

General Discussion

David Wilcox pondered why the Federal Open Market Committee (FOMC) didn't exercise the escape option during the 2021–2022 inflationary episode, which was explicitly built into their statement, and suggested the committee owes the public an explanation. He further argued that a move back to considering deviations rather than shortfalls from maximum employment would be a mistake, because the former approach would allow for tightening solely based on a labor market where “too many” people are employed. He didn't think a move back to traditional inflation targeting would be beneficial either. Moreover, Wilcox cautioned against drawing conclusions about the conduct of monetary policy in ordinary times based on an extraordinary period such as the 2021–2022 episode induced largely by the COVID-19 pandemic. Regarding the timing of a conversation on the 2 percent inflation target, Wilcox thought an increase would be more appropriate after an extended period of stable inflation, perhaps for the 2030 review of the Fed framework.

In response to Wilcox on the escape option, William English observed that the FOMC was likely hesitant to abandon the policy guidance as it might weaken guidance as a tool in the future. The committee seemed to believe that policy could be adjusted faster later to make up for it—and indeed, this was what they did, he concluded. David Romer emphasized the importance of the fact that the Fed didn't use the escape clause. He argued that the Fed didn't use it because they were not willing to give up on a hot labor market even if inflation was high.

Donald Kohn argued that the Fed should start with a thorough review of its process and what actually happened. Kohn remarked that many other central banks had adopted this approach and such review should also involve

the Fed disclosing how it views the issues in using its tools, including forward guidance and quantitative easing.

Thinking about the aftermath of the 2021–2022 episode, Charles Evans questioned if the Fed really managed to reduce inflation. He pointed to the work by Bernanke and Blanchard (2023), which suggests the inflation surge that began in 2021 was largely a result of the supply shocks, including shocks to commodity prices—part of inflation easing came from the unwinding of the supply shocks.¹ He pointed out the potential danger of the Fed taking on more mandates, especially considering the complexity of the supply shocks during the pandemic, where we saw a lot of relative price increases in a significant share of the consumer price index (CPI) basket.

Kohn noted that the forward guidance was largely at fault, but according to the Fed, forward guidance was derived from the framework. The Fed had expected to get to 2 percent from below, and in such an instance, holding accommodative policy until full employment is reached would just have resulted in inflation averaging above the target for some period in accordance with flexible average inflation targeting (FAIT). In reality, Kohn continued, inflation was high for a relatively long time, and the Fed seemed to have difficulties judging when full employment had been reached—just as Wilcox pointed out, the question is why the Fed didn't use its escape clause.

Frederic Mishkin commented that although FAIT is a good approach, the problem is the lack of clarity around what the horizon was. With no indication of what the horizon was, the 2 percent inflation target was weakened. If the horizon is sufficiently long, then inflation can be above the average target for a long time and yet not be inconsistent with the average target. However, Mishkin added, in the end it likely didn't matter because of what he called the “Powell doctrine”: If a mistake is made, you turn around quickly and fix it; indeed, this is exactly what the Fed did when it started raising federal funds rates dramatically in early 2022, thus indicating that it was committed to getting inflation back to 2 percent in a reasonable period of time.

Jason Furman observed that a missing part of the conversation was that gradualism has increasingly become part of how monetary policy is conducted—an approach that supports holding off on raising federal funds rates until one is entirely certain it will not be a mistake, which essentially guarantees that rates will be raised too late. This suggests that the FOMC is constantly behind the curve and that, in practice, only long rates are being

1. Ben S. Bernanke and Olivier J. Blanchard, “What Caused the US Pandemic-Era Inflation?” working paper 31417 (Cambridge, Mass.: National Bureau of Economic Research, 2023).

used to conduct policy. Furman pointed out that, for example, the inflation rate fell over 2 percentage points over the past year, but the funds rate was not adjusting constantly, contrary to what a Taylor rule would suggest should be done. Furman acknowledged the advantage of this gradualism approach—avoiding big, disruptive rate increases—but it also means what the FOMC says matters more, for better or worse. Furthermore, Furman added that the other extreme would be to follow a random walk, incorporating all available information at each meeting and adjusting the rates accordingly—essentially basing decisions only on the past six weeks. Romer agreed with Furman that the Fed is indeed very slow moving and not very nimble; this is one of the reasons his paper, coauthored with Christina Romer, concludes that forward guidance, which makes it harder for the Fed to adjust policy in response to unexpected developments, should not be an explicit part of the Fed framework.²

Ben Bernanke wondered about the counterfactual and how much of a difference it would have made had the Fed still been using the old framework. If the 2021–2022 episode was indeed largely driven by supply shocks and therefore transitory in nature, even under the old framework, the Fed would have taken some time before taking action, at least until there was movement in inflation expectations. In this regard, David Romer argued that, by late September 2021, the real economy was clearly on track to reach any reasonable estimate of maximum employment and inflation was not on track to fall below 2 percent, hence the Fed would almost surely have tightened earlier under the old framework. On the other hand, Mishkin cautioned that we must not forget about the demand shocks during this episode, which were caused by the substantial fiscal expansion and people being unable to spend and instead increasing their savings.

Commenting on the presentation by Evans, Kohn noted that the necessity of preemption was missing and pointed to the importance of the labor market in forecasting inflation. Kohn further remarked that the framework must never get in the way of preemption. Evans responded that preemption in theory is great, but there is uncertainty around relevant measures—we don't have a good grasp of where the natural rate of unemployment is, for example. As for the output gap, he said, trend output moves around as much as any other available measure, which leads to similar issues of uncertainty. In a similar vein, Mishkin noted we don't have a clear definition of the term, "full employment," and a crucial mistake leading to the absence of preemption was the view that the Philips curve was flat.

2. The final version of this paper is included in the present *BPEA* volume.

Commenting on the optimal Fed targets, Valerie Ramey argued that optimal control theory implies that the price path, not the inflation rate, should be the target for achieving price stability, since even transitory inflation results in a permanently higher price path. Ramey also observed that Romer and Romer's findings imply that, in 2021–2022, the Fed switched to a “Rawlsian Justice” objective function, using monetary policy to minimize the unemployment rate of the most marginal workers. She argued that the rest of the population paid a steep price for this policy in terms of much higher inflation. Martin Baily questioned the use of optimal control in practice, adding that forecasting the economy is challenging to economists given the extent of the uncertainty around inflation-affecting factors that also include fiscal policy, commodity prices, and productivity. Baily contended that it is crucial to recognize the uncertainty and inform the public that the Fed doesn't necessarily have the means, for example, to hit the 2 percent target at a particular time.

English commented that tightening in response to a tight labor market *can* be reasonable if we expect an increase in wage and price inflation. David Romer agreed, stating that raising rates in response to a hot labor market—or in anticipation of one—is not equivalent to not caring about employment, and that there is a trade-off the Fed needs to constantly be aware of between the strength of the economy today and the possible inflation that would require tighter policy and a weaker economy in the future.

Randall Kroszner suggested the Fed should make a clear distinction between monetary policy and financial stability. According to Kroszner, in March and April 2020, the failure of drawing this distinction became obvious in the wake of the Fed's asset purchasing, when it became very difficult to reverse without implicitly signaling some degree of tightening. He pointed to the liquidity-driven investment issue that the Bank of England faced in 2022—while still being clear about their focus on fighting inflation and reducing the balance sheet, they engaged in targeted, *temporary* asset purchasing to address this issue and explicitly communicated their approach; the markets reacted appropriately, and the approach was ultimately successful.

Daniel Tarullo raised a broader point that we might want to consider the overall utility of the monetary policy framework—if the framework is too brief, it is likely not to be very determinative for policy; or if it is too detailed, it would instead run the risk of becoming outdated quickly. The alternative then would be a longer document outlining all possible scenarios. Tarullo added that the more salient question might be whether decisions are guided by the framework or the framework is merely a reflection of what policy-makers would have done anyway.

Joe Beaulieu drew attention to inflation expectations. He wondered about the process of making inflation expectations, how we get from one set of expectations to another, and what transition period looks like. Beaulieu noted there is currently no model that helps us understand this process.

Ben Harris commented that an overarching problem underlying the framework discussion might be the inclusion of shelter in the Fed's preferred measure of inflation—the personal consumption expenditures (PCE) price index—that is based on a long lag whose length and dynamics are not well understood. Harris further emphasized the lack of understanding of the transmission between monetary policy and housing and pointed out the weighting issue of shelter in the PCE basket as an example.