Testimony for the Task Force on Monetary policy, Treasury Market Resilience and Economic Prosperity of the House Committee on Financial Services

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I appreciate this opportunity. The Task Force is an important innovation that will enhance the Congress' ability to oversee Federal Reserve monetary policy. Congress has, in the Federal Reserve Act, set goals for the Federal Reserve in the conduct of monetary policy—maximum employment and stable prices. But it also has, very wisely, allowed the Fed to determine the best policies to meet those goals without direct interference from the political process. That's because history shows that political pressures are invariably on one side—for lower interest rates, which people facing elections see as boosting job creation in the short term. But giving in to these pressures results subsequently in inflation. That would be very costly. As we've been reminded of late, Americans hate inflation; and for the Fed to eradicate it once it takes hold often entails considerable pain, as it did in the early 1980s.

With a high degree of policy independence, however, comes responsibility—of the Federal Reserve to clearly explain what it is doing and why, and of the Congress to examine those explanations and to challenge them, especially when the Federal Reserve has not met its legislated goals for a while. Obviously, the better informed you are, the more effective this process will be.

The path from policy choices on Constitution Avenue to prosperity on Main Street is a long and winding one, not well mapped and subject to many influences, economic and financial, that are not under the direct control of

the Federal Reserve. Your staff suggested that it might be useful for me to provide a high-level overview of that path. I draw on 40 years of experience in the Federal Reserve. I joined the Fed staff in Kansas City in 1970, came to Washington as a staff economist in 1975, where I served until 2002, when I was appointed to the Board of Governors by President Bush, who subsequently elevated me to vice chairman in 2006. I retired from the Board in 2010 and have been at Brookings since then.

Policy decisions start by asking how the economy is likely to evolve over coming quarters relative to those longer-term goals, and if it is not going to achieve the goals soon, how policy – usually short-term interest rates -- should be altered to get it closer, sooner. Since 2012 the Fed's Federal Open Market Committee has issued a "Statement on Longer-term Goals and Monetary Policy Strategy"—the so-called framework—that is a starting point for this discussion. The framework defines the goals and gives some very general thoughts on the approach to achieving them. Maximum employment is given by influences outside the control of the Fed—the structure of the labor market, the ease of matching people and jobs—and maximum sustainable employment must be inferred from the behavior of other variables, like wages and prices. Inflation is also subject to outside influences, but over time the Fed can control inflation, and it is responsible for achieving and maintaining price stability, which it has defined as 2 per cent annual growth in a particular measure of consumer prices.

In 2020, in response to a prolonged period of very low interest rates—often at zero -- sluggish growth of employment coming out of the recession, and persistent shortfalls of inflation from 2 percent, the Fed altered its strategy for meeting its goals in two ways. It adopted what it called Flexible Average Inflation Targeting, which called for "inflation moderately above 2 percent for some time" after it had been running persistently below 2 percent; this was designed to keep consumer, business, and market inflation expectations anchored at the 2 per cent target. It also would react to shortfalls in employment from estimates of its maximum, but not to overshoots unless pressures in labor markets were already manifested in increases in inflation

above target. The intention here was mainly to make sure that inflation averaged 2 percent over time, which. In turn would be reflected in expectations and moderate interest rates, giving the Fed sufficient scope to lower interest rates to counter any adverse shock to the economy. Obviously, the post-covid recovery presented the Fed with a very different environment than the low rate, low inflation one it had been dealing with from 2009 to 2019, and which it was addressing in its revised statement. In light of this experience, the Fed is now reviewing its statement; its strategy must be robust to a variety of shocks and stresses, not just those of its most recent experience. The minutes of the last FOMC meeting confirm that policymakers recognize this imperative.

Adjustment to an overnight interest rate is the main instrument the FR uses to make progress toward the goals you gave it. That rate does not directly affect prices or employment; rather it works by influencing prices in financial markets, which in turn induce changes in spending and the balance of aggregate supply and demand. To give an example, if the Fed sees softness developing in the economy and inflation potentially falling below 2 percent, it will cut rates. The decrease, along with any expected future decreases, will reduce the longer-term interest rates households and businesses pay when they borrow to buy cars and houses or to build factories, stimulating demand. Lower rates also tend to raise the prices of other assets, like equities and houses, promoting spending by the owners of that wealth. Lower rates also tend to reduce the foreign exchange value of the dollar, stimulating exports and damping import competition for US producers.

Note how indirect this process is. The effects of a policy on the objectives will depend on how financial markets react to the action and any shifts in expectations about future actions, and how households and businesses respond to the evolution of interest rates, equity prices, and the exchange rate. Our knowledge of the dimensions of all these steps and their timing is incomplete. Although asset prices respond promptly to any change in the policy outlook, businesses and households take time to make and alter decisions. Hence the well-known lags in the effects of monetary policy. And

experience suggests that the lags are especially long between policy actions and changes in inflation. Given contracts and commitments, it takes a while for workers and businesses to decide whether a change in spending is large enough and persistent enough to call for an adjustment to wages and prices, and then some time to execute on any shift that seems warranted. For this reason, whenever possible, monetary policy decisions should be based importantly on a forecast of future employment and inflation.

Moreover, financial conditions and the balance of aggregate supply and demand are affected by many things in addition to monetary policy. Indeed, I often thought about my policy decisions as hinging on identifying those other influences and then offsetting them. Here's how the Fed's statement on longer-rum goals and strategy puts it. "Employment, inflation, and long-term interest rates fluctuate over time in response to economic and financial disturbances. Monetary policy plays an important role in stabilizing the economy in response to these disturbances."

In considering these so-called shocks to financial conditions and the economy, the Federal Reserve needs to differentiate between those that happen to demand and those that affect supply. Monetary policy is generally well suited to offsetting demand shocks. The chain I just described was about boosting (or in the case of raising rates, damping) demand. It cannot offset an adverse supply shock—a rise in the price of a good resulting for example from a reduction in supply or an increase in taxes on that good. Adverse supply shocks raise prices and reduce real incomes—moving the economy away from both objectives at least temporarily. Advice for policymakers in this situation is often to "look through" the supply shock—not try to offset its effects, which might worsen outcomes. But policymakers need to be attentive to second-round effects. If a rise in the price level from supply restriction begins to get built into higher inflation expectations, a price level change can result in persistently higher inflation and require a policy response. And uncertainty about future disturbances that discourages consumption or investment can put the employment goal at greater risk. In the presence of second-round effects, adverse supply shocks require

policymakers to perform a balancing act—assess which goal is at greater risk over the intermediate to longer-term and take actions to mitigate that risk.

Monetary policy's ability to perform its balancing role in response to demand or supply disruptions —in particular to boost growth and prevent unwelcome disinflation in response to economic weakness-- has been constrained several times in recent years because the policy interest rate had already been reduced to zero. In these circumstances, the Fed has activated what are known as unconventional policy instruments—asset purchases (QE) and forward guidance about interest rates. These are simply extensions of conventional rate policy when that policy is no longer available. Asset purchases directly lower long-term rates and boost asset prices to make purchases of houses, cars, and business capital more attractive. Forward guidance on interest rates is intended to prevent premature expectations of rising rates from becoming built into higher actual rates, tightening financial conditions.

Expectations of prices and interest rates have played a critical role in our story. Inflation expectations anchored around the Fed's target of two percent are necessary to achieve that target. When people expect inflation to be higher or lower than the target, they will raise prices and wages at rates that will tend to make those expectations a reality. That's why the Fed keeps such a careful eye on measures of inflation expectations.

And expectations about future policy have important effects on current financial conditions and hence on achieving objectives. The better people understand Fed policy and intentions, the more stabilizing market responses to policy and to unexpected economic developments are likely to be; markets and the Fed in synch will foster faster progress toward the goals. And that's why the Federal Reserve has become much more transparent over time about why it is making its decisions and its outlook for the future. It has announced that in its 2025 framework review it will be looking at ways to make its communication even more helpful.

The bottom line is that, for a variety of reasons, the path to realizing the Congressionally mandated objectives is surrounded by a good deal of uncertainty. Policymakers need to operate flexibly and adapt their policy actions and communication to new information about the forces acting on the economy and transmitting policy impulses to employment and prices.

I recognize that this overview has been at a very high and abstract level. Your attention is undoubtedly focused more on recent experience with the economy and monetary policy and prospects going forward. I hope this has provided a framework for discussing these issues, and I am happy to take your questions on various topics related to monetary policy.