At the onset of the coronavirus pandemic in March 2020, the US money stock surged at a pace that in the past has produced inflation. The newly announced policy of the Federal Reserve labeled “flexible average inflation targeting” offers no assurance that the United States will emerge from the pandemic with price stability rather than an uncontrolled rise in inflation. In “COVID-19 and the Fed’s Monetary Policy,” Robert L. Hetzel recommends a monetary policy consistent with the dissipation of the spring 2020 bulge in money to avoid reigniting inflation.

DETAILS OF THE FLEXIBLE AVERAGE INFLATION TARGETING POLICY

- The new policy of the Federal Open Market Committee (FOMC) is the opposite of the policy followed by former FOMC chairman Alan Greenspan of raising the fed funds rate preemptively during economic recoveries so that inflation never emerges.

- The new policy will raise the funds rate only when inflation persistently exceeds the FOMC’s 2 percent inflation target.

- This policy risks an uncontrolled rise in inflation, similar to what happened during the Great Inflation of the 1970s, when there were similar levels of rapid money creation.

A DEPARTURE FROM THE FEDERAL RESERVE’S TRADITIONAL FOCUS ON MONETARY POLICY

Historically, the Federal Reserve (Fed) has understood its role in stabilizing economic activity as influencing the cost and availability of credit. In this spirit, the Fed initiated a series of programs designed to influence the flow of credit. These programs involved using the Fed’s balance sheet to make loans to various sectors of the economy.

The Fed instituted these programs in the (unproven) belief that financial markets could no longer transfer resources from households to businesses and municipalities. As current FOMC chairman Jerome Powell saw it, the Fed was correcting the failure of markets to perform their role as intermediaries by providing financing that would not otherwise be available. Measured by the provision of reserves through open market purchases of Treasury securities and agency mortgage-backed securities, however, the Fed’s most important actions constituted expansionary monetary policy.

Powell has also emphasized the Fed’s commitment to using monetary policy to achieve a socially desirable low rate of unemployment.
KEY TAKEAWAY

As the economy emerges from the recession, the Fed needs to follow a consistent rule so that its actions ensure that the spring bulge in money is reversed. To achieve that result, the Fed should follow the Greenspan policy of preemptive increases in the funds rate to avoid an overshoot of its 2 percent inflation target. The Fed's announced policy of allowing an overshoot, “flexible average inflation targeting,” assumes that the Fed can engineer a controlled increase in inflation. There is no historical evidence for that assumption.

Should the US economy expect a revival of inflation when the country emerges from the COVID recession? Not necessarily. Households and corporations are holding the large increase in money balances that occurred in spring 2020 as precautionary balances. However, policymakers must remember that sustained expansionary monetary policy causes inflation. At the onset of the COVID crisis, it was important for policy to be expansionary to avoid deflation. Monetary stability now requires that policy allow the bulge in money to unwind. The surest way to achieve that goal is to follow the Greenspan policy of preemptive increases in the funds rate during the economic recovery.