Following Fed Policy Errors and High Inflation, What's Next?

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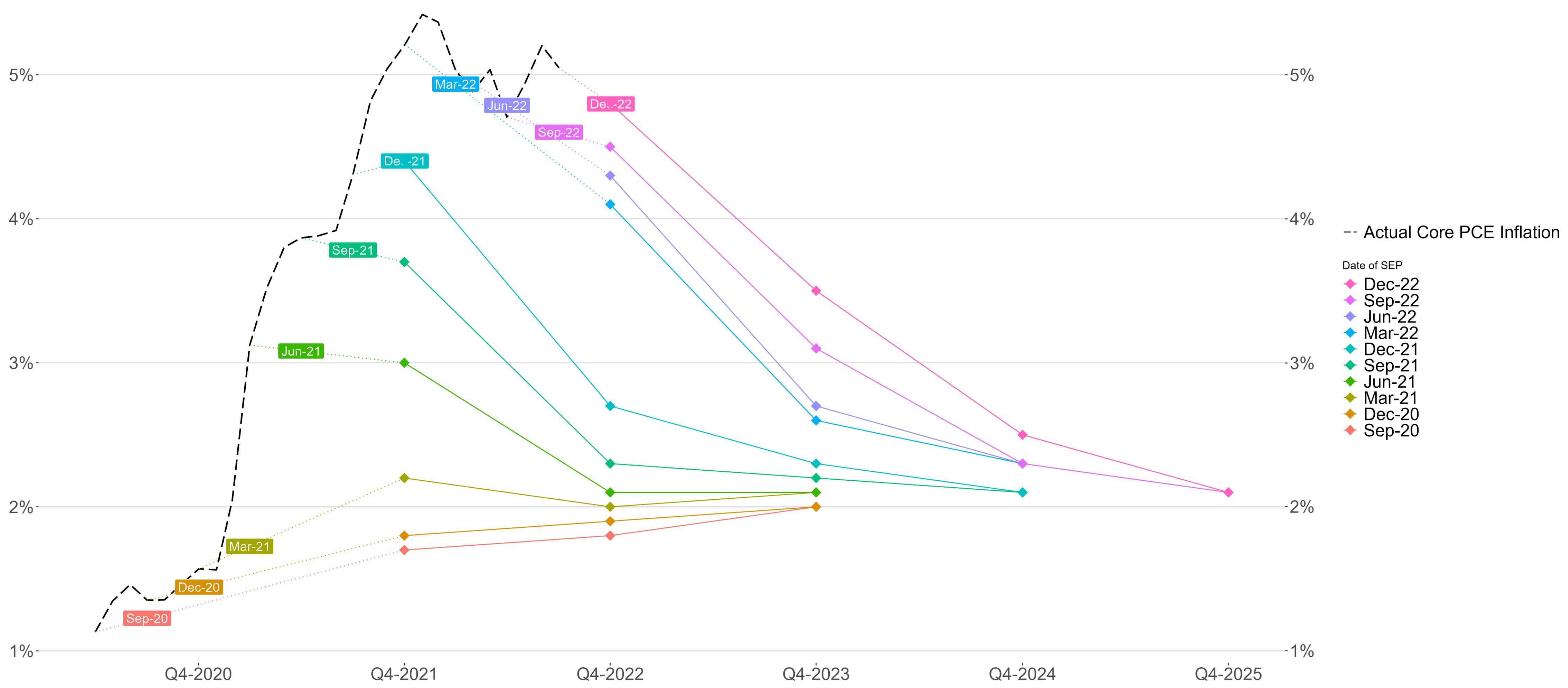
Hoover Institution Economic Policy Seminar

January 4, 2023

Bad Forecasts, Policy Errors and High Inflation Place Fed in Difficult Situation

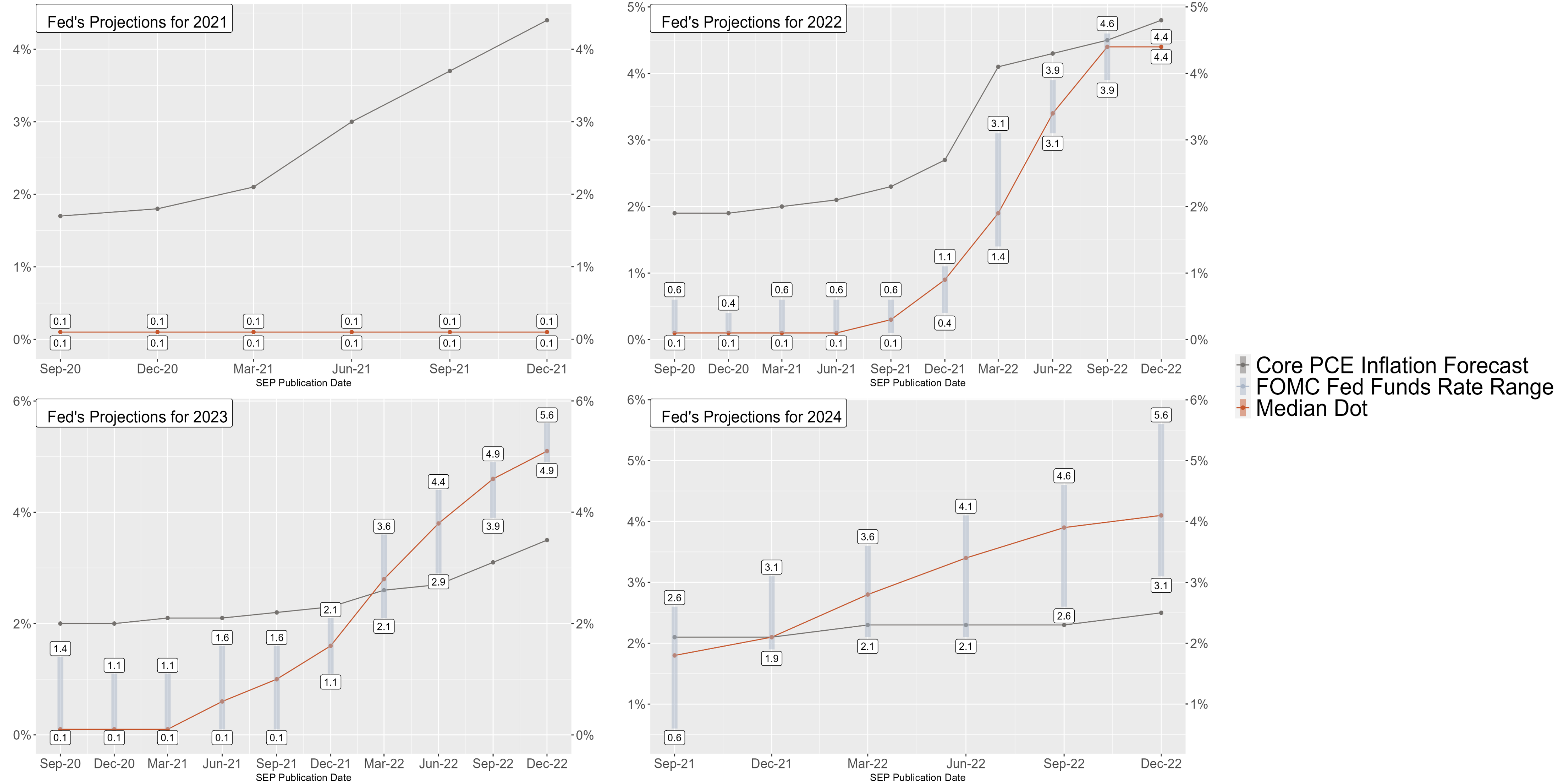
- The Fed’s inflationary monetary policies stemmed from an array of errors and misjudgments
- The Fed’s forecasts were persistently wrong
- The Fed’s mis-estimated the appropriate policy rate required to achieve its inflation and economic forecasts
- Certainly, unprecedented deficit spending was a critical source of excess demand and inflation along with monetary excesses, but
- The Fed must take appropriate steps to reduce inflation to 2%, learn from its mistakes and address its shortcomings

Fed's Forecasts of Core PCE Inflation and Actuals



Sources: Board of Governors of Federal Reserve System, Quarterly Summary of Economic Projections
Notes: Forecasts are for Q4/Q4 percentage change in core PCE inflation for years ending 2021, 2022, 2023, 2024, and 2025;
lines between forecasts of annual inflation are for visual convenience and not part of Fed's forecasts; dotted line is from last inflation observation available to Fed at time of SEP;
full data set available on request

Fed Inflation Projections and Dots, 2021-2024



Sources: Board of Governors of Federal Reserve System, Quarterly Summary of Economic Projections, Bureau of Economic Analysis
Notes: Projections of inflation are Q4/Q4 percentage change for year indicated while Fed funds rate estimate is for year-end

Sources of Forecasts and Policy Errors

- Sources of bad forecasts
  - **Modeling errors**: FRB-US & DSGE, Phillips Curve, excessive reliance on forward guidance to manage inflationary expectations
  - **Human errors**: presumption that inflation would stay low like post-GFC; blaming "transitory" supply constraints while ignoring surge in demand
  - **Institutional errors**: Fed ignored lessons from history; group think; focus on "best forecasts" without considering alternative scenarios
- Additional sources of bad policies
  - **New strategic plan** prioritized employment, favored higher inflation and eschewed preemptive tightening
  - **Fed's discretion** ignored what Taylor Rule and other guidelines suggested

Will Fed Stand Up to Current Challenges?

- Fed must raise rates to reduce inflation to 2% and anchor expectations
  - Inflation is high and aggregate demand is strong (NGDP +9.2% yr/yr)
  - Real rates remain negative and below a Taylor Rule prescription
- Challenges: Fed tightening cycles tend not to go smoothly
  - Tightening policy may involve short-run economic costs (recession, higher unemployment) and risks financial stresses or instability
- Observations: some Fed members now tilt toward pausing rate hikes
- Concerns: Fed covets discretion despite track record showing that using rules help avoid major mistakes; will Fed revert to bad habits and "relax" 2% inflation target?

Learning from the Surge in Inflation

- The Fed should examine how to effectively incorporate rules into its monetary policy deliberations and not just rely on discretion
- The Fed’s new strategic plan of 2020 contributed to its mistakes, and a new strategic review would be timely
  - Focus: a balanced approach to the dual mandate, removing the asymmetries in current plan, and reinstituting preemptive tightening
- Shed hubris and learn the right lessons from history