<u>The Fed's New Old Clothes</u>

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On behalf of the SOMC, let me warmly welcome everyone to the Yale Club for our first opportunity since March 6th, 2020 for an in-person meeting, and also welcome to our online guests as we are pleased to make our experience hybrid. I would like to take this chance to thank the Manhattan Institute for its generosity and interest in the SOMC through its support of our conferences and outreach, including the work by several SOMC members who are frequent contributors to MI's <u>City Journal.</u>

Our last in-person meeting was a conference in honor of Marvin Goodfriend, a world class academic economist and central banker, and someone whose perspective on policy we sorely miss – particularly the insights from his seminal piece on interest rate policy and inflation scares.[1] In short, Marvin advocated prompt and even preemptive reactions to "inflation scares", arguing that doing so historically let the Fed more effectively stabilize the economy.

Of course, at our March 6, 2020 meeting, we were unknowingly on the cusp of a major pandemic. The reading (February 2020) on inflation as measured by the PCE Ex Food and Energy was 1.61% year-over-year, that for unemployment (16 years or older) was 3.5% (having been at or below 4.1% since December of 2017). However, just a few days prior to our meeting, March 3, 2020, the FOMC had an unscheduled meeting, where because of their concerns over Covid-19, they lowered the target range for the federal funds rate by 1/2 percentage point, to 1 to 1-1/4 percent.

Five months later, in August of 2020, the Fed adorned itself with New Clothes – its New Monetary Policy Framework that had been part of an extended year-long strategic review. The inspiration for these "New Clothes" was the determination that the neutral nominal funds rate remained too low and too close to the zero nominal lower bound for the conduct of appropriate cyclical monetary policy, inflation was averaging slightly below the Fed's 2% target, and that a more inclusive perspective on employment implied that the Fed could and should keep policy exceptionally accommodative by historical standards without great risk to the dual mandate. This New Framework adopted a "lower for longer strategy" for the funds rate (and a corresponding expansionary QE strategy) whereby the Fed should intentionally run inflation above target to make up for inflation being modestly below target.

The New Framework downplayed critical risks, including: (a) that inclusive inflation was as important a consideration as inclusive unemployment. Namely, that the costs of even modest inflation would not be equitable shared, and that lower income families would suffer more from moderate inflation; (b) that the flip side to lower for longer would be that the Fed would procrastinate and inevitably be late to address a rise in inflation (e.g. from inflation scares as Goodfriend pointed out) that could de-anchor

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[1] Marvin Goodfriend, "Interest Rate Policy and the Inflation Scare Problem: 1979–1992," <u>Federal Reserve Bank of Richmond Economic Quarterly</u>, Volume 79/1 Winter 1993, 1-23.

inflation expectations; (c) that if the Fed is unwilling to tighten and make policy neutral on a sunny day – that is, when inflation is low and unemployment is low -- imagine the anguish and political pressure it will feel when it attempts to tighten when the weather turns for the worse as discussed by former Federal Reserve Chairman Arthur Burns (1979)[2]?

Which is exactly where the Fed finds itself today.

While the subsequent substantial post-pandemic sharp rise in inflation has unfortunately not been transitory, it appears that fortunately the longevity of the Fed's New Monetary Framework of August of 2020 has been transitory. With the Fed's preferred inflation measure currently running at 5.1% y-o-y in September 2022, the Fed in January of 2022[3] dug into its wardrobe to find it's more reliable "Old" clothes from the late 1980's: namely, that the key to achieving the dual mandate is that price stability is a necessity for maximum growth. You'll notice that every FOMC member is now wearing these "New Old" clothes, ill- fitting or not! These "New Old" clothes will better serve the Fed at meeting their dual mandate than their trendy short lived New Clothes from August of 2020 which left the FOMC, like the emperor in the children's story "Emperor's New Clothes," rather over-exposed.

We have a great event today. Our first panel, moderated by Deborah Lucas from MIT, will highlight the Fed's Challenge and ways it can strengthen its resolve, featuring papers by Mickey Levy from Berenberg Capital Markets as well as a paper by our newest SOMC member, Jeff Lacker, and Charles Plosser, respectively former Presidents of the Richmond and Philadelphia Federal Reserve Banks. This will then be followed by an open discussion of issues related to "What, if Anything, Should Give the Fed Pause in its Determination to Address the Current Steep and Sustained Rise in Inflation?" The second panel will be a moderated discussion led by Athanasios Orphanides from MIT, with our two prominent guests – John Taylor from Stanford University and the Hoover Institution and Don Kohn, from the Brookings Institution and former Vice Chairman of the Federal Reserve. Their topic will be "How Should the Fed Address its Current Challenge and Risks?" We will close with a lunchtime presentation by Mike Bordo, of Rutgers University and the Hoover Institution, on the History of Central Banks.

Again, our warmest thanks for joining us today. And generous thanks to the Manhattan Institute.

[2] Arthur F. Burns, "The Anguish of Central Banking," Per Jacobsson Lecture, September 30, 1979.

[3] Kate Davidson and Aubree Eliza Weaver, "Powell's path to maximum employment? Price stability," Politico, January 12, 2022. https://www.politico.com/newsletters/morning-money/2022/01/12/powells-path-to-maximum-employment-price-stability-799819