Robert Hetzel
May 20, 2022

How the FOMC Can Start Learning

The monetary standard explains how the central bank gives the price level a well-defined value and how its reaction function for setting the funds rate interacts with the stabilizing properties of the price system. What monetary standard has the FOMC created? Fed policymakers do not say. Perhaps, they do not even know. The Fed still has a long way to go to fulfill the program of transparency initiated by Marvin Goodfriend with his 1986 paper "Monetary Mystique: Secrecy and Central Banking." To a significant extent, the Fed remains in the "trust me" stage.

When the FOMC makes mistakes, as it does every 15 years or so, it brings down the economy. Given the high stakes, the implicit understanding of the monetary standard that guides the FOMC consensus should be made explicit and thus subject to professional and public scrutiny. The proposal here to structure FOMC decision making would force the FOMC to articulate the body of knowledge that guides its decision making and make it subject to open debate. The proposal would also force the FOMC to defend the monetary standard it has created by placing it in the historical context of what standards have destabilized and what standards have stabilized the economy.

1.   Can the FOMC learn how to conduct a stabilizing monetary policy?

From March 2021 to March 2022, inflation (core personal consumption expenditures chain-type price index,) was 5.2 percent, up from 1.5 percent from February 2019 to February 2020, and well above the FOMC's 2 percent inflation target. Previously, in the course of the Great Inflation, this measure of inflation rose irregularly from an average of 1.3 percent for the period 1960Q1 through 1964Q4 to an average of 9.7 percent in the early 1980s. Why did the FOMC not learn from this previous experience how to control inflation? More generally, can the FOMC learn in the sense of accumulating a body of knowledge about the optimal monetary standard that grows over time and that remains independent of changes in its membership. Milton Friedman said that the test of an institution is how well it does under poor leadership. Can one have confidence that the FOMC will always do well by this criterion?

Learning requires that the body of knowledge that guides the FOMC's choice of the monetary standard be explicit in order that it can be tested by actual outcomes. The explicitness required for ex post evaluation of policy requires that the FOMC go beyond defending its actions in terms of the contemporaneous state of the economy and place those actions in the context of its long-run understanding of the optimal monetary standard. There is a need for a model that organizes a historical narrative that explains when monetary policy was stabilizing and when it was destabilizing.

Explicitness about the nature of the two-way interaction between the behavior of the Fed and the behavior of the economy as intermediated by the price system would allow widespread vetting and debate of the monetary standard by the academic community. In the 1960s and 1970s, the monetarist-Keynesian debate raised all the issues relevant for the design of an optimal monetary standard. Brunner and Meltzer (1964) criticized the FOMC for the lack of an analytical framework relating its objectives to the setting of its instruments. Friedman (1960) advocated a rule to impose consistency over time in the period-by-period decisions made by the FOMC to make predictable the influence of the FOMC on the objectives of policy.

When the author joined the Richmond Fed in 1975, he got various defensive responses from Fed policymakers (outside of the Richmond Fed) for the absence of an explicit analytical framework relating objectives to the setting of the FOMC's policy instrument. One answer was that each of the 19 individuals who sit around the FOMC table have a separate model of the interaction between the behavior of the FOMC and the behavior of the economy. There could be no way to impose uniformity on these disparate models. However, it is the task of the FOMC chair to arrive at a consensus that imposes continuity over time on policy. Markets require knowledge of that consensus to forecast the FOMC's behavior in response to incoming news on the economy. It should be the task of the chair to articulate the framework that shapes that consensus.

A different answer was that with no consensus within the academic community over the optimal monetary standard, the FOMC had no reliable guidance from academia. Commonly, in the 1970s, policymakers defended policy by asserting that it had to be all right because it was more stimulative than desired by the monetarists and tighter than desired by the Keynesians. Two very different answers relied on a political economy argument. Al Burger of the St. Louis Fed told the author that the chair could most easily arrive at a consensus and control policy over time by limiting FOMC discussion to the immediate policy action on the table as opposed to organizing a discussion of policy based on a rule. Marvin Goodfriend told the author that the chair felt their position strengthened in communicating an FOMC consensus with at most one or two dissents to evidence a debate by limiting debate to the period-by-period choice of a policy action. Consensus is important because congressmen attacking the Fed do not understand the fundamental issues but can take advantage of a "chicken fight" within the FOMC (Marvin's words) to attack the Fed over tightening.

2.   Forcing the FOMC to articulate the nature of the monetary standard

In a criticism of the Democratic party, columnist for *The New York Times*, David Brooks (2022) wrote: "We all make mistakes. The question is do we learn from them?" Brooks listed such mistakes starting with "It is possible to overstimulate the economy." To learn, it is first necessary to admit the possibility of making mistakes. Such an admonition would be a challenge to Fed culture. The Fed assigns adverse outcomes to external shocks, which it avers to having mitigated. There is no group of economists within the Fed devoted to learning from historical experience. To retain control of the narrative, which presumes the Fed understands the structure of the economy and the consequences of its actions, the Fed institutionalizes historical amnesia.

What is important is to go beyond writing a history that catalogues mistakes. The moral is then too glib: Do not make mistakes. What is required is to learn the nature of the optimal rule based on an understanding of the optimal monetary standard. For that to happen, the FOMC needs to articulate monetary policy in a way that not only makes its predictions clear but also defensible in terms of what monetary standards have been stabilizing or destabilizing in the past.

3.   Structuring FOMC debate to clarify the nature of the monetary standard

The choice of the optimal monetary standard would be far more straightforward if a professional consensus over the choice existed. Unfortunately, it does not. What one can expect of the FOMC, however, is an informed debate based on a deep knowledge of monetary history. Accountability requires that such debate be regularly and promptly released to the public. The proposal here consists of three parts. The first part is establishment of a monetary history group responsible to the FOMC. (Being responsible to the FOMC instead of the chair means that promotion does not depend on unconditional support of the chair's position.) Understanding the

historical evolution of the monetary standard and its consequences for stability or instability of the economy is a full time job. The role of the monetary history group would be to engage FOMC participants in a discussion of the nature of the monetary standard and to place it in historical perspective. Such a discussion could take place quarterly and a transcript would be made public within a short time frame.

The second part would be to restructure the Board staff document that offers forecasts prior to FOMC meetings (the Teal Book). The first half of the Tealbook would be to place the contemporaneous behavior of the economy in historical perspective. Why did the economy evolve in such a way that led to the current situation? The Board staff uses two models to explain the behavior of the domestic economy: a large-scale structural model of the US, FRB/US and a DSGE model. In Part 1 of the Teal book, the Board staff would use these models to explain the evolution of the economy through the current period.

The second half of the Tealbook would continue to contain the traditional forecast of the economy. At present the forecast is entirely judgmental. In the author's experience, the major purpose is to organize how new information since the last FOMC meeting has affected the estimate of the current behavior of the economy. That is, forecasting is guess and adjust as new information arrives. The proposal here is to discipline the staff forecast with a monetary policy that imposes consistency on the choice of the funds rate over time. Specifically, the FOMC would give the staff a reaction function to use in its forecasts. It would be periodically reviewed, but presumably infrequently changed and would be made public.

The third part of the proposal is for a committee (all participants) Summary of Economic Projections (SEP). A consensus forecast of the economy built up from scratch is impractical because of the number of individuals sitting around the FOMC table. Necessarily, the committee (all participants) would start with the Board staff forecast and modify its broad lines under the guidance of the chair. Especially, regional Bank presidents bring information about the economy from their own districts not available to the staff. A committee (all participants) SEP would be based on the resulting modified forecast.

At the press conference, the chair would present not only the committee (all participants) SEP but also would make available the staff forecast. The chair would explain why the committee (all participants) version is more optimistic or pessimistic than the staff forecast. Within, say, a month the Fed would make available the full transcript of the FOMC meeting. Getting monetary policy right is a matter of existential importance. The public has a right to know that FOMC participants are discussing policy with a deep knowledge of monetary history and the alternative frameworks the economics profession has devised to understand monetary policy.

Such a deep discussion would result from the regular interaction of the committee (all participants) with the monetary history group. The role of the history group would be to challenge the Fed narrative. The standard assumption of Fed narrative is that the evolution of monetary policy follows the evolution of the economy. Economic instability arises from external shocks. In contrast, the monetary history group would treat the evolution of the monetary standard as providing semi-controlled experiments about the optimal monetary standard. The stabilizing properties of the price system and the monetary character of inflation impose continuity over time to the structure of the economy. For example, the Powell FOMC treats inflation as a nonmonetary phenomenon. The Fed is an inflation fighter. With the contrasting monetary view, the Fed is an inflation creator.

## 4.	Illustrating the need for articulation and debate of the monetary standard

Learning requires treating monetary history as a series of semi-controlled experiments that elucidate the nature of the optimal monetary standard and the rule that implements it. Because of the radical change in monetary policy announced by FOMC chair Jerome Powell (2020) in his August 2020 Jackson Hole speech, the FOMC has provided a semi-controlled experiment from which one can learn. As exposited, however, the Powell policy conflated a change in the monetary standard with a policy of Odyssean forward guidance of "lower for longer." It will not be enough to just say, "Next time, we will be more proactive in raising the funds rate." The FOMC changed the monetary standard by reverting to the pre-Volcker-Greenspan policy of activist aggregate-demand management as a consequence of making a low, inclusive unemployment rate an independent target in addition to its inflation target. In contrast, after the Volcker disinflation of the early 1980s, the FOMC had treated changes in unemployment as an indicator of whether the economy was growing unsustainably fast or slow. The goal of "maximum employment" emerged as a consequence of a healthy economy.

Success or failure of the Powell policy will be measured by whether inflation subsides to near 2 percent by the end of 2022 or whether a recession is required to restore 2 percent inflation. However, the experiment would have been clearer and easier to learn from if Powell had exposited it within the broader perspective of what the FOMC considers the optimal monetary standard. Success would rehabilitate the activist policy of the 1970s. Failure would make clear that it would have been better to stay with the Volcker-Greenspan policy that produced the Great Moderation.

Powell (2020) announced the pandemic monetary policy at the Jackson Hole conference. The FOMC based the radical change on the lessons it drew from the recovery from the Great Recession. Although not articulated, the FOMC interpreted the recovery using the Keynesian Modigliani-Papademos (1975 and 1976) framework in which the change in inflation depends upon the difference between the unemployment rate and a NAIRU value. That is, the FOMC controls inflation by manipulating the amount of slack in the economy. One presumed lesson was that the Yellen FOMC's preemptive increases in the funds rate, given the persistence of somewhat below target inflation, prevented a socially desirable decline in the unemployment rate to a low, inclusive value. That is, the FOMC maintained an undesirable amount of slack in the economy. In the absence of knowledge of the NAIRU, the FOMC should have abandoned the Volcker-Greenspan policy of preemptive increases in the funds rate and waited for an increase in inflation before raising the funds rate.

A second presumed lesson was based on the belief that with the funds rate at the zero lower bound (ZLB) and with quantitative easing monetary policy was stimulative. It followed that powerful real forces, especially globalization, depressed inflation. The prospect of a periodic return to the ZLB would impart a negative bias to inflation or even create a negative downward price spiral. Keeping inflation from falling below the 2 percent target would be challenging. When the unemployment rate shot up to 14.7 percent in April 2020, the FOMC believed that it could implement a strongly stimulative monetary policy through "Odyssean forward guidance" without fear of excessive inflation. Both presumed lessons entailed abandoning the Volcker-Greenspan policy of preemptive increases in the funds rate in economic recovery to preserve near price stability.

In any assessment of these "lessons learned," it is important to note that there will exist multiple interpretations of any one historical event like the recovery from the Great Recession. In particular, Hetzel (2022) provides a very different interpretation. The reason that inflation remained slightly below target was that monetary policy was not stimulative. It simply preserved the prior

expectation of near price stability achieved in the Greenspan era after 1997 and reinforced by the Great Recession. At the start of the recovery, monetary policy was moderately contractionary. The reason was the universal expectation that a strong recovery would follow a deep contraction, as had always occurred in the past. The resulting strong upward tilt in the yield curve, which kept long-term yields relatively high, made monetary policy moderately contractionary. Moreover, the FOMC was slow to develop strong forward guidance and QE. Only starting in 2016 did a normal recovery begin.

Nevertheless, overall, the recovery following the Great Recession, was a period of significant real and nominal stability. That performance is remarkable given a negative natural rate of interest and weakness in the world economy punctuated by successive crises (the near breakup of the Eurozone, Brexit, the Chinese devaluation and capital outflows threatening a tightening of Chinese monetary policy, and finally the Trump trade war). That stability had to derive significantly from the FOMC's policy of forward guidance and quantitative easing (QE) in maintaining aggregate demand despite forces making for weakness. There was never any threat of a downward price spiral. Because QE works through money creation that makes investors' portfolios liquid and produces a rebalancing that raises asset prices (equities, houses, consumer durables), the FOMC should have understood that the money creation that characterized the pandemic monetary policy would provide economic stimulus.

When a normal recovery began in mid-2016, the FOMC initiated a steady succession of funds rate increases. Those increases occurred despite an inflation rate marginally below the FOMC's 2 percent target. Preemptive increases in the funds rate maintained a long recovery that allowed the labor market to match applicants with openings and to achieve a historically low unemployment rate.

The contrast between the two interpretations of the recovery from the Great Recession implies very different frameworks for implementing a stabilizing monetary policy. The monetary standard put in place by the Powell FOMC was one of activist aggregate demand management based on the pursuit of two independent goals (low inflation and low unemployment) presumed linked by a structural albeit flat Phillips curve. The alternative framework (see Hetzel 2022) of Wicksellian monetarism entails establishing credibility for near price stability to shape the expectations of firms setting prices for multiple periods (firms in the sticky-price sector as in Aoki 2001). The FOMC then follows a rule that allows the price system free rein to determine real variables (output and employment) through procedures that cause the real funds rate to track its natural counterpart. Instead of alternating between expansionary and contractionary monetary policy required by an activist monetary policy, policy is always neutral.

A test of the Powell policy will be whether the FOMC succeeds in restoring 2 percent inflation without a recession. The failure of an activist aggregate demand policy a second time would make it harder to blame exogenous cost-push forces for inflation as did FOMC chairman Arthur Burns (1979).

5.   Choosing a model to articulate the monetary standard

The economics profession is now no closer than ever to a consensus over the fundamental issues in macroeconomics: Are recessions an inherent feature of a free market economy? That is, does the price system work poorly to maintain full employment? Is inflation a nonmonetary phenomenon? That is, does the Fed control inflation through its control of the amount of slack (unemployment) in the economy. Alternatively, does central bank interference with the operation of

the price system cause recessions? Is inflation a monetary phenomenon? That is, does the control of inflation require that monetary policy discipline money creation? These issues are the same ones raised in the monetarist-Keynesian debate in the 1970s.

An answer to these questions requires a model. The workhorse model of the economy is the New Keynesian (NK) model. However, the assumption of rational expectations means that all the agents in the model including the central bank understand the structure of the economy. The central bank would then never implement a rule that caused recessions or inflation. Estimation of NK models will never address the issue of the role of monetary instability in causing economic instability. In addition, if the central bank is not responsible for economic instability, the models do not need to contain money. The models then do not address the empirical generalizations organized around money identified by Milton Friedman.

Another issue is that even with models that differ their estimation will always produce a fit to the data. Estimation then can neither reject a model nor evaluate its predictive ability relative to competing models. Finally, NK models assume knowledge not possessed by the policymaker. Econometricians are far from constructing models that can reliably explain the behavior of the natural values of variables such as the natural rate of interest or the natural rate of unemployment. Furthermore, the reaction functions used are reduced forms.

The approach required for model identification is to determine which of differing models best organizes a review of historical experience. Such a methodology was pioneered by Friedman and Schwartz (1963) in *A Monetary History*. They identify episodes of monetary instability accompanied by information about the behavior of the Fed documenting how that behavior arose independently of instability in the private economy. A quantity theoretic benchmark for identifying episodes of monetary instability that does not require stability of money demand flags departures from a rule that provides for a stable nominal anchor and that allows the price system an unfettered ability to determine real variables. Like Friedman and Schwartz, one then concatenates these episodes to construct a consistent historical narrative.

The choice between these alternative models requires a solution to the identification problem. Obviously, a solution would be enhanced if economists could run controlled experiments by running different monetary policies. The second best alternative is to identify how monetary policy has evolved over time using knowledge of how policymakers understood the world in which they operated. One can then generalize across the different policies in an attempt to determine which policies are associated with economic stability and which with instability.

References

Brooks, David. "Seven Lessons the Democrats Need to Learn—Fast," *The New York Times*, April 28, 2022.

Brunner, Karl, and Allan H. Meltzer. *The Federal Reserve's Attachment to the Free Reserve Concept*. House Committee on Banking and Currency, Subcommittee on Domestic Finance, Government Printing Office, Washington, D.C., May 1964.

Burns, Arthur F. *The Anguish of Central Banking*. Belgrade, Yugoslavia, Per Jacobsson Foundation, 1979.

Friedman, Milton. *A Program for Monetary Stability*. New York: Fordham University Press, 1960.

Friedman, Milton and Anna J. Schwartz. *A Monetary History of the United States*, 1867-1960. Princeton: Princeton University Press, 1963.

Goodfriend, Marvin. "Monetary Mystique: Secrecy and Central Banking." *Journal of Monetary Economics* 17 (January 1986), 63-92.

Hetzel, Robert L. *The Federal Reserve System. A New* History, University of Chicago Press, forthcoming 2022.

Modigliani, Franco and Lucas Papademos. "Targets for Monetary Policy in the Coming Year." *Brookings Papers on Economic Activity* 1 (1975), 141-63.

_____. "Monetary Policy for the Coming Quarters: The Conflicting Views." Federal Reserve Bank of Boston *The New England Economic Review* 76 (March/April 1976), 2-35.

Powell, Jerome H. "New Economic Challenges and the Fed's Monetary Policy Review." Speech given at 'Navigating the Decade Ahead: Implications for Monetary Policy', an economic policy symposium sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming, August 27, 2020.