Why I Dissented: Neel Kashkari

September 18, 2020

AUTHOR

Neel Kashkari

President and Chief Executive Officer

This essay is also available on Medium.

I strongly support the new Statement on Longer-Run Goals and Monetary Policy Strategy[1] that the Federal Open Market Committee has adopted. It incorporates the lessons we have learned from the prior recovery and gives the Committee sufficient flexibility to make up for periods of low inflation in order to achieve our dual mandate goals. However, I voted against the FOMC's September 16, 2020, policy statement because, while I believe the statement is a positive step forward in putting those lessons into practice, I would have preferred the Committee make a stronger commitment to not raising rates until we were certain to have achieved our dual mandate objectives.

Kashkari: need stronger commitment to not raising rates.

The 2015 tightening cycle

To explain my rationale for seeking stronger forward guidance, I first must review what I learned from the recent tightening cycle that began in 2015. That policy tightening was predicated on the Committee's view that the labor market was reaching maximum employment and therefore inflation was around the corner. When I first became an FOMC voter, I dissented against all three of the Committee's rate hikes in 2017 because, as I wrote then: *"We are still coming up short on our inflation target, and the job market continues to strengthen, suggesting that slack remains."*[2] Recently, Governor Brainard commented: *"had the changes to monetary policy goals and strategy we made in the new [monetary policy strategy] been in place several years ago, it is likely that accommodation would have been withdrawn later, and the gains [to the labor market] would have been greater."*[3] We misread the labor market and, as a result, the tightening cycle that we embarked upon was not optimal to achieving our dual mandate goals of maximum employment and stable prices.

misread the labor market

In recent years, we have repeatedly believed we were at or beyond maximum employment only to be surprised when many more Americans reentered the labor market or chose not to leave, increasing the productive capacity of the economy without causing high inflation. To me, maximum employment is the point at which the labor market is just tight enough to deliver 2 percent inflation in equilibrium. If we were to push the labor market harder, we would end up with inflation greater than 2 percent. By this definition, even in January 2020, we had not yet reached maximum employment.

Why did we consistently make this error? First, we heard repeatedly from businesses who complained that they couldn't find workers. Some said we had a "historic worker shortage." At the same time, wages were only rising modestly. I learned that businesses want qualified workers at wages they are used to paying. If they can't readily find workers at historical wage levels, then they declare a worker shortage. The fact that wages weren't climbing more quickly helped me to see through their complaints and realize that there was likely still slack in the labor market.

Second, economists and policymakers often raise their estimates of the natural rate of unemployment in recessions, believing that workers' skills diminish, their skills become obsolete in a changing economy, and as they are dislocated from the labor market, they then become hard to reengage during a recovery. For example, if some policymakers believed that 4 percent was the lowest the unemployment rate could go without triggering high inflation during an expansion, they might ratchet it up to 5 percent or 6 percent after a recession. And then when the unemployment rate fell during the recovery back to 6 percent or even 5 percent, some policymakers might believe we must be at maximum employment. In December 2015, when the Committee decided to first raise rates off the effective lower bound, the median FOMC participant thought the lowest unemployment could go without triggering inflation was 4.9 percent, while the actual unemployment rate at the time was 5.1 percent. By February 2020, the unemployment rate had fallen to 3.5 percent without inflation returning to our target. That's 2.3 million more Americans working than we thought the economy could sustain just a few years earlier.

While I accept that there may be some increase in the natural rate of unemployment in recessions, I believe that economists have overstated the extent of the increase. The result has been a ratcheting up of the natural rate of unemployment in recessions that is harmful because it leads to policy that is too tight. My takeaway from this recent experience is that it is difficult to assess in real time whether we are at maximum employment and whether inflation really is around the corner.

Why do I want stronger forward guidance?

The new policy statement includes this new forward guidance language:

> *"The Committee expects it will be appropriate to maintain this target range until labor market conditions have reached levels consistent with the Committee's assessments of maximum employment and inflation has risen to 2 percent and is on track to moderately exceed 2 percent for some time."*

This language is an example of outcome-based forward guidance, where the Committee indicates it expects to keep rates at the effective lower bound until certain economic conditions are met. I support the adoption of outcome-based forward guidance as an important step forward for the Committee's approach to setting monetary policy.

My preference, however, would have been for this new forward guidance to be stronger. Specifically, this new language still relies on the Committee to assess whether we are at maximum employment and whether inflation is expected to climb. As I just reviewed, those are difficult judgments to make in real time. For example, what would have happened had the FOMC adopted this forward guidance in 2012, when it first adopted its 2 percent inflation target? Inflation briefly crossed 2 percent in January 2017 before falling back down. Given that we believed at the time we were at or beyond maximum employment, this new forward guidance would likely have deferred liftoff from December 2015 to January 2017, a little more than one year later. While that would have been an improvement over what the Committee actually did, we still would have been lifting off based on a misreading of the labor market and a false signal that underlying inflation had really returned to target. Hence, we still may not have achieved our dual mandate goals of maximum employment and 2 percent inflation.

My proposal

In June 2019, I proposed forward guidance that I continue to believe would better assist the FOMC in achieving its dual mandate goals. Specifically, I propose the following:

> *"The Committee expects to maintain this target range until core inflation has reached 2 percent on a sustained basis."*

By eliminating both the direct reference to our assessment of maximum employment and any forecast of inflation climbing, this proposed language guards against the risk of underestimating slack in the labor market. We would only lift off once we had demonstrated that we really were at maximum employment, because core inflation would have had to actually hit or exceed 2 percent on a sustained basis in order to lift off. Policymakers will have a range of opinions about what constitutes a sustained basis, but for me in this environment, it means roughly a year.

Our new monetary policy strategy says that after periods of low inflation, the Committee *"will likely aim to achieve inflation moderately above 2 percent for some time."* Not raising rates for roughly a year after core inflation first crosses 2 percent is consistent with a strategy of aiming for a modest overshoot in order to achieve average inflation of 2 percent.

What might be wrong?

Under what scenario might the Committee regret adopting the forward guidance I propose? If inflationary pressures are building, we might have to raise rates to keep inflation expectations anchored at 2 percent. Once core inflation crosses 2 percent on a sustained basis, my proposal allows the Committee to do exactly that. This scenario should not be a concern.

We heard in the last expansion that there might be nonlinearities in the inflation process—that once inflation started climbing, it might accelerate, requiring a very strong policy response to control it. At the time, I called such theories ghost stories, because there was no evidence they were true but they also couldn't be ruled out. I believe that characterization is still appropriate today. The FOMC has powerful tools to combat high inflation but only limited tools to combat low inflation. Persistent low inflation is posing challenges to advanced economies around the world. If this new forward guidance helped to generate higher inflation that the FOMC then had to respond to by raising rates, I think we would consider that a high-class problem.

Endnotes

1 See the statement from the Board of Governors of the Federal Reserve System.

2 See my dissent explanation from 2017.

3 See Brainard's speech.

MORE ON

MONETARY POLICY POLICY

RELATED CONTENT

ARTICLE

A strategy to re-anchor inflation expectations

ARTICLE

The Flattening Yield Curve

ARTICLE

Why I Dissented a Third Time