

# The Anguish and Progress of Central Banking

Gregory D. Hess, IES Abroad

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ECONOMIC POLICIES FOR THE 21ST CENTURY

## The Anguish and Progress of Central Banking

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This short commentary places the Federal Reserve’s New Framework for Longer-Run Goals and Monetary Policy Strategy within the context of the evolution of the practices of Central Banking policies.<sup>1</sup> Section I provides a detailed review of a speech that was part *post-mortem*, part *mea culpa* by former Chairman Arthur Burns. Given in September of 1979, the speech comes just one year after Chairman Burns completed his service as Federal Reserve Board Chair from 1970-1978. This eerily prescient paper, with timely relevance to emerging dilemmas facing the Federal Reserve, also provides a timeless lesson on the political economic pressures, constraints, and limitations that all central banks face. In addition, Burns’ speech provides a historically critical perspective on the anguish associated with the Federal Reserve’s failure to leave unchecked the rising inflation that began in the mid 1960’s and that ultimately evolved into the Great Inflation of the late 1970’s. Section II then outlines the progress that central banks have made in adopting and implementing new tools and norms post-Great Inflation that have steered policy in a consistently better direction. Section III reviews the Federal Reserve’s New Monetary Policy Framework in light of the opposing forces of anguish and progress that central banks are destined to eternally balance and manage, and I provide a few recommendations to strengthen it.

### **I. Arthur Burns’ Anguish**

There is perhaps no paper that provides a more powerful and intriguing elucidation of the constrained and treacherous social and political economy terrain within which central banks operate than Arthur Burns’ paper, “The Anguish of Central Banking.”<sup>2</sup> The prominence and longevity of this paper owes to two noteworthy elements. First, Burns’ use of the term “anguish”—extreme pain, distress, or anxiety—is remarkable, as rarely has central banking been described in such emotionally fraught language. He frames and defines this anguish as follow:

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\* Gregory D. Hess is the President and CEO of IES Abroad, and President Emeritus of Wabash College. He has been a member of the Shadow Open Market Committee (SOMC) since 1999. The views expressed are his own and not the views of IES Abroad. This paper is prepared for the SOMC Event hosted by the Manhattan Institute entitled “SOMC: The Federal Reserve’s New Policy Framework,” on Wednesday, April 14, 2021.

<sup>1</sup> Statement on Longer-Run Goals and Monetary Policy Strategy, Adopted effective January 24, 2012; as reaffirmed effective January 26, 2021. [https://www.federalreserve.gov/monetarypolicy/files/fomc\\_longerrungoals.pdf](https://www.federalreserve.gov/monetarypolicy/files/fomc_longerrungoals.pdf)

<sup>2</sup> Arthur Burns, Per Jacobsson Lecture, Belgrade, Yugoslavia, September 30, 1979. Reprinted in September 1987, pp. 687-698. [https://fraser.stlouisfed.org/files/docs/publications/FRB/pages/1985-1989/32252\\_1985-1989.pdf](https://fraser.stlouisfed.org/files/docs/publications/FRB/pages/1985-1989/32252_1985-1989.pdf)

*“By training if not also by temperament, they [central bankers] are inclined to lay great stress on price stability, and their abhorrence of inflation is continually reinforced by contacts with one another and with like-minded members of the private financial community. And yet, despite their antipathy to inflation and the powerful weapons they could wield against it, central bankers have failed so utterly in this mission in recent years. In this paradox lies the anguish of central banking.” [p.688]*

Quite an admission of guilt since anguish is seldom associated with success. In short, during the period of 1958 to 1978, the Federal Reserve valued price stability, yet could not maintain it nor re-establish when it when it was lost.<sup>3</sup> Anguish, indeed.

The second noteworthy element is Burns’ identification of the fundamental cause of this anguish. Burns details a wide range of important contributing economic factors to the Great Inflation, including “fine tuning,” “loose [government] financing,” “policy errors,” “devaluations of the dollar,” “the extraordinary increases in oil prices that became effective in 1974,” “the sharp deceleration of productivity from the late 1960s onward,” and the role of “widespread expectations ... so that inflation has acquired a momentum of its own.” These events and influences underpinning the Great Inflation are well known to economists and market participants.

However, despite this long list of impressive reasons and contributing economic factors for the enormous rise in inflation during this time-period, he points to a very different fundamental cause. He writes:

*“At the same time, I believe that such analyses overlook a more fundamental factor: the persistent inflationary bias that has emerged from the philosophical and political currents that have been transforming economic life in the United States and elsewhere since the 1930’s. The essence of the unique inflation of our times and the reason central bankers have been ineffective in dealing with it can be understood only in terms of those currents of thought and the political environment they have created.” [pp. 688-689].*

Chairman Burns traces the genesis of this fundamental factor to three reasons. First, he points to the federal government’s response to the Great Depression in that the “New Deal measures laid the foundations of an activist government—a government responsible not only for relieving suffering and insuring against economic adversity, but also for limiting ‘harmful’ competition, subsidizing ‘worthwhile’

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<sup>3</sup> By Burns’ account, “From 1958 through 1964, the United States enjoyed a remarkable degree of price stability. During that stretch of six years, the wholesale price index remained virtually unchanged and the consumer price index rose at an annual rate of only a little more than 1 percent. And then the inflation that has ever since been plaguing the American economy got under way. Average wholesale prices rose at an annual rate of 2 percent from 1964 to 1968, 4 percent from 1968 to 1972, and 10 percent from 1972 to 1978.” [p.688]

activities, and redressing unequal balances of market power. In less than a decade the government became a leading actor on the economic stage. [p.689]” In turn, “Under the compulsions of war, the government demonstrated that it could assure gainful employment for every willing hand,” evolved into “With the war ended, the Employment Act of 1946 explicitly proclaimed the federal government’s responsibility to promote ‘maximum employment,’ and this came to mean ‘full employment’ as a matter of law as well as popular usage.” [p.689.]

Second, he identified long-standing but heightened societal issues driving relevant political economy factors. This included discontentment and the “growing feelings of injustice by or on behalf of other groups—the poor, the aged, the physically handicapped, ethnics, farmers, blue-collar workers, women and so-forth.” Of course, other cultural restrictions contributed, including a “growing rejection by middle-class youth of prevailing institutions and cultural values,” as well as “tensions from the Vietnam War.” [p.690]

Taken together, Burns argues that the importance of the Full Employment Act and extraordinary societal conflict led the government to undertake “in the mid-1960s to address such ‘unfinished tasks’ as reducing frictional unemployment, eliminating poverty, widening the benefits of prosperity, and improving the quality of life, it awakened new ranges of expectation and demand.” [p.690] He goes on to emphasize that:

*The pursuit of costly social reforms often went hand in hand with the pursuits of full employment. In fact, much of the expanding range of government spending was prompted by the commitment to full employment. Inflation came to be widely viewed as a temporary phenomenon—or, provided it remained mild, as an acceptable condition. ‘Maximum’ or ‘full’ employment, after all, had become the nation’s major economic goal—not stability of the price level. That inflation ultimately brings on recessions and otherwise nullifies many of the benefits sought through social legislation was largely ignored [p.691].”*

In short, the Fed was tightly constrained by the divisive political milieu. He notes that “Viewed in the abstract, the Federal Reserve System had the power to abort the inflation at its incipient stage fifteen years ago or at any later date, and it has the power to end it today... It did not do so because the Federal Reserve was itself caught up in the philosophical and political currents that were transforming American life and culture.” [p.692]

As he goes on to argue, the Fed was expected to maintain an accommodative stance to allow the economy to run hot:

*“Every time the government moved to enlarge the flow of benefits to the population at large, or this or that group, the assumption was implicit that monetary policy would somehow accommodate the action.” [p.692]*

And the Fed faced political pressure when it balked at such accommodation:

*“I do not mean to suggest that central bankers are free from responsibility for the inflation that is our common inheritance... [However,] As the Federal Reserve kept testing and probing the limits of its freedom to under nourish the inflation, it repeatedly evoked violent criticism from both the Executive Branch and Congress and therefore had to devote much of its energy to warding off legislation that could destroy any hope of ending inflation.” [p.692-693]*

Overall, Chairman Burns’ conjecture is consistent with our empirical findings from Hess and Shelton [2016]<sup>4</sup> that “during the Burns and Volcker eras, [Congressional] bills threatening the Fed were triggered most frequently by high unemployment. The response to high inflation was tepid by comparison.” We go on to say that “It also fits with Burns’ (1979) retrospective *Cri de Coeur* that the Keynesian belief in the power and duty of government to ensure full employment was paramount in Congressional policymaking during his tenure.”

## **II. Subsequent Progress Leading Up to the Federal Reserve’s 2012 Long Run Framework**

The Federal Reserve has made substantially improved policy decision making starting with Paul Volcker’s appointment as FOMC Chair in August of 1979.<sup>5</sup> One area of improvement is that the Fed is now capable of bold, timely risk-taking decisions in its policymaking. Clearly, the Great Inflation did not end on its own accord. The disinflation of the early 1980s lowered inflation (as measured as year-over-year percentage change of the monthly PCE chain-type index, excluding food and energy, seasonally adjusted) from 7.4% when Volcker began as Chair, to a maximum of 9.8% in November of 1980, to 3.4% when his second term ended in August of 1987. It took boldness and determined decision making by the Federal Reserve’s leadership. To achieve this, the monthly overnight call money bank rate rose from 10.94% when Volcker arrived, to a high of 19.08% in January of 1981, to a modest 6.73% at the end of his second term. And the rate of unemployment (monthly, seasonally adjusted), at 6.0% when Chairman Volcker started his first term, peaked in November and December of 1982 at 10.8%, before falling back

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<sup>4</sup> See Gregory D. Hess and Cameron A. Shelton, “Congress and the Federal Reserve,” Journal of Money, Credit and Banking, May 2016.

<sup>5</sup> For a complementary perspective, see Marvin Goodfriend, “How the World Achieved Consensus on Monetary Policy,” Journal of Economic Perspectives, 21(4), Fall 2007, pp. 47-68.

down to 6.0% when his second term ended. And the lessons learned by subsequent generations of economists paved the way to future policy improvements that progressed the field far beyond anguish. Overall, the Fed has made progress in demonstrating that it is necessary and capable of implementing forceful action using monetary policy in times of crisis.

After the Great Inflation, the Federal Reserve has made timely and determined interventions and actions, in both its monetary policy and central banking functions, to our collective benefit.<sup>6</sup> Indeed, every Chair of the Board of Governors of the Federal Reserve System has been involved in these actions in one form or another. My brief list includes the Federal Reserve's strong liquidity response and encouragement to private banks to lend in the midst of the October 1987 stock market crash on Black Monday, October 19, 1987, when the Dow Jones Industrial Average fell 22.6%; its handling and support of banking and payment systems stemming from the 9/11 terrorist attacks in the U.S. in 2001; the Board of Governor's creative "blue sky" thinking and response to the 2008 financial crisis; finally, the FOMC's response to the 2020 Covid-19 pandemic stabilized, to the extent possible, our economic well-being in light of -31.4% annualized decline in real GDP in the 2020Q2. Overall, the Fed has made progress by demonstrating that it can, and will when necessary, implement forceful action in times of crisis. By contrast, anguish has an inevitable, fatalistic, inactive, and paralytic quality to it; it is not associated with forceful action.

Second, the economics profession, as well as the Federal Reserve itself, has embraced the importance of central bank independence from government influence. A key article in this empirical literature is by Alesina and Summers (1993), who demonstrated that more independent central banks generate lower and less volatile inflation rates. As such, central bank independence supports price stability, although the authors do not find evidence that it either positively or negatively influences other measures of real economic performance.<sup>7</sup> Their paper emphasizes both "political independence," which is the ability for the central bank to choose its own policy objectives independently from the government, as well as "economic independence," which is, the ability of a central bank to choose its monetary policy instruments without government interference. In an era of large fiscal deficits, balance sheet expansion by the Fed from quantitative easing, strong political language, and sharp partisan elbows, this topic has re-emerged as an important political and financial markets issue for the Fed.

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<sup>6</sup> Of course, the benefit from these bold actions may have increased the frequency of their presumed necessity due to issues of moral hazard and the perceived "[insert the name of the FOMC Chair]-put" in equity markets.

<sup>7</sup> Alberto Alesina and Lawrence H. Summers, "Central Bank Independence and Macroeconomic Performance: Some Comparative Evidence," Journal of Money, Credit and Banking, Vol. 25, No. 2 (May 1993), pp. 151-162.

Third, the Federal Reserve has progressed the practice of monetary policy by adopting the language, and some aspects, of interest rate rules. Following on from John Taylor's (1993) analytically and communicatively elegant and influential piece, a language has developed and framed discussion on the determination of a simple policy overnight interest rate, the nominal federal funds rate, that is useful for policy. In Taylor's rule, the nominal fed funds rate depends on the risk-free rate of interest, the rate of inflation, the gap between the inflation rate and the target inflation rate, and the output gap.<sup>8</sup> The rule suggests that the FOMC should adopt an inflation target, over-responded positively, symmetrically, and pro-cyclically when inflation deviates from target, and modestly and symmetrically keep the federal funds rate pro-cyclical with deviations of output from potential.

Fourth, as critical as the Taylor Rule has been for defining a language and framework for monetary policy, the Federal Reserve has borrowed additional qualitative factors from the Taylor Rule that have partially strengthened its policies. The first is that policy should be transparent. The Taylor Rule, much like the earlier Milton Friedman and Bennett McCallum rules for the monetary base, is certainly that. Critically, as a language has developed around it, the Taylor Rule has been influential as a tool for refining and clarifying communication about monetary policy. And, as we have evolved from Chairman Greenspan's cryptic remarks to full-on, routine press conferences, communication about anchoring inflation expectations, discussing trends in the risk-free rate, etc., this language from the Taylor Rule has become increasingly essential in underpinning a common monetary policy language.

The second qualitative factor that has emerged from the Taylor Rule, and that the Federal Reserve has borrowed, is the extent to which policy is deemed to be systematic—stable and predictable. Again, the Taylor Rule is systematic. Unstable and erratic policies confuse financial market participants, and ultimately undermine the achievement of outcomes of price stability, maximum employment, and moderate interest rates, that policymakers seek to obtain. Of course, while the Taylor Rule could provide policy guidance for alternatives that were deemed in the range of possible at the time, it has struggled in an era of ultra-low policy interest rates that have reached the effective lower bound. Indeed, the overnight interest rule is no longer a sufficient condition for monetary policy, as a central bank's balance sheet and trajectory must now be fully comprehended to best measure the stance of

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<sup>8</sup> John B. Taylor, "Discretion versus Policy Rules in Practice," Carnegie-Rochester Conference Series on Public Policy, vol. 39, 1993, pp. 195-214. The Taylor Rule is  $i = r^* + \pi + .5(\pi - \pi^*) + .5(y - y^*)$ , where  $i$  is the nominal federal funds rate,  $\pi$  is the rate of inflation over the previous four quarters,  $\pi^*$  is the target rate of inflation and  $(y - y^*)$  is the present deviation of real GDP from target. This equation, which broadly mimicked the nominal federal funds rate from 1984 through 1992, pushed aside monetary aggregate rules that, while theoretically connected to prices, were subject to variation in seasonality and long-term swings in velocity.

monetary policy. Also, simple interest rate rules are unlikely to remain helpful during periods of financial crises, a point also made in Clarida, Gali and Gertler.<sup>9</sup>

The Federal Reserve's fifth step of progress, a major step toward the eventual adoption of a specific long-run inflation target, is incapsulated in a speech by then Federal Reserve Governor, Ben Bernanke, in 2003.<sup>10</sup> In this, he argues persuasively "how an incremental move toward inflation targeting, in the form of the announcement of a long-run inflation objective, might help the Fed communicate better and perhaps improve policy decisions as well, without the costs feared by those concerned about potential loss of flexibility."<sup>11</sup> He points to associated benefits such as providing a long-run "anchor" to monetary policy and long-term inflation expectations, as well as corresponding reductions of inflation risk premia in financial markets and the enhancement of short-run stabilization policy. He also advocates that the long-run target rate should allow room for short-term stabilization policy and recommends that "the FOMC regard[s] this inflation rate as a long-run objective only and sets no fixed time frame for reaching it." As such, built into his remarks eighteen years ago, Bernanke recognized the importance of constrained flexibility of inflation in the short-run even with a specific long-term goal for inflation.

The FOMC's progress was codified on January 24, 2012 in its Statement on Longer-Run Goals and Monetary Policy Strategy. The statement reaffirms the commitment to its dual mandate and specifies a 2% longer-run goal for inflation as measured by the annual rate of the PCE price index. As foreshadowed in Bernanke's speech in 2003, the specificity of this goal should be recognized as the adoption of inflation targeting by the FOMC, albeit flexible in its implementation. It recognized further that the maximum level of employment was determined by nonmonetary factors and that it would monitor a wide range of indicators. Finally, the FOMC adopted an approach to use policy to directly meet the dual mandate when employment and inflation misses were complementary (i.e., when employment is low [high] and inflation is low [high]) and use a balanced approach when they were not, while taking into account the magnitude and persistence of the deviations.

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<sup>9</sup> Clarida, Richard, Jordi Gali, and Mark Gertler. 1999. "The Science of Monetary Policy: A New Keynesian Perspective." Journal of Economic Literature, 37 (4): 1661-1707. This paper is an exceptional guide for analyzing monetary policy rules in optimizing dynamic New Keynesian models, which underpin the analysis of many central bank models of the economy.

<sup>10</sup> Remarks by Governor Ben S. Bernanke at the 28th Annual Policy Conference: Inflation Targeting: Prospects and Problems, Federal Reserve Bank of St. Louis, St. Louis, Missouri October 17, 2003, Panel Discussion.

<sup>11</sup> This contrasts with Chairman Greenspan's articulation of price stability as when "the expected rate of change of the general level of prices ceases to be a factor in individual and business decision-making." Greenspan, Alan, 1990. Statement before the U.S. Congress, House of Representatives, Sub-committee on Domestic Monetary Policy of the Committee on Banking, Finance and Urban Affairs.



### III. **The Fed's New 2020 Framework and Suggestions for Strengthening it**

In light of the modest economic growth in the U.S. from 2013-19, PCE inflation rates that have persistently come in below the FOMC's stated annual target of 2%, and an extensive listening tour throughout the Federal Reserve System and the country, on August 27, 2020 the FOMC adopted a revised Statement on its Longer-Run Goals and Monetary Policy Strategy.<sup>12</sup> It further made substantial changes to its forward guidance for the funds rate to provide "transparent outcome-based guidance linked to the macroeconomic conditions that must [my emphasis] prevail before the Committee expects to lift off from the effective lower bound (ELB)."<sup>13</sup> [Clarida p. 1]

In a nutshell, here are the essential and important features of the new framework:<sup>14</sup> First, the FOMC will "delay liftoff from the ELB until a threshold for average inflation has been reached." [P. 5. Clarida]. Second, since inflation has persistently been below 2%, the FOMC will appropriately aim to keep inflation moderately above 2% for some time in order to have average inflation at 2% and inflation expectations anchored at 2%.<sup>15</sup> Third, the FOMC expects [my emphasis] that policy will stay accommodative until the conditions for policy normalization have been met: namely maximum employment and inflation that exceeds 2% for some time. Fourth, the FOMC introduced an inclusivity clause to its assessment and understanding of maximum employment.<sup>16</sup>

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<sup>12</sup> Real GDP quarterly growth averaged 2.5 percent on an annual basis from 2013 to 2019. The quarterly PCE index grew, on average, 1.34 percent on an annual basis, during this same time period.

<sup>13</sup> Vice Chair Richard Clarida, "The Economy and Monetary Policy," Brookings Institution Webcast, November 16, 2020. <https://www.federalreserve.gov/newsevents/speech/clarida20201116a.htm> Also see Statement on Longer-Run Goals and Monetary Policy Strategy, Adopted effective January 24, 2012; as reaffirmed effective January 26, 2021. [https://www.federalreserve.gov/monetarypolicy/files/fomc\\_longerrungoals.pdf](https://www.federalreserve.gov/monetarypolicy/files/fomc_longerrungoals.pdf)

<sup>14</sup> Two other elements emphasized by Clarida [2020] are: The new framework is intended after lifting off from "the ELB to return inflation to its 2 percent goal, but not to push inflation below 2 percent;" Also, that the 2 percent goal is the long run target for inflation, but it is not an after the fact commitment after all circumstances.

<sup>15</sup> Former Vice-Chair Alan Blinder states "So let me hazard a guess: The Fed will be perfectly copacetic with inflation rates as high as 2.5%, maybe even slightly higher, for two to four quarters—as long as inflation shows no signs of breaking out on the upside." March 15, 2021 Wall Street Journal Op-Ed, "There's No Need to Panic About a Little Inflation." Remarkably, three additional former FOMC members repeated similar guestimates in webinars within a week of the op-ed.

<sup>16</sup> Inclusivity is a critical mission for any organization. At IES Abroad we highlight this as one of our greatest strengths and intangible assets, and we allocate significant resources for recruitment, advising, scholarships and programming to assist in inclusivity. In and of itself inclusivity is a worthy and essential goal for employment, reflecting the racial and socio-economic divisions in our country that have not been this deep or jagged since the 1960's. Interestingly, inflation also has differential impacts that affect some groups harder than others, particularly those that are poor. However, the FOMC has not yet identified inclusive inflation measures as part of its new framework. See William Easterly and Stan Fischer, "Inflation and the Poor," Journal of Money, Credit and Banking, vol 33, No 2., May 2001, p. 160-178. They find that "direct measures of improvements in well-being of the poor -- the change in their share in national income, the percent decline in poverty, and the percent change in the real

In short, according to its own public statements, the FOMC wishes to set the funds rate lower for longer, expects that it will not raise the federal funds rate until key benchmarks are realized for inflation as well as for measures of employment, and it plans to modestly overshoot its long-run target of 2% for a short period of time because it has undershot the long run target for ten years or so. Correspondingly, the FOMC's decisions will depend on outcomes, not projections.<sup>17</sup>

There are two ways to strengthen the new mandate. First, from my vantage point, the current long-run framework is too situational and too narrowly focused on our recent circumstances. As such, it does not give sufficient weight to a commitment to a broader framework that is rules-based, transparent, and systematic. Second, the framework suggests that the FOMC is taking an aggressive posture and lexicographically diminishing inflation concerns as compared to employment concerns, further into the future than need be. This pivot is taking place during an era and groundswell of progressive policymaking with corresponding large fiscal demands. And it's got me worried about the possibility of a 1960's Burns' style re-anguishment of monetary policy.

However, the FOMC can strengthen its new framework in a couple of ways to bypass its narrow situational focus. First, it can make monetary policy more transparent. Here is a specific example. The FOMC's new framework explicitly prescribes that it will allow inflation to exceed the long-run target for a period of time in response to the fact that inflation has been persistently below the long-run target by 0.7% on average from 2013-2019. The first question to come to mind is whether if inflation had persistently exceeded their long run target, would the FOMC insist on running inflation below the long-run target for a period of time? This is not just aimless theorizing; rather, it speaks to the FOMC's long-run monetary policy framework, as well as its levels of tolerance and symmetry for deviations from its dual mandate. Again, if inflation had been running at 2.7% for five-to-ten years, would the FOMC purposely undershoot its long run 2% target for several quarters afterward? I would be surprised if I was the first person to ask this question. And by answering this simple question, the FOMC can provide more transparency to its truly long-run framework.

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minimum wage -- to be negatively correlated with inflation in pooled cross-country samples." Also see Xavier Jaravel, "The Unequal Gains from Product Innovations: Evidence from the U.S. Retail Sector," Quarterly Journal of Economics., 134, May 2019, 715-783. Using U.S. scanner data from 2004-2015, he finds that after taking into consideration that higher income households purchase goods that have higher levels of innovation, that annual inflation for goods was 0.88 percentage points higher for lower income families than for higher income families.

<sup>17</sup> Outcome based policy seems both somewhat at odds with Milton Friedman's broadly accepted view that monetary policy has long and variable lags and the FOMC's own 2021 Statement on Long Run Goals and Monetary Policy Strategy – "Monetary policy actions tend to influence economic activity, employment, and prices with a lag."

Second, the FOMC should strive to adopt more systematic policies in its new policy framework.

Indeed, the FOMC's failure to adopt a systematic policy approach is more problematic at present because the effective lower bound for interest rates means the Fed has had to rely heavily on quantitative easing to adjust the stance of monetary policy for over twelve years. And yet the FOMC remains quiet on making its QE actions systematically related to macroeconomic outcomes and projections in pursuit of its price stability and maximum employment objectives. As we stated in Hess and Orphanides (2018), "Since the zero lower bound on interest rates was reached in 2008, QE has become another important policy tool. At present, to assess the complete stance of monetary policy requires an understanding of how the FOMC plans to change the federal funds rate, as well as an understanding of what it intends to do with the size of the Fed's balance sheet. ... In recent years, the FOMC has provided some forward guidance with respect to the federal funds rate—the so-called "dot plot." However, no similar forward guidance is provided for the size of the Fed's balance sheet," which makes it difficult to assess how and in response to what will the FOMC adjust policy in this critical area.

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Finally, the FOMC must carefully consider how it will deal with and pivot away from "the anguish" zone should it find itself in it. But let me begin by stating that I hope that the FOMC's new policy framework is successful, and that it can keep inflation reasonably low and allow a glide path for employment gains to continue. However, I have found that while it is better to think like an optimist, it is also better to plan like a pessimist. And the planner and risk manager in me is telling me that the FOMC has to consider two potentially unpleasant scenarios that could lead to the anguish zone: first, inflation scares, where inflation expectations in financial markets unexpectedly and materially rise; and second, a negative supply shock that severely raises inflation and lowers employment. I will discuss each in turn.

First, Marvin Goodfriend (1993) wrote a lot about inflation scares, which he defines as "a significant long-rate rise in the absence of an aggressive funds rate tightening an inflation scare since it

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<sup>18</sup> Gregory D. Hess and Athanasios Orphanides, "Monetary Policy Normalization Should Be More Systematic and Less Wobbly," SOMC Meeting, March 9, 2018. <https://www.shadowfed.org/wp-content/uploads/2018/03/Hess-OrphanidesSOMC-March2018.pdf>

<sup>19</sup> We are referring to the published [Summary of Economic Projections](#). Note that the most recent version, March 17, 2021, continues to identify "Appropriate Monetary Policy," solely through the nominal federal funds rate. Interestingly, the FOMC minutes of the November 2020 meeting suggest that more information of this type may be forthcoming, though it is still unclear if they will move their balance sheet discussion into a systematic and predictable rule-based direction. That being said, it has been 12 years since QE has been actively used as a policy instrument, and that's a long time not to begin to systematize such an important and critical policy channel.

reflects rising expected long-run inflation [p.8].”<sup>20</sup> Critically, inflation scares could create a difficult dilemma for the FOMC in its new framework. For instance, if the FOMC resists inflation scares and tightens monetary policy conditions, then it will cause a slowdown in economic activity and it would seem as if the new framework’s pre-conditions for tightening policy (that is, inflation above 2% and maximum employment obtained) would have been un-met. By contrast, if the FOMC ignores the rise in inflation expectations, this could ultimately lead to a self-fulfilling higher rate of inflation and unmoored inflation expectations, which could ultimately lead to challenges for the credibility of monetary policy and the long-run inflation target.

Second, supply shocks, like the oil price shocks of 1973 and 1979, had severe economic consequences in the U.S., including accelerating rates of inflation and decreased levels of employment. The first shock challenged Chairman Burns since inflation rates were already rising, a divisive political climate was in place due to the Vietnam War and domestic social strife, and expectations for an accommodative Fed were in place. Picking between tackling the employment problem or the inflation problem first led to a set of “stop-go” policies, which managed to accomplish a lot of economic volatility and no resolution to the difficulties. Chairman Volcker’s approach was to lexicographically prioritize dealing with the inflation problem. I am sure Chairman Volcker’s decisions and actions gave him heartburn, but not anguish. And it ushered in a prosperous era of low inflation, low inflation expectations, and the understanding that this low inflation environment underpinned maximum employment.

I wonder how the Federal Reserve’s New Framework would handle a pivot away from the anguish zone should they find themselves in it. Currently it is pursuing a policy of Start Inflation Now, or S-I-N. Could the FOMC Pivot to W-I-N (Whip Inflation Now), should it enter the Anguish Zone? Can the Fed’s New Framework pierce through similar social, political economy, and legislative factors that constrained Chairman Burns?

In a world where we see the Fed becoming involved or re-involved in wider areas that speak to progressive concerns such as global warming, anti-racism, and the Community Re-Investment Act, it is easy to imagine that the FOMC could eventually become hamstrung in the ways that Chairman Burns suggests the Fed was in the 1960’s. To be clear, I personally support these progressive causes and understand the Fed is legally mandated in some cases to be part of these processes given its regulatory and oversight roles. But the FOMC’s interest in fulfilling the dual mandate requires a level of political

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<sup>20</sup> Marvin Goodfriend, “Interest Rate Policy and the Inflation Scare Problem: 1979-1992,” Federal Reserve Bank of Richmond, *Economic Quarterly*, Winter 1993, 79(1), 1-23.

independence that suggests that it take a narrower role and distance itself from these broader social, political and legislative debates. For a wider role could find the FOMC pulled and bullied by political, economic, and social forces and cast it adrift into a sea of anguish.