

Was Something Structurally Wrong at the FOMC?

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There is little doubt that the Federal Reserve was late to start raising interest rates as inflation rose in 2021-2022. Even Chair Jerome Powell admitted that not starting until March 2022 was too late.¹ Some critics have even accused the FOMC of being as much as a full year late in pulling the rate trigger,² though that seems exaggerated to me. In fact, as late as January 2022, private forecasters were more or less where the Fed was: forecasting that core PCE inflation, then over 5%, would decline to about 2¼% in 2023.³ In that case, why raise rates? All the inflation optimists were wrong, of course. But if misery loves company, the Fed had plenty of both.

The forecasting error

I begin this essay with the forecasting error because mistakes in monetary policy often emanate from poor forecasts rather than from any structural problem at the central bank. This one surely did. But why was the inflation forecast so important? And why was it so wrong?

Regarding the first question, it is well known that the effects of monetary policy on inflation arrive only after “long and variable lags.” As a hypothetical example, but one that is highly relevant to the present context, imagine that inflation is running at 3%, and the central bank’s forecast under current policy is that it will either (a) recede to 2% in one of two years or (b) rise to 4% in one or two years. The monetary policies suggested by these two alternative forecasts are radically different, and many forecasts in early 2022 looked more like (a) than like (b). The Fed’s forecasts in its Summaries of Economic Projections (SEPs) certainly did.

¹ Siegel, Rachel. “Fed chair says interest rates should have gone up sooner.” *The Washington Post*, May 12, 2022. <https://www.washingtonpost.com/us-policy/2022/05/12/fed-powell-rates-marketplace/>.

² Taylor, John B. “The Fed’s State of Exception.” Project Syndicate, August 2021. <https://www.project-syndicate.org/commentary/fed-interest-rate-policy-deviation-from-monetary-policy-rule-by-john-taylor-5-2021-08>.

³ David Wilcox, “If the Fed Is Wrong on Inflation, It’s Not Alone,” *Bloomberg U.S. Insight*, January 23, 2022.

Except when the inflation rate is going nowhere (as was true in the pre-pandemic years), forecasting inflation is fraught with risk. And it becomes next to impossible when there are large supply shocks and when you don't have a usable Phillips curve. As the classic example of the former, the CBO's retrospective on its own forecasting errors since 1976 concluded that "Some of the largest errors in forecasting CPI inflation can be attributed to forecasters' inability to predict major changes in crude oil prices. For example, ... oil prices increased rapidly in 2022 [due to] Russia's invasion of Ukraine." (CBO, 2023)⁴ In the early 2020s, the FOMC was handicapped by both supply shocks and only a dim memory of a reliable Phillips curve.

So why not eschew the so-called preemptive strategy, which requires acting on a forecast, and adopt instead what I have called the Bunker Hill strategy? *Don't fire your interest rate bullets until you see the whites of inflation's eyes.*

The traditional answer is that, because of lags, the Bunker Hill strategy will always leave the central bank behind the curve, whether inflation is rising or falling. Although the FOMC didn't say so in August 2020, many observers interpreted the Fed's new framework as favoring Bunker Hill over preemption despite the inflation risk. *Let's not tighten just because unemployment is low.* Remember, after years of watching inflation run below its 2% target, allowing a modest overshoot of inflation seemed welcome.

Several other bits of data—many of them now forgotten--were relevant to what seems in retrospect to have been excessive complacency at the FOMC. Perhaps foremost among these were residual worries about the strength of the economy. Real GDP growth actually ran slightly

⁴ CBO's Economic Forecasting Record: 2023 Update, June 2023.
https://www.cbo.gov/publication/59349#_idTextAnchor038

negative during the first two quarters of 2022--thereby meeting the media definition of a recession—although domestic private demand was much stronger.⁵ (The NBER dating committee was not tempted to declare a recession.) Lacking a crystal ball, the Fed had no idea that growth would speed up to above 4% in the second half of 2023.⁶ In fact, between the March 2022 and June 2022 SEPs, the FOMCs median forecasts for growth in 2022 and 2023 were *reduced* from 2.8% and 2.2% respectively to 1.7% in both years—evidence of greater pessimism. Commensurate with that revision, the committee also marked up its unemployment forecasts for the ends of 2022 and 2023.

Yet inflation was high and rising alarmingly at the time, so the Fed finally started tightening in March 2022, albeit cautiously at first. They must, however, have had some residual worries about the strength of the economy.

Lest you think I am bending over backwards to support a revisionist history designed to cover up an egregious policy error, as late as August 31, 2022 the blog of the St. Louis Fed, an institution not known as a hotbed of dovish sentiment and certainly not controlled by Washington, concluded that:

According to the August Blue Chip Consensus, real GDP growth will average less than 1% annualized over the second half of this year and into the first half of 2023.... While the expected return to positive GDP growth is heartening, heightened uncertainty about the outlook for medium-term inflation and the likelihood of further tightening actions by the FOMC suggests that *risks to the macroeconomy remain tilted to the downside.* (italics added)⁷

⁵ The annualized growth rates using today's data were -2% in 2022:1 and -0.6% in 2022:2.

⁶ The FOMC's March 2022 forecast of growth over the four quarters of 2023 was just 2.2%. (The actual number was almost 3.2%.) Its June 2022 forecast for 2023 was even lower—1.7%. These and other FOMC forecasts come from various issues of the FOMC's SEP.

⁷ <https://www.stlouisfed.org/publications/regional-economist/2022/aug/gdp-growth-decelerating-inflation-us-economic-outlook>

Beyond growth worries, there were also some oddities in the various measures of inflation—perhaps enough to sow confusion. Regardless of whether you focus on the CPI (as the media does) or the PCE measure (as the Fed does), the gap between headline and core measures widened spectacularly—a sure sign that major food and energy shocks were afoot. Figure 1 illustrates this phenomenon using monthly PCE data from twelve months prior. You can see that the gap between core and headline PCE inflation was negligible early in 2021, rose to about a percentage point by February 2022, and then soared to a peak of nearly 2 percentage points in June 2022. By March 2023, it was all the way back down to zero again. Notably, these supply shocks began before the Russian invasion of Ukraine in February 2022. But they got a substantial boost from that war.

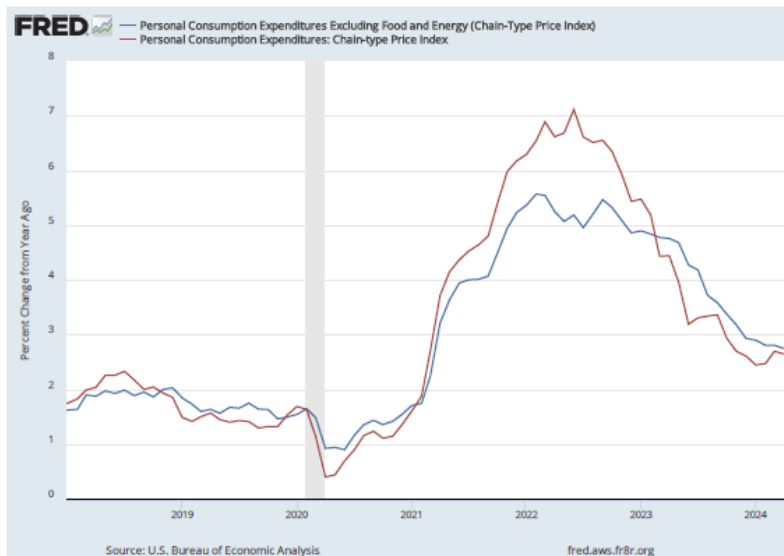


Figure 1: Core and headline PCE inflation, 2019-2024

Since the 1980s, the Fed and other central banks have learned to “look through” food and energy shocks for two main reasons: Central banks can’t do anything about them, and they generally disappear or even reverse on their own. (Brainard, 2022) This thinking was one driving

force behind the optimistic predictions made in 2021 and 2022 by “Team Transitory,” of which I admit to being a member (and which the FOMC also joined). We were wrong, though only on the timing. The “transitory” inflation lasted too long to merit that diminutive adjective. But Figure 1 shows that inflation eventually fell dramatically and the gap between core and headline reversed.

One reason for the longer-than-expected delay in disinflation is that much more than food and energy shocks were going on in the Covid and post-Covid periods. That’s why (and when) the traditional term “supply shock” gave way to a new and different term: “supply disruptions.” These disruptions extended well beyond the food and energy sectors; indeed, they mostly affected items included in core inflation. They also lasted longer than many economists thought likely.

The supply disruptions were so ubiquitous and varied that—unlike, say, oil prices—they defied measurement. How do you combine soaring shipping costs with strains on container and port capacity, shortages of trucks and truckers, and even (for a while) of cardboard boxes? The Federal Reserve Bank of New York now maintains a Global Supply Chain Pressure Index that attempts to summarize most of that. They describe it as follows on their website:

The GSCPI integrates a number of commonly used metrics with the aim of providing a comprehensive summary of potential supply chain disruptions. Global transportation costs are measured by employing data from the Baltic Dry Index (BDI) and the Harpex index, as well as airfreight cost indices from the U.S. Bureau of Labor Statistics. The GSCPI also uses several supply chain-related components from Purchasing Managers’ Index (PMI) surveys, focusing on manufacturing firms across seven interconnected economies: China, the euro area, Japan, South Korea, Taiwan, the United Kingdom, and the United States.⁸

⁸ <https://www.newyorkfed.org/research/policy/gscpi#/overview>

Figure 2, which shows the behavior of this index since 2018, tells the following story. There were basically no unusual supply pressures before the pandemic, a notable climb to about three standard deviations above the mean when the pandemic struck, a surprising drop later in 2020, and then a huge and prolonged climb to a peak more than four standard deviations above the mean from late 2020 to late 2021. The supply pressures only disappear in early 2023. Little if any of this action is captured by the standard distinction between core and headline inflation. It basically happened in the core, reflecting the inability of supply to keep pace with soaring demand for many types of goods.

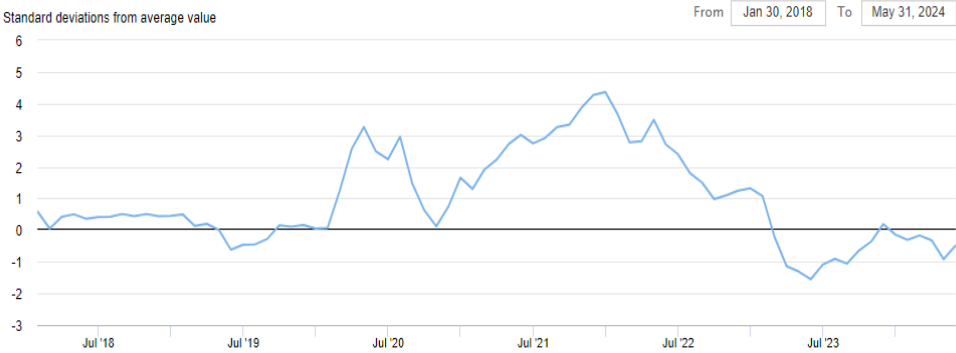


Figure 2: Federal Reserve Bank of New York GSCPI, 2018-2024

These unusual supply-demand imbalances go a long way toward explaining why Team Transitory got the timing so wrong. And they don't suggest any structural problem with FOMC procedures, just incorrect guesses about what an unprecedented set of circumstances would bring.

Some, but certainly not all, of the supply chain disruptions may underlie another unusual aspect of the inflationary outburst of 2022: CPI inflation ran far above PCE inflation, especially in 2022, when the gap between the two rose as high as 1.9 percentage points (see Figure 3). The difference from normal is quantitative, not qualitative, as CPI inflation runs above PCE inflation

most of the time—the average gap between 1990 and 2019 was about 50 basis points.⁹ By comparison, the CPI-PCE gap shown in Figure 3 is huge.

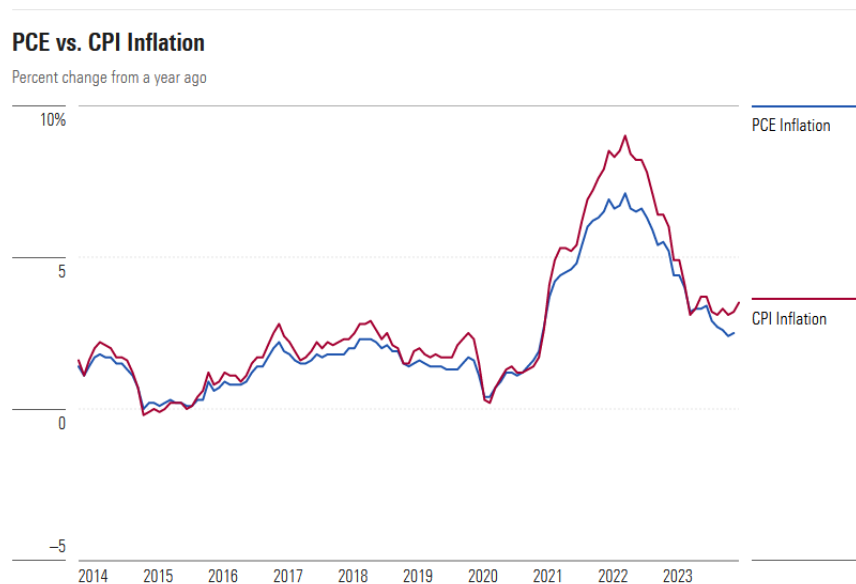


Figure 3: PCE v. CPI inflation, 2014-2024

Now try to put yourself in the shoes of a Federal Reserve inflation forecaster *circa* 2022.

Inflation has been rising for months, but:

- You adopted flexible *average* inflation targeting in August 2020—a framework that now calls for some overshooting of the 2% target. (More on this later.)
- The U.S. economy actually *shrank* in the first half of 2022.
- Headline inflation is running well above core inflation, and you know that gaps like that normally close on their own.
- CPI inflation is running well above PCE inflation, which is your target. The gap is far larger than the historic norm.

⁹ Thus the Fed's 2% PCE target translates to a 2.5% CPI target—a point that is often forgotten.

- Mainstream forecasts of inflation over the next year or two are relatively benign.

Is it any wonder that the Fed let itself fall behind the curve?

None of this is meant to exonerate the FOMC. It was slow to start raising rates even after inflation began to rise. By March 2022, the 12-month CPI inflation rate was already up to 8.5%, near its eventual peak. FOMC members also heard many voices complaining that they were “behind the curve.” An error is an error, and this was a large one. I’m only arguing that the error was understandable, not an episode of contagious stupidity on a committee nor a reflection of some structural problem in the way monetary policy decisions are reached, such as overreliance on groupthink.¹⁰

The rest of this paper focuses on possible reasons for the policy error, quickly eliminating several possibilities and then focusing on the Fed’s August 2020 framework—and how it might share the guilt. The central question is: Is there something structural that made the FOMC susceptible to this error? To anticipate what may be a surprising conclusion, I will argue that something as simple as having a point target (2%), rather than a range (say, 1.5-2.5%), may have been more problematic than is commonly understood. Call that problem “structural,” if you like. I call it easily fixable.

A dovish FOMC?

The Fed’s dual mandate allows some leeway for FOMC members to disagree on the relative weights on low inflation versus high employment, and also where the natural rate of unemployment is. While every committee member seeks a 2% PCE inflation rate, more “dovish” members may place a higher weight on employment than more “hawkish” members during the

¹⁰ On the debate over groupthink on the FOMC, see Coy (2024).

adjustment to 2%. They may also have a lower estimate of the natural rate of unemployment. In a close call, such disparate views may matter even though everyone agrees on the same inflation target.

Was the FOMC of 2021 unusually dovish? I don't think so. It's hard for me to think of a committee that included Esther George, James Bullard, Loretta Mester, Michelle Bowman, and Christopher Waller as packed with doves who are soft on inflation.¹¹ Financial media often rank FOMC members on a dovish-hawkish scale. While such rankings are far from scientific assessments, in July 2021, the *Financial Times* rated six members as hawkish, six as dovish, and six including the chair as "centrists."¹² Sounds evenly divided. But the "centrists" in the FT ranking included Mester and Waller, which seem like clear misclassifications to me.¹³

Even if the FOMC had been loaded with doves at the time, that would not have signaled a *structural* design flaw. After all, it's presidents of the United States who get to select Fed governors over time (subject to Senate confirmation). If those choices are deemed "too dovish," you know whom to blame. The twelve Reserve Bank presidents, on the other hand, are *not* presidential appointees. But they tend to be more hawkish on average than the governors,¹⁴ whom they outnumber around the FOMC table though not in the vote.¹⁵ So you might, if anything, argue that the FOMC's legal composition tilts structurally hawkish.¹⁶

¹¹ Official Fed jargon distinguishes between FOMC "members" (the 12 who get to vote) and FOMC "participants" (the entire 19). For the most part, this distinction is unimportant, and I don't make it.

¹² There was one vacancy on the Board at the time.

¹³ Colby Smith and James Politi, "Hawks vs doves: US Federal Reserve divided over when to dial back economic support," *Financial Times*, July 25, 2021 <https://www.ft.com/content/33e420c1-9220-49c0-bc06-105eb921dfd3>

¹⁴ Among many possible citations, see Federal Reserve Bank of St. Louis, *A History of FOMC Dissents*, September 2014, updated June 2024. <https://www.stlouisfed.org/on-the-economy/2014/september/a-history-of-fomc-dissents>

¹⁵ Only five Reserve Bank presidents get to vote at any meeting.

¹⁶ Faust (1996) makes this claim and provides a rationale.

Is a committee just slow to move?

Another possibility is that committee decisions are just hard to change, especially if committee members value consensus and seek unanimity—both of which generally characterize the FOMC and definitely characterize Chair Powell.¹⁷ If consensus-seeking members who are watching the same data change their minds only gradually, and not synchronously, it may take a while before the whole committee is prepared to act. As evidence for such inertia, we know that econometrically estimated Taylor rules that allow last quarter's funds rate to enter the equation always find it to be significant.¹⁸

The FOMCs of late 2021 and early 2022 had been living at the Fed's version of zero (a range of 0-25 basis points) since March 2020. Perhaps the strong attraction of the *status quo* overwhelmed good judgment. Maybe. But I doubt it. In times of crisis, such as 2008 and 2020, the FOMC has shown itself capable of moving dramatically and quickly.

Besides, experimental evidence suggests that committees react to incoming data about as quickly as individual decisionmakers do. Since Blinder and Morgan (2005) first discovered this surprising finding in an experiment with Princeton University students, it has been replicated, with different subjects in different countries. The first, I believe, was by a team of Bank of England economists using students from the LSE.¹⁹ A questionnaire study of MPC members at Norges Bank and the Sveriges Riksbank found that members believe that group decisions on

¹⁷ Not all monetary policy committees seek unanimity. Some prominent counterexamples are the monetary policy committees of the Bank of England and the Sveriges Riksbank, which I have called *individualistic* committees. (Blinder, 2004)

¹⁸ See Clarida, Gali, and Gertler (2000), pp. 157-158 and Sack (1998) pp. 2-4. For further debate and discussion on policy inertia, see Rudebusch (2002, 2006).

¹⁹ Clare Lombardelli, James Proudman, and James Talbot, "Committees Versus Individuals: An Experimental Analysis of Monetary Policy Decision Making," *International Journal of Central Banking*, May 2005, pp. 181-205.

monetary policy are better than individual decisions.²⁰ That would imply, among other things, that they are not inertia bound.

The August 2020 framework

If central bankers believe that raising interest rates will slow economic growth and job creation, as most do, that belief alone should make banks with a dual mandate slower on the trigger than what Mervyn King (1997, p. 89) memorably called “inflation nutters,” meaning banks that care only about inflation. The Fed, of course, has long had a dual mandate—given to it by Congress, that has not changed for decades, and the Fed speaks of it often. However, in August 2020 the FOMC announced several meaningful changes in the way it was going to *interpret* that unchanged mandate.

To understand these changes, it is useful to compare them with what went before. Theoretical models of central bank behavior are typically built around a periodic loss function that looks something like this:

$$L = (\pi - \pi^*)^2 + \lambda(y - y^*)^2 .$$

Here π^* is the inflation target, the Fed’s rendering of “stable prices,” which is now 2%; and y^* is full-employment GDP, the operational version of “maximum employment.”²¹

Notice two aspects of this loss function. First, the quadratic functional form embodies a strong symmetry. Too *much* employment (represented by $y > y^*$) is modeled as being just as bad as too *little* (represented by $y < y^*$). This is a dubious proposition, to say the least, especially

²⁰ Mikael Apel, Carl Andreas Claussen, Petra Lennartsdotter, and Øistein Røisland, “Monetary Policy Committees: Comparing Theory and ‘Inside’ Information from MPC Members.” *International Journal of Central Banking*, December 2015, pp. 47-89.

²¹ $y - y^*$ could easily be changed to $u - u^*$ for unemployment or $E - E^*$ for employment.

when inflation is already penalized in the loss function. Why fret about high employment except for its possible effect on inflation?²²

Second, the period-by-period inflation target is always 2%. It does not depend, e.g., on recent history. Rather, bygones are bygones. An inflation miss on the low side does not mean that the central bank will try to engineer an equal and opposite miss on the high side. Both of these symmetrical aspects were altered in August 2020.

The employment target was changed from gaps to *shortfalls*: "...the Committee seeks over time to mitigate shortfalls of employment from the Committee's assessment of its maximum level..."²³ Given the moribund Phillips curve, the FOMC would no longer raise rates *only* because employment was thought to be overshooting its natural rate. This change was meaningful, important, and possibly germane to the policy error of 2021-2022. After all, previous FOMCs might have been spooked by the persistently low unemployment rates that began late in 2021, and therefore might have been inclined to raise interest rates sooner.

In fact, I was on the FOMC that achieved the perfect soft landing in 1994-1995, and that is precisely what we did. With inflation steady around 3% at the time, not rising, our principal rationale for raising the funds rate was fear that very low unemployment would trigger higher inflation. We were lauded for that "preemptive" approach at the time. But maybe we were wrong. After all, unemployment fell further in the 1990s without higher inflation.

Whether or not the asymmetry implied by concentrating on *shortfalls* rather than *deviations* from the natural rate contributed much to the policy error of 2021-2022 depends on

²² In pure economic theory, the answer might be that y^* is the first-best equilibrium level of GDP, so that any deviation yields lower utility. Actual policymakers are not detained by such thoughts.

²³ <https://www.federalreserve.gov/newsevents/pressreleases/monetary20200827a.htm>.

whether you believe that an overheated economy contributed much to the burst of inflation. The *ex post* evidence seems to say “not much.” (More on this shortly.) But that was not obvious *ex ante*. The various rounds of fiscal stimulus alone were enormous and the pent-up demand to spend was palpable as Americans emerged from their Covid shelters.

The other notable change in August 2020 was in the inflation target. It remained at 2% for the PCE index, but was modified to what came to be called *flexible average inflation targeting* (FAIT). As the FOMC put it then: “... the Committee seeks to achieve inflation that averages 2 percent over time, and therefore judges that, following periods when inflation has been running persistently below 2 percent, appropriate monetary policy will likely aim to achieve inflation moderately above 2 percent for some time.”²⁴ Of course, by August 2020 inflation had indeed run “persistently below 2 percent” for some time, so the new framework implied that the FOMC would target inflation modestly *above* 2% (how much above?) for a while (how long?).

The revised policy framework was immediately criticized for its vagueness and subsequently also criticized for its asymmetry. Notably, the FOMC’s statement did *not* state that following periods when inflation has been running persistently *above* 2 percent, appropriate monetary policy would likely aim to achieve inflation moderately *below* 2 percent for a while. And nowadays, despite the burst of inflation far above 2% in 2021-2024, nobody expects that, once the Fed reaches its 2% target, it will try to push inflation even lower for a time. The asymmetry was presumably intended, as the big perceived threat then was getting constrained

²⁴ *2020 Statement on Longer-Run Goals and Monetary Policy Strategy*. Federal Reserve Board. January 14, 2021. <https://www.federalreserve.gov/monetarypolicy/review-of-monetary-policy-strategy-tools-and-communications-statement-on-longer-run-goals-monetary-policy-strategy.htm>.

by the effective lower bound on nominal interest rates. Bygones on the upside were to remain bygones.

Obviously, both of these August 2020 changes pushed the FOMC in the dovish direction. Blaming the new framework, which could certainly be considered “structural,” for the high inflation that soon followed therefore seemed natural—and many have done so.²⁵ My guess is that there will be changes in the framework in 2025.

Was the August 2020 framework really to blame?

The case that dovish asymmetries in the new framework played a role in the policy error seems obvious, and there is doubtless some truth to it. But I think the blame has been exaggerated. Remember, the case against the new framework would have to be (a) that it led the FOMC to stick with easy money too long; and (b) that maintaining near-zero interest rates both stimulated excessive aggregate demand and permitted expansionary fiscal policy to do so; and (c) that the resulting overheated economy fueled inflation.

At least two major pieces of evidence undermine parts (b) and (c). One has already been alluded to: The econometric modeling evidence developed by Reifschneider (2024) and Zandi (2024) implies that sticking with excessively loose monetary (and, in Zandi’s case, also fiscal) policy for too long added only a minor amount to the inflationary surge in 2021-2022. Far bigger contributions came from supply shocks and supply constraints. Tightening monetary policy earlier would have helped, but not much. As Reifschneider (2024, p. 1) concluded, “a more restrictive strategy on the part of the FOMC would have done little to check inflation in 2021 and 2022,” and “the modest reductions in inflation suggested by these simulations would have

²⁵ For some examples, see Levy and Plosser (2024) or Eggertsson and Kohn (2023).

come at a cost of higher unemployment and lower real wages,” making “the net social benefit of a more restrictive policy response on the part of the FOMC seem doubtful.”

The second piece of evidence is the remarkable behavior of inflationary expectations during this episode. Figure 4 displays the five-year breakeven inflation rate implied by the TIPS market from 2019 into 2024. The lefthand side of the graph starts by showing one measure of what was worrying the FOMC prior to the pandemic recession: The expected inflation rate implied by the TIPS market was stubbornly hanging around 1.5% when, because TIPS inflation compensation is based on the CPI, the Fed wanted it closer to 2.5%.

Expected inflation then plummeted to near zero briefly during the Covid recession before beginning a slow but steady climb to 2.5% by March 2021—where it remained for about six months. Notice that this is *exactly* the number the Fed wanted.



Figure 4: Five-year breakeven inflation rate implied by the TIPS market, 2019-2024.

Then came the bad news: Expected inflation by this measure rose in late 2021 and early 2022, briefly reaching a peak around 3.5% before receding into the 2-2.5% range again. That brief episode must have caused some consternation at the Fed--and elsewhere. But when you remember that *actual* CPI inflation soared from around 5% in mid-2021 to about 9% in June

2022, and then remained above 6% for the next eight months, that rise in *expected* inflation seems both modest and short-lived. The main impression that should be taken away from Figure 4 is that long-term inflationary expectations were remarkably well anchored near the Fed’s target throughout this period. Despite plenty of bad inflation news that might have spooked traders, markets did not believe the Fed would lose control of an overheating economy.

A range rather than a number

My main suggestions for the 2025 framework discussions are that the FOMC should drop FAIT—which it has not followed in any case (no one would call the 2022 inflation overshoot “moderate”)—and change its inflation target from 2% to a range between 1.5% and 2.5%. The midpoint of that range, which naturally attracts most of the attention, would still be 2%; so this small change would not be deemed a retreat in the war against inflation. Rather, it would be seen—and should be explained—as an admission that no central bank can control inflation to the first decimal place. Getting within ½ percent of target is good enough.

Let’s now rerun the history of 2016-2024 on the ahistorical assumption that the FOMC’s target had been 1.5%-2.5%, rather than 2%, all the time. During the four full years 2016-2019, both PCE inflation and core PCE inflation averaged 1.7%—with only minor deviations from year to year.²⁶ With inflation both low and stable, the Fed should have been happy with that outcome. And it would have been happy had it been shooting for a 1.5%-2.5% target range, a range that was almost never breached.

²⁶ For headline, annual inflation rates varied between 1.5% and 1.9%. For core, the range was 1.5% to 2.0%.

Instead, however, the Fed was distressed that it was constantly falling short of its 2% target—by a mere 30 basis points on average! That attitude was silly on its face. Yes, 1.7 is not 2.0, but no human being can detect a 30 basis point difference in the *annual* rate of inflation. Nor can a central bank be expected to control inflation that tightly. But the FOMC viewed the chronic undershoot as a failure and felt it necessary to express a desire to push inflation *above* 2% “for some time,” presumably to avoid another collision with the effective lower bound.

As inflation subsequently soared to heights not seen in the U.S. since the 1980s, the difference between a point target (2%) and a range (1.5-2.5%) became totally unimportant. 2.5% inflation was in the distant rearview mirror. But as tight money and normalization of supply conditions brought inflation under control, it became meaningful again.

At this writing, 12-month PCE inflation is down to 2.6%, having visited 2.5% in January and February 2024. If the FOMC had a 1.5-2.5% target range today, its disinflation job would be basically over—subject to some wariness that inflation not stage another uprising. Instead, we see and hear a lot of hand wringing about how hard it is to travel “the last mile” to 2.0%. In its June 12, 2024 statement, for example, the FOMC said that it “does not expect it will be appropriate to reduce the target range [for the funds rate] until it has gained greater confidence that inflation is moving sustainably toward 2 percent.”²⁷ All this while the *real* funds rate was pushing 3%—clearly implying “tight money.”

Looking forward rather than backward, how might changing from a point target to a range alter the FOMC’s behavior? Most obviously, it would get the central bank to ignore small

²⁷ Federal Open Market Committee. “Federal Reserve Issues FOMC Statement.” Board of Governors of the Federal Reserve System. June 12, 2024.

deviations from 2% as unimportant—which they are. Markets would quickly catch on to that and read nothing into inflation rates of, say, 1.8% or 2.2%. More important, a range would reduce (not eliminate) the need for great subtlety in forward guidance, which has tripped up many central banks many times. I say this because the inflation numbers would in some sense “speak for themselves.” Seeing inflation rise to, say, 2.3% or 2.4% would automatically trigger what we used to call a “tightening bias” as markets focused on inflation approaching its upper bound. Similarly, as inflation approached the lower bound of 1.5%, markets would start building in an “easing bias.” In principle, this process should be smooth and modestly predictable. While having a range would not be a perfect substitute for forward guidance, it would partly reinforce it and partly supplant it.

Notice also that the range would be inherently *symmetric*, unlike flexible average inflation targeting *in practice*. When the FOMC announced FAIT in August 2020, it explained—vaguely and presumably intentionally—how it would work only in the case of an *undershoot*, not in the case of an *overshoot*. And as mentioned, no one thinks the FOMC will react to the large overshoot since 2021 by trying to create a long period of inflation under 2%. So switching to a range in 2025 would be a step back toward symmetry, which hawks may like but doves may not.

Finally, lest anyone think that moving from a point target to a range would put the Federal Reserve out of step with central banking norms, readers should know that it’s just the opposite: Central banks with point targets constitute a small minority group. Yes, several of the most prominent central banks—including the ECB, the Bank of England, and the Bank of Japan—do post point targets (2%) like the Fed. But they are in the clear minority. Most central banks post

target *ranges*. In Canada and also in New Zealand, where inflation targeting started, it's 1% to 3%, which is twice as wide a range as I'm suggesting. In Australia, it's 2-3%.²⁸

The other aspect of asymmetry is the output/employment target, which the FOMC changed to "shortfalls" in August 2020. For reasons already stated, I don't see a strong case for abandoning that language, though others do. The issue is debatable, and I may be showing my own dovish feathers here, but frankly, I'm not convinced that it's all that important. The main reasons have been touched on already in this essay. For one thing, falling short of "full employment" does seem (to me, at least) like a more serious problem than overshooting full employment. For another, the "Phillips curve," to the extent one exists, looks pretty flat, meaning that modest overshoots will lead to only small increases in inflation.

In conclusion

The FOMC made a substantial, though perhaps understandable error in failing to raise interest rates until March 2022. Much of that policy error can be attributed to faulty forecasts of inflation, which the Fed shared with many other forecasters. It was not an outlier. But the error was not quite as consequential as the Fed's sharpest critics allege. Even if the FOMC had started to hike rates earlier (how much earlier?) the econometric evidence suggests that the effects on peak inflation would likely have been small. Supply constraints, not excess demand, ruled the roost. They came, driving inflation higher; and then they went, pulling inflation down.

²⁸ For a long list of over 50 central banks, see <http://www.centralbanknews.info/p/inflation-targets.html?m=1>. Their data apply to 2022.

The FOMC's August 2020 framework shoulders more of the blame for the inflationary surge than it should—probably because the new wording revised both of the Fed's goals, low inflation and high employment, in dovish directions. For that reason alone, the framework will almost certainly be changed in 2025, given the high inflation since then. But how?

I suggest that the August 2020 change in the employment goal, from symmetry to "shortfalls," is sensible and was probably not too important anyway. But the change in the inflation goal, from a 2% point target to FAIT, probably was consequential. It may have made the FOMC slow on the draw as inflation gathered steam, and I worry a bit that it may be keeping monetary policy too tight for too long now. In both directions, I argue, a 1.5%-2.5% target range would be a better choice. In answer to the question that forms the title of this essay, that may be the structural flaw that the Fed should fix.

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