Welcoming and Introductory Remarks

Charles I. Plosser

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Let me welcome all of you to our semi-annual Shadow Open Market Committee meeting. Thank you for coming. I also want to express appreciation to Purdue University for hosting us today. On a personal note, I want to welcome Jim Bullard, my former colleague at the Fed and now a colleague on the SOMC. Welcome aboard Jim.

As most of you may know, the SOMC recently celebrated its 50th Anniversary. Since the early 1970s the SOMC has been offering insights and commentary on economic policy, but especially on monetary and financial policy. The composition of the committee has been made up of both academic economists, business economists, and economists who have served as central bankers both before and after serving as members of the SOMC. Five of our current eleven members have served in policy making positions or in senior staff roles at the Fed and the ECB. That experience brings vast knowledge and perspective to our discussions.

Today we are delighted bring together not only our members but several additional experts and former central bankers including Richard Clarida, Thomas Hoenig, Donald Kohn, Vincent Reinhart, and David Romer. Our discussions will center around the Fed's intent to conduct a review of its strategic approach to monetary policy, first released in 2012 and revised in 2020. This is an important undertaking and it should not be treated as fine-tuning exercise. The Fed and central banks around the world have faced great challenges over the last two decades and much remains unsettled or unsettling. Thus, it is critical that the task be undertaken carefully and objectively.

I thought I would start with a little history of the Fed's 2012 Statement of Longer-Run Goals and Monetary Policy Strategy, which I also will refer to as the consensus statement. It was the first of its kind to be publicly released by the Fed. Our colleague, Jeff Lacker, has authored a nice paper looking back at how the document came about.

In 2011, with the support of Chairman Bernanke, I enlisted the help of several other FOMC members, including Jeff Lacker and Jim Bullard, to craft a statement on establishing an inflation target that could gain support of the FOMC. After much give and take and hours of meetings with all FOMC members, a consensus statement was approved by the FOMC in January 2012.

The strategic plan of 2012 was a significant step to improve transparency and accountability. Several elements are key in my view. First, the statement explicitly committed the Fed to a specified inflation target of 2 percent. This meant that the Fed would conduct policy in such a way to keep inflation at 2 percent. Whether inflation was above or below target it would conduct policy in a manner that would seek to return inflation to target. In that since it was a symmetric, or balanced approach to inflation. This constituted the Fed's interpretation of its price stability mandate. It was not a price level target nor was it a target with a range, although both were discussed.

The second important element of the 2012 strategy was the acknowledgement that it was inappropriate for the Fed to specify a fixed quantitative objective for its employment mandate. It said maximum employment was determined by many non-monetary factors ranging from tax policies to structural dynamics of the labor market that changed over time. This interpretation of the employment mandate was vague but seemed to be the best it could do given the realities of the economy and the capabilities of monetary policy.

The third element I want to emphasize is that the consensus statement stressed that the two aims of its mandate were not necessarily in conflict and that price stability was an important contributor to maximum employment, The statement went on to say that if the goals seemed to be in conflict it would pursue a balanced approach to achieving its objectives,

The 2012 consensus statement was reconfirmed with minor edits every year through 2019. The Fed then undertook a review of the strategic plan culminating in the revised statement released in August 2020. In some ways the new plan was similar to the 2012 plan but in other, important ways, it contained significant departures.

Mickey Levy and I presented our assessment of the 2020 strategic plan, titled "The Murky Future of Monetary Policy," at the SOMC meeting in September 2020, just a month after the Fed's announcement. As the paper's title suggests, we skeptical of the plan on a number of dimensions. The 2020 strategic plan superficially seeks to achieve a 2% rate of inflation over the longer-term as did the 2012 plan. However, the devil is in the details, and I am sure our discussions today will delve into many of the issues.

Most notable in my mind is that the 2020 plan reinterpreted the Fed's mandate in significant ways. The plan was heavily influenced by the period of the somewhat below target inflation of the prior decade. Moreover, the unemployment rate steadily declined during this period, dropping below 4 percent in 2018 -2019. The Fed concluded, for a variety of reasons that will be discussed in the panels, the risks of inflation running too low were greater than if it was running too high. This asymmetric loss function led the Fed to devise a strategy that favored higher inflation, which was called "flexible average inflation targeting" (FAIT). This strategy called for the Fed to engineer a period of above target inflation to offset periods when inflation was too low. But notably, it did not intend to create periods of below target inflation to offset periods of above target inflation. If executed precisely as described, such a strategy would not deliver an average inflation rate of 2 percent but something higher than that, hence it was called a flexible average inflation target.

The asymmetry shows up in the employment side of the mandate as well. The Fed has long operated under the premise that an expectational Phillips curve was the lens through which monetary policy shaped inflation dynamics. It interpreted prior decade as evidence of a weakening of the links between unemployment in labor markets or measures of slack in understanding the dynamics of inflation. I thought we learned in this lesson in the 1970s. One of the Fed's take aways away from the decade following the financial crisis was that it would be possible to continue to use easy monetary policy to stimulate employment gains even in the face of tight labor markets without necessarily generating inflation.

In light of this analysis, the Fed indicated would no longer use pre-emptive tightening (a widely accepted practice) to reduce the risk of emerging inflationary pressures and instead wait until inflation was evident before tightening policy. This view doubled downed on the 2020 plan 's shift to elevate employment concerns relative to inflation.

Another implication of this reinterpretation of the mandate and the "flat Phillips Curve," as the Fed called it, is that it left inflationary expectations as the primary variable remaining in the Fed's model of inflation dynamics. Consequently, the 2020 strategic plan was heavily focused on managing inflation expectations. But it is unclear what tools and how it will use them to give credibility to the expectations it sought to manage. This is unsatisfactory from a theoretical and policy perspective. How do you deliver stable prices and anchored expectations when you find that the variable you attempt to control, economic or labor market slack, is not a very good guide to predicting inflation or understanding inflation dynamics.

This suggests to me that we need to take a step back from the efforts to fine-tune more complex approaches to our monetary policy strategy, which is how I would characterize the 2020 strategic plan, and seek a better understanding of what has changed in the environment and how it has altered the transmission mechanism of monetary policy. Since the financial crisis a lot has changed in our financial system. There are more regulations on banks, including higher capital and liquidity requirements, interest on reserves and quantitative easing have virtual wiped out the federal funds market as tool used by banks to finance short-term liquidity. How have these changes affected the stability of the financial system and the transmission of monetary policy? In some models, the merging of money and credit markets leaves the price level indeterminate, undermining Fed independence and its ability of the to achieve price stability.

These are important questions for designing monetary policy strategies and work needs to be done to get better answers. As that work evolves, we should seek a strategies for monetary policy that are robust to different environments and thus not highly model specific. We should also recognize that our ability to fine-tune expectations is limited and our credibility is fragile. Adopting policies that are easily communicated to the public, and policies that are robust and credible would likely serve the Fed and the economy well.

There are many issues I have not touched on such as rules vs discretion and systematic policies, communications, and public accountability. I am confident that panelists will offer their own perspectives and more detail that will differ from mine. I look forward to a lively and productive conversation. Thank you and let's get started.