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Hoover Institution Policy Conference: How to Get Back on Track

Remarks on “The Fed: Bad Forecasts and Misguided Monetary Policy” by Mickey Levy

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The Fed's Forecasting and Policy Errors

The range of the projections in the SEP's show that no [FOMC member] came anywhere close to anticipating the rise in inflation. The Fed's estimates of the appropriate interest rate were equally off the mark.

Through December 2021, not one Fed member projected that a positive real Fed funds rate would be necessary to reduce inflation through 2023, and through the December 2022 SEP, no Fed member projected that a positive real Fed funds rate was appropriate for 2022.

Levy, page 16

Levy on Sources and Nature of the Errors

1. Modeling and analytical errors
   - Over reliance on managing $E(\pi)$ and forward guidance
   - A presumption – baked into FRB-US model – that inflationary expectations are strongly anchored at the Fed's target rate.
   - Early insistence that the inflation rise in 2021 reflected temporary, self-reversing, factors.
2. Human and institutional errors
   - Poor judgment and inadequate risk management
   - Misguided data assessments
   - Failure to heed important lessons from history
   - Circle-the-wagons mentality
3. Fed's new strategic plan

Deeper Incentive Problems

1. There were clear incentives for the Fed to make the forecasting and policy errors it made.
2. Circumstances in 2021-2022 intensified the incentives for bad Fed projections and avoidable policy errors.

I will develop this thesis in steps:

- Start simple, highlighting a basic tension in the Fed's incentives around its projections, choice of models, and communications.
- Add complexities and circumstances in 2021-2022.

The Basic Tension

FOMC members hold the following beliefs:

1. Expected inflation affects actual inflation.
   - Any Phillips Curve with a forward-looking element in the expected inflation term has this property.
2. Fed projections influence expected inflation.

1 & 2 can incentivize the Fed to distort its inflation projections so as to achieve near-term policy goals at lower cost.

Of course, if the Fed distorts its projections, it risks undermining its credibility as a forecaster and its reputation for honest communications.

In normal times, credibility and reputation concerns may suffice to restrain any temptation to distort Fed projections.

A Fuller Statement

1. Expected inflation affects actual inflation.
2. Forward guidance, Fed projections, and headline models all have the potential to influence $E(\pi)$.
   - So Fed projections, choice and design of headline models, and explicit FG all function as forward guidance.
3. The future conduct of MP influences future inflation.
   - Immediate corollary: Expectations about the future conduct of monetary policy influence expected inflation.

Adding 3 $\Rightarrow$ The Fed also has incentives to distort projections of its own policy rates. As before, there is a tradeoff between Fed desires to meet near-term policy goals at least cost and the desire to preserve its credibility and reputation.

Notable Circumstances as of 2021-2022

1. Inflation has recently begun to exceed the desired rate (after many years of inflation at or below the desired rate).
2. Genuine uncertainty about one or both of:
   a) The persistence of undesirably high inflation, absent tighter monetary policy (i.e., hikes in the policy rate).
   b) The extent and duration of tightening required to bring inflation back to a desired level.

These circumstances intensify Fed incentives to distort its projections in a manner that lowers inflation at the least cost. Similarly, they intensify Fed incentives to double down on a narrative that stresses the transitory, self-correcting nature of the recent inflation surge.

To do otherwise validate narratives that stress the prospects for persistent inflation – which, in turn, raises expected inflation and the cost of achieving policy objectives.

A Third Notable Circumstance

"With regard to inflation expectations, there is a broad agreement among academics and policymakers that achieving price stability on a sustained basis requires that inflationary expectations be well anchored at the rate of inflation consistent with the price stability goal. *This is especially true in the world that prevails today, with flat Phillips Curves in which the primary determinant of actual inflation is expected inflation*." (My emphasis)

Fed Vice Chair Richard Clarida on the Fed's new strategic plan, 31 August 2020.

Validating contrary narratives risks de-anchoring inflation expectations at a time when the Fed saw anchoring as especially important.

Over Reliance on Managing Expectations, Distorted Projections

"Based on the earlier sustained low inflation, the Fed over-estimated its inflation-fighting credibility and relied too much on its ability to manage inflationary expectations...."

"The inconsistencies between the Fed's projections of inflation and its estimates of the appropriate interest rate suggest that the Fed mistakenly attributed all of the rise of inflation to a temporary negative supply shock, which proved incorrect. This led to confusing communications, misleading forward guidance and a loss of credibility."

Levy, page 8

Words from a Former BOE Governor

"We are told that this burst of inflation is transitory. And for several years, central banks have been giving "forward guidance" that interest rates will remain close to or below zero for the indefinite future. This policy stance relies heavily on the assumptions that expectations drive inflation, and central banks drive expectations. In other words, longer-term inflation is determined by the official inflation target."

Former Bank of England Governor Mervyn King in "The King Canute Theory of Inflation," *Bloomberg,* 23 November 2021.

Choice/Design of Headline Models

"The [FRB-US] model presumes that inflationary expectations are anchored to the Fed's 2% longer-run inflation target, such that increases in inflation above 2% naturally tend to regress back to 2%. The magnitude and duration of fiscal stimulus impulses are muted by model specifications."

Levy, page 10

Consider the reaction if, in 2021 or early 2022, the Board staff suddenly featured models that lack a strong anchor for inflation expectations. FOMC members would have (reasonably) viewed such a move as harmful to their efforts to achieve their mandate.

Persistent Forecast Errors and Credibility Loss

"Once the Fed came around to acknowledge that high inflation would persist, its estimates that it could lower inflation through maintaining a negative real Fed funds rate seem to rely on the transitory argument and were puzzling. The Fed funds futures began pricing in Fed rate increases well above the Fed's estimates, challenging the Fed's forecasts and they proved correct. There are concerns that this dented the Fed's credibility (Reis 2022). As the Fed's forecasting errors persisted, it did not seem to seriously consider alternative outcomes."

Levy, page 15

Doubling Down on the Transitory Narrative

Governor Waller: “The mistake in my mind, that we made, was we bet the farm on the transitory story. And any risk management model, you would have said, what if it doesn’t go away? What should we be doing to get ready for that event, if it doesn’t go away.”

Levy, page 16, quoting remarks by Fed Governor Chris Waller in an interview with CNBC’s Steve Liesman on 20 January 2023.

But “sound risk management” would have lent credibility to contrary inflation narratives, potentially de-anchoring inflation expectations, and raising the cost of achieving the Fed’s mandate.

Diffusing the Incentives and Their Consequences Within and Beyond the Fed

"Like so many organizations, the Fed has a "circle the wagons" mentality in which FOMC members are encouraged (feel pressure) to support the views of the institution and not deviate very much. Certainly, policy deliberations include outlying views, but the Fed discourages official dissents."

"[M]any private forecasters take their cues form the Fed (and many of them have been trained at the Fed).

Levy, page 17

Incentives Are Not Destiny

1. Recognition and acknowledgment are the first steps in addressing incentive problems and their consequences.
2. Further steps require institutional change, which is typically hard.
3. I offer four suggested reforms that would help contain the negative effects of the incentive problems sketched above.

Reforms, 1

1. De-conflate the Fed's forecasting function from forward guidance. How?
    - Replace **projections conditional on each FOMC member's estimate of the "appropriate monetary policy"** with projections conditional on specified trajectories for the policy rate and other policy instruments.
    - Board staff to specify the baseline monetary policy trajectory, a materially looser policy trajectory, and a materially tighter one.
    - Staff to articulate assumptions about fiscal policy as well.
    - Regional Fed banks can also supply projections conditional on other specified policy trajectories, if they wish.

Reforms, 2

This approach to FOMC-member projections has several advantages over the current approach. It:

A. Clarifies the policy assumptions behind the projections.
B. Simplifies the aggregation of projections.
C. Lessens the incentives to distort projections and ratify the Fed’s view about the economic outlook.
D. Reveals what each FOMC member believes about the output, unemployment and inflation effects of deviations from the baseline policy trajectory.
E. Let’s regional Feds softly dissent from the Board view by offering projections conditioned on other policy trajectories.

Reforms, 3

2. The Fed should sponsor an annual conference that highlights tail risks for monetary policy and central banking, advances non-standard scenario analyses, considers emerging and latent threats to sound monetary policy, draws lessons from historical episodes, etc.

- Scientific committee: Experts drawn from outside the Fed.
- Paper authors: Mostly drawn from outside the Fed system.
- Discussants: Mostly drawn from inside the Fed system.
- Cash prizes for most thought-provoking, innovative papers.

Sponsorship by a few regional Feds (a coalition of the willing) is sufficient to launch this idea.

Reforms, 4

3. Separate business-as-usual forecasting from the assessment of recession risks, major inflation threats, and financial crisis risks.
    - The skills, methods, and data required for business-as-usual forecasting differ from those needed for the other assessments.
4. Encourage non-conformist models and analyses.
    - There's a certain logic, and powerful institutional pressures, behind the Fed's tendency to favor models, analyses, and narratives that feature strongly anchored inflation expectations.
    - But the entire Fed system need not bow to this logic and the conformist pressures. The regional Feds are a natural home for nurturing non-conformist thinking. They should be encouraged to the play that role.