's inflation forecast for this period was much higher than the actual inflation rate. In the beginning, the Fed's 2% inflation target was set to boost the U.S. economy through a certain amount of inflation. However, under the existing monetary policy framework, the inflation rate generally failed to reach the 2% target and was much lower than the Fed's expected value. The desire to drive economic development through inflation can not achieve the effect expected by the Fed if, in the long run, it is very likely to lead to a downturn in the market economy.

Figure 2: Inflation rate of United States [7].

Figure 3: Expectation of inflation rate of United States [8].

At the same time, the low inflation rate does not cause the unemployment rate to rise, but rather the unemployment rate is decreasing year by year. Under the traditional monetary policy framework, unemployment and inflation alternate with each other. However, at present, the alternation between the two is becoming less and less obvious, which obviously contradicts the traditional monetary policy's theoretical support.

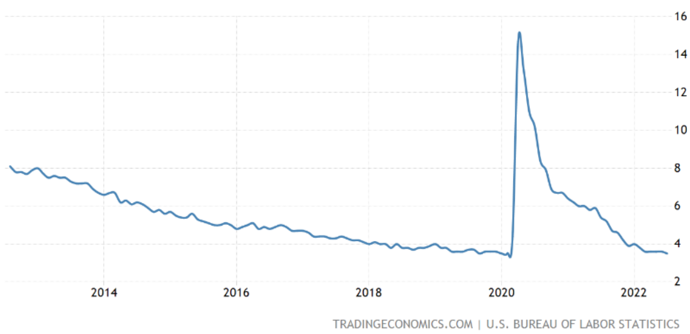

Figure 4: Unemployment rate of United States [9].

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4. The Fed's New Framework for Monetary Policy

At the end of 2018, after analyzing, assessing, and summarizing the economic situation at that time, the Federal Reserve made a new vision of the monetary policy structure based on the current situation to adapt to the current socioeconomic development trends. After more than a year of preparation, Powell released the report "New Economic Challenges and the Review of the Fed's Monetary Policy" (hereinafter referred to as "the Report") in August 2020. The report spells out a new monetary policy framework for the public to address current economic developments. The new monetary policy has been changed primarily in the following areas.

4.1. Deregulation of the Unemployment Rate

The new monetary policy focuses more on the employment aspect and emphasizes that people should be employed as much as possible. While the previous monetary policy focused more on the effects of inflation than employment, the new monetary policy framework shifts the importance of both. If the unemployment rate is lower than the Fed's estimated unemployment level, the Fed will take the corresponding monetary policy in the previous monetary policy framework, such as raising interest rates to make the unemployment rate return to the expected unemployment level and other means. In the current new monetary policy framework, the Fed believes that employment should be maximized and as many people as possible should be employed. Thus, in the face of unemployment rates below the average level predicted by the Federal Reserve, the Fed will not immediately take monetary policy to deal with the current low unemployment problem but rather wait and see what happens to allow more people to be employed [9].

The Fed will make such a change mainly in response to the current unemployment rate declining year by year, the reality of the situation. The current decline in unemployment has not caused inflation to rise. In this case, if the original monetary policy framework is still used, there is a high probability that economic development will be hampered by blindly adjusting the unemployment rate. For example, the use of tight monetary policy makes the unemployment rate return to the original level of the range and makes the economy shrink. Therefore, the Fed has changed its original strategy to make monetary policy move in a more expansionary direction.

4.2. Setting Flexible Inflation Targets

In addition to adjustments to the unemployment rate, the Federal Reserve has also focused on inflation. In the original monetary policy framework, the Fed set the inflation target at 2%, which means that if inflation exceeds 2% or falls below 2%, the Fed will immediately respond by using monetary policy to regulate inflation at around 2% in a timely manner. Under the new monetary policy framework, the average inflation rate over a period of time is maintained at around 2%, which means that the inflation rate does not just look at the current data, but is regulated by observing the average data over a period of time.

For example, if the current inflation rate exceeds 2%, the Federal Reserve will immediately respond by regulating the inflation rate through monetary policy to bring it back to the 2% target level under the old monetary framework. However, under the new monetary policy framework, the Fed will not react immediately but will observe the average inflation rate over a period of time before taking the next step.

This change by the Federal Reserve is undoubtedly a response to the current economic situation. After analyzing the U.S. inflation rate data, it was found that the average inflation rate in the U.S. from 2013 to 2019 was below 2%. According to the new U.S. monetary policy framework, the inflation rate should be above 2% for a certain period of time in order to achieve the target expectation of average inflation at 2%. According to the Fisher equation, it can be derived that the real interest rate is roughly obtained by subtracting the nominal interest rate from the inflation rate. The real interest rate will decrease in the coming period due to the increase in the inflation rate, while the nominal interest rate remains unchanged, which has a significant effect on the current use of interest rates to regulate the economy in the United States. A large amount of capital will flow into the market more actively because of the decline in real interest rates, further promoting economic development.

5. The State of the U.S. Economy under the New Framework

Since the Fed changed its monetary policy framework in August 2020, the Fed's attitude toward inflation has changed at different times, from expecting inflation to enjoying inflation to worrying about inflation, and the Fed has now taken a restraining attitude toward inflation.

At the beginning of the new monetary policy framework, the Fed hoped to promote inflation at the time by changing it to a long-term average of 2%. At that time, the Fed was very eager for an increase in inflation, hoping to implement a more expansionary monetary policy through an appropriate increase in inflation to counter the impact of the new crown pneumonia epidemic in the United States in February 2020 on the U.S. economy. The U.S. unemployment rate has remained high for a long time, especially under the impact of the new crown epidemic. In this context, the Fed's expectations for high inflation are obvious.

In the second year of the new monetary framework, 2021, the Fed begins to enjoy the economic recovery from inflation. In the first quarter of 2021, the U.S. inflation rate began to exceed 2% and soared at a very rapid pace in the first six months of 2021. At the same time, the unemployment rate is gradually declining, gradually returning to values prior to the new crown epidemic. In terms of GDP, after negative GDP growth in the U.S. in FY2020, it turns positive for the first time in 2021. It can be seen that the impact of the new crown on the U.S. economy has been greatly reduced under the new monetary framework, and the Fed is enjoying the dividends from the elevated inflation rate, which as of then seems to have brought the U.S. to a new and unprecedented land.

In November 2021, the Fed introduced a new program called "Taper," which called for a reduction in bond purchases by $15 billion per month as planned, with subsequent plans to be determined based on future realities [10]. The Fed's new program also reflects the Fed's concern about the fast-growing inflation rate and its desire to further reduce the uncertainty of future inflation development by reducing the amount of money in circulation in the market. In addition, Powell also pointed out in November that the current inflation rate should be abandoned as a temporary This statement also reflects the Fed's concern about the uncertainty of the future development of current inflation.

In the months leading up to January 2022, the inflation rate has reached 7.5%. In the face of such high inflation, the Federal Reserve has opened a number of interest rate increases to curb inflation. As of August 24, the Fed's federal funds rate was raised to 2.33% from the original 0.08% (2022.3.16). It can be seen that after 2022, the Fed has begun to move from inflationary concerns to the stage of curbing inflation. Although the Fed has significantly raised its federal funds rate in less than half a year, inflation has still not lost momentum and still continues to move higher.

6. The Relationship Between Monetary Policy and High Inflation Rates

For the current high inflation in the United States, many people have attributed the high inflation to the more expansionary new monetary framework and believe that the Fed's shift from a target system to an average inflation flexibility target system of 2% over time is an important reason for the current high inflation.

However, as far as the formation of the new monetary policy framework is concerned, it is based on the analysis of the current state of the U.S. economy and may not be directly responsible for the current high inflation, but more on the improper application of monetary policy by policymakers under the new monetary framework. The definition of flexible inflation under the new monetary policy framework is an average inflation rate of 2% over a period of time, and given that the average inflation from 2010 to 2019 was below 2%, monetary inflation should be maintained above 2% for a period of time under the new monetary policy framework. But this does not mean that inflation can not be higher. Rather, policymakers need to set expectations for the average flexible inflation rate, how long the next inflation rate will be above 2%, and how much above 2% can be tolerated. However, Powell did not give a reasonable expectation in 2021; instead, he thought that the current inflation was a temporary increase due to the epidemic shock and could return to a reasonable level after a period of time on its own. As a result of this erroneous analysis, inflation continues to rise like a flood in 2022 and can no longer be effectively controlled through monetary policy.

In addition, the current international situation also has an impact on inflation. The outbreak of the Russo-Ukrainian war in early 2022 led to a rapid rise in oil prices, and the U.S. is highly dependent on oil. The rapid increase in gasoline prices in the U.S. in 2022 also reflects the impact of the current international situation on U.S. market prices.

Figure 5: Gasoline price of United States [11].

7. Insights

According to the content of the new monetary framework, the new monetary framework of the United States has adopted a more expansionary monetary policy than the original framework, which is also based on the current impact of the new crown epidemic and the current economic development rate of decline in the reality of the policy adopted. Countries around the world are also facing the ravages of the new coronavirus epidemic. In addition, some countries or regions are also facing the risk of economic downturn. While the Bank of Japan and some European central banks have implemented negative interest rate monetary policies to promote current economic development, the United States may make significant changes to the monetary framework in order to implement some new ideas.

Relevant research focuses on the relativity of regularity and camera selectivity [12]. The Federal Reserve's new framework for monetary policy reflects the needs of current social development and shows that the monetary framework is not static but needs to be changed to suit different times. Therefore, countries around the world should also make changes to their monetary frameworks according to their own national conditions and socio-economic development, so that the monetary policy framework is more flexible under the rules.

However, when learning from the new monetary thinking of the United States, it is also necessary to see its shortcomings. At present, the U.S. economy is in a period of high inflation, and the main reason for this is that policymakers are detached from the real data when analyzing the current economic situation and do not rely on the current economic development-related data to make scientific forecasts for the future economy. Therefore, central banks should make policies based on the current reality, analyze the real data and never predict the future economic direction, make

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reasonable and scientific future policies, and pay close attention to international trends to actively make policy responses to promote the smooth operation of their economies.

8. Conclusion

The importance of monetary policy in a country's economic development is immeasurable, and monetary policy has changed with the times. The new monetary policy framework under Powell's presidency of the Federal Reserve undoubtedly reflects the change of monetary policy with the changing times. The monetary policy under the new monetary policy framework has played a major role in boosting the U.S. economy, especially under the impact of the new crown epidemic, which has enabled the U.S. economy to recover rapidly in 2021. However, the new monetary policy framework will also face new challenges, and the assessment of the refinement of the new framework becomes important. The lack of analysis and experience by policymakers on the form of the new monetary framework has led to the high inflation rate in the US. Central banks should also learn from their past experiences, and when developing a new monetary policy framework, they should fully comprehend current reality and make scientific forecasts based on realistic data, in order to formulate a monetary policy that is in line with reality and ensures the stable and healthy development of their economies.

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