The Fed: Lessons Learned from the Past Three Years

Kristin Forbes
MIT-Sloan School of Management, NBER & CEPR

MIT MANAGEMENT SLOAN SCHOOL

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The More Things Change?

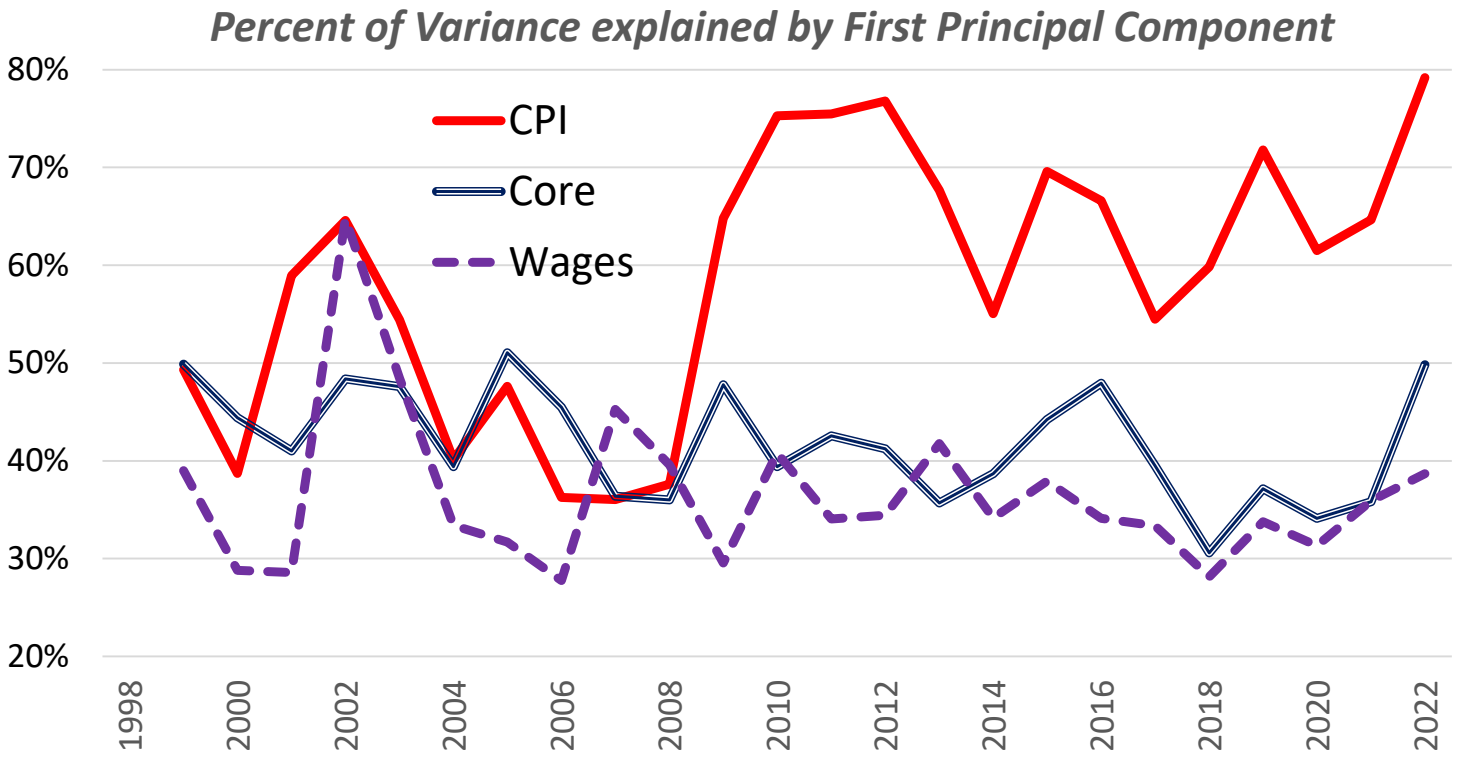
Key changes in the macroenvironment

1) Role of global shocks
2) High inflation & steep Phillips curve
3) Policy rates well above ELBs

Implications for the Fed Framework Review

1. Role of Globla Shocks

For Different Inflation Measures



Notes: Percent of variance of quarterly inflation explained by the first principal component. Calculated as 5-year rolling averages for 24 advanced economies with OECD data. CPI is CPI or HPIC inflation. Core is CPI inflation excluding food and energy. Wage inflation is based on hourly earnings in manufacturing. All inflation data from OECD. Graph is based on analysis in Forbes (2020), "Inflation Dynamics: Dead, Dormant or Determined Abroad?". *Brookings Papers on Economics Activity*, Fall, except uses data updated through 2022Q1 and lusing 5-year rolling averages instead of fixed periods.

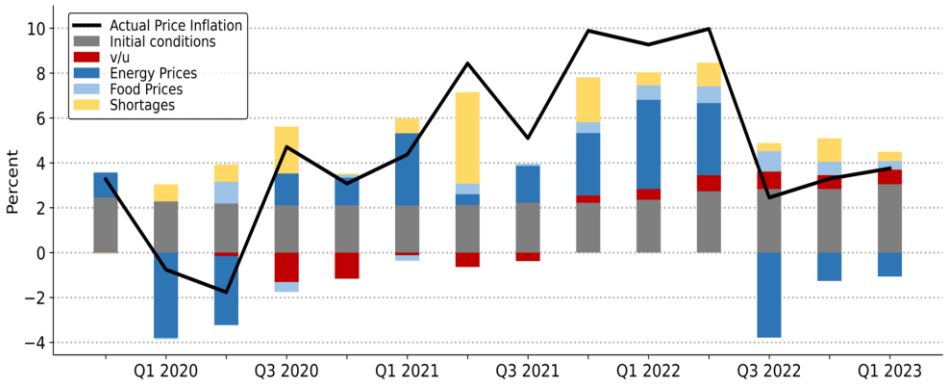
1. Role of Global Shocks

Bernanke and Blanchard (2023)

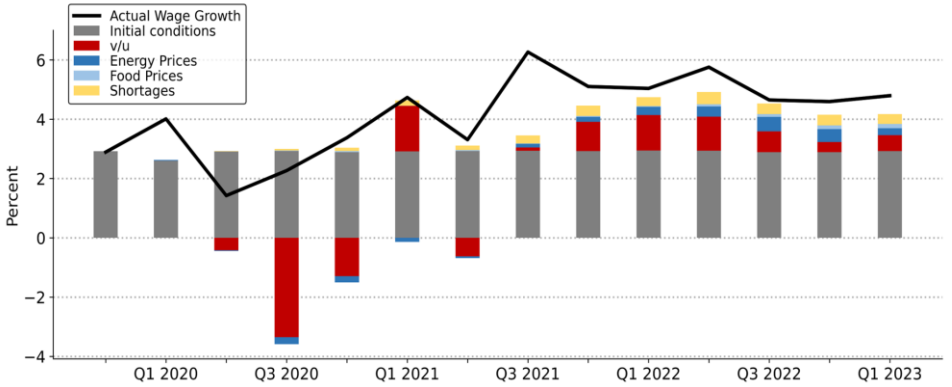
1) CPI inflation: Important role of global shocks
2) Wage inflation: modest impact so far

Critical: no deanchoring of inflation expectations and minimal "catchup"

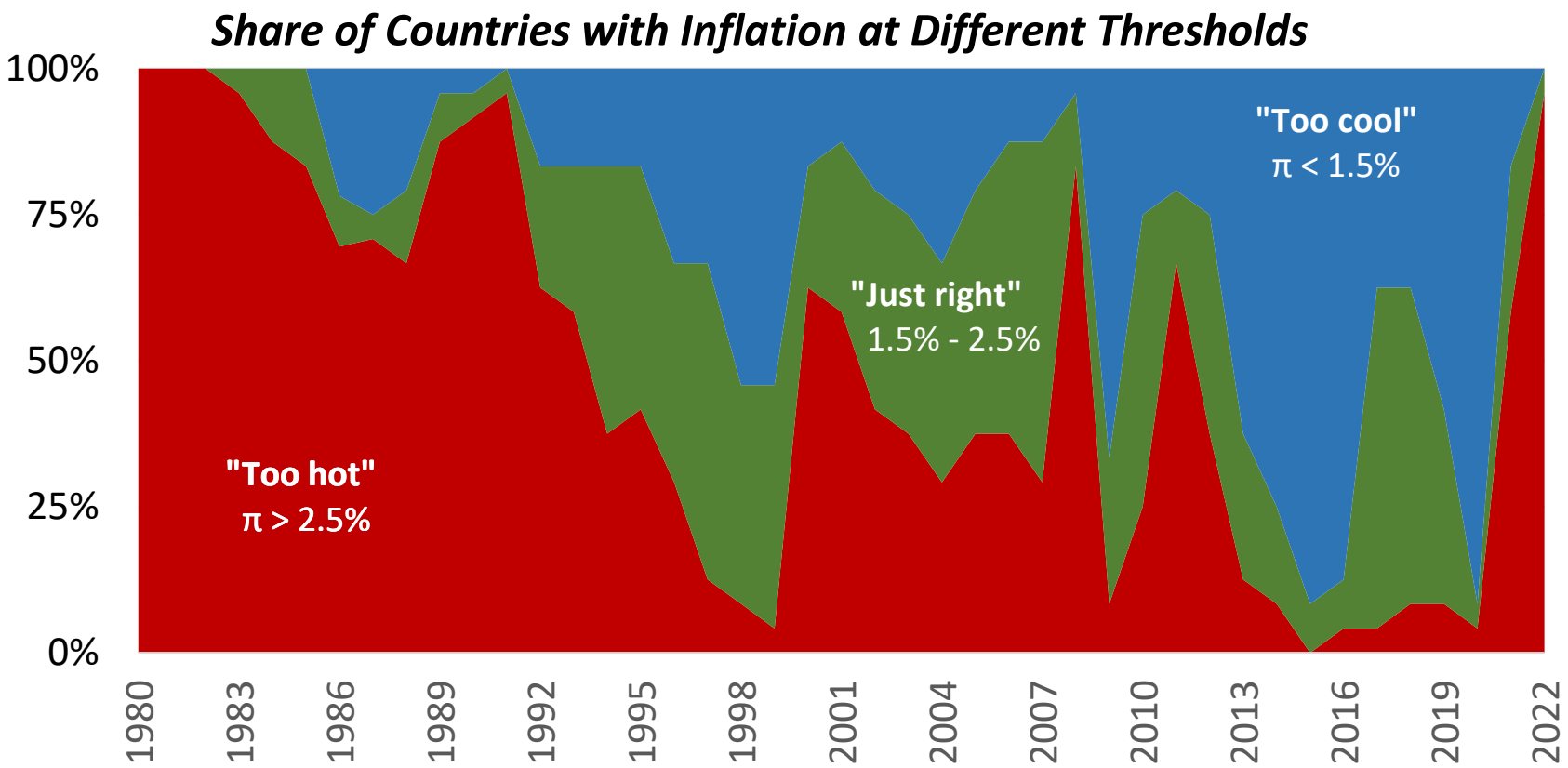
The decomposition of price inflation post 2020:1



The decomposition of wage inflation post 2020:1

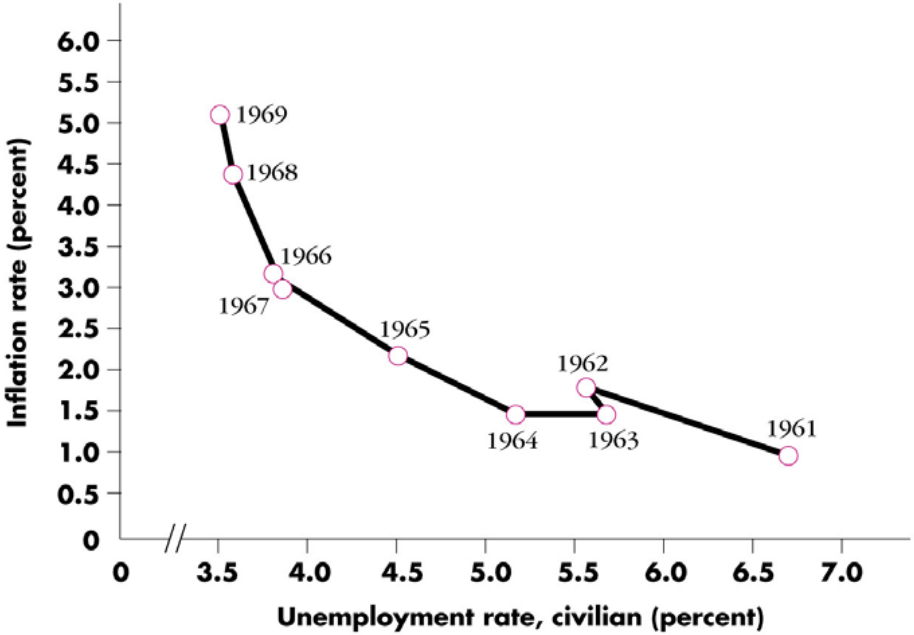


2. Return of High Inflation



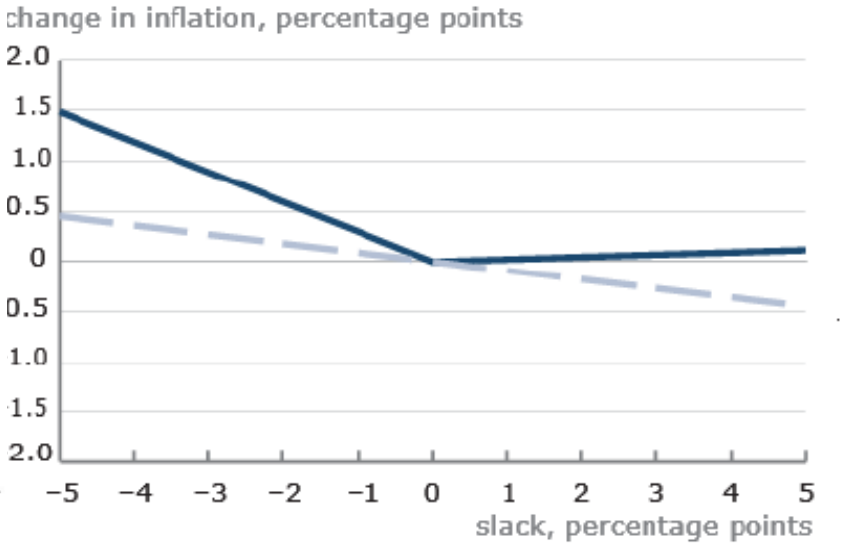
Notes: Percent of countries in sample with annual CPI inflation that is "too hot" (>2.5%); "just right" (1.5%-2.5%) or "too cool" (<1.5%). Sample is 24 advanced economies in the OECD and underlying data from IMF, *World Economic Outlook*, October 2022..

3. Phillips Curve is NOT Dead



The original Phillips Curve for the US

Source: Dornbusch, Fischer, Startz, *Macroeconomics*



Source: Forbes, Gagnon and Collins. (2022). "Low Inflation Bends the Phillips Curve Around the World." *Economia* 45(89): 52-72.

4. Policy Interest Rates Above ELBs

Country / Area	
Canada	4.25
ECB	3.50
Japan	~ 0
Norway	3.50
Sweden	2.50
Switzerland	2.50
UK	5.00
US	5.25
G-8 average	***3.32***

Source: IMF, *International Financial Statistics*

4. Policy Interest Rates above ELBs

Country / Area	12/30/06	05/11/23
Canada	4.25	4.50
ECB	3.50	3.75
Japan	~ 0	~ 0
Norway	3.50	3.25
Sweden	2.50	3.50
Switzerland	2.50	1.50
UK	5.00	4.50
US	5.25	5.25
G-8 average	***3.32***	***3.27***

Source: IMF, *International Financial Statistics*

Implications for the Fed's Framework Review

1. Global shocks
   - Harder to meet 2% in any month
   - **Consider more flexible numeric target**
   - **Band? 2% in 2 years?**
   - **Less forward guidance/maintain flexibility**

2. Higher inflation
3. Phillips curve alive

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   - **Return to more symmetric framework**
   - **Adjust rates preemptively to labor mkt deviations in both directions**

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4. Policy Rates well above ELBs
   - Less concern about limited policy space
   - **Clarify framework for other monetary tools**
   - **Differentiate AP for financial stability concerns (limited window/hold short-term)**