Has the Fed Escaped the Forward Guidance Trap?

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Have We Dodged the Bullets?
Shadow Open Market Committee Meeting
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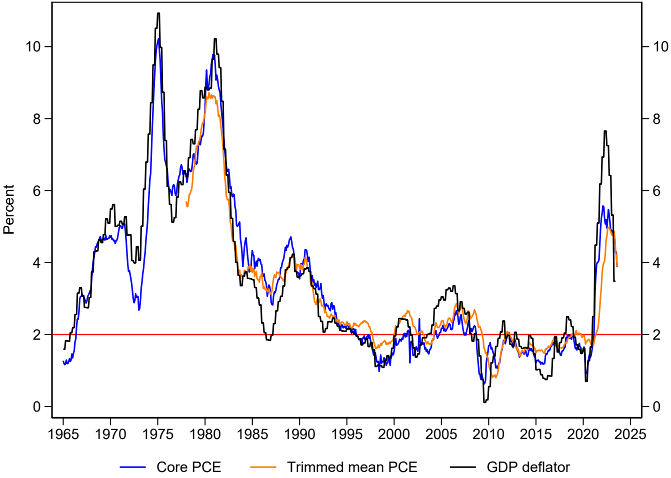
The post-pandemic inflation in historical context

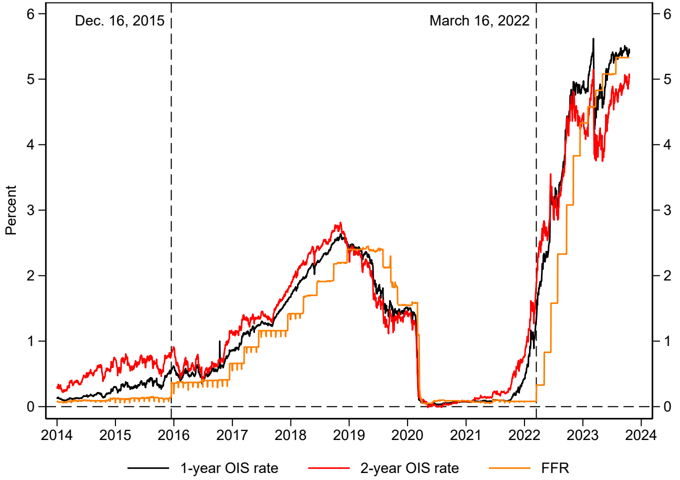


Alternative measures of inflation.

The Fed's policy error: The forward guidance trap

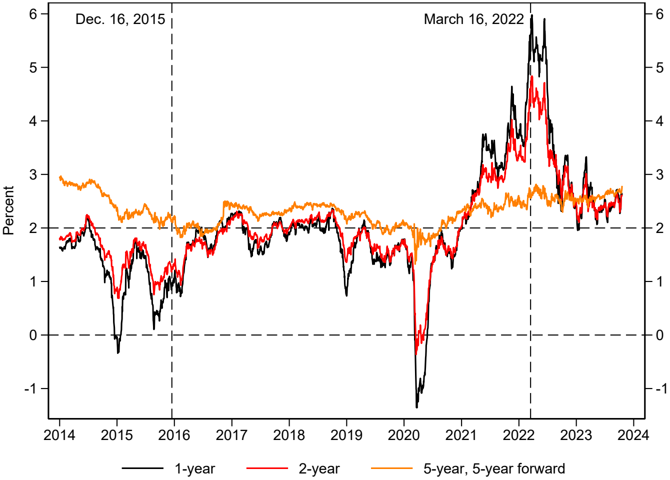
- The Fed used its discretion to peg the federal funds rate at zero for too long after the pandemic.
- During 2021, with actual and expected inflation rising as the economy recovered, the Fed continued to push real interest rates to even lower and excessively negative levels.
- What explains this error?
- The adoption and implementation of a flawed policy strategy.
- The Fed fell into the forward guidance trap.

Federal funds rate and OIS rates

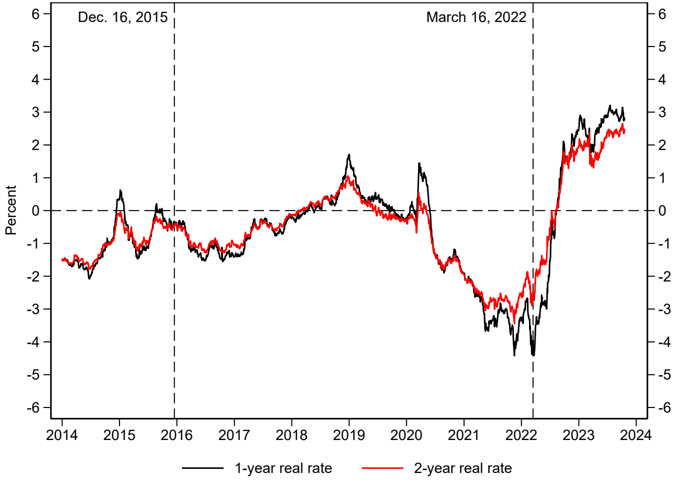


Vertical lines denote policy liftoff after GFC and pandemic recessions.

Inflation swap rates

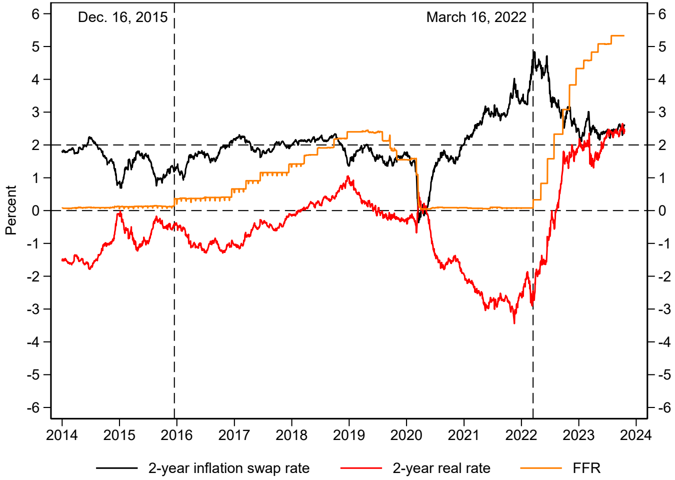


Real interest rates



Real rates based on OIS and inflation swap rates.

Real interest rate and inflation



Real rate based on two-year OIS and inflation swap rates.

How did the Fed fall into the forward guidance trap?

- A decision to move from forecast-based to outcomes-based forward guidance.
- An implicit commitment to a gradual reduction of net asset purchases (tapering), and to raising policy rates only after net asset purchases ended.

The introduction of outcomes-based forward guidance

- July 29, 2020 (statement):
  "The Committee expects to maintain this target range until it is confident that the economy has weathered recent events and is on track to achieve its maximum employment and price stability goals.
- September 16, 2020 (statement):
  "The Committee ... expects it will be appropriate to maintain this target range until labor market conditions have reached levels consistent with the Committee's assessments of maximum employment and inflation has risen to 2 percent and is on track to moderately exceed 2 percent for some time."
- November 3, 2021 (press conference):
  "We have not focused on whether we meet the liftoff test, because we don't meet the liftoff test now because we're not at maximum employment."

The interaction with balance sheet policy

- November 3, 2021 (minutes):
  "Various participants noted that the Committee should be prepared to adjust the pace of asset purchases and raise the target range for the federal funds rate sooner than participants currently anticipated if inflation continued to run higher than levels consistent with the Committee's objectives."

- December 15, 2021 (minutes):
  "participants judged that the increase in policy accommodation provided by the ongoing pace of net asset purchases was no longer necessary."

- January 26, 2022 (statement):
  "The Committee decided to continue to reduce the monthly pace of its net asset purchases, bringing them to an end in early March."

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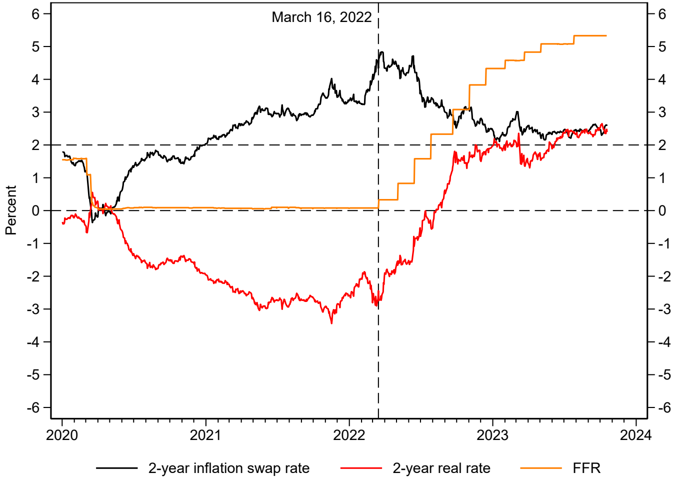

Real rate based on two-year OIS and inflation swap rates.

Has the Fed escaped the forward guidance trap?

- The Fed's aggressive hikes in 2022 guided real interest rates to a restrictive policy stance. If the Fed continues to maintain this stance, the Fed will manage to restore price stability.
- For the time being, the Fed has abandoned its flawed approach to forward guidance. However, the Fed has not changed its overall policy strategy and communication and continues to exhibit a preference for unhelpful discretion.
- A simple forecast-based policy rule could serve as a benchmark for communicating the systematic, contingent nature of monetary policy.
- The Fed should revisit its policy strategy and become more systematic: "articulating rules as guides provides the best kind of forward guidance, which would be helpful in stabilizing the economy and the path of inflation." (Charles Plosser, November 15, 2012).