HOOVER INSTITUTION
ECONOMICS WORKING PAPERS

The Fed's Risky Experiment

Charles Plosser*

Economics Working Paper 21116

HOOVER INSTITUTION
434 GALVEZ MALL
STANFORD UNIVERSITY
STANFORD, CA 94305-6010

June 18, 2021

In August of 2020 Chair Jerome Powell (2020) unveiled the Federal Reserve's revised "Statement on Longer-run Goals and Monetary Policy Strategy." The revision made several significant changes to the original statement first announced in January 2012.[1] Importantly, it changed the Fed's interpretation of its inflation and employment mandates in important ways. The breadth and lack of clarity expressed in the new interpretations led Levy and Plosser (2020) to conclude that going forward, the Fed has laid the foundation for a less transparent more discretionary regime that will likely result in a more uncertain or unpredictable path for monetary policy. There is little doubt that the economic experience of the post-financial crisis (GFC) had a strong influence on the new strategic approach adopted by the Fed, and it is reflected in its implementation of the new strategy. The key questions are, Did the Fed take away the right lessons from its post crisis evaluation and are the solutions it adopted transparent, credible, effective, and robust? What are the risks if the Fed fails to execute the strategy as planned or it does not deliver the desired outcomes?

---

* Charles I. Plosser is a Visiting Fellow at the Hoover Institution, Stanford University, former President and CEO of the Federal Reserve Bank of Philadelphia, and a member of the Shadow Open Market Committee. The comments of Peter Ireland, Andrew Levin, and Mickey Levy are appreciated.

[1] See Lacker (2020) for an interesting discussion of how the original statement came about.

The Fed's Risky Experiment

by
Charles Plosser*
The Hoover Institution

June 18, 2021
Revised and Updated: July 28, 2018

In August of 2020 Chair Jerome Powell (2020) unveiled the Federal Reserve's revised "Statement on Longer-run Goals and Monetary Policy Strategy." The revision made several significant changes to the original statement first announced in January 2012.[1] Importantly, it changed the Fed's interpretation of its inflation and employment mandates in important ways. The breadth and lack of clarity expressed in the new interpretations led Levy and Plosser (2020) to conclude that going forward, the Fed has laid the foundation for a less transparent more discretionary regime that will likely result in a more uncertain or unpredictable path for monetary policy.

As discussed by Levy and Plosser (2020), the new interpretations elevated and broaden the employment mandate to mean maximum "inclusive" employment shifting away from the previous interpretation where the Fed focused on something akin to the "natural rate" of unemployment. This new interpretation stresses the level of employment and adds a vague and unprecedented distributional element to the Fed's objective. In the absence of more quantitative guidance, it offers the Fed enormous flexibility to interpret and justify its actions and makes it more difficult for the public to judge its success and hold it accountable. It also risks introducing dangerous political under currents to its decision-making process.

On the inflation side of the mandate, the Fed replaced its inflation targeting (IT) regime with an average inflation target (AIT). Vice Chair Clarida (2020a) referred to this new target as an "aspiration" and is not to be construed as an arithmetic average but a "flexible" concept. In

* Charles I. Plosser is a Visiting Fellow at the Hoover Institution, Stanford University, former President and CEO of the Federal Reserve Bank of Philadelphia, and a member of the Shadow Open Market Committee. The comments of Peter Ireland, Andrew Levin, and Mickey Levy are appreciated.

[1] See Lacker (2020) for an interesting discussion of how the original statement came about.

addition, the Fed articulated an asymmetric element to its strategy by intentionally overshooting its aspirational inflation objective to make-up for any shortfalls in inflation while emphasizing that it does not intend to similarly seek to offset overshoots, thus reinforcing the idea that the "average" target is in no sense an average of expected outcomes. The Fed has not offered any quantitative guidance as to how this strategy will be implemented. Here again, the lack of clarity allows for a wide range of discretionary policy actions by the Fed, increasing policy uncertainty.

There is little doubt that the economic experience of the post-financial crisis (GFC) had a strong influence on the new strategic approach adopted by the Fed, and it is reflected in its implementation of the new strategy. The Fed's new strategy to monetary policy is reflected in three new guiding principles.

- The Fed seeks to conduct monetary policy to achieve a "flexible" average inflation rate of 2 percent. When inflation has run below the target for a period of time the Fed will seek an above target inflation rate for some time to make-up for the shortfall. This make-up strategy will not be applied to periods of above target is inflation.
- The Fed's view of inflation dynamics is fundamentally changed. It views the sensitivity of inflation to variations in economic "slack" and low interest policy has significantly diminished. The Phillips curve is flat. Thus, employment can increase and unemployment can fall without undesirable consequences for inflation. As employment or unemployment is no longer a useful guide to inflation determination, the Fed will rely predominately on establishing inflation expectations to control the path of inflation.
- The Fed's new views regarding inflation allows it to use its primary interest instrument to aggressively pursue its new inclusive employment goals. Specifically, it will not increase its federal funds rate target until its employment objective is achieved. Subsequent policy moves will be outcome-based with respect to inflation, not based on forecasts. Thus, the Fed will no longer act pre-emptively with respect to inflation as it has in the past.

The key questions are, Did the Fed take away the right lessons from its post crisis evaluation and are the solutions it adopted transparent, credible, effective, and robust? What are the risks if the Fed fails to execute the strategy as planned or it does not deliver the desired outcomes? In what follows I will review the background and rationale for the Fed's new strategies and highlight the challenges and risks they pose, particularly in the current environment.

Background and Rationale for the New Strategy

Chair Powell stressed four developments that shaped the Fed's new approach to monetary policy. First, he argues that the longer run growth rate of the US economy has fallen. The reasons for the decline are not well understood but likely a involve a combination of factors including productivity growth and demographics that mostly lie beyond the scope of monetary policy. The second development, an implication of the first, is that the general level of real interest rates has declined. These factors have led to an environment in which the "normal" level of the federal funds rate is lower.[2] As a result, the Fed is concerned that it will confront the effective lower bound (ELB) on nominal interest rates more frequently, thus limiting its ability to reduce its nominal funds rate target in response to shocks. The Fed is also concerned that the inability to provide more stimulus at the ELB risks a decline in inflation expectations that may limit its ability to achieve its inflation objective. The ELB has been a fixation of the Fed for more than a decade and it continues to loom large in its approach to policy.

The third element cited by Powell is the benefits for employment and the labor market more generally, of the more than decade long expansion, an outcome not surprising or unusual for long expansions. Fourth, Powell notes that the post-GFC steady strengthening labor market did not lead to a significant rise in inflation, even though interest rates were kept quite low throughout the period and the Fed's balance sheet rose more than five-fold.

[2] In Fed terminology, r* has declined.

The message the Fed took from its analysis seems to be that the character of recessions and recoveries has changed in a fundamental way and that going forward its approach to monetary policy should also change. The changes are reflected in the Fed's revised strategy statement and its implementation of monetary policy.

Implementing the New Strategy

The Fed's reshaping of monetary policy focusses on three elements. The first addresses the perceived limitations caused by the ELB. As mentioned, the Fed adopted what it calls a "flexible" average inflation targeting regime while seeking to anchor longer-term inflation expectations at 2 percent. If the Fed had stopped at that, then one might think that the Fed was adopting a version of price-level-targeting (PLT), something that many economists have considered desirable.[3] As its name implies, average inflation targeting requires that outcomes below the desired target would be offset or made-up by allowing or achieving outcomes above the average target and likewise outcomes exceeding the desired target would be offset with outcomes below the target, hence achieving the desired target on average. Thus, when the average inflation goal is 2 percent then the price level would be expected to grow along a 2 percent trend consistent with longer-term inflation expectations.

This would have been simple and easily understood by markets and the public. But the Fed added a complication. It chose to be asymmetric.

Specifically, the Fed intends to allow, or engineer, inflation to offset persistent shortfalls from its 2 percent target but will intentionally not seek offset overruns. The Fed realizes that such an asymmetric approach cannot yield the average inflation it has specified. So it has explicitly acknowledged that its concept of "average" is a "flexible" one, as the average inflation will be above 2 percent if the approach is successful. The Fed seems to think it can anchor inflation

[3] Gauti and Woodford (2003) present a theoretical discussion of monetary policy at the ELB. They note that price-level-targeting, though unlikely to be optimal, can improve performance relative to rules that are not history dependent. See Plosser (2019) for a brief discussion of the pros and cons of implementing price-level-targeting.

expectations and achieve its 2 percent target without an operating strategy that can deliver such an outcome.

Some Fed critics interpreted the Fed's previous inflation targeting (IT) regime as implicitly managed as if the 2 percent target was a ceiling. This interpretation was wrong but, one might not be far off-base in characterizing the new asymmetric regime as one where 2 percent inflation is treated as the inflation floor. This new operating regime embeds an inflationary bias into its conduct of monetary policy that is inconsistent with its stated goal of anchoring inflation and inflation expectations at 2 percent.

The magnitude of this inflation bias is hard to judge as the Fed has not offered much in the way of quantitative guidance as to how the strategy will be implemented. How much and for how long must inflation run below target before the deliberate overshooting strategy kicks in? What is the magnitude and degree of overshooting expected before the policy changes to reestablish the long run 2 percent goal? The benefits of the asymmetry are far from apparent, and it complicates the communication and the effective execution of the strategy. As pointed out, it is not even clear how such a strategy could achieve an average inflation rate of say 2 percent under the best of circumstances if only shortfalls are offset. Thus, this new approach may find it hard to anchor longer-term inflation expectations at 2 percent. Such basic concerns are hardly comforting or a transparent form of communication or commitment.

Of course, much of the complexity in the Fed's new approach to inflation stems from its emphasis on the ELB. The Fed's approach to the ELB seems to adopt a strategy suggested by Reifschneider and Williams (2000) and others that is commonly referred to as "lower for longer."[4] The theory is that by promising to hold rates lower for longer the Fed seeks to raise inflation expectations over the short to medium term thus helping to lower real rates and boost

---

[4] To deal with the ELB some central banks have attempted to use negative policy rates, although the success has been mixed at best. Bordo and Levin (2017) explore central bank digital currency and its possible implications for delivering negative rates at the ELB. Other central banks, including the Fed, have chosen to use large scale asset purchases, or quantitative easing (QE), to provide more accommodation at the ELB. Here, too, the effectiveness has been questioned and its unintended consequences for financial stability and central bank independence can be worrisome. See Plosser (2009, 2016, 2018, 2020) for discussions related to unconventional monetary policies and Fed independence.

current economic activity even though the Fed cannot lower the nominal short-term rate. While such an approach is valid in some theoretical models, to be effective it requires the central bank to be highly credible in its promises to deliver on the temporary higher for longer future inflation without undermining the public's longer-term expectations of inflation. If the Fed is unable to manipulate public expectations in this manner the strategy fails to deliver the desired stimulus and/or undermines the Fed's inflation objective. There is no substantive evidence that this works in practice.

Clarida (2020b) offered his own interpretation of the new inflation strategy. His view is not really the "flexible" asymmetric AIT regime as described by Powell (2020) or Clarida (2020a) but a regime switching approach like that suggested in Bernanke (2017) and Bernanke, Kiley, and Roberts (2019). Clarida (2020b) envisions a temporary price-level-targeting (TPLT) framework where monetary policy continues to use inflation targeting (IT) in normal times but, when the ELB becomes binding, it switches to a PLT or AIT like framework. Unlike the Fed's new strategy, the TPLP regime is only initiated when and if the policy rate reaches the ELB, although the quantitative metrics regarding implementation remain unspecified. The view expressed by Clarida also differs from the new language of the Fed in that it envisions returning to an IT regime in normal times.

Nevertheless, a simple AIT or PLT strategy, if credible, would go a long way in addressing the ELB problem, without the additional complexity of asymmetry or a regime switching framework. The alternative strategies proposed by the Fed or Clarida are much more difficult to communicate, execute, and less transparent.

The second element of the Fed's implementation involves its view of the dynamics of inflation, which seem to have changed dramatically. For decades, the Fed's operated under the premise that low inflation was caused by an economy characterized by high rates of unemployment or other measures of "slack," and high inflation was driven by low rates of unemployment or tightness in the labor market. Despite the warnings from Friedman (1968) and Edward Phelps (1967), the simple logic of this Phillips curve perspective has been that the Fed could raise or lower the nominal interest rate to restrain or stimulate the real economy, thus raise, or lower, the unemployment rate and that would control the inflation rate. Of course, this view was significantly undermined in the 1960s and 70s when inflation soared to double digits while the unemployment rate rose, giving rise to what became known as stagflation. This generated serious doubts about the robustness of the Phillips curve. Moreover, the last five years, with its extremely low interest rates, low unemployment, and low inflation, cast further doubt regarding the reliability of the Phillips curve as a model for the inflation rate. Since the 1970s, much research was devoted to reviving the Phillips curve with alterations and refinements. The empirical relationship between inflation and unemployment continues to be elusive.[5] Attempts to forecast inflation based on unemployment rates have not been particularly successful. The Fed has finally acknowledged the problem.[6]

The conclusion reached by the Fed is that the below target inflation of the late 2010s was the consequence of the ELB on inflation expectations and the flattening of the Phillips curve, so that inflation became unresponsive to the decline in unemployment, or other measures of "slack," and the low interest rate policy.[7] The Fed seems to have abandoned the Philips curve, not such a bad thing, but what is the Fed's new theory of inflation? It appears that the Fed has adopted the view that to control inflation it simply has to manipulate expectations to achieve its desired outcome. Tell the public and the market that it should expect inflation to exceed its 2 percent target for some period of time after episodes of sustained low inflation, then to expect it to lower inflation back to its long-term goal. So, what is the cause of inflation? What policy tools does the Fed have to move inflation up or down and how do they work? These questions were not addressed in the Fed's new monetary framework. It is difficult to believe that the Fed can make its promises credible without linking its promises to its tools and actions. While the Fed has professed its desire to achieve its inflation target, its apparent reliance on verbal

[5] See Stock and Watson (2009) and Atkeson and Ohanian (2001), for example.

[6] One thing economists have concluded is that inflation expectations are important in understanding the dynamics of inflation. This view has motivated many central banks, including the Fed, to adopt inflation targets to provide a measure of commitment and an anchor to help achieve inflation goals.

[7] See Powell (2020) and Clarida (2020a).

pronouncements of its intentions to control it, opens the door to a highly discretionary use of its traditional tools to achieve other objectives.

As mentioned, the post-GFC recovery certainly exhibited some unique empirical characteristics that did not fit easily within the Fed's traditional framework. The Fed's new strategy reveals its view that the problems stemmed from external factors, specifically, declining real growth that caused the confrontation with the ELB and the structural changes in the Phillips curve, which, of course, was never a reliable basis for understanding inflation dynamics.

Yet, there were many other changes to the environment following the GFC. Financial regulations and the way the Fed chose to conduct policy likely impacted the transmission of monetary policy but seemed to be ignored or deemed irrelevant by the Fed in adopting its new strategy. For example, the Fed began paying interest on reserves (IOR), thus changing the way banks responded to an change in the quantity of reserves or the interest rate paid by the Fed, which was often above other short-term rates; through its QE policy the Fed flooded the banking system with reserves eviscerating the federal funds market and blowing up its balance sheet; the Fed adopted a new operating regime in the form of a floor system that changed the role of the Fed's balance sheet; regulations significantly changed the way bank capital requirements were calculated and imposed new liquidity constraints on banks. In the Fed's view, none of these changes in its own actions or its approach to policy, or in the regulatory environment, played any role in understanding the inflation outcomes of the post-GFC period.

The implicit decoupling of inflation outcomes from the Fed's standard policy tools and actions, such as low interest rates, and having long since discarded money growth as a useful tool or indicator, frees it to implement the third element of its new strategy – using its monetary policy tools to focus primarily on its newly interpreted maximum inclusive employment objective. Specifically, the Fed issued explicit guidance that it will not raise interest rates until its employment goals are achieved.

This strategy acts to delay the timing of when the Fed is likely to shift its policy stance to control inflation. The Fed has reinforced this by declaring that it will not act pre-emptively to avoid inflation but will only do so in response to inflation outcomes once its employment goal is met. This is a particularly risky approach to policy. As Levy and Plosser (2020) noted, such promises, or forward guidance, could leave the Fed in a very awkward position if inflation increased notably before the Fed reached its goal of maximum inclusive employment. This is the scenario that the Fed ruled out in its new framework. While it has thrown out its prior approach to inflation dynamics, it has not offered an alternative, except to say that it can anchor expectations of inflation at 2 percent without an explanation of how it will use its tools to achieve such an outcome. Moreover, the Fed's new emphasis on the distributional aspects of maximum employment is likely to further mire the Fed in political controversies threatening its independence and lead to delay in implementing a less accommodative policy.

A Progress Report – Is This Time Different?

It is less than a year into the Fed's new approach to monetary policy, but it is worth looking at how policy is playing out.

The recession began in February 2020, but in many dimensions, it has evolved quite differently from the last recession which was distinguished by a financial crisis. This time financial institutions were healthy entering the recession and have largely remained so. There was no housing crisis and the market for homes remained robust. The economic fallout was largely the result of the forced government shutdowns in response to the pandemic rather that economic imbalances or other internal economic weaknesses.

The recession also proved very brief, beginning in February 2020 and ending in April 2020. Nonetheless, the contraction was a very sharp and deep. Just as remarkable was the robust rebound. By 2021 Q2 real GDP returned to the pre-recession peak. Figure 1 illustrates the remarkable difference in the great financial crisis and the current episode caused by the pandemic and policy related shutdowns. The Fed's new framework was heavily based on the 2007-09 recession and subsequent recovery. Yet the current recession and recovery seem very different from what was previously experienced. Perhaps it's worth considering whether the Fed's new playbook, drawn up based on the GFC and its aftermath, is robust.

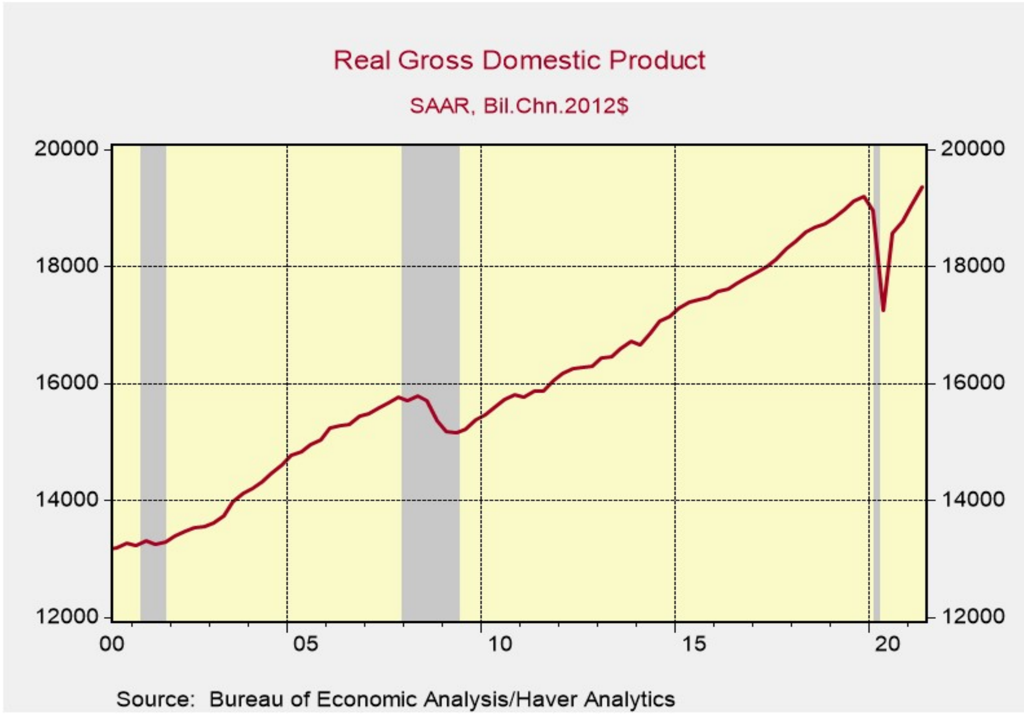

Figure 1

Other dimensions of this latest period have proved quite different. Fiscal policy has been extremely aggressive. Federal spending has expanded sharply relative to the GFC and the deficit, as a percent of GDP, rose to its highest level since WWII and the total public debt now exceeds 100 percent of GDP. The Administration envisions an extended period of significant deficit spending. Federal spending as a share of GDP is also expected to remain high by historical standards. Fiscal policy continues to be on an unsustainable path, likely putting political pressure on the Fed to continue monetizing a significant portion of the government debt. Almost 60 percent of the expansion in the Federal debt was purchase by the Fed between December 2019 and May 2021 compared to less than 10 percent in the twelve years beginning in December 2007 and ending in December 2019. This does not include agency debt or holdings of MBS which are not part of the public debt.[8] Goodhart and Pradan (2020), for example, argue that government spending growth in many countries is unsustainable. Moreover, governments are likely to find citizens unwilling to support the required tax increases, or the reduction in government

[8] Bordo and Levy (2020) discuss the broad historical linkages of fiscal deficits to inflation.

subsidies, especially those related to income, health, and welfare, much of which is driven by demographics and the ageing of populations. The political difficulty of raising taxes or cutting spending means the only alternative to managing the growth in public debt will be to inflate it away. Thus, the return of inflation over the longer term is highly likely in their view.

Monetary growth during the past year is similarly striking. It began in March 2020 with the Fed's intervention to stabilize the Treasury market. From the end of February 2020 to the end of May 2020 the Fed purchased nearly $1.7 trillion of Treasury securities. During that same period, the money stock, as measured my M2, increased by about $2.4 trillion. As can be seen in Figure 2 and Table 1, rapid money growth continues. Compared to the GFC this episode is extraordinarily different. Since the beginning of the pandemic (end of February 2020) to the end of May 2021 (15 months) M2 growth was 24.6 percent. During the last 12 months, beginning in June 2020 growth was over 12 percent and the 6-month and 3-month growth rates have continued expanding at double digit rates. It is instructive to note that this 12 percent rate is still twice the growth rate of the ten-year (December 2009 to December 2019).

Table 1

Money Stock: M2
% Change at Annual Rate

10 yr. 12/09-12/19	3 mos. 3/21-6/21	6 mos. 12/20-6/21	12 mos. 6/20-6/21	15 mos. 3/20-6/21
6.1	9.9	13.6	12.2	21.3

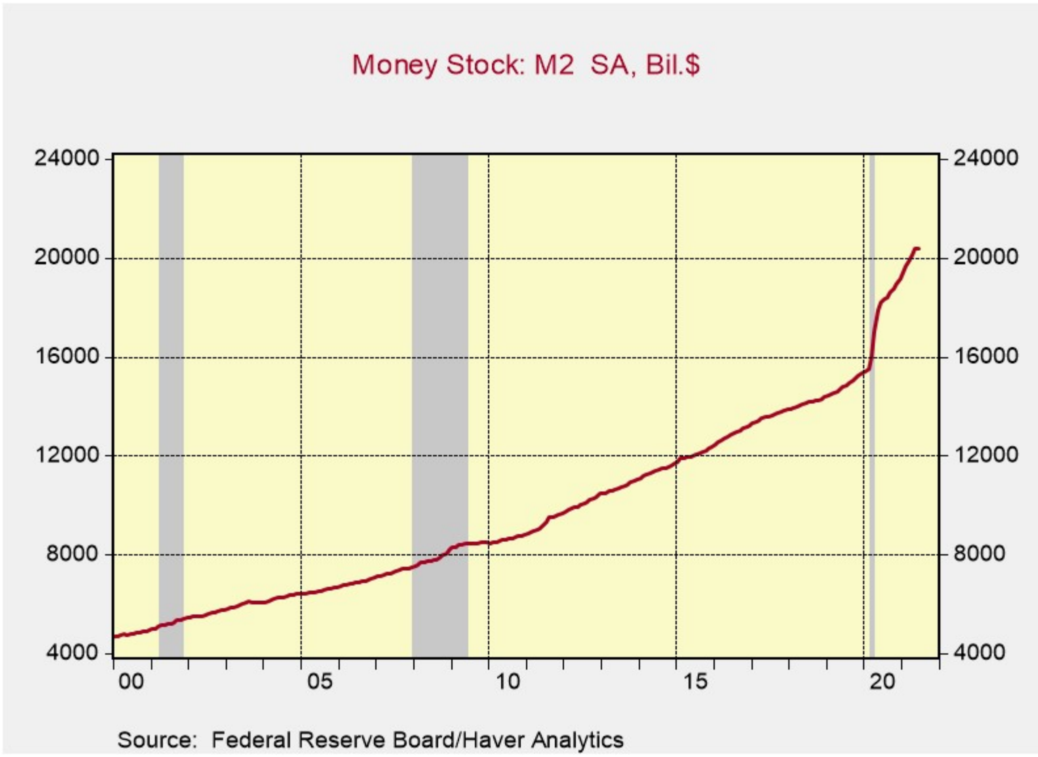

Figure 2

For some, the modest growth in money after the GFC might be part of the story why inflation remained low during the following decade, although this consideration did not seem relevant to the Fed. For those who wonder about the effect of money growth on inflation, the Fed has embarked on a bold and risky experiment. The Fed has mostly dismissed the role money as a useful tool of monetary policy and particularly as a guide to inflation. If that view proves unwise or mistaken, and a change in policy is not forthcoming, the financial markets and the economy may be in for a very bumpy ride over the next several years.

But the Fed's efforts at accommodation extend beyond its low interest policy and money growth. It has doubled down on its asset purchases program, acquiring about $4 trillion in securities (including Treasuries and MBS) in about 14 months and continues to purchase $120 billion a month. This policy continues over a year into the recovery when consumer spending is strong, investment is healthy, and GDP has surpassed its prior peak. During the last recession it took the Fed over 6 years to add $4 trillion to its balance sheet. Thus, by its own criteria, the Fed is pursuing an accommodation of historic proportions.

Inflation is accelerating. Year-over-year PCE inflation stands at 4.0 percent. In Table 2 the acceleration is apparent in 6-month and 3-month values of 5.6 percent and 6.6 percent, respectively. For reference the average inflation over the 10-year pre-COVID interval was 1.6 percent. Interestingly, the admittedly volatile, 1-month rate of PCE inflation has been above an annualized rate of 2 percent in 9 of the last 12 months. The price level returned to its January 2020 pre-pandemic peak in June 2020 and has continued its steady rise. The 2-year PCE inflation rate (through June 2021) is now 2.4 percent and above the pre-pandemic trend of 1.6 percent. In fact, the 3-, 4- and 5-year average inflation rates are all between 2.06 and 2.18 percent. So, there is no shortfall of inflation from target over at any look back horizon up to 5 years.

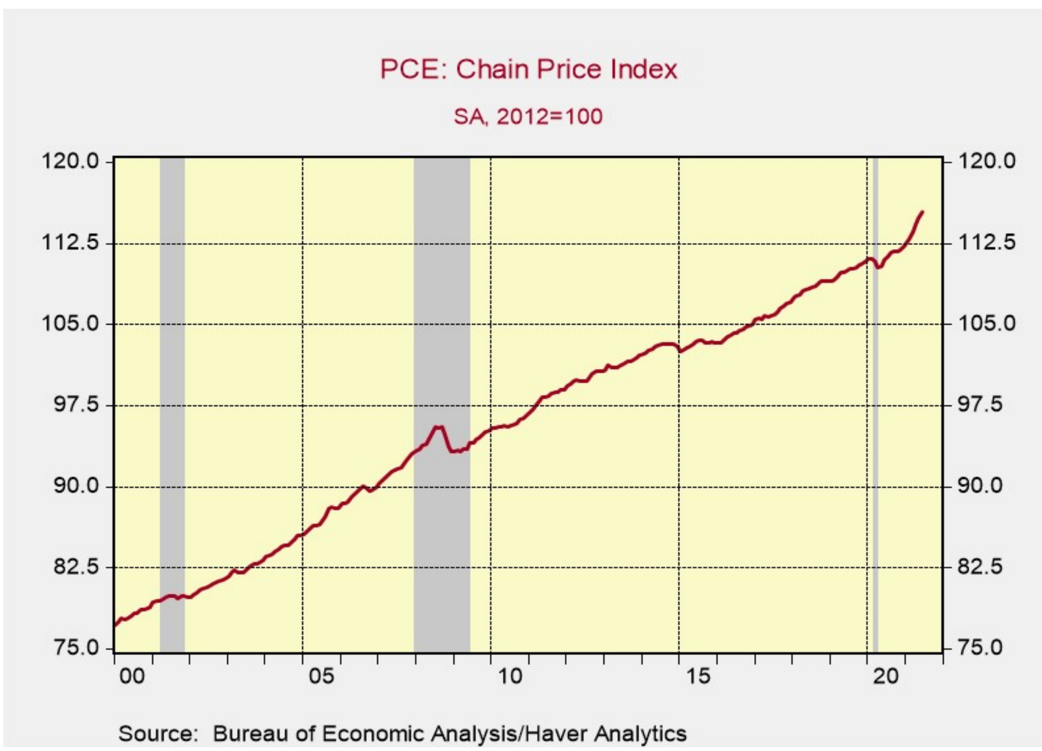

Figure 3

Table 2

PCE Inflation
% Change at Annual Rate

10 yr. 12/09-12/19	3 mos. 3/21-6/21	6 mos. 12/20-6/21	12 mos. 6/20-6/21	15 mos. 3/20-6/21
1.6	6.6	5.6	4.0	3.3

A natural question is to ask the Fed to put its “flexible” AIT approach in context. The make-up of the shortfall in the price level of the last two to five years has been accomplished and its 2 percent growth rate is on target. With current inflation running above 5 percent, how much longer does the Fed want inflation to run “hot.” At what point will it become uncomfortable? This is particularly timely as inflation expectations have risen and the Fed must guard against those expectations rising further and becoming entrenched above 2 percent. These are the sort of quantitative metrics that the Fed has not communicated to the public and yet “inquiring minds want to know” so they can plan. Uncertain or unpredictable monetary policy does not contribute to a stable or sustainable recovery.

Concluding Observations

The Fed’s new monetary policy strategy represents a significant departure from past practices and a remarkable restructuring of its priorities. Its new “flexible” asymmetric AIT plan is a complicated approach to the management of inflation that requires moving inflation and inflation expectations up and down in a specific, yet credible, way that presumably improves the Fed’s attempts to conduct short-term stabilization policy at the ELB. Yet it offers almost no quantitative guidance that informs the public how the desired movements and time frames should be judged, must less information about how the Fed will use its tools to accomplish these unquantified goals. Thus, the framework lacks transparency and credibility.

The new strategy says that the Fed remains committed to a long-run goal of inflation of 2 percent but, without greater clarity and transparency, the added complexity comes with greater risks. The approach involves a more active, discretionary, and perhaps, volatile path of monetary policy. For example, higher inflation rates intended to make-up for shortfalls could last longer or go higher than anticipated and lead to a loss of credibility and an unanchoring of inflation expectations. This may jeopardize longer term inflation goals and economic stability as the Fed seeks regain control and restore credibility. Inflation and inflation expectations are not like a faucet that the Fed can turn off and on as it pleases.

The second remarkable change in the Fed's new monetary strategy is the elevation of a revised maximum inclusive employment goal as its foremost objective. This change is reflected in its extraordinary new guidance that it will not raise its federal funds rate target until its employment objective is achieved. This guidance was thought to be justified based on post-GFC experience when low interests and low unemployment or "slack" failed to raise inflation. The Fed seems to have concluded that in its new world there has been a decoupling of its policy tools from the inflation process. It seems to have not contemplated that inflation could arise before maximum employment is reached. While far from specific, the earlier versions of the Fed's strategy statement said that in circumstances when its two goals, price stability and employment, appeared to be in conflict, it would follow a "balanced approach" to its conduct of policy. The Fed's new strategy statement removed this phrase. What is the public to think the Fed will do?

Of course, what the Fed did not believe would happen is now upon us. Inflation is up sharply while many Fed speakers say we are a long way from its employment goals. The Fed is stressing the temporary nature of current inflation, emphasizing supply side issues such as "bottlenecks" in product and labor markets. Stressing the temporary supply side induced inflation allows the Fed to maintain current policies and avoid the inherent conflict between its guidance to continue aggressive ease to promote employment and its commitment to maintain its inflation goal. But the degree to which the current price increases will lead to more persistent or sustained inflation will depend on the degree to which the current policy mix of aggressive monetary and fiscal policies are maintained. Failing to adjust the current stance of policy could ensure that the current inflation becomes more persistent, much as the Fed did in the 1970s when excessive attention on employment turned what might have been a temporary inflation episode into a more than a decade long economic disaster.

The Fed is facing a dilemma of its own making. If it chooses to move more decisively to deal with inflation, its credibility may be undermined for abandoning its employment guidance, likely leading to political pushback, and if it remains firm to its employment commitment and fails to contain inflation or inflation expectations, it loses credibility as well for failing to follow through on its inflation commitment. The Fed is walking a fine line. It did not need to find itself in this predicament. Will the new framework prove to be a strategic one or one of convenience that must be abandoned or repeatedly revised? A framework that is simple and more systematic rather than one that is complex and discretionary would be preferable.

References

Atkeson, Andrew and Lee E. Ohanian (2001). "Are Phillips Curves Useful for Forecasting Inflation?" *Federal Reserve Bank of Minneapolis Quarterly Review* 25(1), Winter 2001. https://www.minneapolisfed.org/research/quarterly-review/are-phillips-curves-useful-for-forecasting-inflation

Bernanke, Ben S. (2017). "Temporary Price-Level Targeting: An Alternative Framework for Monetary Policy." Ben Bernanke's Blog, October 12. https://www.brookings.edu/blog/ben-bernanke/2017/10/12/temporary-price-level-targeting-an-alternative-framework-for-monetary-policy/

Bernanke, Ben S., Michael T. Kiley, and John M. Roberts (2019). "Monetary Policy Strategies for a Low-Rate Environment," *AEA Papers and Proceedings*, vol. 109 (May), pp. 421–26.

Bordo, Michael D. and Andrew T. Levin (2017). "Central Bank Digital Currency and the Future of Monetary Policy." NBER Working Paper No. 23711 (August 2017). Cambridge, MA. https://www.nber.org/system/files/working_papers/w23711/w23711.pdf

Bordo, Michael D. and Mickey D. Levy (2020). “Do Enlarged Fiscal Deficits Cause Inflation: The Historical Record.” NBRER Working Paper No. 28195 (December 2020). Cambridge, MA. https://www.nber.org/system/files/working_papers/w28195/w28195.pdf

Burns, Arthur (1979). Per Jacobsson Lecture. Belgrade, Yugoslavia, September 30, 1979. Reprinted in *Federal Reserve Bulletin,* September 1987, pp. 687-698. https://fraser.stlouisfed.org/files/docs/publications/FRB/pages/1985-1989/32252_1985-1989.pdf

Clarida, Richard H. (2020a). “The Federal Reserve’s New Monetary Policy Framework: A Robust Evolution.” Speech delivered at the Peterson Institute for International Economics, August 31, 2020. https://www.federalreserve.gov/newsevents/speech/clarida20200831a.htm

Clarida, Richard H. (2020b). “Federal Reserve’s New Framework: Context and Consequences.” Speech delivered at the Brookings Institution, Washington, D.C. November 16, 2020. https://www.federalreserve.gov/newsevents/speech/clarida20201116a.htm

Eggertsson, Gauti B. and Michael Woodford. (2003). "The Zero Bound on Interest Rates and Optimal Monetary Policy," *Brookings Papers on Economic Activity 2003, no. 1 (2003):* 139-211. http://www.jstor.org/stable/1209148.

Friedman, Milton (1968). "The Role of Monetary Policy." *American Economic Review,* 58 (1): 1–17.

Goodhart, Charles and Manoj Pradan (2020). *The Great Demographic Reversal.* Palgrave Macmillan, London, 2020.

Hess, Gregory D. (2021). "The Anguish and Progress of Central Bankers." Prepared for the Shadow Open Market Committee, April 14, 2021. https://www.shadowfed.org/wp-content/uploads/2021/04/Hess-SOMC-April2021.pdf

Lacker, Jeffery M. (2020). "A Look Back at the Consensus Statement." *Cato Journal,* Vol. 40, No. 2 (Spring/Summer 2020), Cato Institute, Washington, D.C. https://www.cato.org/sites/cato.org/files/2020-05/cj-v40n2-3_1.pdf

Levy, Mickey D. and Charles Plosser (2020). "The Murky Future of Monetary Policy," prepared for the *Hoover Institution's Monetary Policy Conference,* October 1, 2020. https://www.hoover.org/sites/default/files/research/docs/20119-levy-plosser_1.pdf

Phelps, Edmund S. (1967). "Phillips Curves, Expectations of Inflation and Optimal Unemployment over Time." *Economica*, 34 (135): 254–281.

Plosser, Charles (2009). "Ensuring Sound Monetary Policy in the Aftermath of Crisis." Speech delivered at the *U.S. Monetary Policy Forum*, New York, NY. February 27, 2009. https://fraser.stlouisfed.org/title/statements-speeches-charles-i-plosser-6101/ensuring-sound-monetary-policy-aftermath-crisis-586672

Plosser, Charles (2016). "Balancing Central Bank Independence and Accountability," in *Central Bank Governance and Oversight Reform,* J. H Cochrane and J. B. Taylor, Editors. Hoover Institution Press, 2016. https://www.hoover.org/sites/default/files/research/docs/cochranetaylor_centralbank_ch6.pdf

Plosser, Charles (2018). "The Risks of a Fed Balance Sheet Unconstrained by Monetary Policy," in *The Structural Foundations of Monetary Policy*, M. D, Bordo, J. H. Cochrane and A. Seru, Editors. Hoover Institution Press, 2018.

https://www.hoover.org/sites/default/files/research/docs/ch01a_section1_cochrane_9780817921347.pdf

Plosser, Charles (2019). “A Cautionary Note on Price-Level-Targeting.” *Defining Ideas,* a Hoover Institution Journal, May 1, 2019.
https://www.hoover.org/research/cautionary-note-price-level-targeting

Plosser, Charles (2020). “Operating Regimes and Fed Independence.” *The Cato Journal*, Spring/Summer 2020, pp. 361-371.
https://www.cato.org/cato-journal/spring/summer-2020/operating-regimes-fed-independence

Powell, Jerome H. (2020). “New Economic Challenges and the Fed’s Monetary Policy.” speech delivered at the Federal Reserve Bank of Kansas City Economic Symposium, Jackson Hole, Wyoming. August 27, 2020.
https://www.federalreserve.gov/newsevents/speech/powell20200827a.htm

Reifschneider, David and John C. Williams (2000). “Three Lessons for Monetary Policy in a Low Inflation Era.” *Journal of Money, Credit and Banking*. Vol. 32, issue 4, pp. 936-66.

Stock, James H. and Mark W. Watson (2009). “Phillips Curve Inflation Forecasts.” *Understanding Inflation and the Implications for Monetary Policy: A Phillips Curve Retrospective, J.* Fuhrer, Y. Kodrzycki, J. Little, and G. Olivei, Editors. MIT Press.
https://scholar.harvard.edu/files/stock/files/phillipscurveinflationforecasts.pdf