Comments on “The Inflation Surge of the 2020s: the role of monetary policy”

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Post Mortems are important

- 2019 framework review paper by Eberly, Stock, and Wright (ESW)
- Effectiveness of Fed policy framework and tools in promoting the post-GFC economic recovery

- Different this time because we need to first assess and understand cause of inflation surge
- ESW evaluated Fed’s 2012 framework starting in 2009
- Seeds of Fed’s 2020 framework visible from the mid-20 teens

Mindset is also important

- ESW concluded Fed’s new tools (forward guidance and asset purchases) could have been even more important in the post-2008 economic recovery if they had been rolled out sooner and more forcefully
  - Fed took this advice on board in March 2020

- Fed should have waited longer to lift off from the ELB
  - Eggertsson and Kohn (EK) also see liftoff regret as formative

- Mindset about low r* and risks of repeat visits to the ELB as key policy challenge coming into the 2019 framework review

Paragraph 2, Statement on Longer-Run Goals and Monetary Policy Strategy, 2020

2. Employment, inflation, ~~employment,~~ and long-term interest rates fluctuate over time in response to economic and financial disturbances. Monetary policy plays an important role in stabilizing the economy in response to these disturbances. The Committee's primary means of adjusting the stance of monetary policy is through changes in the target range for the federal funds rate. The Committee judges that the level of the federal funds rate consistent with maximum employment and price stability over the longer run has declined relative to its historical average. Therefore, the federal funds rate is likely to be constrained by its effective lower bound more frequently than in the past. Owing in part to the proximity of interest rates to the effective lower bound, the Committee judges that downward risks to employment and inflation have increased. The Committee is prepared to use its full range of tools to achieve its maximum employment and price stability goals.

How broad should a framework be?

- 2020 framework narrow relative to its predecessor
- EK recommend next framework be broader
  - Specific scenarios and stress tests?
- Framework statement is goals and principles
- Other communications spell out tactics

Forward guidance

- 2012 rate and purchase guidance had included escape clauses for inflation, inflation expectations, threats to price stability
- 2020 guidance very different
  - September rate guidance and December purchase guidance muscular and unconditional
- EK right to be critical but they go too far
- What about the statement's final paragraph?

"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."

Maximum employment: ordering

- Goals ordered consistently through 2020 framework statement to reflect wording in the Federal Reserve Act
- EK say Fed “wanted to communicate its increased attention to this part of the dual mandate”
- How does the ordering communicate anything beyond what is in the FRA itself?

Maximum Employment: new words

- EK critical of "more expansive definition of maximum employment"

3. The maximum level of employment is **a broad-based and inclusive goal that is not directly measurable and changes over time owing** largely ~~determined by~~ **to** nonmonetary factors that affect the structure and dynamics of the labor market. ~~These~~

- New words were "broad-based and inclusive"
- Dropped reference to SEP median longer-run unemployment rate
- Many descriptors from the 2012 statement retained: "not directly measurable," "changes over time," "nonmonetary factors"

Maximum Employment: asymmetry

- New framework statement replaced "deviations" with "shortfalls"
  - FOMC "seeks over time to mitigate *shortfalls* of employment from the Committee's assessment of its maximum level"
- Ignore overshoots of maximum employment
  - Little implication for inflation so long as Phillips curve is flat
- EK simple model – change generates bias toward expansionary policy and inflation
- Asymmetric loss function in Tealbook since mid-2016
  - Recognized as helping Fed achieve its inflation goal

Did the 2020 framework kill preemption?

- Clear downgrade to role of u* in new framework (and upgrade to role of inflation expectations)

- Doesn’t equate with end of preemptive policy

“policy decisions reflect its longer-run goals, **its medium-term outlook**, and its assessments of the balance of risks, including risks to the financial system that could impede the attainment of the Committee’s goals”

- Loretta Mester – Fed delay in tightening reflected overly optimistic forecasts for inflation

Summary

- Paper provides a nice exploration of the new framework and how it interacted with Fed policy and communications as inflation rose

- Recommendations at the end provide valuable contribution
- Did not address EK’s very good discussion about asset purchase tapering process

- Thanks for your attention!