

## RESEARCH SUMMARY

## The Fate of FAIT: Salvaging the Fed's Framework

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In August 2020, the Federal Reserve adopted a new monetary policy framework called Flexible Average Inflation Targeting (FAIT) to keep inflation close to 2 percent on average. This framework, however, has come under intense scrutiny for its failure to prevent the 2021–2022 inflation surge.

In “The Fate of FAIT: Salvaging the Fed's Framework,” David Beckworth and Patrick Horan argue that the Fed can improve FAIT by applying the properties of a nominal GDP-level target (NGDPLT), which targets the total dollars spent on final goods and services within the United States. In other words, if total spending falls below target, the Fed would pursue an expansionary policy to bring it up to target; if total spending rises above target, the Fed would pursue a contractionary policy to bring it down to target. The authors call this improved framework FAIT-N.

### FAIT and Its Flaws

FAIT suffers from at least three major problems:

1. *Asymmetry.* The Fed overshoots 2 percent inflation to make up for previous undershoots but not vice versa. This practice has confused many observers about how FAIT works.
2. *Knowledge.* FAIT requires the Fed to distinguish between changes in the price level due to changes in demand versus changes in supply. It also requires the Fed to know the economy's maximum level of employment. Both are difficult to know in real time.
3. *Discretion.* The Fed determines the conditions under which its makeup policy occurs. The lack of a rules-based approach can be destabilizing because it can lead to the Fed pursuing an agenda not consistent with its price stability mandate. It can also lead to greater public uncertainty about the future course of monetary policy.

### Saving FAIT

By adopting the properties of an NGDPLT, the FAIT-N framework addresses the three problems mentioned above.

1. It is a symmetric framework, where the Fed makes up for misses from below as well as above.
2. The Fed does not need to make any assumptions about changes in inflation coming from supply shocks or about the maximum level of employment; instead, it should be concerned only with the level of nominal GDP.
3. The Fed can use the Mercatus Center's NGDP gap measure to implement FAIT-N. This approach can be rules-based because the value of the NGDP gap can be plugged into a Taylor rule, a formula for how the Fed sets its target interest rate.

The authors also show how a FAIT-N Taylor rule would have performed in recent years. They demonstrate that it would have lowered the Fed's target interest rate sooner during the Great Recession and would have raised the target interest rate sooner during the 2021–2022 inflation surge, mitigating both crises.