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RESEARCH SUMMARY

What Kind of Landing: Soft or Hard?

In the past, the Federal Open Market Committee (FOMC) has reduced inflation through contractionary monetary policy—but only at the cost of recession. Recent comments from its members suggest the FOMC does not possess a strategy that would avoid a similar outcome for the economy. In "What Kind of Landing: Soft or Hard?" Robert L. Hetzel suggests a strategy for returning to price stability in a way that can also reduce the risk of a serious recession.

EXPECTATIONS ARE CENTRAL TO UNDERSTANDING HOW INFLATIONS END

In the 1970s, in response to inflation, the FOMC raised the federal funds rate until the economy weakened. It then kept the rate unchanged to avoid sending a signal to markets that it would accept higher inflation as the norm. Recession ensued. In other words, the FOMC had to make the tradeoff of a recession to prove to markets its adherence to the goal of low inflation.

If today's Federal Reserve follows this same pattern, there is reason to expect a similar outcome—a significant recession for the US economy.

FOMC POLICY REMAINS "TRUST ME"

The FOMC has a target of 2 percent inflation but does not share with the public its framework for achieving it. Instead, its policy remains "trust me." FOMC statements seem to be little more than subjective opinions—guesses about the extent to which the funds rate must rise to begin to bring down inflation. They are presented without reference to an underlying strategy (or rule) that imposes coherence on policy over time.

The FOMC should be guided by a vision of where future policy is headed. That vision needs to articulate not only a determination to restore price stability but also a conception of the policy that will maintain it.

A PROPOSAL FOR A SOFT LANDING

An explicit strategy for returning inflation to the 2 percent target would demonstrate that the FOMC is grappling with the genuine issues raised by its policy. Without such a strategy, the FOMC can provide no assurance that it will not push the funds rate to a level that will cause a severe recession.

KEY RECOMMENDATIONS:

- The FOMC should raise the funds rate moderately (e.g., 0.25 percentage points) at each of its meetings until it becomes clear that the economy is weakening in a sustained way.
- The FOMC would then begin to work the funds rate down moderately.
- The FOMC would specify a benchmark path for growth in nominal output.

In this way the FOMC can achieve a gradual reduction in inflation without the need for a sharp recession.

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