Thoughts on Fed Policy and the Fed's Framework

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The last few years have been unusually eventful from a monetary policy point of view. After several decades of price stability, the U.S. experienced a bout of inflation in 2021 and 2022. The Fed was widely viewed as having been slow to react. But in 2022, it reacted forcefully, raising interest rates more rapidly than it had since the early 1980s. As of this writing, inflation has returned most of the way back to target.

Remarkably, the Fed has been able to engineer this disinflation without triggering a recession. Actually, the economy seems not to have skipped a beat when it comes to output and employment growth. Two years ago, few commentators believed this to be a likely outcome.

These events make this an opportune time for the Fed to reevaluate its monetary policy framework. The last framework review was conducted at a time when the Fed had been so successful at bringing about rough price stability for so long that the main problem being debated was the fact that inflation had persistently undershot its target by a few tenths of a percent. It seemed lost on many at the time what a sign of success that debate was. The Covid recession and subsequent bout of inflation has refocused discourse about monetary policy on bigger, more fundamental issues.

What conclusions one draws from the experience of the last few years depends critically on how one interprets what happened. The Covid recession caused a number of unusual developments, both on the demand side of the economy and on the supply side. On the demand side, large fiscal stimulus measures were passed in 2020 and 2021 and households built up unusually large savings early in the pandemic which they then proceeded to spend down. On the supply side, Covid resulted in a substantial reduction in labor supply which reversed slowly. Furthermore, Covid resulted in a substantial shift in expenditure patterns of households away from services and towards goods. This resulted in severe bottlenecks in the goods-producing sector of the economy and called for a sizeable temporary increase in the relative price of goods.

**Did the Fed Make a Serious Policy Error in 2021?**

How should the Fed have reacted to this set of circumstances? One view is that the Fed made a serious error in 2021 by failing to raise rates aggressively as inflation rose. The Fed's failure to act aggressively in 2021 may have been caused by some of the novel aspects the framework the Fed adopted in 2020. First, the Fed adopted a flexible average inflation target (FAIT), which prescribed that inflation should be allowed to run moderately above 2% for some time after periods when inflation had persistently undershot the 2% target. Since inflation had indeed persistently undershot the target in the years prior to Covid, the FAIT framework prescribed patience during the early months of the rise in inflation in 2021.

Second, the Fed had come under sustained criticism in the years prior to Covid for preemptively tightening policy starting in 2015. That preemptive tightening was seen as hampering the economy's ability to reach full employment. The preemptive tightening was motivated by a concern that the labor market was reaching full employment and was at risk of overheating. But estimates of the natural rate of unemployment have repeatedly turned out to be too pessimistic, suggesting that policy was tightened too early. Because of this, the Fed faced intense pressure prior to Covid to allow the labor market to find the true level of full employment without reference to potentially faulty estimates of the natural rate.

This strand of thought found its way into the Fed's 2020 framework in that the working definition of maximum employment was changed to the "highest level of employment that does not generate sustained pressures that put the price-stability mandate at risk" (Clarida, 2022). The language in the framework statement emphasized the elimination of shortfalls rather than the symmetric elimination of gaps from the natural rate. In effect, the Fed adopted more of a "plucking" view of the labor market (Friedman, 1964, 1993, Dupraz, Nakamura, Steinsson, 2024) rather than a traditional natural rate view.

Perhaps due to these types of considerations, the FOMC adopted the policy stance in the aftermath of Covid that interest rates would not be increased before the economy had reached full employment and inflation was on track to moderately exceed 2 percent for some time. The exact language of the FOMC statement from September and November 2021 was:

"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."

Somewhat surprisingly, it was not clear from these statements that this aspect of policy was subject to an escape clause in situations where inflation was substantially above target. I recall thinking at the time that this went without saying. But others did not see things this way. Since it was not clear whether the economy had reached full employment in the fall of 2021, the focus on maximum employment contributed to a slow response of the Fed. (12-month PCE inflation was 5.5% in October 2021 and the unemployment rate was 4.5%.)

In addition to these factors, Chair Powel was up for renomination in the fall of 2021, making an unpopular pivot to tighter monetary policy more difficult politically. Finally, the FOMC had led markets to expect that it would curtail quantitative easing prior to raising rates. This, arguably, resulted in a slower pivot towards tighter policy than was optimal.

**A More Positive View**

As I mentioned above, an important reason for the inflation spike was the large shift in demand away from services and towards goods during and after Covid. This shift meant that the relative price of goods needed to rise. This could happen by goods prices increasing, services prices decreasing, or some combination. In addition, a considerable part of the increase in inflation in 2021 and 2022 was due to food and energy. A key policy question was then whether the Fed should have tightened policy enough to force down services prices to offset the rise in the prices of goods, food, and energy.

An alternative policy was to seek to prevent the price increases in goods, food, and energy from spilling over into services. If successful, this type of policy would result in a relatively short-lived deviation of inflation from target. Inflation would come down once the relative price of goods, food, and energy had stabilized and might even reverse as the relative price of goods reversed when bottlenecks in the supply of goods eased.

This seems to have been largely the policy that the Fed followed over the past few years. This policy has been remarkably successful in avoiding a recession, an achievement that is hard to overstate. It has not been fully successful when it comes to spillovers of goods, food, and energy inflation to services inflation. The contribution of services to overall inflation has risen from about 1.5% prior to Covid to about 3.5% in early 2023 before starting to recede. At the same time inflation in goods, food, and energy has fallen to approximately zero by early 2024.

My overall assessment of the Fed's policy in 2021 and 2022 is that the Fed did get behind the curve in the late fall of 2021 and early 2022. The fact that the language of the FOMC statement was not changed between September and November 2021 was a mistake that delayed the policy pivot by at least a month. The fact that the FOMC felt the need to end QE before starting to raise interest rates also unnecessarily slowed the needed policy pivot. However, the Fed's historically aggressive interest rate increases in 2022 – four 75bp increases in a row – made up this ground relatively quickly. As a result, the damage was likely modest.

Arguably, a key reason why the Fed was able to engineer a disinflation over the past few years without triggering a recession was that longer run inflation expectations remained largely anchored. There were some signs of unanchoring between September 2021 and March 2022 with 5-year breakeven inflation from TIPS rising from 2.5% to 3.5%. But this quickly reversed once the Fed began its aggressive rate increases. Inflation expectations even further out (e.g., the 5 year – 5 year forward breakeven inflation rate from TIPS) did not budge at all during this period. The fact that longer run inflation expectation were relatively well anchored was the consequence of a relentless focus on price stability over the prior 40 years. This was therefore a hard-earned win for the Fed and demonstrated the value of having a large amount of credibility.

**Maximal Employment and Preemptive Tightening**

One of the key questions that faces the Fed as it reviews its policy framework is how best to fulfill its employment mandate. I am quite sympathetic to the "plucking" view of business cycles, i.e., the view that business cycles largely represent shortfalls of employment below a full employment level rather than symmetric fluctuations around a natural rate. This view suggests that the Fed should be aiming for lower levels of unemployment than traditional analysis has indicated. Traditional analysis that pegs the natural rate of unemployment at something like 5% (or more) is in my view not supported by much good evidence. It seems to me that the level of unemployment that represents full employment is closer to 3.5% and perhaps even lower. I believe the Fed should take this plucking view very seriously and should calibrate its policy accordingly.

However, the fact that views about the natural rate of unemployment have been poorly calibrated in the past does not imply that the Fed should forswear preemptive tightening of policy. Monetary policy operates on the economy with some lag and the economy can be highly inertial. Just as the captain of a large ship must turn the wheel far before the ship hits an obstacle, the Fed must adjust policy with an eye towards where it wants the economy to end up 6 to 12 months hence. This logic calls for preemptive tightening of policy at times (and preemptive loosening of policy at other times). The Fed's framework should make clear that preemptive policy actions are an integral part of the Fed's policy toolkit.

**Flexible Average Inflation Targeting**

The goal of adopting flexible average inflation targeting in 2020 was to better anchor long-run inflation expectations at the target rate of 2%. This is an important goal. However, the specific problem that led to the specific design of flexible average inflation targeting in 2020 was only one of several problems that the Fed might face regarding the anchoring of long-run inflation expectations. At that time, the Fed was worried that small but persistent undershoots of inflation in the years before 2020 might eventually get embedded in longer-run inflation expectation. The subsequent much larger increase in inflation has brought some needed perspective to this issue.

A heavy emphasis on anchoring long-term inflation expectations is appropriate and important for the Fed's Statement on Longer-Run Goals and Monetary Policy Strategy. The trouble is that it is not clear that we have a good understanding of how to achieve such anchoring. The idea of moving slightly towards price-level targeting – which is what flexible average inflation targeting does – is theoretically appealing in simple models. But whether it works in practice is not at all clear.

I used to think that central banks' relentless and constant focus on credibility in the post-Volcker era was at times too much of a good thing. But the experience of the last 4 years has changed my view in this regard. This experience has fortified my belief that credibility is hugely valuable when the central bank needs to respond to adverse shocks (supply shocks or fiscal shocks) and that credibility is most often earned slowly over time by both the actions and words of central bankers. This suggests that a heavy focus on anchoring of longer-run inflation expectations is appropriate. Exactly what form this heavy focus should take is less clear to me. More research is needed on this issue.

**Credibility and the Sacrifice Ratio**

Why was the "sacrifice ratio" so favorable in this disinflation in contrast to earlier disinflations? My guess is that a key reason for this is that the Fed had built up enormous amounts of credibility over the preceding four decades. This credibility allowed the Fed to respond more cautiously to the shocks that hit the economy in the aftermath of Covid without this leading to an increase in longer-run inflation expectations.

For simplicity, consider the situation of an economy hit by an adverse temporary supply shock. The central bank may want to allow inflation to temporarily increase in response to this shock, so as to avoid having to engineer a large recession. This is what optimal policy looks like in simple models. The trouble is that a central bank with poor credibility will see inflation expectations rise rapidly when inflation rises. This will in turn further push up inflation. The dynamics of inflation may thus deviate sharply from the dynamics of the original supply shock. Even if the original supply shock is transitory, the dynamics of inflation will take on a life of its own because of the feedback loop between inflation expectations and inflation. To bring inflation back to target, the central bank is then likely to need to engineer a recession. So, the central bank with poor credibility is not really able to avoid engineering a recession.

Contrast this with a central bank that has good credibility. It can communicate to the markets that it is temporarily allowing inflation to rise above target due to the temporary supply shock but that it will conduct policy so that inflation falls back down to target when the supply shock dissipates. The central bank's credibility will imply that longer-run inflation expectations remain anchored. This in turn implies that the deviation of inflation from target will have similar dynamics as the supply shock itself. As a consequence, the central bank can be patient and avoid driving the economy into recession.

The situation after Covid was more complicated than just an adverse supply shock. But I think the basic story from the paragraphs above captures the essence of why the sacrifice ratio was more favorable over the past few years than in earlier disinflation episodes. In the early 1980s, the Fed's credibility was poor and long-run inflation expectations were poorly anchored. The Volcker Fed acted very aggressively to convince markets of its commitment to lower inflation. But credibility is difficult to attain quickly. As a result, markets were skeptical for years of the degree to which inflation would stay low and long-run inflation expectations only gradually converged to low levels. This meant that the Fed needed to engineer a recession to bring inflation down.

**Scars to Credibility**

The Fed's high level of credibility was extremely valuable over the past few years and arguably allowed the US economy to avoid recession. But the Fed "used up" some of its credibility in this episode. What I mean by this is that the Fed would likely be harder pressed to pull off the same thing again in the immediate future. More than one episode of elevated inflation within a short period may, to some, start to look like a pattern. This implies that it is especially important for the Fed to build credibility over the next 5 to 10 years. The Fed will, for some time, have scarred credibility, and during that time its ability to respond to adverse shocks with a low sacrifice ratio will be impaired. Erring on the side of tighter policy during this period is likely prudent since the Fed cannot lean as heavily on its credibility before the scars of 2021-2022 heal.

**A Higher Inflation Target?**

The notion that the Fed might consider raising its inflation target – perhaps to 3% or 4% -- has been debated since the economy hit the zero lower bound (ZLB) on nominal interest rates in late 2008. The main argument in favor of this view is that it would provide the Fed with more room to ease policy during a severe downturn. The conventional wisdom that r* may have fallen over the past few decades has also played an important role in this debate.

I was at one point somewhat sympathetic to this view. But I have become less sympathetic over the past 5 years. The main reason for this change in my views is simply the fact that people really dislike inflation, even relatively modest amounts of inflation. This intense dislike of inflation has become abundantly clear over the past few years. This has driven home to me the wisdom of Alan Greenspan's definition of price stability as a state "when people do not consider inflation a factor in their decisions." I worry that an increase in the inflation target will result in a situation where the public does not feel that price stability – defined in this way – has been achieved.

The success of the Fed in responding to both the Great Recession and the Covid recession also plays into my view on keeping the inflation target at 2%. More room to ease policy would indeed have been valuable during and in the immediate aftermath of the Great Recession. But what happened was a far cry from the deflationary death spiral that some models predict can happen at the ZLB. Likewise, the Fed was able to provide a large amount of accommodation during Covid through a combination of rate cuts, forward guidance, and quantitative easing.

**Lender of Last Resort**

The final argument that I would like to make is that the Fed's framework should incorporate the Fed's role as a lender of last resort. The Fed's 2020 Statement on Longer-Run Goals and Monetary Policy

Strategy implicitly defines monetary policy narrowly as interest rate policy (and perhaps quantitative easing) and does not discuss its role or its policy as a lender of last resort. But one of the core roles of a central bank is to act as a lender of last resort in a banking panic. The Fed has a checkered history in this regard. Its failure to act in the Great Depression was arguably a disaster, and the wisdom of allowing Lehman Brothers to fail in 2008 is a highly contentious issue. Furthermore, for historical reasons, the most straightforward mechanism through which the Fed can act as a lender of last resort – the discount window – is impaired by the stigma associated with its use. This is not a good state of affairs.

The Fed has developed a considerable amount of expertise in acting as a lender of last resort since 2008 and did so quite successfully during the Covid period. However, the Fed's role as a lender of last resort is not continually acknowledged as a core function of the Fed. Nor am I aware of a statement of policy principle by the Fed on this important topic. This risks demoting financial stability and crisis management to a secondary status in public and academic discourse. Fortunately, all is quiet on this front most of the time. But the Fed's actions as a lender of last resort in times of crisis (and commitments to act if needed) are a no less consequential part of the Fed's overall policy than "normal" monetary policy.

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