Did The Federal Reserve's 2020 Policy Framework Limit Its Response to Inflation?

Evidence and Implications for the Framework Review

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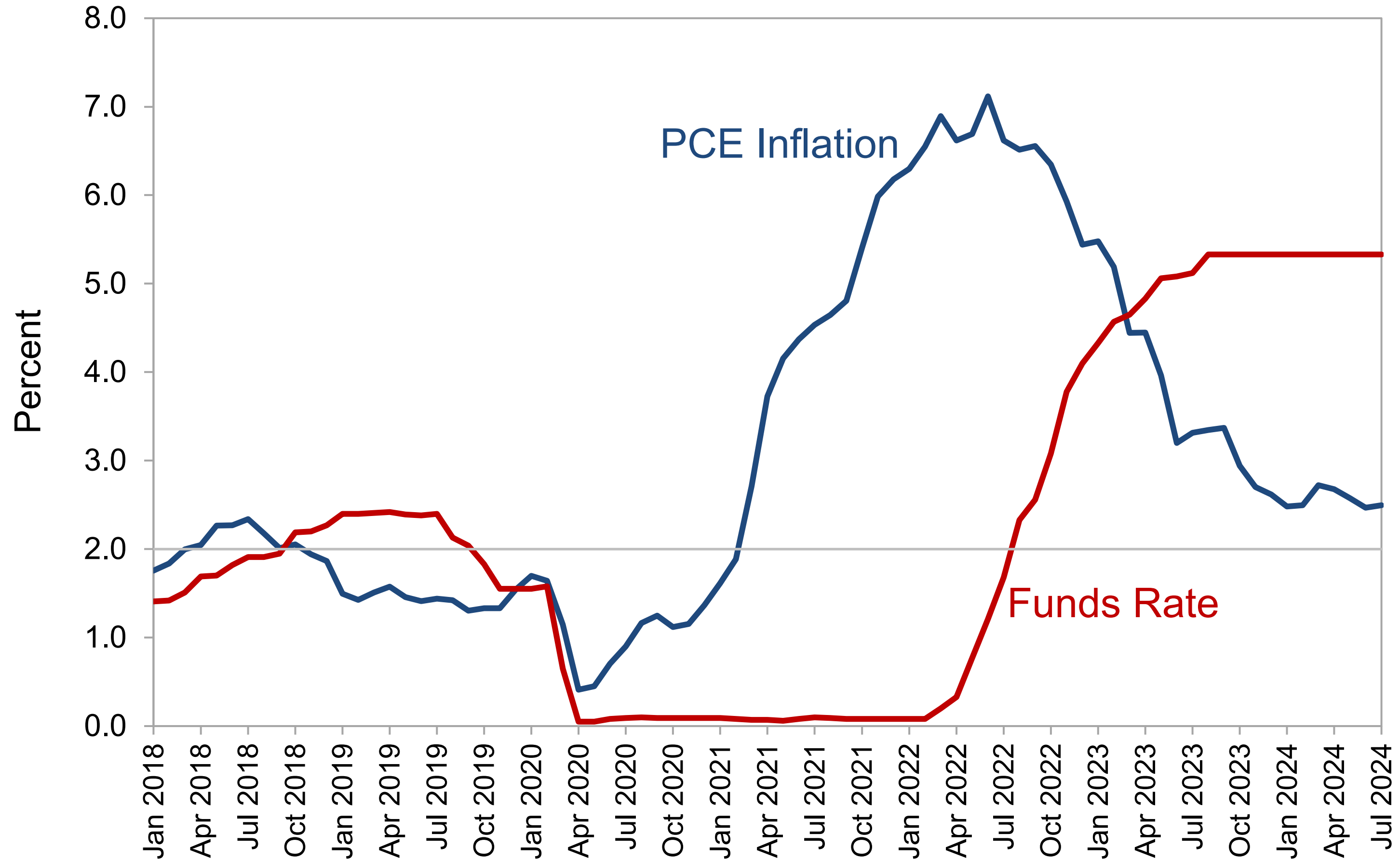
PCE Inflation and the Federal Funds Rate, 2018-2024



(Bureau of Economic Analysis, and Federal Reserve)

Elements of the Framework that Could Have Slowed the Response to Inflation

- The adoption of flexible average inflation targeting.
- The elevation and strengthening of the maximum employment goal.
- The asymmetric treatment of the maximum employment goal.
- The move away from preemptive policy.

Narrative Sources

- FOMC Minutes.
- FOMC Statements
- Fed Chair speeches and testimonies.
- Speeches of other key FOMC members.

Finding 1: FAIT did not limit the Fed's response to inflation.

Looking ahead, participants generally expected inflation to ease as the effect of these transitory factors dissipated, but several participants remarked that they anticipated that supply chain limitations and input shortages would put upward pressure on prices into next year.

(Minutes, June 15 –16, 2021, p. 10)

Finding 2: The strengthening and elevation of the maximum employment goal was very important.

"With regard to the employment side of our mandate, our revised statement emphasizes that maximum employment is a broad-based and inclusive goal. This change reflects our appreciation for the benefits of a strong labor market, particularly for many in low- and moderate-income communities"

(Powell speech, August 27, 2020, p. 11)

“This sizzling hot labor market ....”

“With the unemployment rate back to very low pre-pandemic levels, and a variety of indicators showing the labor market is very strong, maximum employment has been achieved.”

(Williams speech, May 5, 2022, p. 11)

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.

(Statement, September 20 –21, 2020, p. 1)

"If a central bank tightens policy in response to factors that turn out to be temporary, the main policy effects are likely to arrive after the need has passed. … Today, with substantial slack remaining in the labor market and the pandemic continuing, such a mistake could be particularly harmful."

(Powell speech, August 27, 2021, p. 9)

Various participants stressed that economic conditions were likely to justify keeping the rate at or near its lower bound over the next couple of years.

(Minutes, September 21–22, 2021, p. 10)

Finding 3: The asymmetric treatment of the maximum employment goal could matter, but wasn't relevant in the recent episode.

Table 1

Outcomes of Episodes When the Federal Reserve Staff Projected a Hot Labor Market

Period	Undesirable Macroeconomic Outcome
1967–1970	Inflation
1972–1973	Inflation
1978	Inflation
1988	Inflation
1996–2000	Dot-com boom and bust
2017–2018	none

Notes: The periods in the first column are times when the Federal Reserve staff projected average unemployment over the coming four quarters at least 0.5 percentage point below their estimate of the natural rate.

Finding 4: The move away from preemption did slow down the response.

“Participants … noted that the existing outcome-based guidance implied that the path of the federal funds rate and the balance sheet would depend on actual progress toward reaching the Committee’s maximum-employment and inflation goals. In particular, some participants emphasized that an important feature of the outcome-based guidance was that policy would be set based on observed progress toward the Committee’s goals, not on uncertain economic forecasts”

(Minutes, April 27–28, 2021, p. 10)

Table 1. Economic projections of Federal Reserve Board members and Federal Reserve Bank presidents, under their individual assumptions of projected appropriate monetary policy, September 2021

Percent

Variable	Median[1]				
	2021	2022	2023	2024	Longer run
Change in real GDP	5.9	3.8	2.5	2.0	1.8
June projection	7.0	3.3	2.4		1.8
Unemployment rate	4.8	3.8	3.5	3.5	4.0
June projection	4.5	3.8	3.5		4.0
PCE inflation	4.2	2.2	2.2	2.1	2.0
June projection	3.4	2.1	2.2		2.0
Core PCE inflation[4]	3.7	2.3	2.2	2.1	
June projection	3.0	2.1	2.1		
Memo: Projected appropriate policy path					
Federal funds rate	0.1	0.3	1.0	1.8	2.5
June projection	0.1	0.1	0.6		2.5

(Projection Materials, September 21–22, 2021, p. 2.)

Implications for the Framework Review

Implications Related to Our Findings

- Back off from the changes to the employment goal. (Including the asymmetric treatment of shortfalls and overruns of full employment.)
- Embrace forward-looking and preemptive policy.

Other Suggestions

- FAIT has benefits and few costs (but be explicit that it is only relevant at the zero lower bound).
- Explicit forward guidance should be used sparingly.
- In general, the framework review should aim for greater universality and nimbleness in the conduct of monetary policy.