The Fed's Delayed Exits from Monetary Ease:
The Fed Rarely Learns from History

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ECONOMIC POLICIES FOR THE 21ST CENTURY

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Inflation is at a 40-year high and gaining momentum, and the Federal Reserve is now faced with the difficult challenge of tightening monetary policy enough to reduce inflation back to target, but not too much to generate recession. With so much experience, how did the Fed get itself into such a situation? Unfortunately, delayed exits from periods of countercyclical monetary easing have been a reoccurring theme in modern U.S. history and have frequently contributed to subsequent recessions.

Since the Fed assumed a more active role in managing aggregate demand following World War II, it has tilted toward prioritizing employment and downgraded its price stability objective toward favoring higher inflation. The Fed has altered its objectives and pursued them using a discretionary approach to monetary policy that has resulted in occasional but very costly mistakes. This has involved excessive fine-tuning of economic outcomes without adequate regard to the lags between monetary policy, the economy and inflation, and occasionally deviating from its desired tactic of data-dependent monetary policy. History also suggests that the Fed has been guilty of the all-too-human trait of "fighting the last battle", basing policies on the experiences of the last cycle rather than the most appropriate lessons of history.

We review historic episodes of the Fed's exits following periods of monetary ease that resulted in undesired inflation and subsequent tightening phases. This includes the post-World War II period, the 1960s and 1970s, the early 1990s, the 2002-2006 period, the period following the 2008-2009 financial crisis and the current pandemic period. While every inflation episode unfolded under different circumstances, we find that they were all initiated by some combination of monetary and fiscal stimulus that generated excess demand. In each episode, the Fed proved too slow to remove its monetary stimulus, fueling inflation, and the subsequent tightening most frequently resulted in recession.

Our findings contrast with the assessment of the Biden Administration's Council of Economic Advisors, which attributes these bouts of inflation to supply shocks and a variety of other factors but not the stimulative impacts of monetary and fiscal policies (Rouse, et al 2021). Consistent with this misguided view, as inflation rose in 2021, the Fed asserted the inflation was transitory, due to supply shocks, while significantly understating the robust growth of aggregate demand and the monetary or fiscal policies that stimulated it (Powell 2021). In December 2021, the Fed belatedly pivoted toward acknowledging the persistence of inflation and the need for the Fed to raise rates to slow aggregate demand (Federal Reserve 2021). By then, monetary policy was far behind sharply accelerating inflation and embedded inflationary expectations.

The cyclical experiences since the 1920s were carefully documented by Michael Bordo and John Landon-Lane (Bordo and Landon Lane 2013). Their narratives and empirical evidence found that up until the 1950s, when zero inflation was considered the benchmark and was anchored by the gold standard, the Fed began to raise rates after the *general price level* turned up and then tightened policy, leading to recession. Since the 1960s, when modest inflation became the benchmark, the Fed began to tighten after *inflation* began rising and its belated exits to remove the inflation led to recession.

History provides many important lessons for monetary policy, but the Fed has tended to misinterpret them. The Fed's new strategy framework prioritizes employment over inflation and institutionalizes an asymmetry toward higher inflation and threatens the Fed's credibility (Levy and Plosser 2020). Its discretionary policy approach without regard to rules or guidelines is conducive to excessive fine-tuning and ignoring lags. The mistakes of history are repeating themselves now and the Fed faces difficult challenges. Beyond the current bout of inflation, the Fed must reassess its objectives, adopt a balanced approach to achieve them based on policy rules that provide adequate flexibility during abnormal conditions. Otherwise, it will continue to be prone to policy mistakes in the future.

Inflation episodes in modern US history

Post-World War II. The high inflation that followed World War II has important analogies to the current situation. Before the Treasury-Fed Accord of February 1951, the Fed supported the Treasury's financing of World War II with artificially low rates and rapid money growth. As the war ended and on the heels of the Great Depression, it was widely agreed that managing aggregate demand was the proper role of the government. The biggest concern was aggregate demand would collapse and recession and deflation would follow, like the post-WWI period.

Instead, pent-up demand surged, fueled by sustained low interest rates and monetary ease, as the Fed was constrained from rising interest rates under the fiscal dominance of the Treasury (Bordo-Levy 2020). Consumption and housing boomed. Business investment spending surged. The excess demand for goods strained the transition from wartime to civilian production and drove up production costs. Businesses benefited from strong demand and raised product prices after the wartime wage-price controls were lifted. The inflation of 1945-1948 was temporary but intense, with three consecutive years of inflation exceeding 10% following the removal of wartime price controls.

The Fed belatedly tightened monetary policy through higher bank capital requirements and by raising reserve requirements while the government's defense spending fell faster than anticipated and fiscal policy turned restrictive. This generated a mild recession in 1949 that quickly subdued inflation. This episode highlighted several common themes: monetary stimulus generates aggregate demand with a lag, and once inflation rises significantly, it is difficult to reduce it without harming economic expansion.

The late 1960s. After a decade of subdued inflation leading up to 1965, inflation accelerated significantly in the second half of the decade, from 1.6% in 1965 to 5.9% in 1970. Excessive fiscal stimulus--President Johnson's Great Society Programs and Vietnam War spending--accommodated by easy monetary policy, generated excess demand and higher inflation (Levin and Taylor 2013). By the 1960s, Keynesian policy prescriptions had become mainstream. Activist macroeconomic policies, primarily fiscal but also monetary, attempted to exploit what was perceived to be a reliable Phillips Curve tradeoff between unemployment and inflation. The historical objective of price stability evolved toward a new perspective that moderate inflation was good for economic performance, and the anchor provided by the gold standard eroded.

The surge in government spending stimulated demand, to the dismay of fiscally conservative Fed Chair William McChestney Martin, but the Fed caved into LBJ's wishes not to raise interest rates in late 1965. The Fed attempted to dampen aggregate demand in Summer 1966 through higher bank capital requirements and not lifting Regulation Q on interest rates. This resulted in a "Credit Crunch" that temporarily stalled economic activity, forcing the Fed to step back. Accelerating Vietnam War spending and renewed monetary accommodation spurred aggregate demand and rising inflation. The Martin-led Fed began raising rates aggressively only after LBJ announced he would not seek re-election. Coupled with the extension of the Vietnam War surtax, the economy tilted into mild recession in 1970.

The 1970s. Following the recession of 1970, inflation receded to only 3.5%, nearly triple the 1.3% average inflation in the first half of the 1960s, and the inflationary expectations remained elevated. The failure of inflation to recede back toward price stability represented a change from prior cycles and set the stage for a ratcheting up of inflation. The abandoning of the gold standard in August 1971 unanchored inflationary expectations.

New Fed Chairman Arthur Burns placed more concern on the high unemployment rate, which rose from 4.2% when he became chair in February 1970 to 6.1% in December. Reflecting his eclectic views and skepticism of monetary policy, Burns attributed inflation to an array of non-monetary sources, including labor unions and greedy businesses, rather than Fed policy. This led to his disastrous advocacy of President Nixon's wage and price controls (Stein 1984), followed by a series of monetary policy blunders through the 1970s. The Fed's accommodative monetary policy during President Nixon's re-election bid fueled inflation pressures that were constrained by wage and price controls. The mounting costs of high inflationary expectations became a reality, as they became embedded in wage and price setting behavior, pushed up interest rates and damaged financial markets.

Among the many lessons of the 1970s, the wage and price controls were destructive in many ways. The controls were based on a misunderstanding of the causes of inflation while neglecting the role of monetary policy in stimulating demand. They harmed economic performance, created massive confusion and reduced the credibility of the Fed and the government. Unfortunately, some public statements made by today's Fed and the Biden Administration are eerily similar with statements by Burns and other policymakers of the 1970s.

The oil price shocks in November 1973 and 1979 contributed to the inflation and poor economic performance, but in the absence of accommodative monetary policy, these negative supply shocks would not have generated sustained excess demand and inflation (Cagan 1974). After a temporary spike in nominal spending, aggregate demand and inflation would have fallen. Instead, nominal GDP growth exceeded 10% in the consecutive years 1978-1981, creating the excess demand that fueled the wage-price spiral.

The incoherent jumble of policy actions and the mounting economic costs of the higher inflation generated a lack of confidence of the public and financial markets and culminated in the US dollar crisis in 1978. The appropriate and necessary disinflationary policies of the Volcker-led Fed broke inflation and inflationary expectations resulted in damaging recessions during 1980-1982 but ushered in a sustained period of moderate inflation and healthy economic performance.

The 1990s. Fed policy during the 1990s was highlighted by one of the Fed's greatest successes—a mid-cycle monetary tightening in 1994 that resulted in an economic soft-landing and reduced inflationary expectations that established the basis for strong economic performance in the second half of the decade. During the so-called “jobless recovery” that followed the shallow recession of 1990, the Fed maintained an accommodative monetary policy with a 3% funds rate, roughly the same as inflation in 1992-1993. In response to the economic overheating that began in 1993, the Fed raised rates aggressively from 3% in February 1994 to 6% in February 1995, including an intra-FOMC meeting rate increase and several 50 basis point increases.

This dampened inflationary expectations and successfully orchestrated an economic soft-landing, but the sharp rate increases were not costless. Domestically, spikes in Treasury and mortgage yields resulted in bankruptcies of several US public sector money managers. More importantly, the Fed rate hikes contributed to the Mexican debt and peso devaluation crisis (the “Tequilla Crisis”) that rippled through Latin America (Bordo, Humpage and Schwartz 2015).

The 2000s. The negative side effects of rate hikes in 1994 heavily influenced subsequent policies of the Greenspan-led Fed. In 1999, the Fed maintained monetary accommodation despite an overheating economy and the dot.com stock market bubble because it mistakenly insisted on maintaining excess liquidity going into Y2K. In 2000, it tightened monetary policy too much. The stock market bubble burst, and recession unfolded in 2001, culminating with the shock of 9/11.

Following 9/11, a new worry surfaced at the Fed: inflation fell to 1% and the Fed feared that the U.S. would follow Japan’s 1990s path of deflation, which would lead into a downward spiral of weak aggregate demand whose escape would be difficult. Fed Chairman Greenspan characterized deflation as a low probability but high cost outcome, and tilted monetary policy decidedly in the other direction (Greenspan 2003). Fed Governor Bernanke described how Fed asset purchases could combat deflation if the Fed faced the zero lower bound (Bernanke 2002).

Even as inflation rose to 2%, the Fed kept rates at 1%, and when it belatedly began raising rates in mid-2004, in deference to the jarring impacts of the rapid rate increases of the mid-1990s, it pre-announced gradual increases with a clear objective of minimizing any disturbance to financial markets. For a sustained period, rates were decidedly below what a Taylor monetary policy rule would have prescribed, and real estate activity and values and mortgage debt soared (Taylor 2007).

While the Fed’s policies did not cause the debt-financed housing bubble, which involved a proliferation of excessively complex and difficult to value derivatives on mortgage-based debt instruments, the Fed’s lower-for-longer monetary policy clearly facilitated the debt-financed housing boom. Subsequent rate increases in 2005-2006 shifted expectations about housing which unraveled the mortgage debt markets that led to the financial crisis. The Fed tightened too much, raising rates to 5.25%, far above the 2.5% core inflation. This was another instance in which the Fed's over-extended monetary ease created significant subsequent problems.

Post Great Financial Crisis (GFC). The Fed's emergency QEI in November 2008 in response to the frozen mortgage market and short-term funding crisis involved purchases of MBS that Fed Chair Bernanke emphasized were credit policy and would be unwound on a timely basis (Bernanke 2008). After the crisis subsided, the economy recovered slowly and inflation remained subdued. The Fed proceeded with QEII, operation twist (selling short-dated securities and buying long-dated securities) and open-ended QEIII, which Bernanke stated was aimed at lowering the unemployment rate (Bernanke 2012). The Fed maintained zero interest rates until December 2015, and then raised rates very gradually, to 2.5%, modestly higher than PCE inflation (2.3%, 2.0% excluding food and energy). While this Fed policy temporarily jarred financial markets, the economy continued to expand.

The Fed misinterpreted some of the key lessons of the post-GFC experience, and this heavily influenced its response to the 2020 pandemic and contributed to major policy errors. Inflation stayed during the post-GFC expansion because the Fed's aggressive monetary ease combined with the American Recovery and Investment Act of 2009 did not stimulate an acceleration in aggregate demand. Nominal GDP never accelerated above 4%, providing little support for higher prices or wages (Levy 2017). The economic and financial environment was negative, with a crippled banking system and housing sector, and fragile household finances took years to repair.

In this environment, the Fed's QEs increased bank reserves and the monetary base, but remained as excess reserves, and did not translate into increased M2 money supply or credit expansion that generated economic activity. The monetary transmission channels may have been clogged by the Fed paying interest on excess reserves beginning in October 2008, raising capital and liquidity requirements, and imposing tighter controls and bank supervision imposed by the Fed's stress tests of large banks. The Fed's strategic review in 2018-2019, which was driven by concerns that sustained sub-2% inflation would lead to a downward spiral in inflationary expectations and worries about the effective zero lower bound, did not thoroughly analyze how changes in the Fed's operating procedures may have contributed to the failure of monetary policy to achieve the Fed's 2% inflation target.

The 2020 pandemic and current situation. In response to the unfolding severe economic contraction and dysfunction in the US Treasury market, the Fed reduced rates to zero and engaged in massive asset purchases, including MBS. The Fed's actions were matched by the largest fiscal support package in US history. Financial markets quickly stabilized and in May the economy began to recover strongly. The government followed with additional fiscal stimulus. Total deficit spending in response to the pandemic totaled over $5 trillion, over 25% of GDP, three times higher than the pandemic decline in GDP, while the Fed has maintained its zero rates and its asset purchases have more than doubled its balance sheet to $8.9 trillion.

The Fed made clear that a critical lesson it had learned from the GFC was that its monetary response had been too timid, and it presumed that the subdued inflation that followed the GFC would be repeated. This emboldened the Fed to aggressively pursue its maximum employment mandate (Ireland and Levy 2021). The Fed's new strategic framework that Chair Powell introduced in August 2020 institutionalized the Fed's unbalanced approach to monetary policy, prioritizing maximum employment and explicitly favoring higher inflation (Powell 2020). The Fed interpreted its assessment that the Phillips Curve was flat as eliminating the need to pre-emptively tighten monetary policy in response to conditions of maximum employment (Clarida 2020).

The Fed's presumptions and forecasts proved wrong. The economy and labor markets recoveries far exceeded Fed expectations, and PCE inflation rose to 5.8% in December 2021, more than three times higher than the Fed's 1.8% forecast made in December 2020. Even as the recovery accelerated, the Fed emphasized the downside economic risks and asserted that the high inflation was transitory. It incorrectly attributed the inflation to supply shortages, while largely ignoring robust aggregate demand and understating the impact of its aggressive monetary stimulus. In late 2021, the Fed grudgingly backed off this assertion. During the same period, the Fed delayed in its acknowledging that "substantial progress" had been made toward its maximum inclusive employment objective, seemingly in disregard with labor market data that indicated nearly full recoveries from pandemic declines and showed clear signs of tightness. This delayed the tapering of its asset purchases, the Fed's precursor to raising rates.

By the time the Fed signaled in December 2021 that it would need to raise rates in 2022, negative real rates had risen to their highest level ever, money supply had surged, inflation was accelerating and labor markets were severely stressed. Once again, the Fed's delayed exit from overly aggressive monetary ease poses a significant challenge and economic risks.

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