Discussion of "Monetary policy, employment shortfalls, and the natural rate hypothesis" by Michael T. Kiley

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The views expressed here are my own and do not necessarily represent those of others in the Federal Reserve System.

What framework best achieves price stability and full employment?

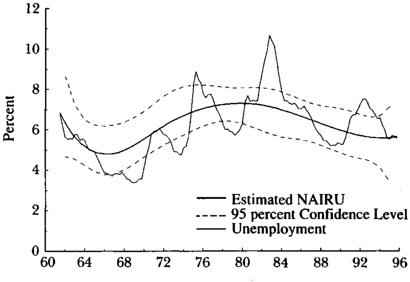
- Model-based evaluation of different policy frameworks $\rightarrow$ compare policy rules
- Methodology:
  - Simple "three-equation models" provide key insights and useful intuition
  - Simulations with FRB/US allow for quantitative evaluation in more detailed model
- Key findings:
  - Make-up policies (lower-for-longer, threshold rules) can substantially alleviate ZLB problems
  - Strong response to output/unemployment improves performance despite mismeasurement
  - Focusing on employment shortfalls "can exacerbate shortfalls and create inflationary pressures"

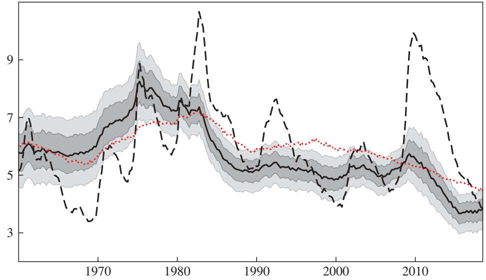
The Fed's mission and strategy

- Dual mandate: *maximum employment* and *stable prices*
- Operationalized in policy framework: "Statement on Longer-Run Goals and Monetary Policy Strategy"
- Framework 2012-2020: aim for two percent PCE inflation "over the longer run" and mitigate "**deviations of employment from [its estimated] maximum level**"
- Framework since 2020: flexible average inflation targeting (FAIT) and mitigate "**shortfalls of employment from [its estimated] maximum level**"
- *What insights from economic research motivated the change in focus from "deviations" to "shortfalls" of employment?*

Difficult to assess overheating and reliably predict rising inflation

- Assessment of maximum sustainable employment requires estimate of *natural rate of unemployment*, u^* (NAIRU?) but highly uncertain (Staiger, Stock, Watson 1997) and revised down over 2010s (e.g., Crump et al., 2019)





- Overheating, $u < u^*$, predicts higher inflation based on *Phillips curve*, but post-GFC experience and empirical research suggest that relationship is weak (Ball and Mazumder 2011, Hazell, Herreño, Nakamura, Steinsson 2023, Smith, Timmermann, Wright 2023)

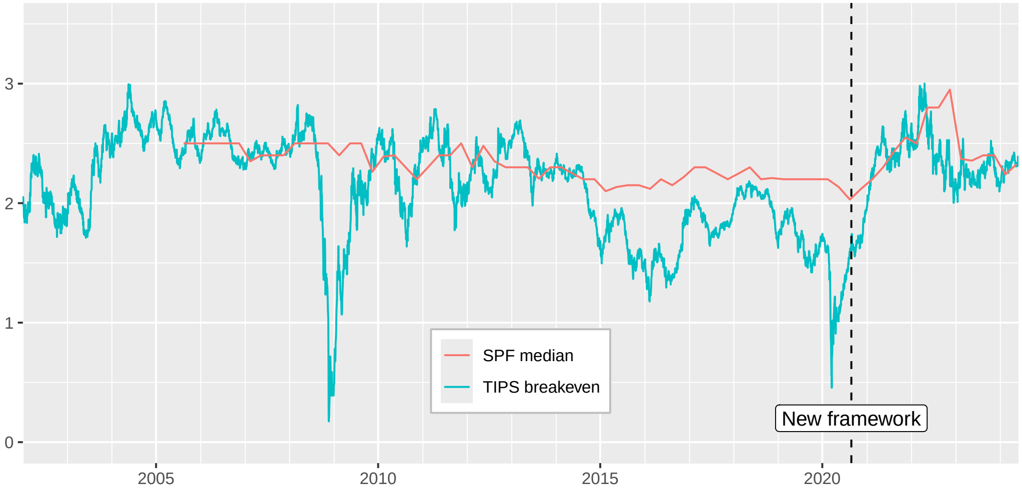
Focusing on employment shortfalls may raise social welfare

- Plucking model (Dupraz, Nakamura, Steinsson 2022)
  - Economic fluctuations are occasional drops below full potential
  - Stabilization policy can raise average level of output and employment
  - Standard methods overestimate u^*
- Tail risks/asymmetry/skewness in business cycles (Morley and Piger, 2012)
- Positive hysteresis and distributional benefits (Aaronson et al., 2019; Feiveson et al., 2020)

Possibility of inflation bias may not be a big problem

- Paper shows that focus on shortfalls can cause upward inflation bias (see also Surico, 2007, and Gust, Lopez-Salido and Meyer, 2017)
- But ZLB causes downward inflation bias (e.g., Kiley and Roberts, 2017) so some upward bias could be a welcome antidote.
  - Chair Powell: “persistent undershoot of inflation … cause for concern” (2020 JH)
  - Higher average inflation lowers likelihood of hitting the ZLB
- And central bank can put more weight on inflation deviation to reduce bias (Bundick and Petrosky-Nadeau, 2022)
  - Policymakers “can achieve their inflation objective on average while still significantly reducing the probability of encountering the zero lower bound”

Little evidence of inflation bias in ten-year CPI inflation expectations



Source: Federal Reserve Board (TIPS yield curve) and Survey of Professional Forecasters

Importance of effective communication about monetary policy

- Model-based results assume complete information, but research has demonstrated importance of incomplete information and learning.
  (Blinder et al., 2008; Eusepi and Preston, 2010; Taylor and Williams, 2010; Cogley et al, 2015, . . .)
- Public does not know reaction function or loss function.
  - Part of the reason for *monetary policy surprises* (Bauer and Swanson 2023a,b)
  - Bauer, Plueger, Sunderam (2024): survey-based *perceived monetary policy rules* vary over time, differ from actual rule, matter for transmission
  - Bernanke review: BoE should provide information about its reaction function
- Shortfalls approach likely easier to communicate to the public.
  - Mitigate *deviations*? "In practice, the Committee has not conducted policy in this way" (Chair Powell, Jackson Hole, 2020)
  - Focus on shortfalls directly follows from maximum employment mandate.