Ellen Meade's comments on Gauti Eggertsson and Don Kohn's "The Inflation Surge of the 2020s: The Role of Monetary Policy"
May 23, 2023

Thanks to the Hutchins Center for inviting me to join you for this important discussion. Brookings is kicking off the Fed's next framework season with two important papers. The Eggertsson and Kohn paper assesses the contribution of the 2020 framework to the surge in inflation. My comments will focus on a few of the topics they raise. The paper is well worth reading and the recommendations at the end make a valuable contribution.

Stock taking exercises are important. The research conference the Fed held in Chicago in 2019 included such an exercise by Janice Eberly, James Stock, and Jonathan Wright. That exercise was not about understanding the causes of the GFC but the effectiveness of the Fed's policy in promoting the economic expansion that began in 2009. The hurdle for stock taking this time will be higher because we need to assess cause—how much did the new framework contribute; what about the forward guidance (which was implementing language for the framework), or the view on evolution of the pandemic and the extent to which the factors boosting inflation were transitory, supply-related, and would resolve over 2021, or the underestimation of the strength of the labor market. I think the authors overestimate the contribution that the new August 2020 framework played in the inflation surge at the expense of other contributors although, to be fair, they concede this point in their introduction.

The 2019 stock taking applied the Fed's 2012 framework to Fed actions from 2009. This was appropriate as the 2012 framework was an articulation and clarification of the strategy the Fed had been following for some time. Similarly, the 2020 framework articulated an approach to policy that was evolving but which began to play an important role in decisionmaking in the 20-teens with respect to thinking about both dual mandate goals.

We can see how the Eberly, Stock, and Wright analysis affected the Fed's thinking on the eve of the pandemic. Their stock taking concluded that the new policy tools of forward guidance and asset purchases had played an important role in speeding the economic recovery but could have been even more helpful if they had been rolled out sooner and more forcefully—recommendations the Fed took on board when it crafted its pandemic response in March 2020. Their analysis is consistent with Eggertsson and Kohn's view about regret around the decision to lift off from the effective lower bound in December

2015: The unemployment rate could have been reduced further with a negligible effect on inflation had the Fed waited to lift off. Eggertsson and Kohn see 2015 liftoff regret as formative for the Fed.

Eggertsson and Kohn describe the mindset that surrounded the 2020 framework change: the lower neutral rate implying a greater likelihood that policy rates would hit the ELB, the attendant risks associated with trips to the ELB for achievement of maximum employment and 2 percent inflation; a potential downward spiral as underachievement of the inflation goal lowers inflation expectations and further reduces the Fed's policy space. There were significant important research contributions from inside and outside the Fed. The authors give a nice review of the issue and associated findings. I agree with them that the mindset about the most important problem facing policymakers dominated thinking coming into the framework review in 2019. Indeed, the new framework statement, which retained the 2012 statement's first paragraph, highlighted the issue in a new second paragraph.

What this meant, however, was that the new framework was very specific to a particular problem. It was not a broad articulation of goals and principles like the 2012 framework had been but narrowed the focus to a particular very significant issue. Eggertsson and Kohn criticize the narrowness of the 2020 framework because it left undefined how the Fed would behave in the event of an inflation surge, which as unlikely as it seemed at the time, is what occurred. I agree with the authors that the next policy framework should be robust to a broad range of possible scenarios. They use the term "stress tests." I'm not sure whether they are advocating that a broad statement of principles be combined with scenario-specific descriptions—more of a framework manual than a framework statement?

In any event, a framework statement of goals and principles, whether narrow or broad, needs other communications that spell out the tactics. This role was played by the forward guidance both in 2012 and 2020. The December 2012 conditional forward guidance around the federal funds rate and around asset purchases included full-throated escape clauses in the event of an inflation surge.

In contrast, the forward guidance the Fed introduced in September and December 2020 was very muscular and did not have similar escape hatches. It indicated that the Fed expected to remain at the effective lower bound until achieving both maximum employment and 2 percent inflation with an expected overshoot. Eggertsson and Kohn are right to criticize this aspect of the forward guidance. However, it's not correct to say as they do that the September 2020 forward guidance "implied that the

FOMC would tolerate any level of inflation without acting, if employment had not reached maximum." To be fair to the Fed, there was a final new paragraph introduced in the September 2020 FOMC statement that provided an out. That paragraph said the Committee could "adjust the stance of monetary policy as appropriate if risks emerge that could impede the attainment of the Committee's goals" and that in assessing the appropriate stance of policy, the Committee would consider, importantly, labor market conditions, inflation pressures, and inflation expectations, among other things.

Should the escape clause have been in the conditional forward guidance as it was back in 2012? I think so, yes. The communications would have been clearer and the conditionality of the forward guidance more explicit. But it is not correct to say that the FOMC had completely tied its hands.

Eggertsson and Kohn also point out that the Committee could simply have adjusted its forward guidance at any meeting. I agree it's not clear why the FOMC waited so long to make meaningful language adjustments. Inflation was averaging 2 percent by early 2021 (whether you take your measure from the start of the effective lower bound in March 2020 as the authors do or from the adoption of the new framework in August 2020). Yet the FOMC statement in November 2021 still said, "With inflation having run 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 language adjustment didn't come until the subsequent meeting when the statement acknowledged that inflation had been exceeding 2 percent for some time. I'm in full agreement with the authors on this point.

Let me turn now to the changes that the 2020 framework introduced on the maximum employment side of the Fed's mandate. Here, I disagree with a good bit of Eggertsson and Kohn's analysis. The authors point to three important changes to the maximum employment side of the Statement on Longer-Run Goals and Monetary Policy Strategy. First, the ordering of the goals was changed throughout the statement to be consistent with the ordering of the goals in the Federal Reserve Act. Eggertsson and Kohn say, "It seems difficult to find an alternative interpretation to this change than that that the Federal Reserve wanted to communicate its increased attention to this part of the dual mandate." But how can a change that simply lines up ordering in the framework statement with the Federal Reserve Act reflect an increased attention beyond what was in the Act itself?

Second, the authors criticize what they call a "more expansive definition of maximum employment" in the 2020 statement, which characterized maximum employment as a "broad based and inclusive goal." They see this new characterization together with the dropping of the median longer-run normal unemployment rate from the Summary of Economic Projections (SEP) as opening "the door for considering the status of subsections of the nation based on income or other defining characteristic."

The 2012 statement cited the SEP median by way of example. I've always thought that was because the SEP is not a Committee forecast but a collection of individual forecasts premised on individual assumptions of appropriate monetary policy. Dropping the reference to a number that is not endorsed by or reflective of the Committee or agreed to in a consensus fashion from a document that is a consensus document does not seem inappropriate to me.

The framework statement retained language saying that maximum employment is "not directly measurable and changes over time owing largely to nonmonetary factors that affect the structure and dynamics of the labor market," that "it would not be appropriate to specify a fixed goal for employment," and that in making its assessments the Committee considers a wide range of indicators. Thus, many aspects of the earlier statement were preserved.

Since the mid-20-teens, the FOMC has been communicating its attention to a broad range of labor market indicators, and staff presentations to the FOMC have routinely included metrics such as unemployment rates by race and ethnicity. In June 2016, the Fed's Monetary Policy Report included a box examining whether gains from the post-GFC expansion had been widely shared; subsequent Reports included boxes analyzing labor market outcomes, housing, returns to education, and so on, for different demographic groups. To me, the addition of the words "broad based and inclusive" merely acknowledged that the FOMC did not take a summary statistic approach to evaluating maximum employment. And the Committee continued to say as it had in 2012 that it saw maximum employment as largely determined by nonmonetary factors.

Further, Eggertsson and Kohn note that some policymakers "highlighted the potential gains for such groups due to the new framework." Statements about potential gains were related to the demographics of the labor market in the late stages of an expansion, which connects to the third change that the authors highlight, the introduction of asymmetry with respect to the employment leg of the mandate:

The Committee would seek to "mitigate *shortfalls* of employment from assessments of its maximum level" rather than "*deviations*" as in the prior framework (italics added for emphasis). Thus, the Fed would ignore overshoots of employment, which it saw as having little implication for inflation given the flatness of the Phillips curve.

Eggertsson and Kohn use a simple model to illustrate that this asymmetry leads to an expansionary bias in policy that generates inflation. Importantly, as they note, if the Phillips curve is flat, the size of the inflation bias could be quantitatively trivial but the gains in employment could be large.
In June 2016, the Tealbook document circulated to policymakers ahead of each FOMC meeting began including a new loss function in its optimal control simulations. That loss function assigned a zero weight to unemployment rate outcomes below the natural rate—that is, the loss function placed an asymmetric weight on the unemployment gap. These simulations are on the Fed's website in Tealbook materials from June 2016 onward and currently posted through the end of 2017.

The June 2016 Tealbook said, "Policymakers choose this relatively low path for the policy rate because the desire to raise inflation to 2 percent is not tempered by any aversion to the undershooting of the natural rate of unemployment that helps achieve this outcome. In this simulation, the tighter labor market causes inflation to reach 2 percent more quickly than in the case of equal weights; inflation then edges above the Committee's longer-run objective for a few years." Thus, the asymmetric loss function was recognized as having an inflation bias, one helpful for meeting the 2 percent inflation goal, and was not motivated by a singular desire to boost employment or help disadvantaged groups.

As policymakers spoke publicly about the new framework, they tended to point to the employment effects of the asymmetry rather than the implications for inflation. Here's where it's important to bring up Fed Listens, which the authors don't really discuss, but which was an important leg of the framework review. When we undertook Fed Listens, we sought to leverage the wide network of Federal Reserve System contacts and advisory councils to hold policymaker listening sessions around the country. It was an accountability exercise first and foremost, and it offered policymakers the chance to hear directly from groups they have little contact with about experiences around the dual-mandate goals. Not surprisingly, back in 2019, we had a hard time getting folks to speak about inflation, but the events provided lots of first-hand stories about developments in labor markets. Conditions were tight and it was difficult to find workers with adequate training. Individuals on the margins were being drawn in and given opportunities that they wouldn't have had a few years before. The labor market was running hot, and it wasn't generating inflation. This experience was formative even for policymakers who lean to the hawkish side of the spectrum.

My final comment pertains to whether the 2020 framework provided the death knell for preemptive policy action. I saw the framework as very much downgrading estimates of u* in the policy process, but I did not see it as throwing preemptive action away. The strategy statement continues to say that the Committee's policy decisions reflect its medium-term outlook in addition to its longer-run goals and assessments of the balance of risks. At the Monetary Policy Forum earlier this year, Cleveland Fed president Loretta Mester agreed that the FOMC should have acted sooner to address inflation but didn't see the delay as having been generated by an absence of preemption so much as overly optimistic forecasts for inflation. She sees the 2020 framework changes as reflecting uncertainty around assessments of maximum employment. "Given that we don't know where u* is, policymakers should not base policy solely on what could be an outdated estimate of this construct. But if inflationary pressures are building, policy can and should take preemptive action. As the strategy statement continues to acknowledge, monetary policy actions tend to influence the economy with a lag. This means it can be costly if monetary policy allows an accommodative stance to remain in place when price pressures rise."

References

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