Priorities on the Path to Normalization

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I was honored to serve as a governor of the Federal Reserve System during the financial crisis. The times were tough, but the institution was strong—sustained by a Fed staff that was tired and tireless, hopeful and humble, brilliant without bravado. The internal battles among its leaders were consumed by big policy questions. We were sometimes divided in our assessments. And our proffered prescriptions.

We offered differing judgments in real time and in real candor. We had contrasting views on the origins of the turmoil, the wherewithal of the government-sponsored entities, the solvency of our banking system, the appropriate burden-sharing among actors in our government, the efficacy and limitations of quantitative easing (QE), the reliability of the Fed's dominant economic models, and the uncertainty around estimates for output and prices.

Our best days included our darkest hours. But complacency was set aside, owing to the exigencies of the circumstances. The search was for truth (as best we could measure it), not victory. And the quality and depth of debate were as large as the perils we faced.

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Present Challenges

Today, the challenges to our central bank may be less urgent. But its task is no less large. So we should resist allowing the policy debate to be small or push aside ideas that depart from the prevailing consensus. The Fed's job is not easier today, and its conclusions are not obvious.

In recent, fiercely fought public debates, inflation hawks and doves are cast into ideological corners spoiling for a fight. The political class, especially in this season, emboldens factions to caricature the opposition and reduce policy prescriptions into simplistic, sloppy slogans. Those in the community of central banks should be wary of this affront. We should not respond in kind, but rather in the spirit of that which sets these institutions apart.

A robust debate between rules and discretion has marked the monetary policy literature for generations. It should not turn into an expedient means of back-solving for a preferred policy outcome.

In recent years, some commentators and academics seek to follow fixed monetary policy rules. The dominant view, however, purports to criticize adherence to preset policy rules. Most favor reliance on policymakers' discretion. I find it a bit puzzling, then, how to reconcile the widespread preference for policymaker discretion with the eagerness to follow a single, precise, unyielding inflation target as a key policy determinant.

The Knowledge Problem and Fed Policy

Our understanding of the macroeconomy, and the effects of extraordinary monetary policy, is decidedly imperfect. Modesty about what we know—and humility about what we do—have long shaped my views. I do not favor conducting monetary policy by fidelity to a fixed policy rule. Nor do I find a single, overly precise inflation measure to be the defining measure of price stability.

So, allow me to pose a question: Should the Fed's overriding policy objective be to lift the measure of the core personal consumption expenditure (PCE) inflation index, as calculated by the Bureau of Economic Analysis of the U.S. Department of Commerce, from 1.3 to 2.0 percent?

Inflation targeting frameworks represent an important advance in the consideration and conduct of monetary policy. If it were costless

to move to a 2.0 percent target, and we were confident that the target was a well-measured and durable inflation indicator, then its achievement could be useful, not least because it would demonstrate the Fed delivering on its oft-repeated promise. But that should not preclude current practice from robust review.[1]

An inflation target of 2.0 percent is tantamount to price stability. But price stability does not always and everywhere require hitting a central bank–sanctioned, inflation target of 2.0 percent. There may be a sound argument for maintaining significant Fed accommodation, but the measured inflation shortfall is insufficient.

If, today, policymakers judge with perfect clarity and certainty the economy's post-2010 performance to be strong, cross-border trade and capital flows sustainable, financial assets prices in durable equilibrium, the future unwind of QE uneventful, the Fed well equipped to respond to the next shock, the financial regulatory system fixed, the too-big-to-fail problem solved, the macroprudential policy tool kit poised for prime time, and financial stability achieved, then I would suggest the Fed's fine-tuning around its inflation target is unobjectionable.

We would then have the luxury of debating the distance between current inflation readings and a professed, perfected inflation target. Absent that, I'd commend a more discerning discussion about Fed policy. And suggest that caricatured, confused commentary about hawks and doves be forgone.

We know far less than we purport about the price formation process; still less about the economy's resilience to economic and financial shocks; and less still about the current constellation of loose monetary policy, stagnant wages, and elevated financial asset prices. We should not allow an imperfect inflation measure to prevent consideration of other critical issues of inquiry. So, might the eagerness to lift core PCE to 2.0 percent be misplaced?

Reasons Why a Precise Inflation Target Is Misplaced

First, inflation is increasingly difficult to measure given mix changes in the economy, changing global trade flows, positive

[1]Chairman Bernanke (2017) recently proposed an alternative to existing practice.

supply shocks, and stale national accounts that make assigning price and quality changes difficult. Research by Marty Feldstein (2017) has ably demonstrated the imprecision of output and inflation estimates.

Second, measured inflation is taken by most as the dominant signal by which output is judged to approach its potential. When potential and actual output converge, it is presumed that the observed interest rate equals the natural rate, and the inflation gap is closed. Policymakers may take comfort in exploiting the theoretical relationship. But any tradeoff between prices and employment and ouput is, at best, temporary; yet the prevailing policy prescription appears permanent.

To mark the 50th anniversary of Milton Friedman's presidential address to the American Economic Association, Mankiw and Reis seek to reconcile the more recent contributions of monetarists and Keynesians. They remind us that "[a]s a scatterplot, [the Phillips curve] has shifted so often that no one takes it to be anything other than a transitory, reduced-form empirical relation" (Mankiw and Reis 2018: 92). More reliable, definitive models for predicting inflation, ouput, and interest rates are taking shape, and are worthy of considerable central bank attention. Until new models supplant those in practice, it's not obvious whether the Fed's new, permanently lower policy rate forecast is correct, coincident, or a contrivance with the Wicksellian natural rate.

Third, the natural rate needed to stabilize inflation and output is highly dependent on the conduct of both monetary and nonmonetary policy, here and abroad. If the current measured low inflation is a global phenomenon, is it the result of global supply or global demand shock? If it's a function of a positive supply shock with new impetus for labor and capital, is it temporary or permanent? If QE and forward guidance are powerful new tools for monetary policy, how "natural" is the rate being observed? And if domestic regulatory and tax policy changes are important determinants of potential output for the year or two ahead, might the natural rate reverse its recent fall with improved policies?

Fourth, the heated inflation rhetoric notwithstanding, the Fed sets the fed funds rates, not interest rates. If the Fed, belatedly, follows through on its promise to unwind QE—and that direction is matched by other large central banks—the Fed's influence on the medium and longer end of the treasury curve will be more limited in

the next couple years. Policymakers have been price-making instead of price-taking for so long that they might be surprised by their own diminishing influence on prices.

Fifth, the inflation gap tells us little about financial stability. A separation principle works in theory—the Fed's interest policies are designed to satisfy the Fed's modal monetary mandate; micro- and macroprudential policy are said to suffice to deal with other risks. I am not at all persuaded that the separation principle works in practice.

Low growth, low rates, low inflation, and low market volatility have proven to be the ideal backdrop for large holders of wealth, explaining well the Fed's popularity among those on Wall Street. But we have little experience with the current policy mix. It may induce behavior that masks market signals, misallocates capital, and creates imbalances that ultimately undermine financial and price stability. If significant tail risks materialize, it is not obvious that markets will be ready, the central bank will be prepared, or the broader economy will be resilient.

The Role of the Fed in the Government

Central bankers themselves are more recognizable public figures than ever, which makes their profiles unrecognizable to their predecessors. The Fed rightfully played an outsized role in the crisis. The trend continues. The Fed is involved more directly in fiscal policy, credit allocation, and management of banking and finance than we would have expected or countenanced years ago.

If the Fed's imprint in the government, economy, and financial sector remains large and permanent, then it strikes me as imprudent to solve for a broader remit by subjecting policy to a single, precise, unyielding, inflation target.

Efforts to expand the Fed's powers and responsibilities in peace time have largely proven popular in the central bank community. Monetary and fiscal policies interact. So some believe that the central bank's modern Wilsonianism is necessary in light of the void left by warring legislators and government dysfunction. But we should be discomfited if important questions about the proper role of the Fed in our government and a balanced assessment of its objectives are reduced and caricatured into a fabled fight between hawks and doves—and somehow resolved by the achievement of a precise inflation target.

Conclusion

My hope is to reorient the discussion from a narrow target to the more difficult, important priorities on the Fed's path to normalization. With new leadership coming to the Fed, there is new opportunity to think more broadly about the challenges ahead. And I am hopeful that the Fed will do so.

Final judgments are likely to be quite different from the dominant narratives currently on offer. Remember that our understanding of the Great Depression did not crystalize until Milton Friedman and Anna Schwartz and Ben Bernanke, among others, wrote their definite accounts many decades later.

References

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