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RESEARCH SUMMARY

The Recovery from the Great Recession: Did the FOMC Learn the Right Lessons?

In August 2020, the Federal Reserve set forth a new framework for conducting monetary policy. In light of the COVID-19 pandemic and the social unrest gripping US cities, the Fed's Federal Open Market Committee (FOMC) decided to pursue an unemployment rate low enough to provide for ample job opportunities in minority communities. To accomplish this goal, the FOMC will forgo preemptive increases in the federal funds rate to ensure an overshoot of its inflation target. Robert Hetzel questions this change in policy—and the justifications for it—in "The Recovery from the Great Recession: Did the FOMC Learn the Right Lessons?"

WHAT THE FOMC CONCLUDED AND WHAT IT DID

- The new monetary policy framework was based on a conclusion made about the recovery from the Great Recession—namely, that policymakers had erred in pursuing preemptive increases in the funds rate to prevent the emergence of inflation.
- Starting in December 2015, the FOMC had raised the funds rate off the zero lower bound (ZLB), and the inflation rate had continued to run below the 2 percent target.
- Going forward, the FOMC will keep the funds rate near zero until inflation persistently exceeds its 2 percent long-run goal. The idea of average-inflation targeting is that the overshoot in inflation will be maintained long enough to compensate for previous undershoots of the 2 percent inflation target.
- Given that the prepandemic unemployment rate was just 3.5 percent with inflation remaining less than 2 percent, this policy is presumed to allow the FOMC to achieve its expanded goal of an unemployment rate low enough to be inclusive of employment in minority communities.
- Preemptive increases had been a hallmark of the previous Volcker-Greenspan era and had guided the policy of returning to price stability. The new framework thus represents a significant departure.

WHAT SHOULD POLICYMAKERS HAVE LEARNED FROM THE RECOVERY?

- The recovery from the Great Recession was a period of considerable economic stability.
- In part, stability was an artifact of an initial moderately contractionary monetary policy that limited the strength of the recovery.
- That price stability provided the foundation for the significant decline in the unemployment rate during the recovery.

KEY TAKEAWAY

The lesson that the FOMC should have drawn from the Great Recession was that a policy of price stability allows the price system to work to produce a socially desirable low level of unemployment. The Fed's current policy is likely to make an overshoot of inflation from the FOMC's 2 percent target much larger than desirable. Whatever its outcome, the change is a rare example of a clear monetary experiment, and policymakers will need to learn from it.