BROOKINGS

Probing for maximum employment: the consequences of the Fed's 2020 policy framework and its implementation in forward guidance

Don Kohn

Hutchins Center

Partly based on Eggertsson and Kohn (2023)

https://www.brookings.edu/articles/the-inflation-surge-of-the-2020s-the-role-of-monetary-policy/

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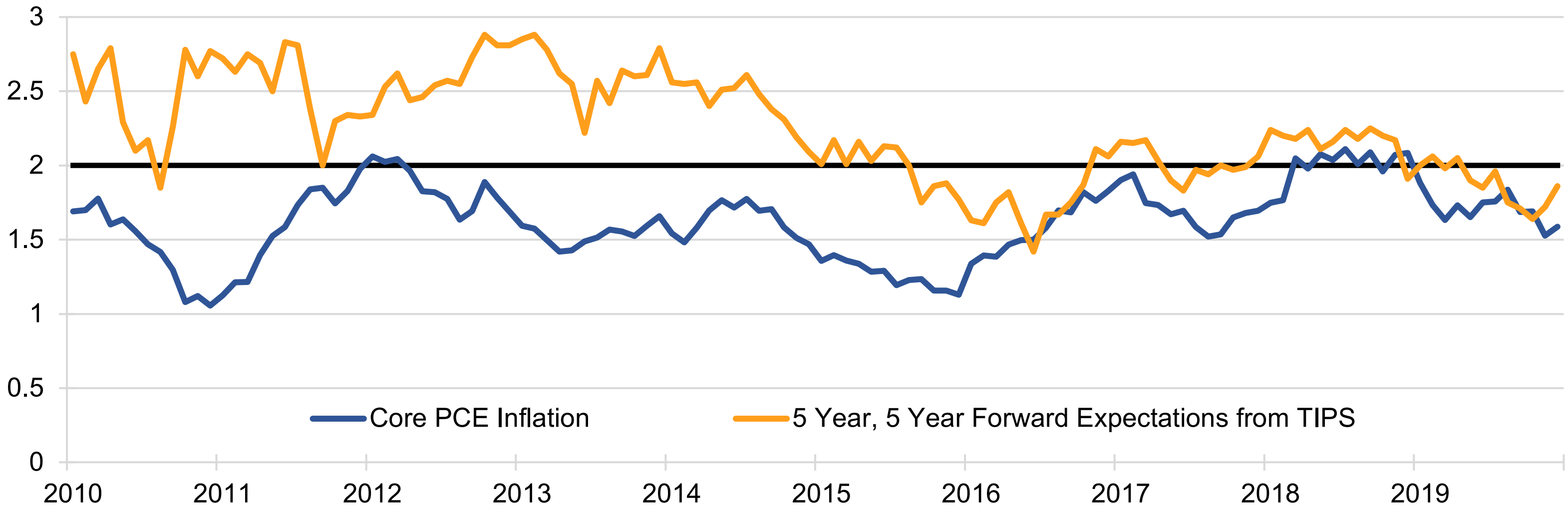
My hypothesis:

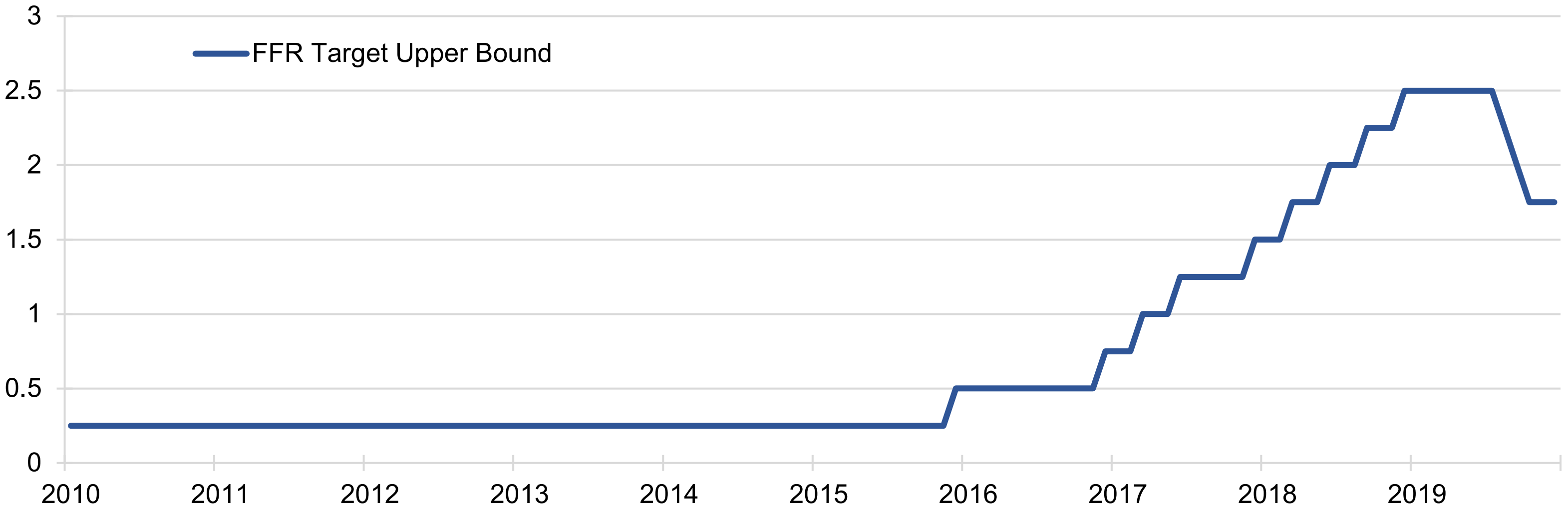
- Probing for maximum employment can have considerable advantages, but it, deliberately, runs inflation risks.
- The new 2020 monetary policy framework and its implementation in forward guidance embodied “probing”; the framework is deliberately asymmetric toward probing in its policy responses to variations of employment and inflation around estimates of full employment and the inflation target; forward guidance was a “forceful” implementation of the framework, doubling down on its asymmetries
- But they also illustrated the potential costs by inducing the the FOMC to wait too long to raise interest rates, contributing to the extent and persistence of inflation in 2021, 2022, and 2023.
- The 2024-25 re-examination of the framework needs to look closely at the costs and benefits of probing and to address a broader range of possible economic circumstances than did the 2020 framework.

2020 Framework: 2010-2019 Context: The ELB

- Inflation fell persistently short of the 2 percent target and expectations drifted down

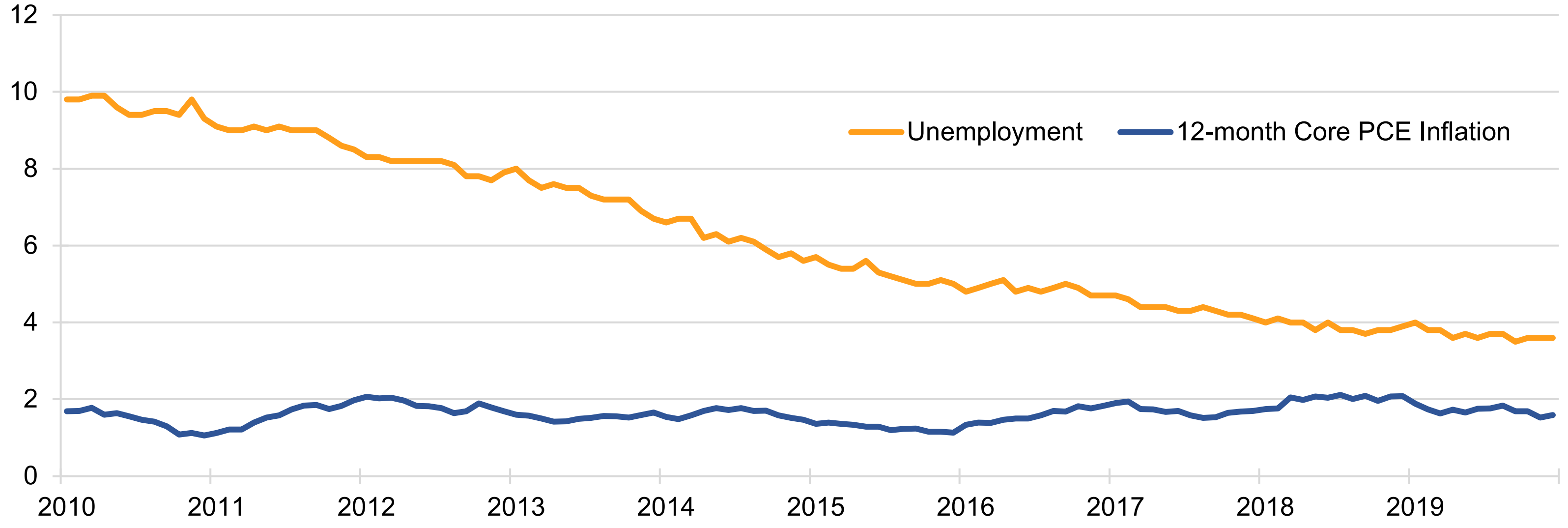


- Despite Fed funds near zero for much of the decade



2020 Framework: 2010-2019 Context: The slope and level of the Phillips curve and the 2015-2019 'mistake'

- The Phillips curve seemed very flat – large changes in unemployment had little effect on inflation



- The NAIRU turned out to be lower than projected when policy began to tighten in 2015, and tightening was seen to have unnecessarily limited employment gains

The 2020 Framework Responds: Labor Market Asymmetry

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 factors may change over time and may not be directly measurable.~~ Consequently, it would not be appropriate to specify a fixed goal for employment; rather, the Committee's policy decisions must be informed by assessments of the **shortfalls of employment from its** maximum level ~~of employment~~, recognizing that such assessments are necessarily uncertain and subject to revision.

The 2020 Framework Responds: Labor Market Asymmetry

In setting monetary policy, the Committee seeks **over time** to mitigate **shortfalls of employment from the Committee's assessment of its maximum level and** deviations of inflation from its longer-run goal ~~and deviations of employment from the Committee's assessments of its maximum level~~.

~~These~~ **The Committee's employment and inflation** objectives are generally complementary. However, under circumstances in which the Committee judges that the objectives are not complementary, it ~~follows a balanced approach in promoting them, taking~~ **takes** into account the magnitude of the **employment shortfalls and inflation** deviations and the potentially different time horizons over which employment and inflation are projected to return to levels judged consistent with its mandate.

The 2020 Framework Responds: Flexible Average Inflation Target

The Committee ~~would be concerned if inflation were running persistently above or below this objective. Communicating this symmetric inflation goal clearly to the public helps keep~~ **judges that** longer-term inflation expectations ~~firmly~~ **that are well** anchored ~~thereby~~ **at 2 percent** foster~~ing~~ price stability and moderate long-term interest rates and ~~enhancing~~ **enhance** the Committee's ability to promote maximum employment in the face of significant economic disturbances. **In order to anchor longer-term inflation expectations at this level, the Committee seeks to achieve inflation that averages 2 percent over time, and therefore judges that, following periods when inflation has been running persistently below two percent, appropriate monetary policy will likely aim to achieve inflation moderately above two percent for some time.**

Framework Implemented in Forward Guidance: September 2020 Guidance on Interest Rates

The Committee seeks to achieve maximum employment and inflation at the rate of 2 percent over the longer run. With inflation running 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 Committee expects to maintain an accommodative stance of monetary policy until these outcomes are achieved.

The Committee decided to keep the target range for the federal funds rate at 0 to ¼ 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 <u>and</u> inflation has risen to 2 percent and is on track to moderately exceed 2 percent for some time. [emphasis added]

Framework Implemented in Forward Guidance: December 2020 on QE

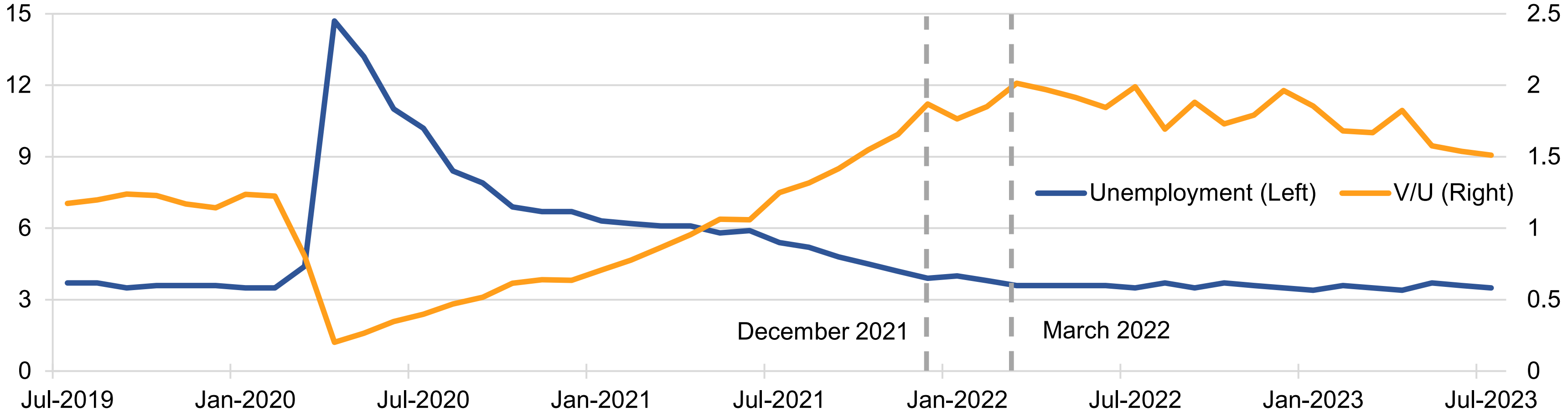
In addition, the Federal Reserve will continue to increase its holdings of Treasury securities by at least $80 billion per month and of agency mortgage-backed securities by at least $40 billion per month <u>until substantial further progress has been made toward the Committee's maximum employment and price stability goals.</u> These asset purchases help foster smooth market functioning and accommodative financial conditions, thereby supporting the flow of credit to households and businesses. [Emphasis added]

What Happened

- Complex, unique situation
  - The pandemic disrupted both the supply and demand of goods, services, and labor; this affected the composition and the balance of AS/AD
  - Unprecedented demand stimulus from fiscal and monetary policy
  - Russian invasion of Ukraine adds to supply side disruptions
- Forecasting became very difficult; the Fed led team transitory.
- Inflation surged, led by supply and demand distortions related to covid, but prolonged and exacerbated by very tight labor markets.
- Economists learned, once again, that people really don’t like inflation: There’s wisdom in the Greenspan definition of price stability as inflation so low that households and businesses don’t need to take it into account in decision-making.

What Happened

- Misjudgment of labor market tightness affected inflation projections and delayed action under forward guidance

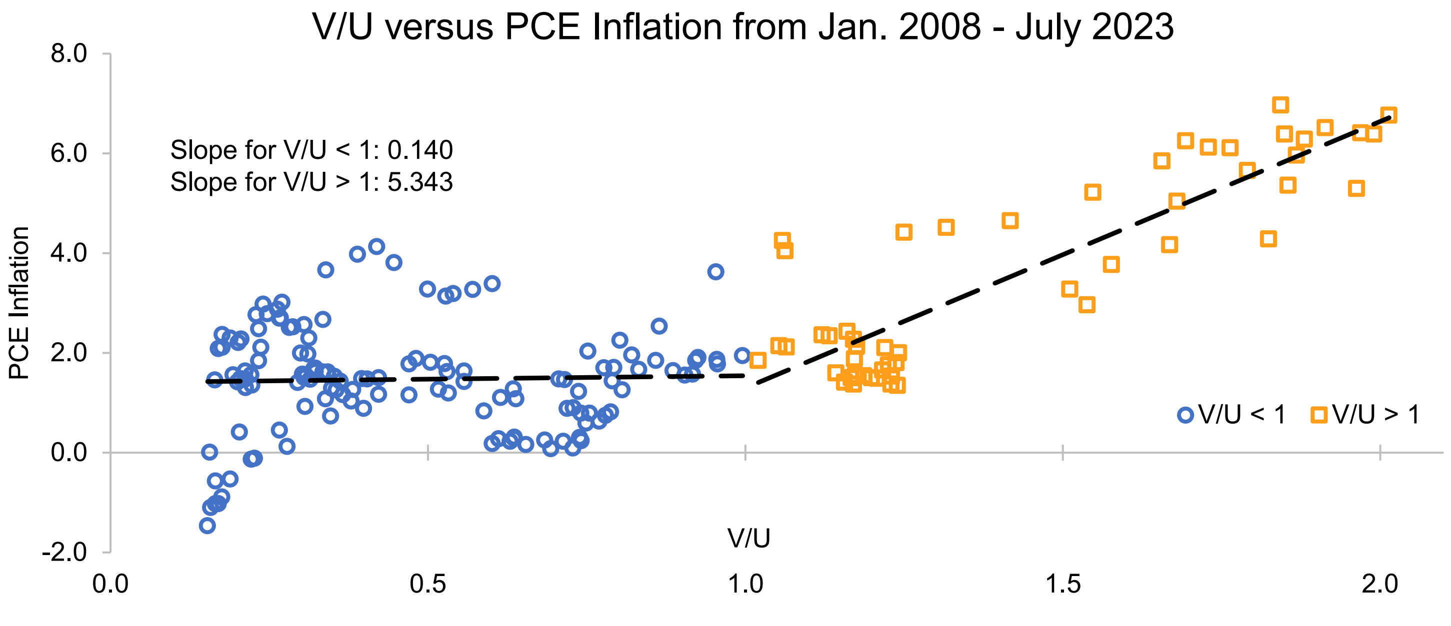


- As late as December 2021, the FOMC still saw labor market slack

In support of these goals, the Committee decided to keep the target range for the federal funds rate at 0 to ¼ percent. With inflation having exceeded 2 percent for some time, the Committee 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.

What Happened

- The role of the nonlinear Phillips curve



What Happened

- The challenge of lags
  - Channels of monetary policy influences on inflation are long and complex.
    - Policy→financial conditions→slack→inflation
      - Waiting for inflation to judge the previous links guarantees inflation overshoots and output volatility under the most benign circumstances
        - Flat Phillips curves are a 2-edged sword.
    - FOMC currently is waiting for lags to play out for disinflation.
  - Best practice monetary policy requires attempts at pre-emption.
- *Responsible, sustainable, probing cannot ignore lags and inflation risks.*

Lessons Learned and the 2024-25 Framework Review

- The 2024-25 review should start with an examination of the 2021-22 experience. What are the lessons learned.
- The 2020 Framework contributed to the lagged response to inflation
  - The 2020 framework focused almost entirely on the 2010-2019 experience
- The 2025 Framework should:
  - Produce acceptable results for the dual mandate under a wide variety of circumstances and shocks, and should be stress tested
    - For example, it should not depend on returning to a low inflation, r*, and u* environment, but it should encompass that possibility and others
  - Assess whether they need both labor market and FAIT asymmetries to deal with the ELB
  - Modify the labor market asymmetry to allow pre-emptive tightening to forestall undesirable inflation increases.
  - Define “maximum employment” as the highest level consistent with stable prices

Lessons Learned and the 2024-25 Framework Review

- The review should encompass the strategies for using unconventional policies (forward guidance and QE), as well as the framework itself
  - The forward guidance on interest rates:
    - Was too specific and binding
    - Wasn't adjusted when circumstances changed
    - Doubled down on framework asymmetry by holding nominal rates at zero until full employment, guaranteeing overshoot on both employment and inflation
    - Delayed liftoff until purchases were entirely halted
  - Securities purchases:
    - Were huge and open ended
    - Gradually shifted from supporting market functioning to supporting the economy, but the size of the purchases wasn't clearly linked to the macro goals
    - Seemed to ignore some financial and economic stability considerations, for example buying MBS through 2021 when the residential real estate market was on fire.