Thoughts on Fed Policy and the Fed Framework

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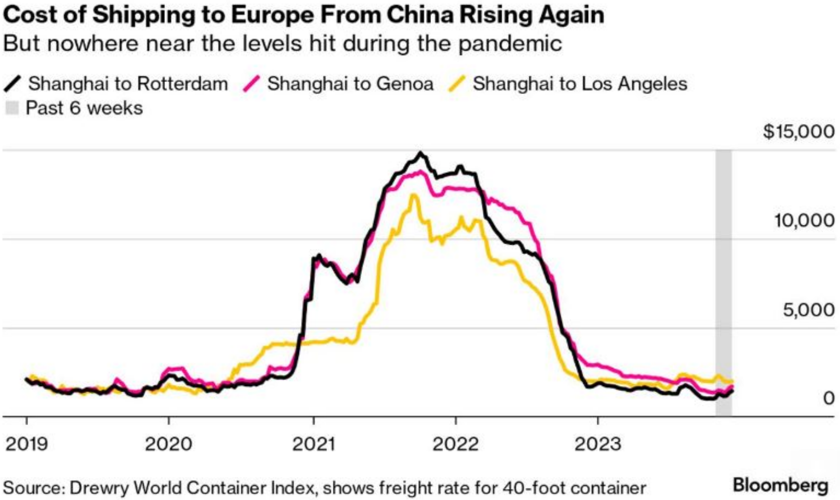
Opportune Time for Framework Review

- Eventful few years for monetary policy
- Bout of inflation in 2021 and 2022
- Disinflation without a recession!
- Main worry last time: Inflation persistently below target by a few 10ths of a percent
- Events since have refocused discourse on bigger, more fundamental issues

Covid shocks:

- Large fiscal stimulus
- Households built up large savings (and then spent these down)
- Substantial reduction in labor supply
- Shift in demand from services to goods

Severe Bottleneck in Goods Post-Covid

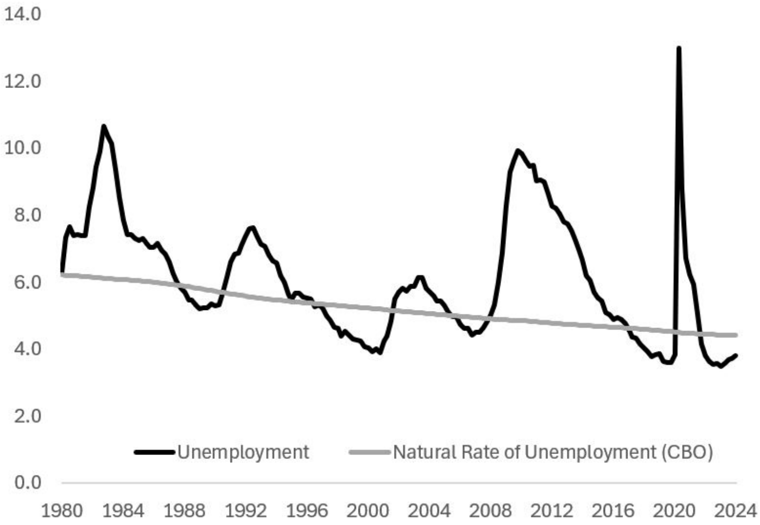


Did Fed Make a Serious Policy Error in 2021?

- Fed was slow to react
- May have been in part due to new framework
- FAIT prescribed patience due to undershoots prior to Covid

- Fed severely criticized for preemptive tightening in 2015
- New framework aimed to eliminate “shortfalls” rather than “deviations”
- Much skepticism about traditional estimates of the natural rate of unemployment

Faulty Natural Rate Estimates?

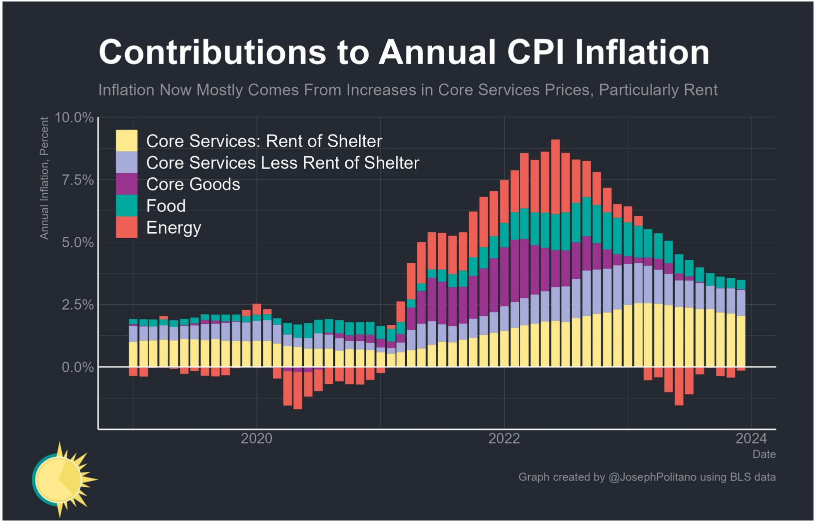


Did Fed Make a Serious Policy Error in 2021?

FOMC statement in October and November 2021:

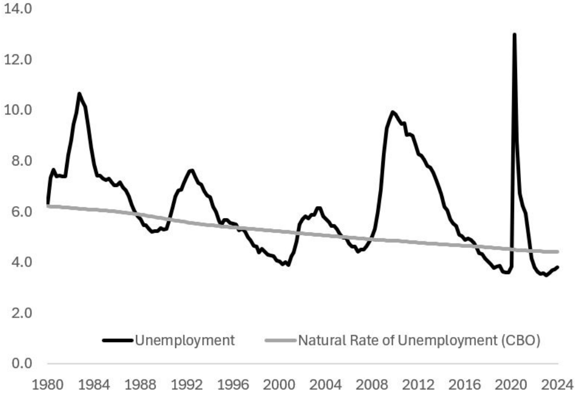
> *The Committee decided to keep the target range for the federal funds rate at 0 to 1/4 percent and expects it will be appropriate to maintain this target range until labor market conditions have reached levels consistent with the Committee's assessments of maximum employment and inflation has risen to 2 percent and is on track to moderately exceed 2 percent for some time.*

A More Positive View



Employment Mandate

- I am sympathetic to "plucking" view of the business cycle
- Full employment closer to 3.5% unemployment than 5%
- Does not imply Fed should forswear preemptive tightening
- Fed must act with an eye towards where it wants economy to be in 6 to 12 months



Flexible Average Inflation Targeting

- Goal to better anchor long-run inflation expectations at 2%
- Important goal!
- Particular concern motivating 2020 formulation only one of many
- Subsequent events have brought perspective

- Inching towards price-level targeting may be helpful
- Hard to know in practice
- Credibility most often earned slowly with actions and words
- Not clear what formulation in framework statement will help

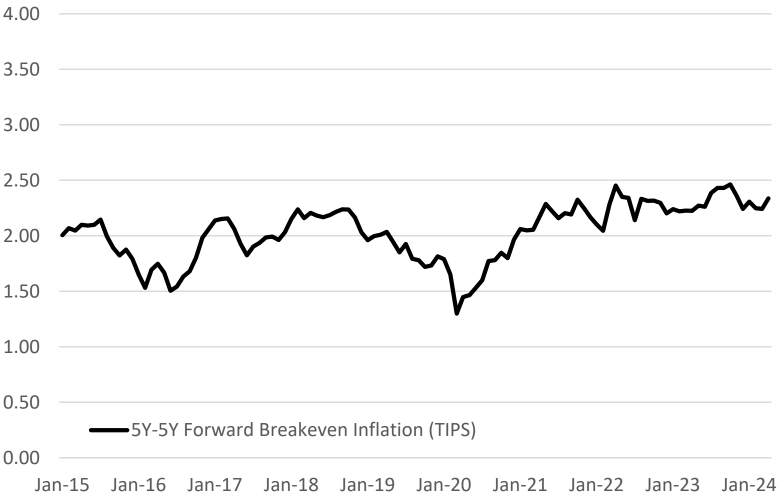
Credibility and the Sacrifice Ratio

- Suppose economy is hit by a temporary adverse supply shock
- Central bank may want to allow inflation to rise temporarily to avoid recession
- This is optimal policy in simple models

- Central bank with poor credibility will see inflation expectations rise
- Inflation dynamics will take on a life of their own

- Central bank with good credibility benefits from anchored expectations
- Inflation rise and fall mirrors that of supply shock

Anchored Expectations Crucial



Scars to Credibility

- Fed's credibility was extremely valuable over past few years
- But Fed "used up" some of its credibility
- Fed must be extra vigilant to rebuild credibility over next 5 to 10 years
- We should aim for Fed to have large war chest of credibility when next tough situation arises

Higher Inflation Target?

- Raising inflation target to 3 or 4% has been much discussed
  - More room to ease in a downturn
  - Perhaps r* has fallen
- I have become less sympathetic to this over time
- The public obviously really, really dislikes inflation
- Greenspan defined price stability as a state

  "when people do not consider inflation a factor in their decisions."

- Not clear the public will feel price stability is achieved at 3 or 4% inflation

Lender of Last Resort

- Fed's framework should discuss its role as a lender of last resort
- This is one of the core roles of a central bank
- Fed has a checkered history (Great Depression / Lehman Brothers)
- Discount window compromised by "stigma"
- No statement of policy principle by the Fed on this important topic