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https://people.ucsc.edu/~walshc/Fed-Pivot-Jackson-Hole-2022.pdf.

The Fed Pivots: Goodbye Soft Landing – Hello Disinflation

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Last week's monetary policy symposium at Jackson Hole WY gave international central bankers an opportunity to dust off their inflation fighting credentials – gone was any talk of soft landings and inclusive economic expansions, in were pledges to bring down inflation and, in the words of US Federal Reserve Chair Jerome Powell, "to keep at it until we are confident the job is done."

This new language brings to mind October 6, 1979, when Federal Reserve Chairman Paul Volker called a special Saturday meeting of the FOMC, the Fed's policy committee, to adopt new policies procedures to fight inflation. These led to skyrocketing interest rates, the Fed's policy rate peaked at 19.1 percent in June 1981, and two back-to-back recessions. Ultimately, though, the Volker-led Fed broke the back of inflation and ushered in the low inflation and economic stability the US enjoyed between 1985 and the financial crisis of 2008.

Today, the U.S. is experiencing inflation rates not seen since the early 1980s, and surveys find that inflation is a major concern of American households. The Pew Research Center's April survey found that 93 percent of American households described inflation as "a very big" or "moderately big problem." This isn't surprising. Despite Fed protestations during 2021 that the surge in inflation was temporary, year-over-year headline inflation in July was 8.5 percent, and inflation has exceeded the Fed's 2 percent target for 17 straight months. For many people, gains from economic expansion have been eaten away by rising prices.

At Jackson Hole, Powell made clear that, like Volcker, he is now committed to reducing inflation. He also highlighted a lesson from the past – delay in reacting makes the cost of reducing inflation higher. It is unfortunate that the Fed has only now remembered this lesson. The FOMC waited until March 2022, when inflation was over 6 percent, before slowly beginning to raise interest rates. Its response has hardly been one of shock and awe; it has taken five months to boost rates to 2.5%. In 1979 the Volcker FOMC caused rates to rise roughly the same amount in just a month. Volcker's dramatic actions came when inflation had averaged over 8 percent during the previous five years. Inflation is not as ingrained now as it was then, but simply waiting in the hope that inflation would quickly recede was always going to be a risky strategy.

The Fed can't do anything about its slow start in fighting inflation, but there are three things it can do now to win the battle. First, if fighting inflation is the Fed's priority, stick to it, and keep inflation at the forefront of how policy is communicated to the public. It is important to continue to avoid discussions of engineering a soft landing or prioritizing short run economic expansion. At this late date, these topics raise questions about the Fed's commitment to fighting inflation. Everyone wants the smallest possible hit to the economy, but even those who might benefit most if a slowdown is avoided may also be the ones most hurt by the failure to control inflation as their limited budgets are stretched further and further.

Second, conducting monetary policy in the face of great uncertainty is a challenge, but there are lessons from the past here too. When uncertain about whether shocks to inflation are temporary or persistent, I argued at Jackson Hole almost 20 years ago that it is better to overestimate the persistence of inflation shocks, just the opposite of what the Fed did. One can hope that inflation quickly subsides, but it is best to plan for "temporary" shocks to inflation to end up persisting. Just as in fighting wildfires, it is best to respond quickly and strongly even to small fires to avoid the risk unpredictable winds convert a small fire into an inferno.

Third, clarify the Fed's policy framework. Doing so would begin by admitting that the 2020 policy review and subsequent adoption of average inflation targeting was a mistake. With an inflation target that was no longer clearly defined and an employment goal the Fed itself described as "not directly measurable," the new policy framework made the Fed less accountable. And, as others have pointed out, the Fed adopted a framework appropriate for a low inflation environment of the previous decade just as the global economy entered a high inflation environment.

In 1978, Volcker's predecessor G. William Miller was asked whether the Fed was responsible for the U.S.'s then 8 percent inflation. He responded, "I take the 5th," appealing to the U.S. Constitution's protection against self-incrimination. (FOMC Transcript 9/19/1978, p. 17) Last year at Jackson Hole, Powell downplayed the Fed's responsibility for inflation. At this year's Jackson Hole, Powell firmly took on the mantle of Volcker, emphasizing that it is the Fed's responsibility to ensure low average inflation. It remains to be seen which former Chairman's legacy will guide policy over the next year.