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RESEARCH SUMMARY

What Is the Monetary Standard? The Fed Should Tell Us

It is assumed that the Federal Open Market Committee (FOMC) understands the structure of the economy so that it knows (a) the origins of instability in markets and (b) how its actions will offset that instability. But what are now implicit assumptions should be made explicit communications, says Robert L. Hetzel. In "What Is the Monetary Standard? The Fed Should Tell Us," he argues that the FOMC needs to explain its understanding of how its actions translate into the achievement of its twin objectives of stable prices and full employment.

A MATTER OF TRANSPARENCY

FOMC participants have actively offered guidance about the future path of the funds rate. Real transparency, however, would require specification of the FOMC's strategy. This requirement is necessary because, as recent experience confirms, the FOMC possesses a limited ability to forecast. Former chair of the Federal Reserve Alan Greenspan has put it this way:

> We have to acknowledge to ourselves that our forecast is going to be wrong. It always is. We expect it to be wrong.

Part of the Fed narrative is that the structure of the economy evolves and that the Fed adjusts monetary policy accordingly. The FOMC needs to explain that this assertion is not just a rationalization for the consequences of a misguided policy. As a matter of transparency and accountability, the FOMC should be able to articulate a consensus view of how its monetary standard supports the operation of a market economy.

A PUBLIC AND PROFESSIONAL DEBATE

FOMC transparency must be accompanied by a public and professional debate over the optimal monetary standard, similar to the monetarist–Keynesian debate that addressed this issue during the 1970s. A revival of this kind of debate is especially urgent given the FOMC's "go-stop" response to the COVID-19 pandemic.

With the onset of the pandemic, the FOMC abandoned the previous policy of preemptive increases in the funds rate to prevent the emergence of inflation. In its place, the FOMC turned to a policy known as "flexible average inflation targeting." Under the new approach, the FOMC pursued an expansionary monetary policy that raised inflation significantly beyond the FOMC's 2 percent inflation target and required forecasts of the tradeoffs between unemployment and inflation. Inflation that was much higher than forecast created the need for an offsetting contractionary monetary policy.

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A BETTER WAY FORWARD

- Rather than focusing on managing the tradeoff between inflation and unemployment, the FOMC would do better to articulate a monetary policy in terms of a long-term strategy that will restore price stability and then maintain that stability.
- The FOMC needs to answer how the current policy ensures that a declining rate of inflation will stop at 2 percent and then remain there.
- Such a policy should allow the FOMC to lower the funds rate to prevent a serious recession while maintaining credibility for a long-run policy to restore price stability.