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A Close VIEW

Maximum Employment and the Risks of a Policy Error

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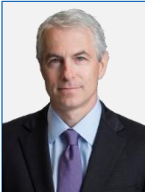

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The Federal Reserve's new policy strategy may support a long and vigorous economic recovery. But if the FOMC is wrong about what drives inflation, it risks the recovery ending in a recession.

In 2017, the Federal Reserve began the slow process of reducing the size of its balance sheet after three rounds of quantitative easing. From the start, policymakers were clear that they did not precisely know the optimal size of the balance sheet; they would probe for it by reducing reserves in the system until the decline in supply put upward pressure on money market rates.

In retrospect, it's clear this approach was problematic. By the time they finished probing, money market conditions were too tight. Policy-makers eventually had to reverse course, restarting Treasury purchases in the fall of 2019 to add reserves back into the system. At best, this can be seen as a mild embarrassment and hit to the Federal Reserve's credibility. At worst, it can be seen as an error that tightened money market conditions at an inopportune time, when the Committee had already pivoted to rate cuts in response to the trade conflict with China.

I refer to this episode as a framework for thinking about the risks of a monetary policy error in the years ahead. To my thinking, the main risk is not a substantial inflationary spiral, like the one that occurred in the late 1960s and early 1970s. The FOMC has made clear that it is only seeking inflation moderately above two percent.[1] Rather, the main risk is that the Committee miscalculates maximum employment, leading to greater inflationary pressure and policy tightening than currently envisioned. This is where the analogy to right-sizing the balance sheet comes in. Just as policy-makers once probed for the limits of balance sheet run-off, they are now probing for the limits of running the economy hot. It's the same calculus, but with much higher stakes.

That the Committee will be probing for just how hot an economy can be achieved is evident in how FOMC Vice Chair Richard Clarida, one of the primary architects of the Committee's new policy strategy, has spoken about the new goal of maximum employment. In a January speech, he commented that, "the Committee now defines maximum employment as the highest level of employment that does not generate sustained pressures that put the price-stability mandate at risk."[2] In plain English, the Committee will be probing for the strongest labor market that can be sustained without inflation rising above the Committee's comfort level.

It remains to be seen if the Committee can probe for maximum employment without sparking significant and undesirable price pressures that would necessitate sharp rate increases. But the issue suggests heightened risks that once maximum employment is reached, the Committee may struggle to fine-tune policy to keep inflation just moderately above two percent A lot will depend on how much policy tightening will be needed to keep inflation at this level.

1. Chair Powell made clear the Committee's relatively limited tolerance for inflation above two percent in an April 8, 2021 public letter to Senator Rick Scott (R-FL), where he noted, "We do not seek inflation that substantially exceeds 2 percent, nor do we seek inflation above 2 percent for a prolonged period….We understand well the lessons of the high inflation experience in the 1960s and 1970s, and the burdens that experience created for all Americans. We do not anticipate inflation pressures of that type, but we have the tools to address such pressures if they do arise."

2. Richard Clarida, "The Federal Reserve's New Framework: Context and Consequences." At "The Roads Ahead for Central Banks" seminar, Hoover Institution, Stanford University, January 13, 2021.

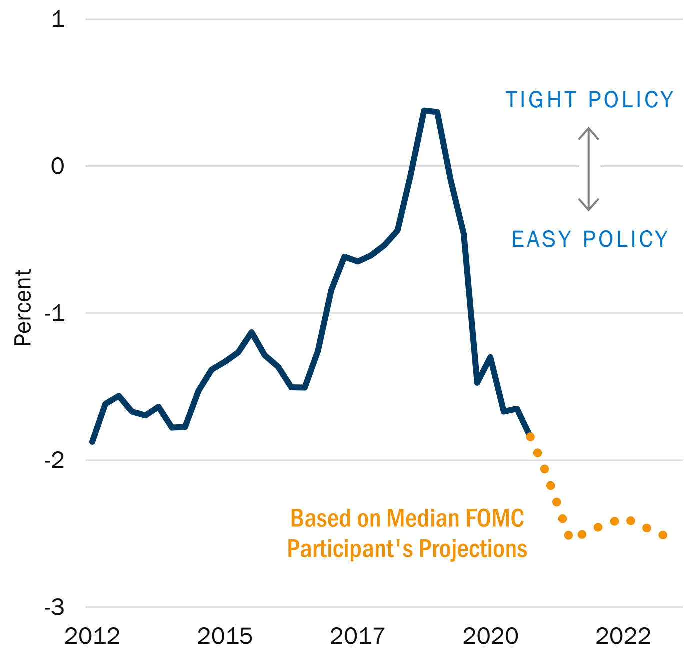
If inflation responds primarily to expectations, as many economists believe, the FOMC might not need to tighten significantly to prevent too-high inflation. It would just need to tighten policy enough to reinforce its inflation-fighting credentials and keep inflation expectations at two percent. Lower inflation outcomes would follow.

If inflation instead responds primarily to economic outcomes, as other economists argue, curbing inflation would require raising rates enough to slow the economy, likely to a below-trend pace, to reverse too-high inflation.[3] That is a process that risks throwing the economy into a recession, especially as growth could well be above trend in the years ahead as a result of sustained fiscal support and easy monetary policy.

The risks in this scenario are made more significant by the fact that the Committee would be seeking to bring down inflation from a point of maximum policy accommodation. This is a direct result of the conditions the Committee has set for raising rates, which in addition to maximum employment include inflation sustainably at two percent, and Committee projections that inflation will rise moderately above that level for some time. These conditions all but guarantee that at lift-off, the real policy rate will be even further below its estimated equilibrium rate than it is now, as Figure 1 at right shows. Based on the median FOMC projection for core PCE inflation, by the end of 2023 the real policy rate would be roughly 250 basis points below neutral. If inflation outcomes are higher than the Committee now projects, policy would be even easier at the time of lift-off. In addition, with inflation running above two percent, the nominal policy rate would need to increase even more just to get back to neutral.[4]

Committee members may not fully agree on the relative importance of outcomes and expectations in the inflation-setting process, but overall, they appear to believe that as long as long-term inflation expectations remain anchored at two percent, inflation shocks are unlikely to persist. This belief will likely influence Committee members' views on appropriate policy in the years ahead. Clarida, for example, has discussed a policy rule that will guide his thinking on the pace of rate increases after liftoff. Unlike standard Taylor rules, his policy rule has no slack component, such as deviations of the unemployment rate or output from their equilibrium levels. Instead, he will look only at inflation outcomes and a term that captures the responsiveness of policy to changes in inflation,

FIGURE 1: THE POLICY SETTING AT LIFT-OFF: FAR FROM NEUTRAL
Real Fed Funds Rate Less Estimate of the Real Neutral Rate



Source: Board of Governors of the Federal Reserve System, Federal Reserve Bank of New York, Bureau of Economic Analysis, MacKay Shields. Neutral rate estimate based on the Laubach Williams model. Values for 2020 – 2023 based on the last from the model. Real fed funds rate based on the fed funds effective and quarterly year-over-year core PCE inflation, and median FOMC participant's projection for the policy rate and core inflation through 2023.

with this term changing in response to shifts in inflation expectations. One hopes this reliance on inflation expectations to guide the policy response proves correct. If economic outcomes play a larger role in the inflation-setting process than Clarida and other Committee members now expect, future rate increases may need to be larger than the Committee and markets currently anticipate.

This is not to suggest that the Committee's new policy strategy is misguided. Quite the opposite, in fact. The shift last year to flexible average inflation targeting was long overdue, as shown by very low inflation and a sluggish labor market recovery in the last economic recovery. But the new strategy is not without risks. It may lead to a stronger recovery and a potentially extended cycle. But down the road, significant policy tightening may be needed to curb inflation, which could risk a severe recession.

3. For more on the expectations versus outcomes debate see, for example, Karen Dynan and Adam Posen, "Global Economic Prospects: Spring 2021." April 1, 2021.
4. Each quarter, Committee participants submit a range of estimates for economic variables, including the longer-run federal funds rate. The concept is similar to that of a neutral policy rate, and assumes inflation at the two percent objective. The current median projection for this variable is 2.5 percent, or 0.5 percent in real terms. But if in the years ahead inflation is running above two percent, and the real neutral rate estimate remains at 0.5 percent, than the nominal neutral policy rate would be above 2.5 percent. Thus higher inflation requires more policy tightening to get back to neutral.

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