BY KARTIK ATHREYA

Inflation and the Road Ahead for Research

While the Fed has never been a stranger to criticism, the criticism has been notable and specific during the past year. The subject: inflation. This is of course fully understandable. Memories remain fresh of last spring and summer, when annual inflation in "personal consumption expenditures" — which the Fed targets to grow at just 2 percent per year — reached 7 percent. Current inflation remains well above target.

As I discussed in my last column, the Fed is taking steps to bring inflation back down to its 2 percent long-run target. This includes decisively raising its policy rates and letting the balance sheet shrink as well. (See "The Fed Is Shrinking Its Balance Sheet. What Does That Mean?" *Econ Focus*, Third Quarter 2022.) The Federal Open Market Committee (FOMC) has repeatedly stressed its commitment to stable prices and made clear that it has both the tools and the will to meet that commitment.

As a research director looking back at this period, just like anyone else, I've thought about the Fed's role, too. To state the obvious, it's important for those of us who work at the Fed to listen to and learn what we can from criticisms.

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But first, let me level set a bit: The FOMC has since acted aggressively by historical standards to bring inflation back down. And as my colleague Alex Wolman documented in a recent Richmond Fed Economic Brief, market participants believe we're on the right track — and presumably their expectations matter for setting the prices and wages that are the proximate drivers of inflation. The task ahead, then, is to validate those expectations, and FOMC members have been both exceptionally clear and unified in saying we will.

And while it is early days, inflation has moderated to some extent, and FOMC members continue to express their resolve to get inflation back to target.

But naturally, we might ask hard questions about the Fed's role in how we got here. There are, I think, reasonable questions to be asked about our monetary policy actions during the pandemic. Starting early in the pandemic, the FOMC provided significant monetary support to the economy, at the same time Congress and the Treasury Department were providing sizeable fiscal transfers in various forms. In addition, agencies extended significant support through a rent moratorium and a pause in student loan repayments.

Should the Fed have acted differently in light of the other institutions' stimulatory actions? My own view is that this is a hard case to make. The various actions of Congress and the agencies were in response to an economic shock unprecedented in size and scope — the pandemic and the related shutdowns — and indeed, spanned two administrations. It is far from clear that the Fed should have looked around the corner at an inflation that appeared very far from even potentially taking place.

Another possible issue critics could raise is that the FOMC in August 2020 released a new Statement on Longer-Run Goals and Monetary Policy Strategy in which the committee announced a policy of "average" inflation targeting — widely viewed as meaning, in practical terms, that the Fed would be less inclined to take preemptive action against future inflation based on employment conditions. But it's important to bear in mind that the committee released that statement in the context of eight straight years of chronic underruns in inflation, and with the best research alerting it to further underruns in the absence of more aggressive action. Specifically, the median inflation projection from FOMC participants then was 1.7 percent for 2021 and 2 percent for 2023. In light of what was then known — both empirically and from economic research — the policy change seems to me like a reasonable one.

Yet, if we accept — and I think we must —that central banks generally own inflation, two related criticisms are harder for me to discount. First is that language in the FOMC's September 2020 statement could be viewed as going beyond the general principles articulated in the longer-run goals document, and cementing a new, higher threshold for rate increases to commence. Second, as time went on, policy rates became increasingly far away from the prescription of an entire battery of "rules" for rate-setting. To be clear, the Fed does not follow any mechanical rule, but the gap between a broad set of rules and our actions must be noted. For reference, I'll note that today this gap has been substantially closed.

Taking these together, one thing is clear: We will learn more as researchers assess the monetary policy of this period, and I'm looking forward to learning from this work as it comes out. For now, though, I think a fair-minded appraisal of the Fed's performance during the pandemic era must give weight, and a lot of it, to the effects of the Fed's actions in helping to prevent a more severe and longer-lasting downturn. But we will get more clarity, and this view is one I'm prepared to revise. **EF**

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