What Lessons Should the Federal Reserve Learn from the Recent Inflation Surge?

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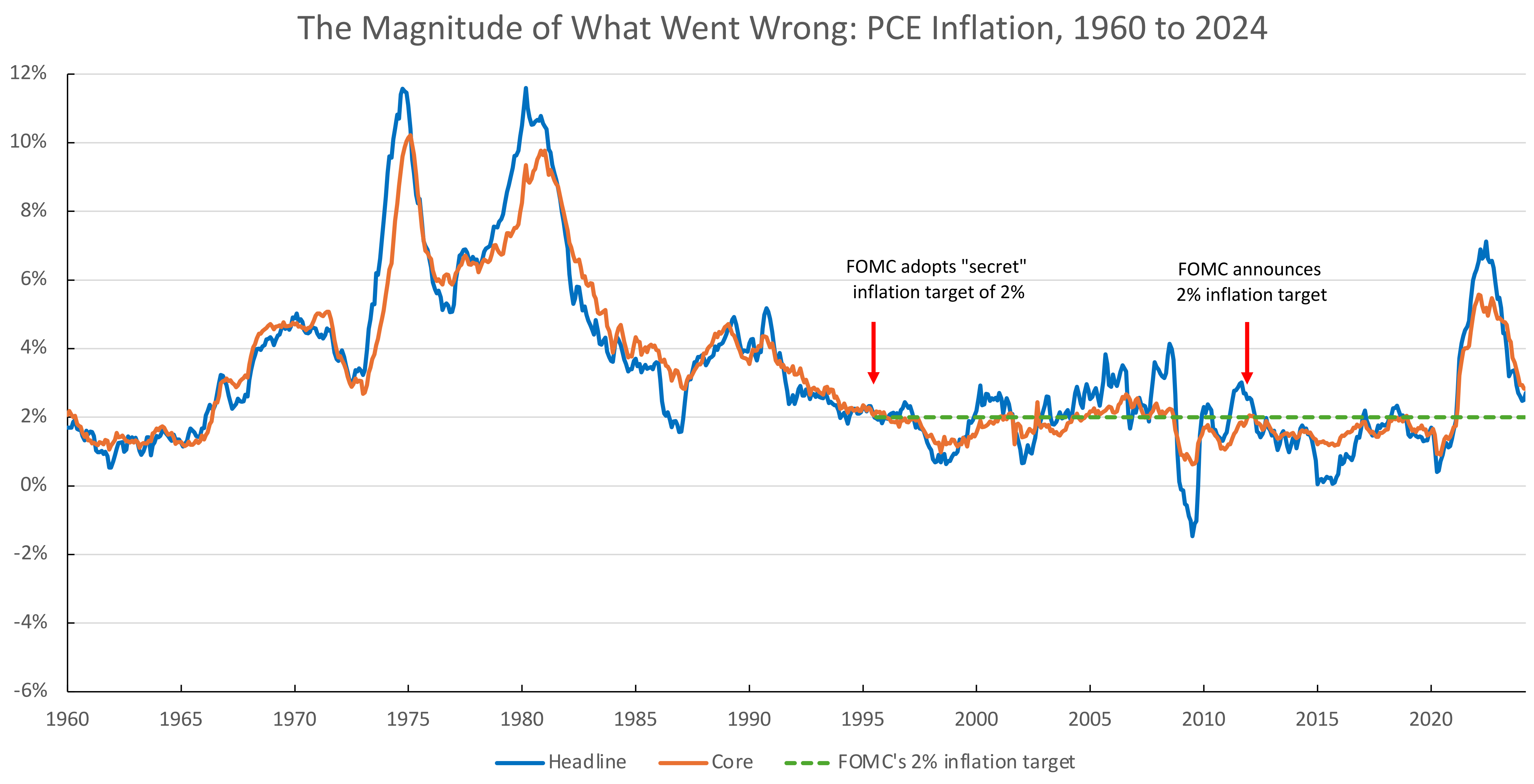
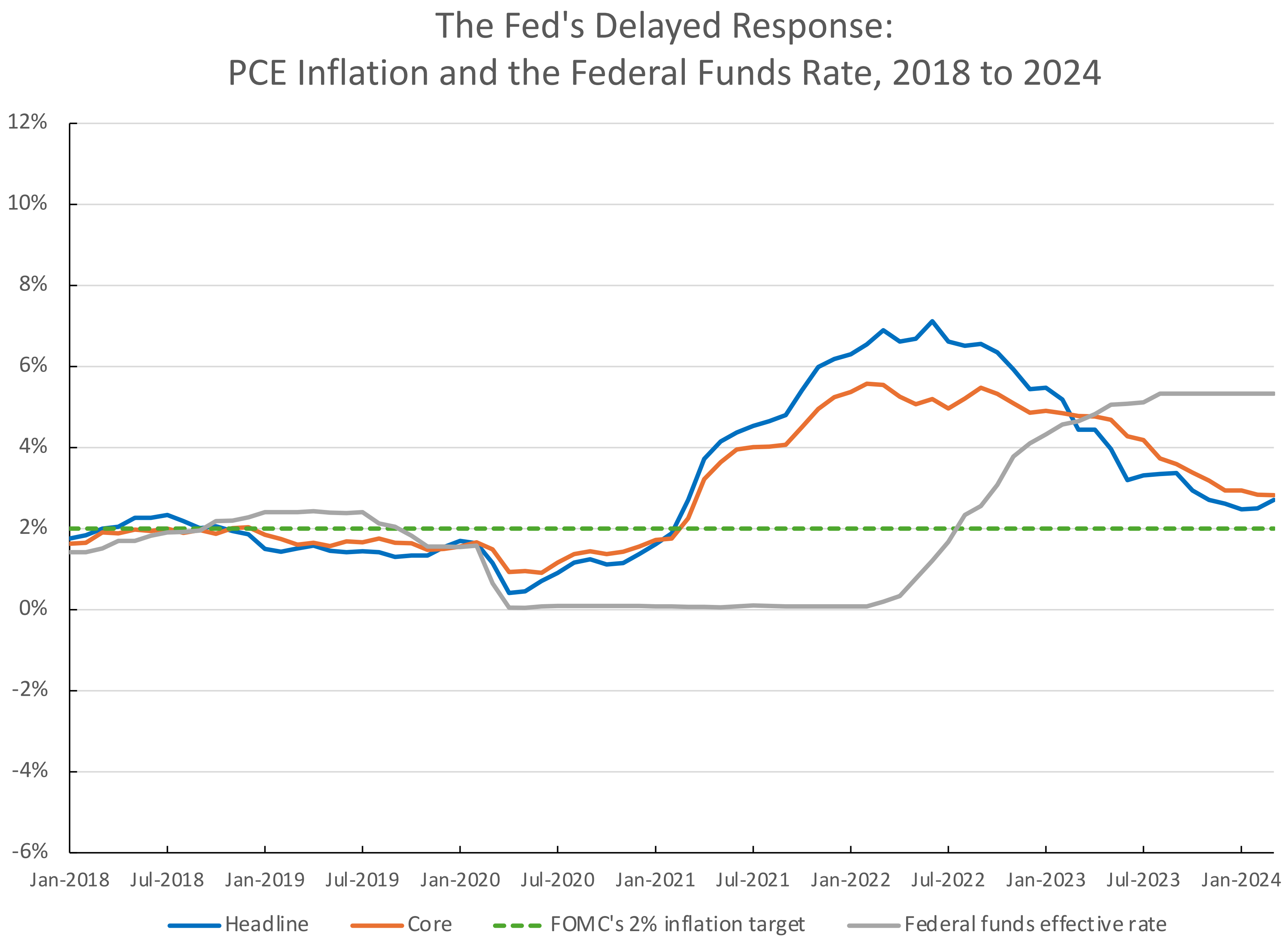
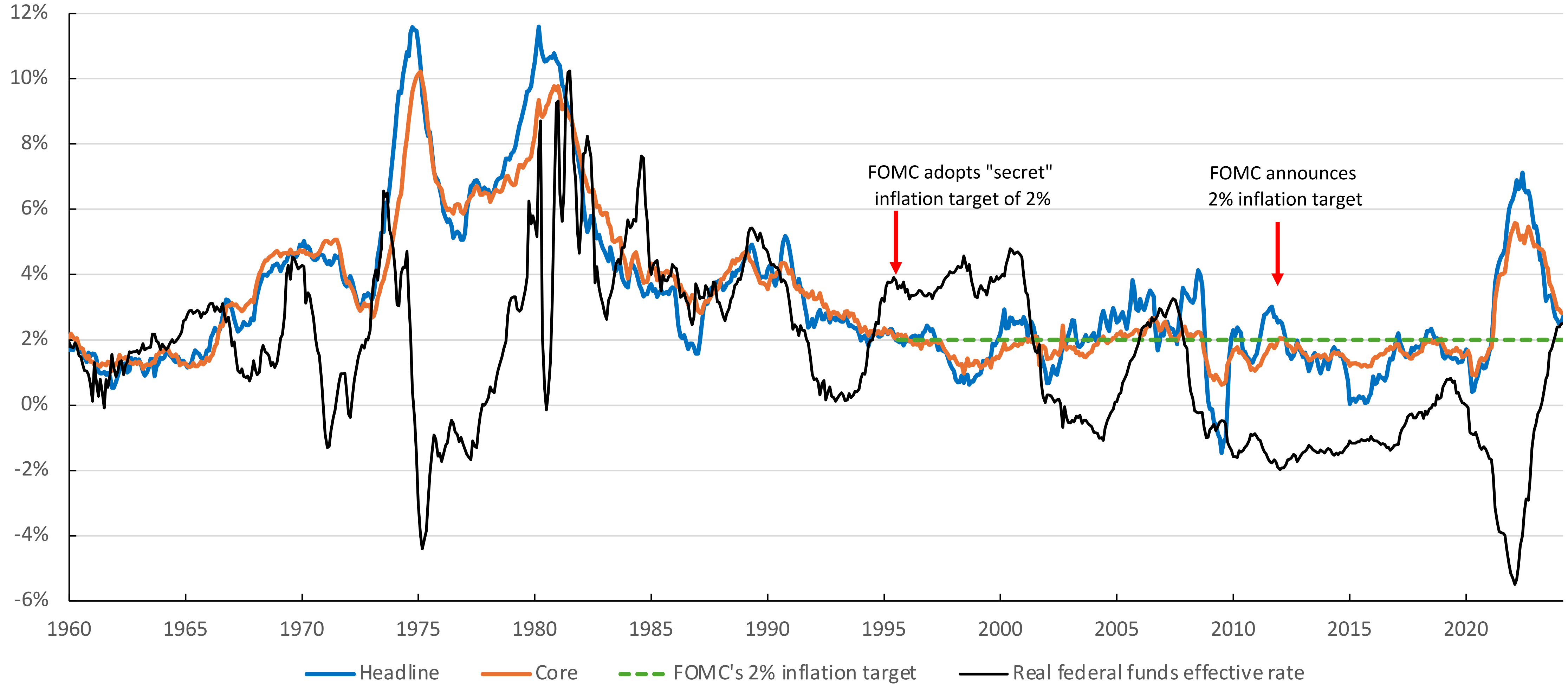

The Magnitude of What Went Wrong: PCE Inflation, 1960 to 2024
12%
10%
8%
6%
4%
2%
0%
-2%
-4%
-6%
1960
1965
1970
1975
1980
1985
1990
1995
2000
2005
2010
2015
2020
FOMC adopts "secret" inflation target of 2%
FOMC announces 2% inflation target
Headline
Core
FOMC's 2% inflation target

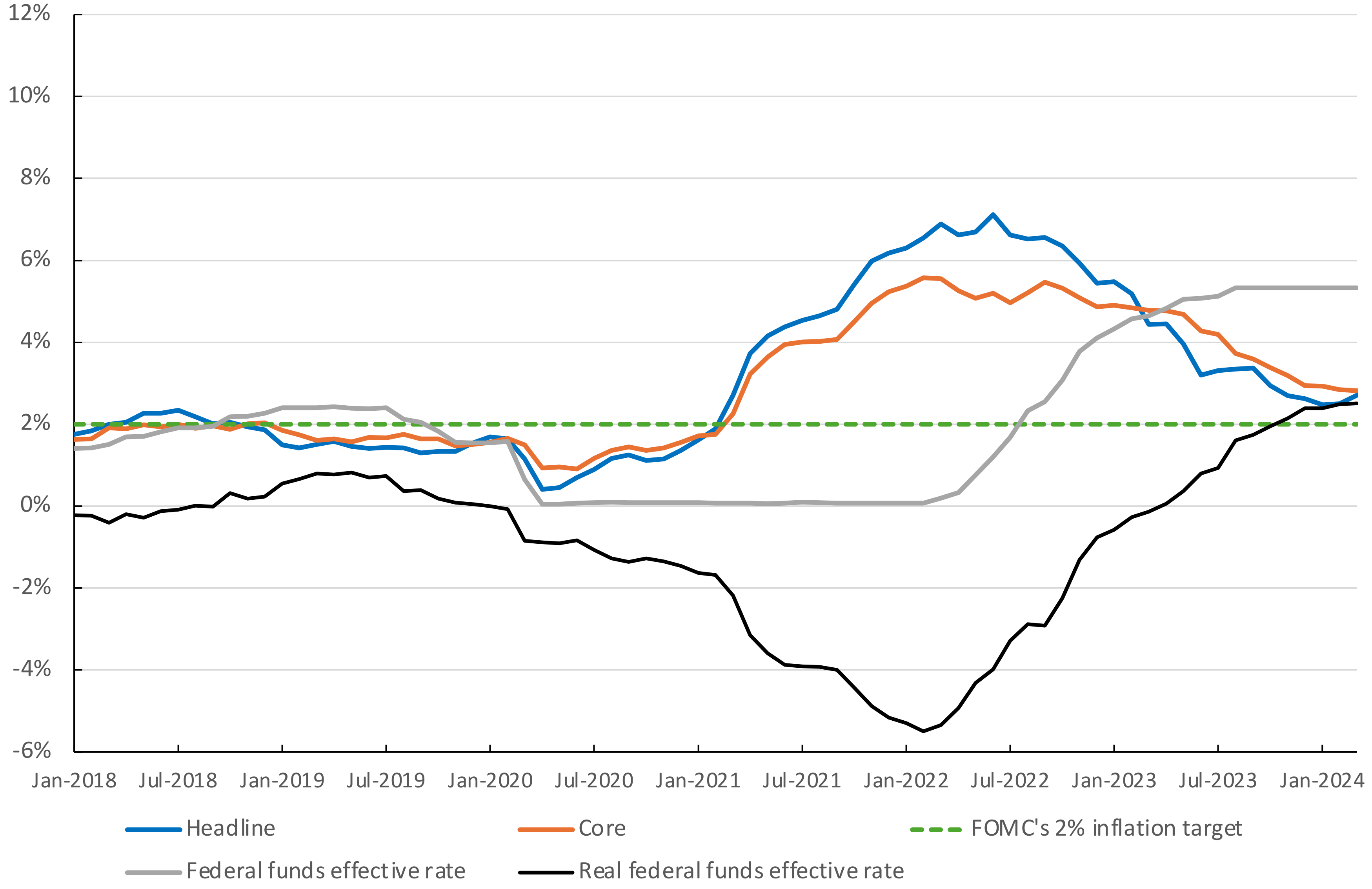


The Fed's Delayed Response:
PCE Inflation and the Federal Funds Rate, 2018 to 2024
12%
10%
8%
6%
4%
2%
0%
-2%
-4%
-6%
Jan-2018
Jul-2018
Jan-2019
Jul-2019
Jan-2020
Jul-2020
Jan-2021
Jul-2021
Jan-2022
Jul-2022
Jan-2023
Jul-2023
Jan-2024
Headline
Core
FOMC's 2% inflation target
Federal funds effective rate

How Far Fed Policy Strayed From Past Practice: PCE Inflation and the Real Federal Funds Rate, 1960 to 2024



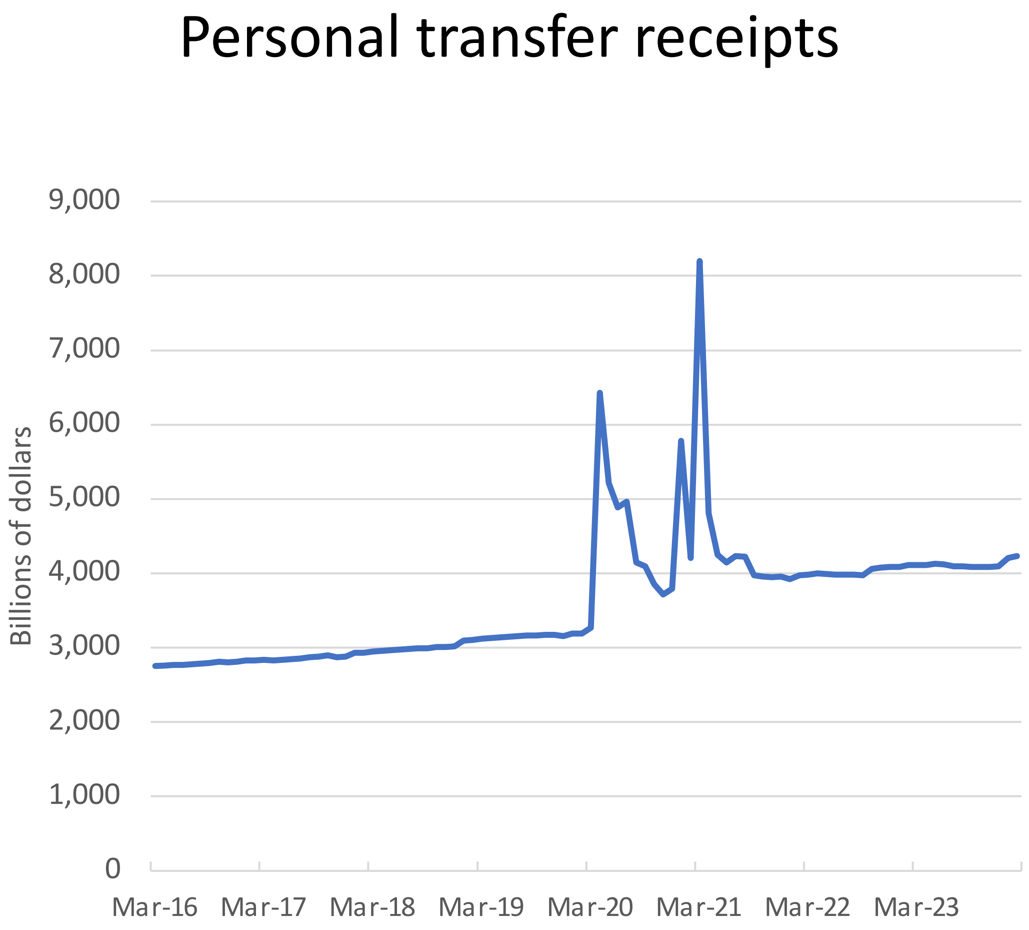
The Fed's Delayed Response: PCE Inflation and the Real Federal Funds Rate, 2018 to 2024

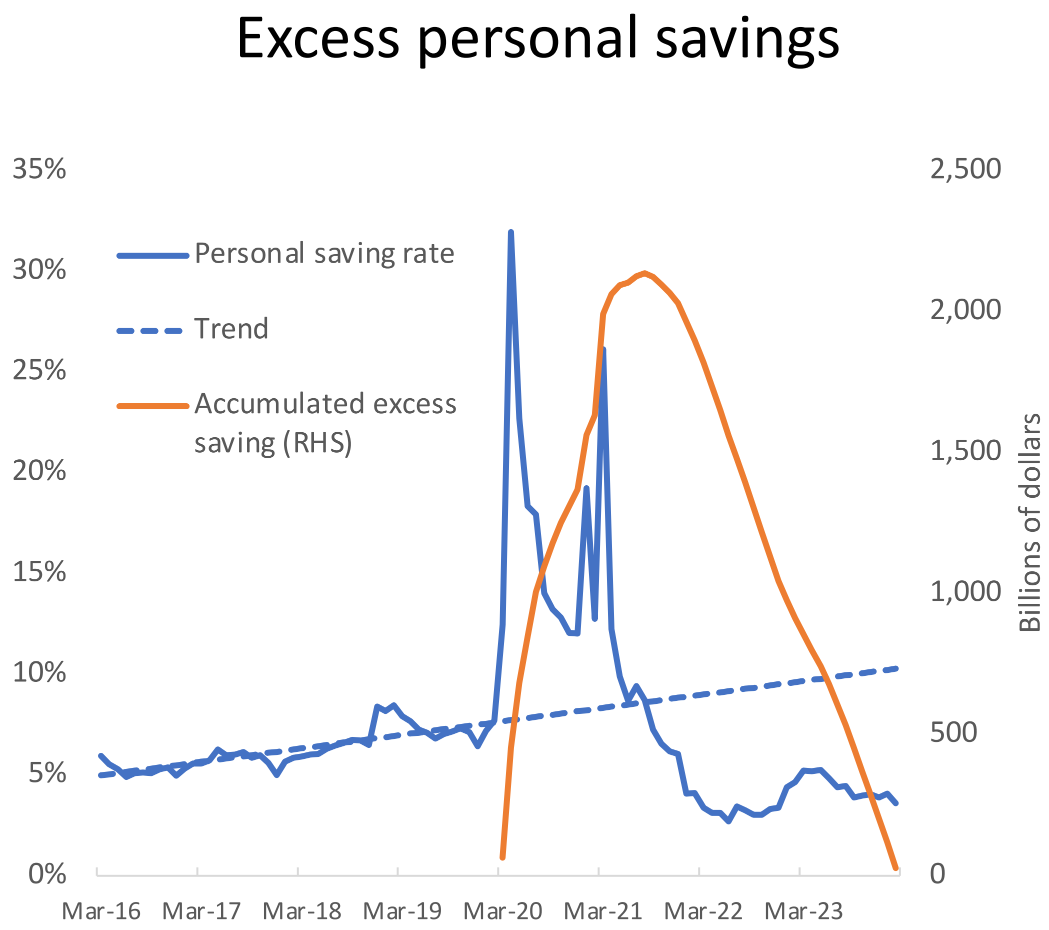


Why did inflation start to surge after the pandemic?

- Pandemic-related business closures reduced revenues and incomes
  - Consumer spending fell, firms reduced employment
  - Closures also reduced supply in some sectors, particularly services
  - Large shift in consumer spending from services to goods
- Fiscal measures aimed at offsetting the income effects
  - Not all transfer payments were spent: Consumer savings piled up
- Pandemic-related constraints were relaxed in early 2021
- Additional round of fiscal measures came in March 2021
- Spending then surged faster than supply recovered

Relief payments pile up in savings, then spent





Why did the Fed delay? Some candidate explanations:

1. FOMC's revised policy framework adopted in August 2020 and implemented at the September 2020 meeting
2. FOMC's "forward guidance" about process for ending asset purchases
3. Early 2021 assessment that inflation surge was "transitory"
4. Political engagement may have inhibited needed pivot in 2021
5. Declining diversity of views within FOMC

1. August 2020 revision of 2012 policy framework tilted policy away from price stability

- Shifted emphasis toward employment objective
  - Described as "broad-based and inclusive goal," without defining those terms
  - Sought to mitigate only "shortfalls of employment from its maximum level," not deviations above the "maximum"
- Flexible Average Inflation Targeting
  - Seek inflation averaging 2% "over time"
  - So, when inflation runs persistently below 2%, they'll aim for inflation "moderately above 2% for some time" – motivated by 2010s experience
  - Asymmetric—don't intend inflation to underrun to offset overshooting
- Arguably signaled diminished propensity to resist inflation above 2%

Implementation of new framework tied their hands

- New forward guidance language in September 2020 statement:

"With inflation running persistently below this longer-run goal, the Committee will aim to achieve inflation **moderately above 2 percent for some time** so that inflation averages 2 percent over time and longer-term inflation expectations remain well anchored at 2 percent. The Committee expects to **maintain an accommodative stance** of monetary policy until these outcomes are achieved."

"The Committee decided to keep the target range for the federal funds rate at 0 to ¼ percent and expects it will be appropriate to maintain this target range until labor market conditions have reached levels consistent with the Committee's assessment of maximum employment **and** inflation has risen to 2 percent and is on track to moderately exceed 2 percent for some time." (Emphasis added)

- *Aimed at avoiding premature tightening, ruled out preempting inflation pressures*

They had an escape clause but did not use it

"In assessing the appropriate stance of monetary policy, the Committee will continue to monitor the implications of incoming information for the economic outlook. **The Committee would be prepared to adjust the stance of monetary policy as appropriate if risks emerge that could impede the attainment of the Committee's goals**. The Committee's assessments will take into account a wide range of information, including readings on public health, labor market conditions, inflation pressures and inflation expectations, and financial and international developments." (Emphasis added)

- Long-standing FOMC practice to include such language: allows deviation from forward guidance in unforeseen circumstances
- Appeared to treat the commitment to attain maximum employment as binding, and the escape clause as boilerplate
- *They had the flexibility to deviate from their FG, but chose not to invoke it*

Lesson learned: 2020 framework and implementation

- Framework revision envisioned holding off on rate increases until seeing inflation moderately above target
  - Silent about how policy would respond to an <u>immoderate</u> overshoot
  - ***FOMC should discuss a comprehensive treatment of inflation scenarios***
- FOMC pledged to hold off increasing rates in response to inflation until reaching “maximum employment”
  - Decades of research has shown the tenuous nature of estimates of maximum employment and the dangers of excessive reliance on them in policy setting
  - Such estimates were politically contentious as well
  - ***Avoid linking forward guidance tightly to maximum employment***
  - ***Take escape clause seriously—more emphasis in public communications***

Lesson learned: Pre-emption remains essential

- Price stability depends on the stability of inflation expectations
  - Long run inflation expectations reflect confidence in the Fed's commitment to return to target after a temporary deviation
  - Short run expectations influence price setting
- "Inflation scares"—incipient increases in inflation expectations—were a recurring feature of the journey to price stability
  - Prompt pre-emptive responses brought expectations back in line
  - Pre-emptive policy response to threats to the stability of inflation expectations is critical to maintaining price stability
- ***The next framework should specifically allow for pre-emptive policy responses to incipient inflation pressures***

2. Rate liftoff tied to the end of asset purchases

- Began purchasing US Treasury securities and agency MBS in March 2020
- FOMC set conditions for end of the asset purchase program

  "In addition, the Federal Reserve will continue to increase its holdings of Treasury securities by at least $80 billion per month and of agency mortgage-backed securities by at least $40 billion per month until **substantial further progress** has been made toward the Committee's maximum employment and price stability goals." (December 2020 FOMC Statement)

- Promised to "taper" purchases before ending them
- Promised "advance notice before announcing a decision to taper"
  - Advance notice, September 2021; tapering announcement, November 2021
- Promised not to raise rates until tapering was complete
  - Tapering completed in March 2022, six months after advance notice

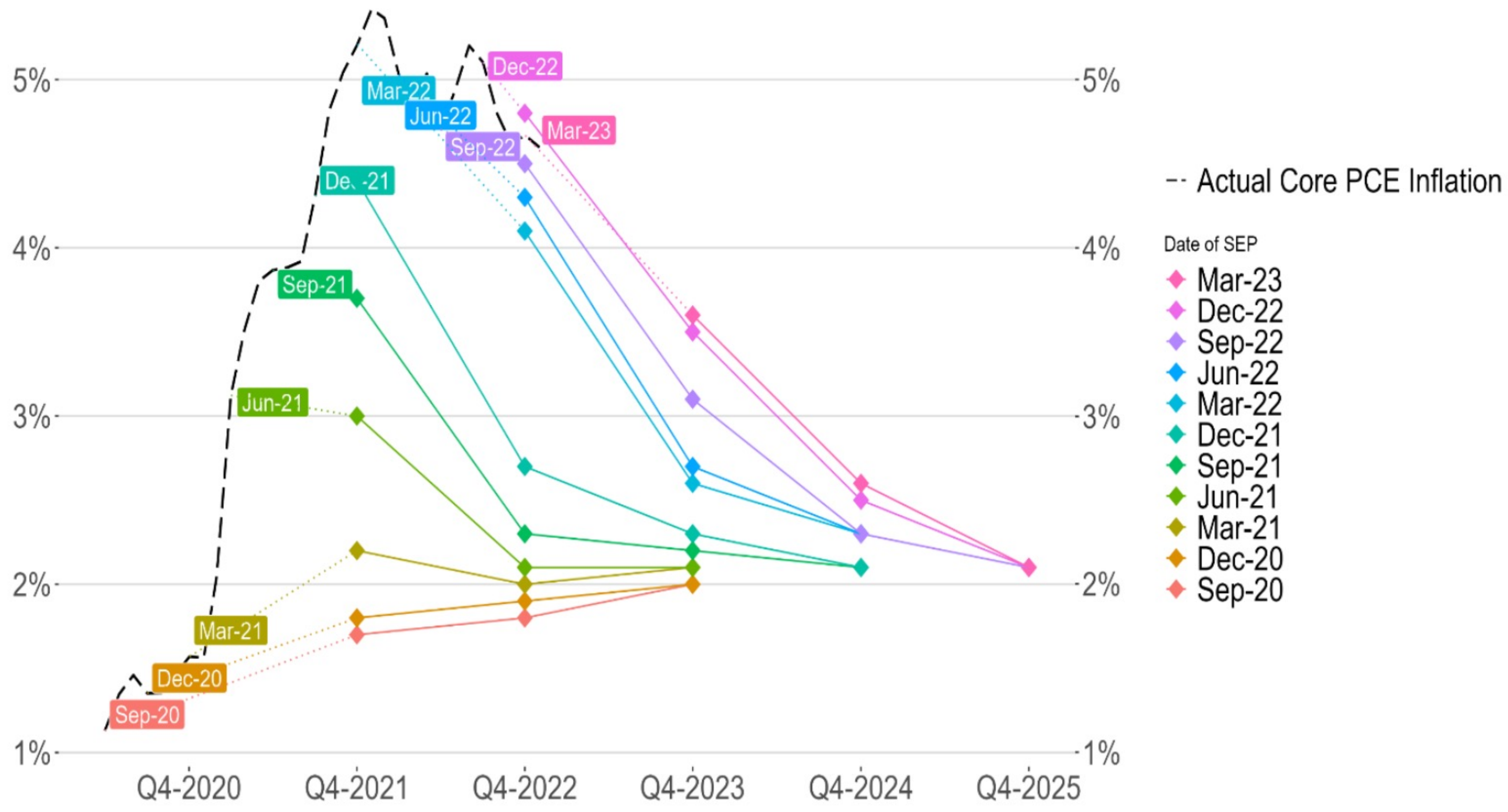
Lesson learned: Communication should emphasize contingency

- Fed communications tend to focus on the most-likely outcome
  - Media is pre-occupied with medians/means of FOMC's economic/policy outlook, particularly the "dot plot" funds rate projection
  - Interest rate "fan chart" generally ignored
  - Summary of Economic Projections constructed around best-case "no further shocks" scenario
- ***Fed should make a concerted effort to convey more uncertainty***
  - *Consider overhauling the Summary of Economic Projections*
  - *Discuss a range of alternative scenarios*
  - *Referencing simple policy rules to convey how policy is likely to respond across those scenarios*

3. Mistaken assessment that inflation was “transitory”

- Powell, Jackson Hole, August 2021: “elevated [inflation] readings are likely to prove **temporary**”
  - Surge was concentrated, not “broad based”—for example, durable goods, energy
  - Cited “base effects” from the immediate post-pandemic period
  - Inflation said to be moderating for some categories
  - Noted that wages hadn’t accelerated
  - Cited stable long-term inflation expectations (5 to 10 years ahead)
  - Argued that longer-term trend has been disinflationary
- These indicators did not prove reliable
  - There are always some prices rising faster or slower than others
  - Wages did end up accelerating, with a lag
  - Measures of near-term inflation expectations did increase
  - Stability of long-term inflation says nothing about what it would take to restore price stability

FOMC inflation forecasts were disappointed



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

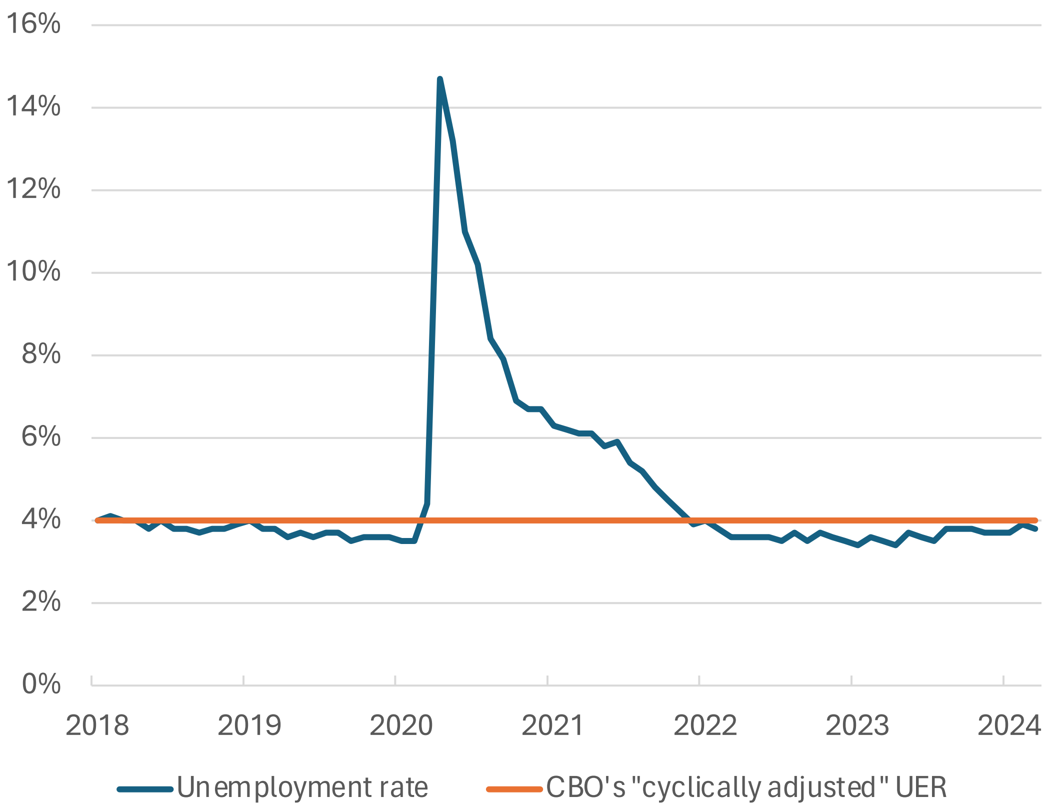
Levy, Mickey D. "The Fed: Bad Forecasts and Misguided Monetary Policy." In Getting Monetary Policy Back on Track, edited by Michael D. Bordo, John H. Cochrane, and John B. Taylor, 261–308. Stanford, California: Hoover Institution, 2024.

Inflation assessment leaned on "maximum employment"

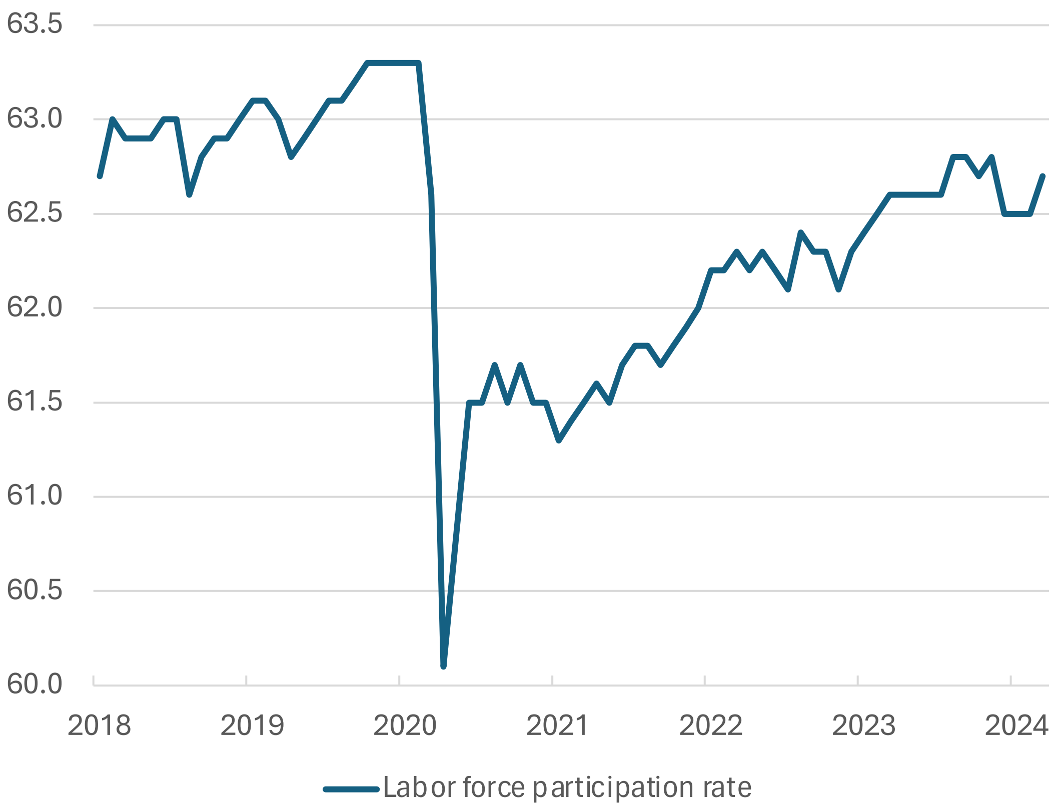
- Based in part on overestimate of the "gap" to maximum employment
  - Maximum employment typically defined in terms of the "natural rate" of unemployment = the unemployment rate that can be sustained (in absence of shocks) without acceleration of inflation
  - UER interpreted expansively as including "discouraged workers"
- One perspective going back to the 1960s sees the natural rate as a fixed parameter, evolving only slowly
- Modern perspective based on better models sees the natural rate as fluctuating in response to a wide variety of economic disturbances
  - Example: unanticipated sectoral shifts in demand, as in a housing downturn
  - Time and effort are required for labor market to absorb and reallocate supply

There was evidence suggesting substantial slack in 2021

The unemployment rate was elevated

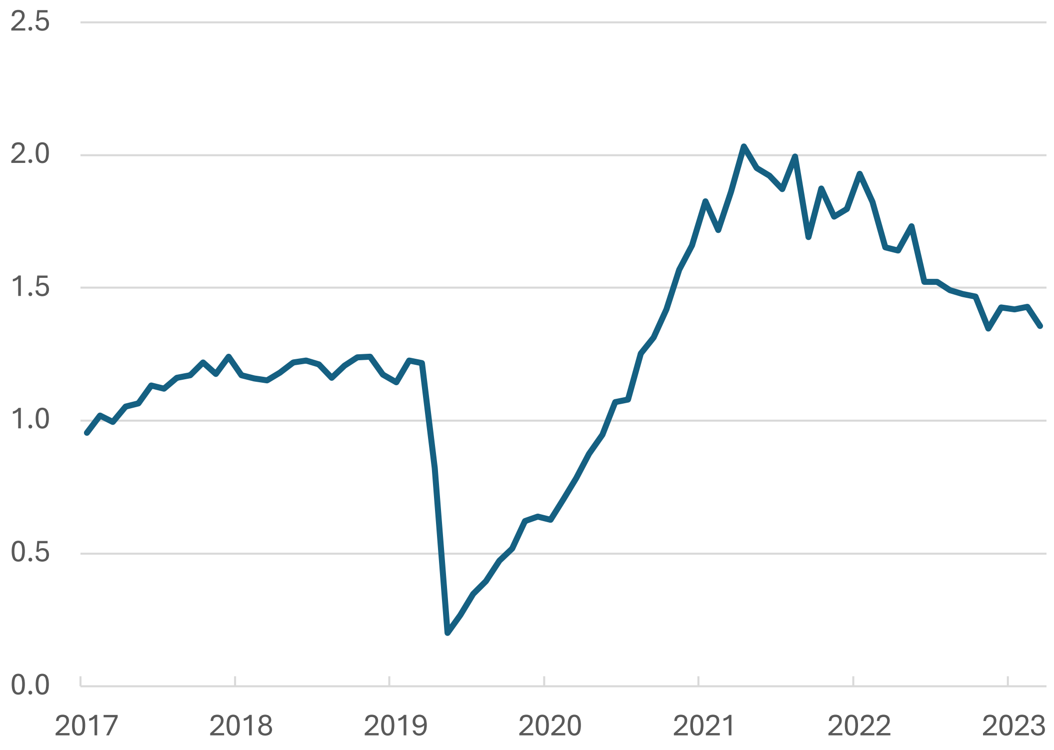


Many workers had dropped out of the labor force

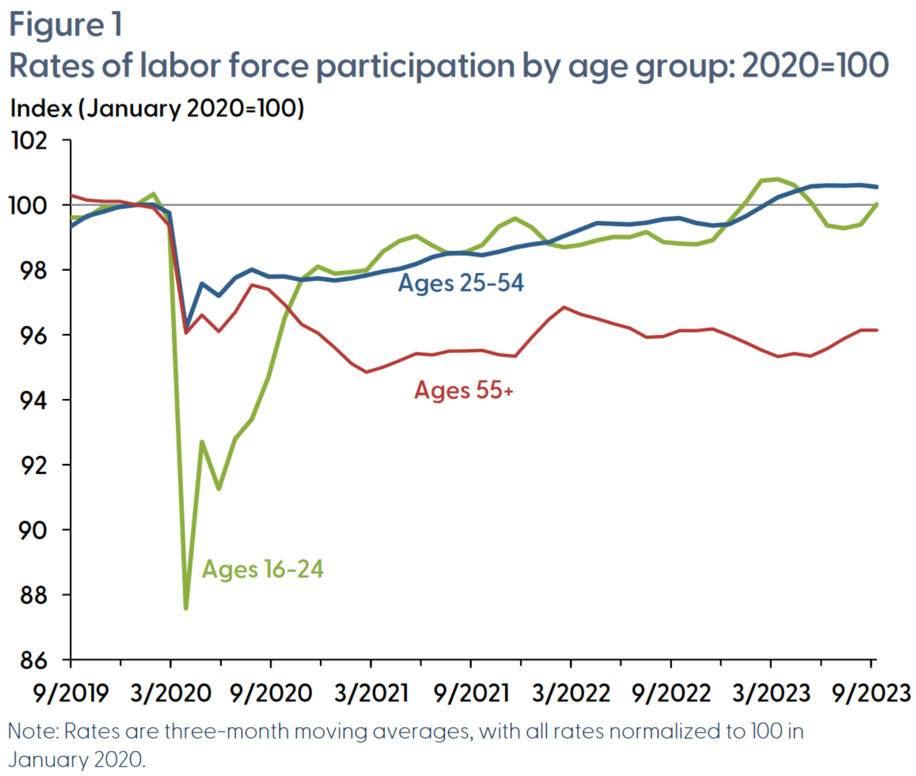


Other labor market indicators told a different story

Ratio of job openings to the number of unemployed signaled tightness



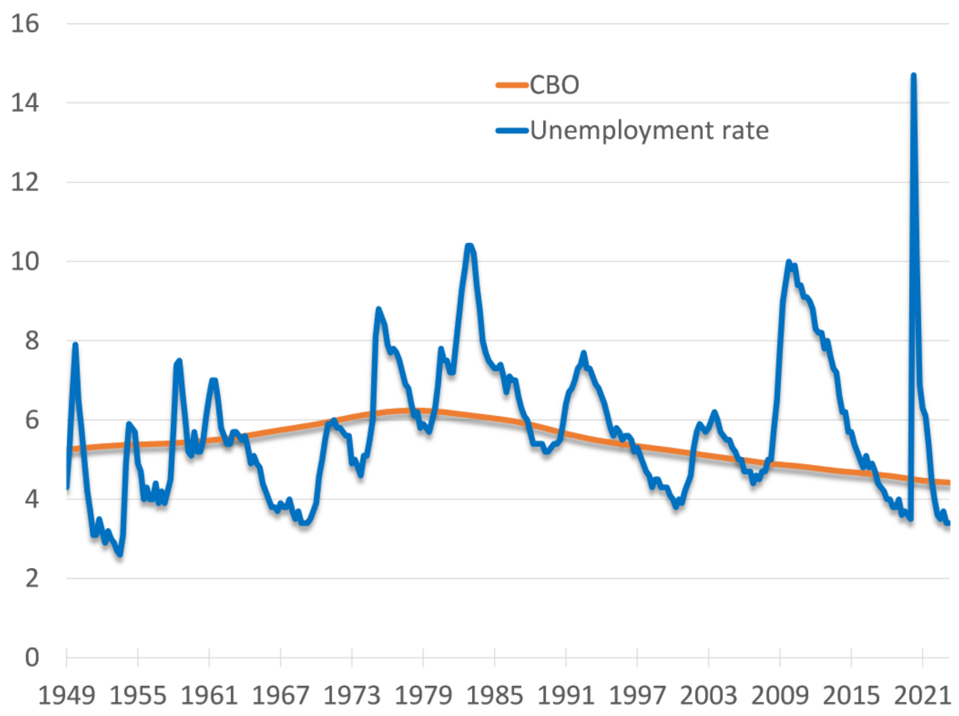
Early retirements from the labor force have not been reversed



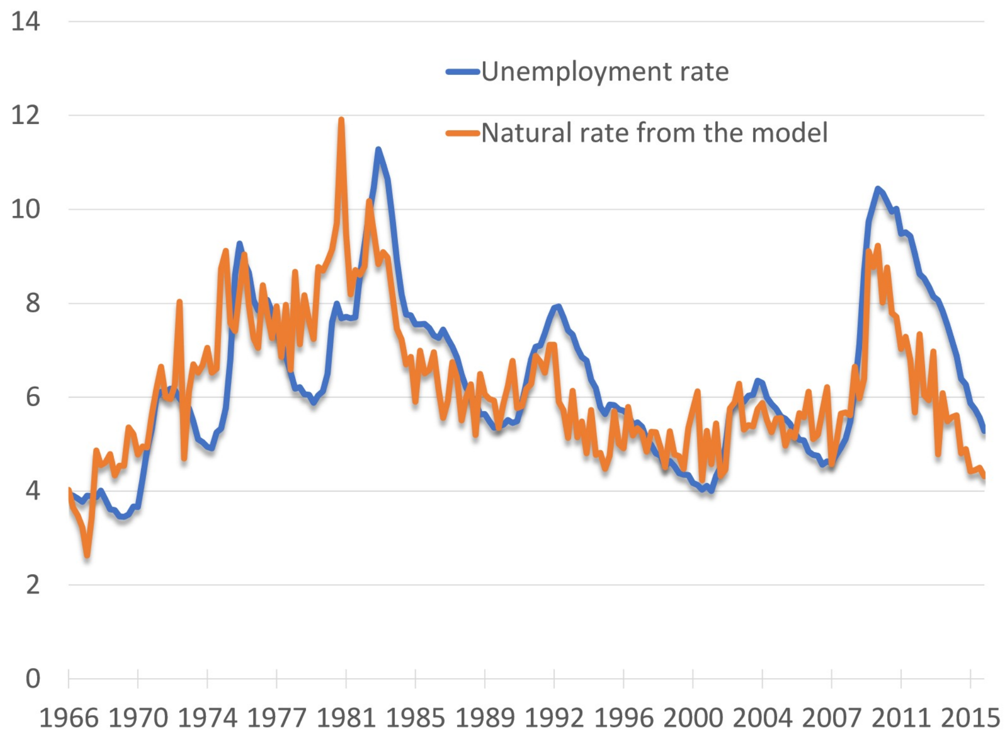
Source: Brandon Miskanic, Nicolas Petrosky-Nadeau, and Cindy Zhao, "To Retire or Keep Working after a Pandemic?" FRBSF Economic Letter 2024-08, March 25, 2024

The natural rate of unemployment can fluctuate a lot

Older perspective: natural rate varies only slowly over time



Modern perspective: natural rate responds to all sorts of disturbances



Source: Robert E. Hall, and Marianna Kudlyak. "The Downward Glide of the Natural Rate of Unemployment during Cyclical Recoveries Could Explain Flat Phillips Curves."

Lesson learned: Maximum employment needs a rethink

- ***Fed should reconsider how it interprets "maximum employment"***
- Should distinguish between:
  - A longer run concept, corresponding to how low the unemployment rate could get over the course of an economic expansion, and
  - A shorter run concept that can deviate significantly from longer run maximum employment in response to disturbances to the economic environment
  - *Thought experiment: How low an unemployment rate could possibly the Fed achieve <u>next quarter</u>?*
    - *The answer is probably not far below the current unemployment rate*
  - The gap between actual unemployment next quarter and that reference rate is what is relevant for inflation dynamics
- ***Fed should better explain the limits of its influence on employment***

4. Political entanglements

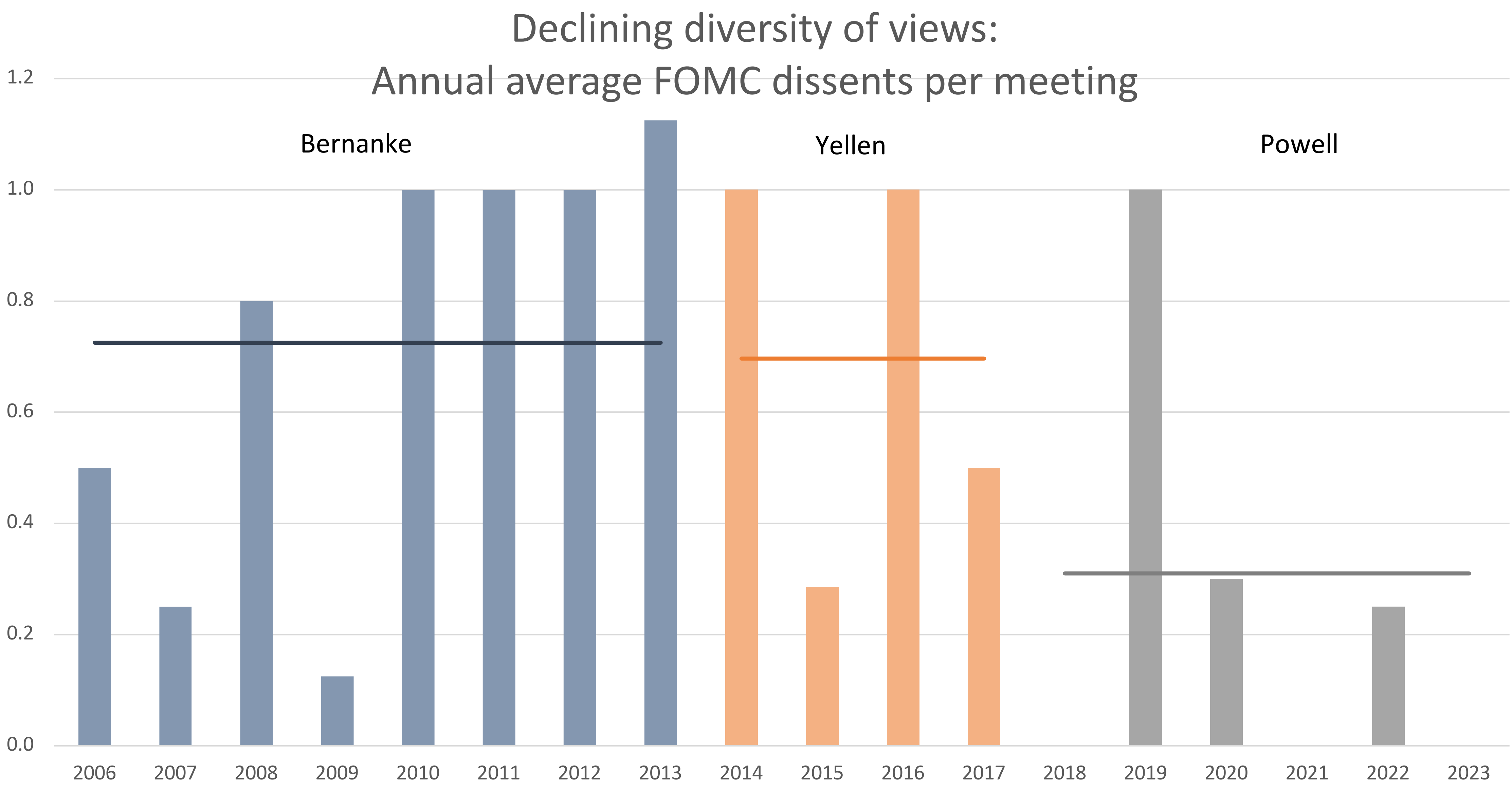
- The Fed cheered on fiscal stimulus, a departure from traditional role
  - Chair Powell advised Speaker Pelosi to "think big"
  - Corollary of monetary policy independence: Fed stays out of fiscal policy
- Fed was deeply involved in design of credit market programs in 2020, even those administered outside the Fed (e.g., Treasury)
  - Fed/Treasury designs rivaled competing designs being crafted in Congress
  - This is a fiscal policy role traditionally left for the Congress and Administration to hash out
- Fed's deep engagement in fiscal policy deliberations may have impeded the Fed's willingness to pivot toward restraint when stimulus was no longer needed

Lesson learned: Stick to monetary policy

- Fed’s interventions in credit markets are fiscal policy
  - **Not at all necessary** for the control of monetary conditions and price stability
  - Circumvents constitutional process, creates winners and losers and generates political controversy
- Often rationalized by the “need” to act rapidly
  - Spring 2020 showed that credit programs can be initiated rapidly if there is political will (bipartisan agreement)
  - Fed intervention without explicit Congressional action means acting when broad political agreement is absent
  - Aversion to the compromising effects of such controversy lies behind the “red lines” that have historically limited Fed intervention
- ***The Fed should revert to a limited role in credit markets and fiscal deliberations***

5. Declining diversity of views in internal deliberations

- Dissents under Powell down more than 50%
  - Under Bernanke and Yellen: about 7 every 10 meetings
  - Under Powell: 3 every 10 meetings
  - Less differences in public views of FOMC members
- After 2010, Board began playing a deeper role in recruiting Reserve Bank presidents
  - More than half of RB presidents in 2009 had an independent research background in monetary and macro economics
  - Arguably better prepares one to advance divergent views, dissent
- The robustness of the Fed’s internal deliberations may have diminished


Declining diversity of views:
Annual average FOMC dissents per meeting
1.2
1.0
0.8
0.6
0.4
0.2
0.0
Bernanke
Yellen
Powell
2006
2007
2008
2009
2010
2011
2012
2013
2014
2015
2016
2017
2018
2019
2020
2021
2022
2023

Lesson learned: Diversity of views can improve decision making

- General presumption in deliberative bodies:
  - The quality of decision-making is stronger when diverse perspectives are voiced and given serious consideration
  - Motivated federated structure of Federal Reserve system at its founding
- External articulation of alternative views:
  - Improves public understanding & enhances incentive to take them seriously internally
  - Compare FOMC to SEC, FDIC, SCOTUS, where dissenting views fully shared
- ***In its upcoming strategic review, the Fed (esp. the Chair) should reflect on its stance regarding diversity of views, Reserve Bank recruitment and norms around public communication and dissent***

Meta-lesson: The value of learning from experience

- The Federal Reserve has historically avoided talking about its past performance, even internally
  - Tends to avoid admitting mistakes in public
- In contrast, the U.S. Armed Forces makes learning more of a priority
  - Routinely conduct “After Action Reviews”
  - Invests in historians and historical research on their past experiences
- Recent (2019-20) review of their 2012 strategic framework was notable instance of reflection for aimed at improving policy
  - Reviews every five years promised—one coming up in 2024-25
  - (Note, however, the risk that frequent framework revisions diminish perceived commitment)
- ***The Fed should critically review the recent inflation surge and publish a report***
- ***More broadly, Fed should invest in retrospective reviews of past policy actions***