"Substantial Progress", Transitory vs Persistent and the Appropriate Calibration of Monetary Policy

Peter N. Ireland and Mickey D. Levy

Hoover Institution

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Recovery, Inflation and Risky Monetary Policy

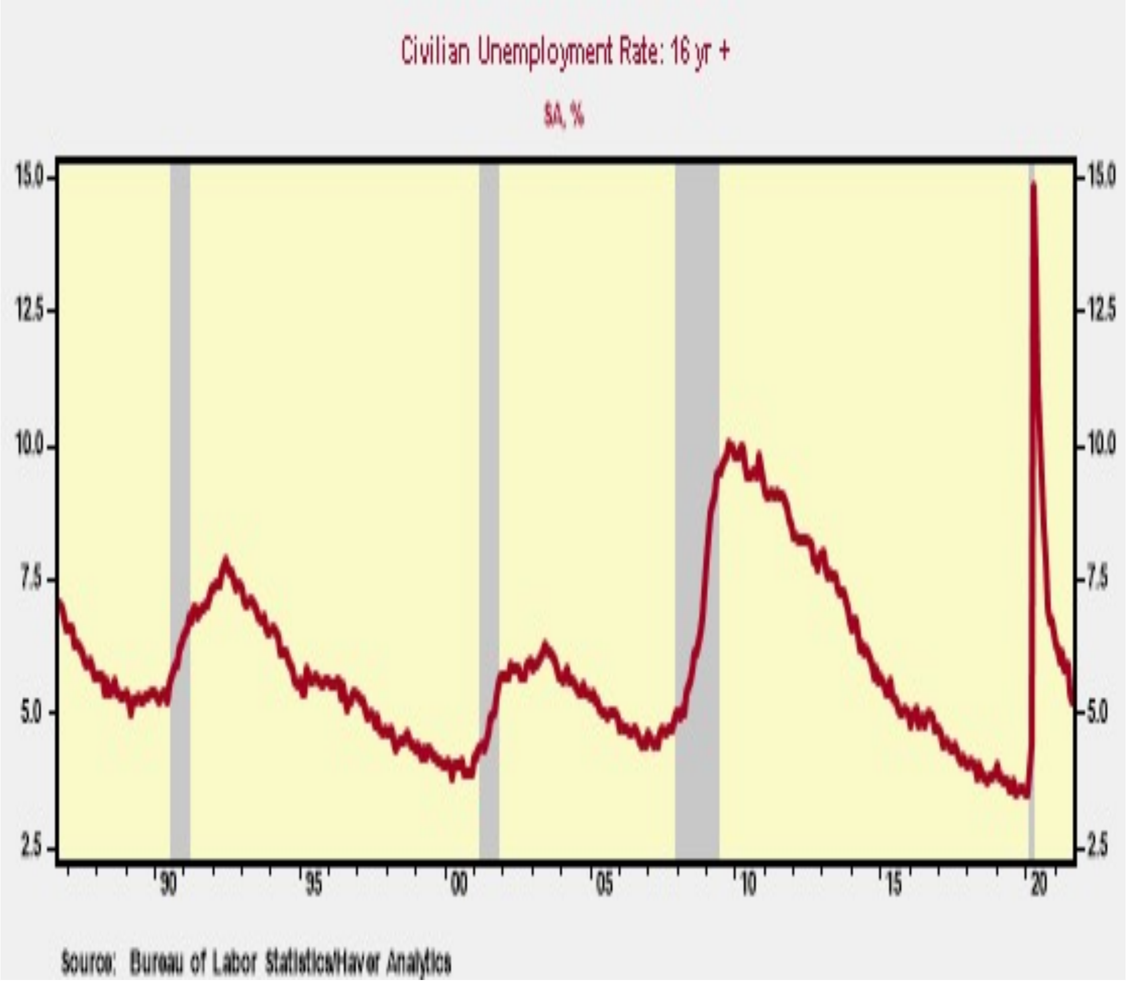
- The US economy and labor markets have recovered much more quickly and strongly than expected
- Inflation has surprised to the upside and is significantly above the Fed’s 2 percent target
- Can these data be reconciled with the Fed’s highly accommodative monetary policy stance?
- Yes, with reference to the Fed’s new strategic framework
- But this reconciliation is an uneasy one, raising deeper questions

Reconciling Data and Policy

- Has the Fed forgotten lessons from monetary history and theory?
- Has the Fed’s implementation of its new strategic plan reintroduced an inflationary bias into monetary policy?
- We begin with an assessment of labor markets and find conditions are similar to mature stages of prior cycles and showing stresses
- The sharp rise in inflation reflects some temporary factors and strong aggregate demand that risks persistent inflation well above 2%
- We provide suggestions for guidelines to enhance the Fed’s new strategic plan that would better achieve the Fed’s dual mandate

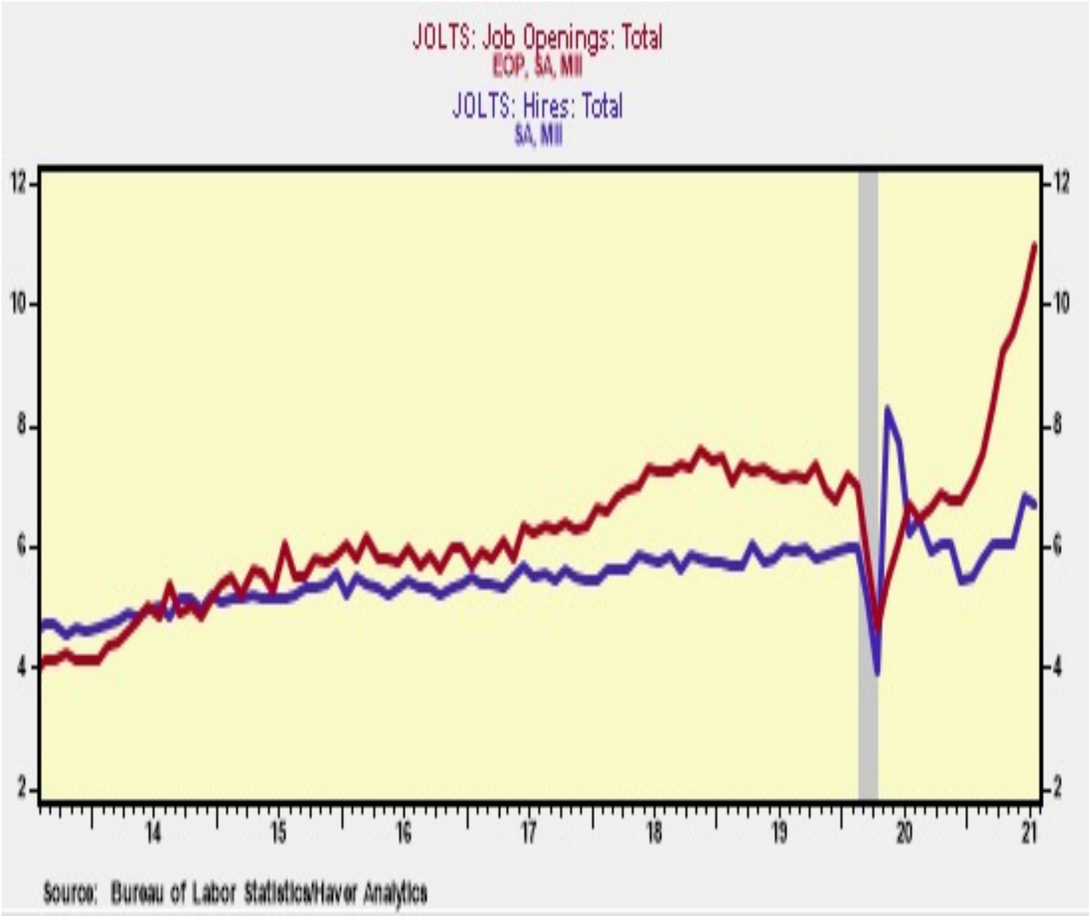
Labor Markets: Substantial Progress Toward Fed's Employment Mandate

- The recovery has significantly exceeded expectations, despite labor supply shortages
- Employment has recovered 75% of the pandemic collapse
- The unemployment rate and total employment have fallen back close to pre-pandemic levels
- Labor force participation rates have picked up for all groups
- U-6 has declined sharply and unemployment measures of all groups have improved commensurately



Strong Labor Demand, Supply Shortages

- July JOLTs report: record-breaking 10.9 mil job openings and 6.7 mil new hires
- The 4.2 mil gap represents 84% of the shortfall from prior peak employment
- This suggests strong demand and labor shortages that are unrelated to monetary policy



Fed Forecasts Unemployment Rate to Fall Back Below Natural Rate of Unemployment

FOMC projection made in:	Actual**	2020	2021	2022	2023	LR
June 2020	13.3	9.3	6.5	5.5	--	4.1
Sept 2020	8.4	7.6	5.5	4.6	4.0	4.1
December 2020	6.7	6.7	5.0	4.2	3.7	4.1
March 2021	6.2		4.5	3.9	3.5	4.0
June 2021	5.8		4.5	3.8	3.5	4.0
Sept 2021	5.2		4.8	3.8	3.5	4.0

- Note: *Projection for December of year
- **Last monthly observation available before Fed's quarterly SEP
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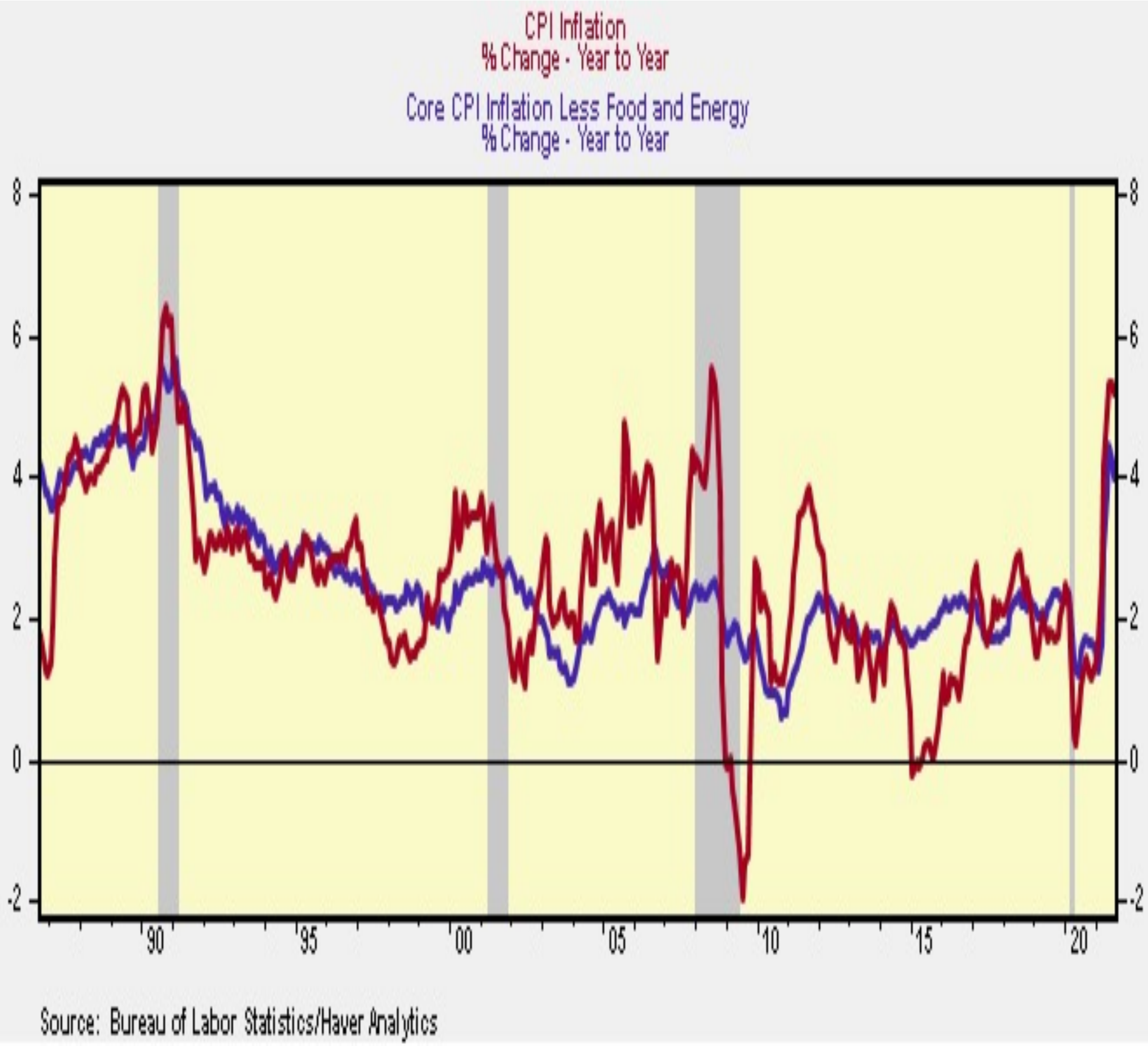
- Sources: Summary of Economic Projections, Board of Governors of Federal Reserve System

Inflation Has Jumped Reflecting Strong Demand and Supply Constraints



Fed Has been Surprised by Inflation But Asserts That It Is Temporary

- Table 2. The FOMC Member Median Inflation Forecasts (Q4/Q4)*

	2021		2022		2023	
Inflation forecast made in:	PCE	Core	PCE	Core	PCE	Core
September 2020	1.7	1.7	1.8	1.9	2.0	2.0
December 2020	1.8	1.8	1.9	1.9	2.0	2.0
March 2021	2.4	2.2	2.0	2.0	2.1	2.1
June 2021	3.4	3.0	2.1	2.1	2.1	2.1
September 2021	4.2	3.7	2.2	2.3	2.2	2.2

- Sources: Summary of Economic Projections, Board of Governors of Federal Reserve System

The FOMC’s Projections are Sanguine

- The FOMC projects inflation to decelerate back toward 2%
- But aggregate demand has strengthened significantly along with supply constraints, and factors point toward sustained strong demand
- The Fed’s inflation forecasts for 2022-2023 have been
  - Invariant to monetary policy
  - Unaffected by UR < U*
  - Unaffected by unprecedented fiscal stimulus
- Forecasts seem based on hope and do not reflect risks
- If monetary and fiscal policies stimulate demand, risks of inflation

Inflationary Expectations and Price and Wage Setting Behavior

- The Fed's comfort with current policy rests on its perceived ability to manage inflationary expectations
- But consumer expectations have risen significantly: FRBNY Survey of Consumer Expectations: 1-yr ahead inflation, 5.2%; 3-yr, 4%
- 5-year expectations implied by inflation swaps (2.75%); TIPS break evens 2.5%
- The high inflation to date and rising inflationary expectations are influencing price and wage-setting behavior
- Mounting anecdotal evidence suggests businesses are rolling out a series of price increases, facilitated by strong aggregate demand
- Can the Fed manage expectations that influence price and wage-setting?

From Data to Policy

- Can the recent data be reconciled with the Fed's highly accommodative monetary policy stance?

- If so, what does this reconciliation tell us about the Fed's newly-amended monetary policy strategy?

Unemployment and Policy

- One key element in the Fed’s new strategy justifies continuing QE and holding interest rates near zero despite the fall in unemployment from 15 to 5 percent.

- The employment mandate is now a “broad-based and inclusive” goal that can’t be summarized by looking at the unemployment rate alone.

- Unfortunately, the FOMC has never been specific about the broader range of indicators consulted.

Unemployment and Policy

- But they have been quite clear in their own assessment: the broad-based objective has not yet been achieved.
- We certainly can't accuse the FOMC of inconsistency. They are doing exactly what they said they would do.
- Still, the data do provide cause for concern.

Unemployment and Policy

- The SEPs show unemployment running below the long-run natural rate in 2022, 2023, and 2024.
- And even at 5.2 percent, unemployment may *already* be below the natural rate.
- One key lesson from modern macroeconomics: natural rates vary, especially when the economy is hit by supply-side shocks.

Unemployment and Policy

- The data on wages and unfilled job postings are consistent with the labor market running hot.

- The SEPs show that the FOMC will keep the labor market running hot for at least three more years.

- The gamble is that today's FOMC can exploit a favorable Phillips curve trade-off to achieve what Arthur Burns could not: "prosperity without inflation."

Inflation and Policy

- A second key feature of the Fed's new strategy justifies continuing QE and holding interest rates near zero despite rising inflation.
- Average inflation targeting calls for higher inflation after a period when inflation has run below target.
- Again, the FOMC has never been specific about how much make-up will be allowed.

Inflation and Policy

- But again they have been quite clear in their own assessment: the current burst of inflation will be transitory not persistent.

- Partly because of supply-side factors that will wear off.

- And partly because, under AIT, some make-up is not just acceptable but desirable.

Inflation and Policy

- The problem is that “transitory versus persistent” is the same language that the Fed used to excuse itself from the task of controlling inflation during the 1970s.

- It hides the role that monetary policy itself plays in *determining* whether inflation will be transitory or persistent.

Inflation and Policy

- Think again in terms of time-varying natural rates: As the economy continues to recover, the natural rate of interest will rise.

- The scenario in which the Fed’s policy rates track the rising natural rate *is* the scenario where inflation is transitory.

- The scenario in which the Fed’s holds rates too low in the face of a rising natural rate *is* the scenario where inflation proves unwanted and persistent.

Inflation and Policy

- FOMC members have said they “have the tools” to correct for an unwanted and persistent inflation overshoot.

- By “have the tools” they must mean “will raise interest rates.”

- But if they can’t say those words now, will they have the fortitude to take action and actually raise rates when the time comes?

Fortifying the New Framework

- Key modifications to the Fed's strategy – "broad and inclusive" employment and AIT – respond to challenges the FOMC faced during the recovery from the *previous* recession of 2008-9.

- Now, the new strategy is being implemented under circumstances that seem quite different, exposing elements of incompleteness in the Fed's new plan.

- How can the FOMC address these elements of incompleteness while retaining the advantages of the new framework?

Fortifying the New Framework

- First, the FOMC should fortify AIT by describing in more detail the circumstances under which a policy response to contain inflation will be needed.

- Second, the FOMC should remind the public that preemptive actions taken to stabilize average inflation *support,* rather than jeopardize, pursuit of its broad-based and inclusive employment goals.

- We encourage the FOMC to proceed with plans for tapering QE and also announce guidelines for raising rates in 2022 if necessary.