EconoFact Chats: The Federal Reserve: Crisis Responses and New Policy Directions

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Michael Klein:
I'm Michael Klein, executive editor of Econofact, a non-partisan web-based publication of The Fletcher School at Tufts University. At Econofact, we bring key facts and incisive analysis to the national debate on economic and social policies, publishing work from leading economists across the country. You can learn more about us and see our work at www.econofact.org.

The Federal Reserve is responsible for setting monetary policy, and in this role is one of the most important economic institutions in the country, if not the world. It is an independent agency and not part of the executive, legislative, nor judicial branches of the government. This gives it the independence needed to conduct monetary policy free of political considerations. Although, politicians often attack the Fed from both the left and the right. The Fed structure and its independence allows it to act more nimbly in the face of economic crises, than Congress and the executive branch, which holds the reign on fiscal policy. We saw this in the 2008 financial and economic crisis, and we see it again now with the economic crisis caused by the pandemic. To discuss the role of the Federal Reserve and economic policy more broadly, I'm very pleased to welcome to Econofact Chats, Jeffrey Fuhrer.

Jeff has recently concluded almost four decades of work in the Federal Reserve System. First at the Board of Governors in Washington followed by more than 25 years at the Federal Reserve Bank of Boston, where he served as research director and most recently special advisor to the president of that Federal Reserve Bank. Jeff is also one of the world's leading researchers on monetary policy. Jeff, welcome to Econofact Chats.

Jeffrey Fuhrer:
Thanks, Michael. It's great to be here.

Michael Klein:
Jeff, all of our listeners will have heard of the Fed, but not everyone may be familiar with the aspects of the Federal Reserve System, such as the role of the Open Market Committee and the regional Federal Reserve Banks. Can you briefly explain how the Fed is structured and how it operates?

Jeffrey Fuhrer:
Sure. It's a federated system. And by that, I mean, it has both a center and spokes distributed around the country. The center in many regards is the Board of Governors located in Washington, DC. And then, there are 12 regional banks that are distributed in locations around the country. The locations come from the population distribution in 1913 and 1914 when The Fed was created, as well as some of the politics at the time.

Michael Klein:
Was there a lot of people in Missouri, because there is [crosstalk 00:03:08] run in Kansas City and St. Louis.
Jeffrey Fuhrer:
Apparently they held an important political power at the time, that may explain why that we've got to there. In any given year, the monetary policy making body of the Federal Open Market Committee takes representatives both from the Reserve Banks and from the board. All of the board members vote, some of the banks vote in a rotating pattern, that's a little complicated to explain. But, their job simply put is to achieve, what's called the dual mandate of the Fed, the congressional given dual mandate of low stable inflation and maximum sustainable employment.

Michael Klein:
In normal times, Jeff, how do the members of the Open Market Committee decide how to use the tools that are available to them to try to steer the economy?

Jeffrey Fuhrer:
So, they draw on a vast array of information. There are really hundreds of economists around the system who prior to each meeting, roughly every six weeks during the year, gather intelligence about financial markets, about the state of employment, production, output, domestic and international conditions, using all that data. And also, using some less formal data sources through their many contacts in the business and community development communities. Using that information, they try to assess where the economy is relative to its desired state of low moderate inflation, and maximum sustainable employment. And then, they try to figure out what monetary policy will close any gaps between where the economy is and where they'd like it to be.

Michael Klein:
And so, the tool that they typically use is the federal funds rate, right?

Jeffrey Fuhrer:
A short-term interest rate that is really the rate at which banks borrow from one another overnight.

Michael Klein:
But, these aren't normal times. And also, things were very far from normal beginning in the fall of 2008 when Lehman Brothers collapsed, and that set off the financial crisis. At times like that and in times like these, how does the operation of the Fed differ from what you just described?

Jeffrey Fuhrer:
Well, in both those times, there were two key problems that the Fed has had to address. The first is that, very quickly during that first crisis in 2008 and nine, there was a seizing up of credit and financial markets. It was almost impossible to borrow in certain markets. In particular, the commercial paper market, which is a market that is used by businesses to borrow short-term, to pay for just important everyday things like payroll and inventory.

Michael Klein:
I remember at that time, there was a concern that GM might not be able to make its payroll one week, which would have set off a widespread panic and could have sunk the economy even further.

Jeffrey Fuhrer:
Yeah, exactly right. So, that was the reason for trying to intervene in those markets, bring it back to normal, because they support everyday business functioning. But the second thing they had to contend
with of course, was that very quickly, the severity of the recession both then and this spring, require them to lower the federal funds rate to approximately zero. And at that point, you might think they're out of ammunition, but in fact, they turn to unconventional policies.

And, the goal of those policies really was to act on the interest rates in the economy that are much more directly tied to real activity. So, rates on longer-term treasuries and longer-term mortgage rates, which of course are important for business borrowing and for mortgages respectively. They bought those securities in large volumes which raised their prices, and lower the yields with the hope of stimulating the economy.

Michael Klein:
So, when you said they're almost out of ammunition, that's because interest rates really can't go negative or they can't go very negative, because basically then, you're paying the bank to hold onto your money.

Jeffrey Fuhrer:
Yeah, not very popular with depositors.

Michael Klein:
No. Even if you do get a toaster, it doesn't seem worth it. So, what you're pointing at Jeff is that, there are these financial system roles that are being played in both very short-term things like making payroll, and longer things like borrowing money to be able to have a mortgage or to buy a car, things like that. Jeremy Stein, a Harvard professor who served as the governor of the Federal Reserve was on Econofact Chats a couple of months ago. And, he talked about what happened this spring when there were unprecedentedly large outflows from bond markets and credit spreads rose very sharply.

We have an Econofact piece about that by Dan Bergstresser talks about, "The huge increase in the credit spread in the municipal bond market." The Fed stepped in at that time, very aggressively and it calmed markets, and it avoided spreading financial turmoil that would have otherwise worsen the downturn. And, he gave the Fed very high grades for tendering of the crisis this spring. Congratulations to you, Jeff.

Jeffrey Fuhrer:
We'll take that grade. I know Jeremy is a pretty tough grader.

Michael Klein:
Yeah. So what happened in the spring though, along with the events in 2008, point to the Fed's role in maintaining financial stability. Now, this is of course a good thing, but it also requires the Fed sometimes to undertake actions that can cause it to be attacked, just caring more about Wall Street and caring about Main Street.

Jeffrey Fuhrer:
And, that's an important criticism to keep in mind. But remember, that the Fed always works through financial markets. When it changes that federal funds rate, the [inaudible 00:08:08] rate, it relies on that action to be transmitted through the financial markets, to have an effect on a broad array of other asset prices that we had talked about just a moment ago.
So, that kind of requires a close partnership between the Fed and the financial markets. But at the same time, our job isn't literally to support financial markets per se, they're really just to make sure that financial markets keep functioning well enough to support non-financial activity and employment. That's the sense in which financial stability is another important goal for the Fed.

Michael Klein:
Some politicians claim that the Fed should be more accountable. There is a call for auditing the Fed a few years ago by those on the right. So, no one likes to be audited, I imagine you were against that policy. But, what would you say to those who think that the Fed should be more accountable to the political process?

Jeffrey Fuhrer:
Well, to start with, just for the record, the Fed is quite highly audited in most everything that it does, all of its many activities. But in this case, was an audit of the week-to-week, the six week Federal Open Market Committee, monetary policy decisions. And, I think most economists would agree that the technical implementation of monetary policy is best left to the central bank, in part, because the goals of Congress and the administration inherently are somewhat different from those of the Fed.

The Fed is there to stabilize the economy, full stop. If that requires raising interest rates as it sometimes does, they need to maintain the independence to do so, in order to keep an economic recovery going on and on. They can't bow to political pressure that might understandably wish to resist rate increases. But at the medium horizon, I think it's fair to say the Fed should be accountable to Congress for performing well on its delegated responsibilities. And, if Congress sees systematic shortcomings in the outcomes that are being delivered by the Fed, they should say so, and the Fed needs to be able to respond. So, I think that kind of accountability is critical in a democratic society.

Michael Klein:
There are also complaints about the Fed from the left, that the Fed doesn't take into account issues like inequality or the plight of lower income Americans. The Fed doesn't run social safety net programs, it only controls interest rates, so it's limited in what it can do. But, even with these limited tools, could it do more?

Jeffrey Fuhrer:
Well, I think it's interesting that as a part of its framework review that had conducted over the last year and a half, that included a listening tour, where the Fed engaged representatives from many of its constituents. Importantly, constituents who represent low income and minority communities that have not fared so well historically in the U.S.

But, a key takeaway from those sessions was essentially that running a hot economy, which was the case prior to the pandemic, was the best thing for these communities. It gave many occupants of those communities, residents of those communities, a chance to get a job when they might not have in the decades before. I think the Fed heard that message clearly, and that is reflected in the way they now discuss the employment leg of their dual mandate in the latest framework document. They essentially say, "They would be concerned about running too cold, an economy below full employment, but less concerned about it running hot."
Michael Klein:
So, it's no longer sort of a symmetric kind of idea, it's more that they're willing to allow the economy to run hotter as opposed to colder.

Jeffrey Fuhrer:
Right, exactly. Because, it may have these benefits that spill over to lower income neighborhoods that have just not done so well.

Michael Klein:
In Econofact Chats that I had with Karen Dynan, who's a former chief economist at the treasury. We were talking about the way in which a hot economy can help lower inequality. And, there's some evidence of that in the Fed triennial Survey of Consumer Finances. But of course now, it's moving in just the opposite direction, because the people who most hard hit by the shutdowns from the pandemic typically are lower-income people; people who are working in frontline jobs, in the service industry and so on.

Jeffrey Fuhrer:
I mean, that's one of the unfortunate consequences of the recession in the wake of the pandemic is that, we were making progress on, for example, narrowing gaps between unemployment rates for White and people of color. But then, you can see in the data since then that spread has reversed. And once again, people of color are doing worse than they were doing just couple months ago. So, that's an unfortunate implication of the pandemic and the recession.

Michael Klein:
Is that typical of recessions, or is this recession different because of its nature and the way it's affected the ability of people to work in frontline and in service jobs?

Jeffrey Fuhrer:
It's common that African-American, Latino, unemployment rates rise even faster and more rapidly than White rates, that is true. But, what had been seen was partly because the Fed was willing to run a hot economy in the 2000s. That gap had closed down. And then as you say, "Because of the nature of the disruption the pandemic caused," where it affected service workers, people in lower-income jobs that were exposed to the pandemic, more so that good trend was unfortunately reversed.

Michael Klein:
So, it's wonderful that we know that a hot economy has many benefits, including lowering inequality. But, people have raised concerns about running a hot economy, and especially that it sparks inflation. So, there's a bit of a puzzle of what's going on now with inflation. In fact, since the global financial crisis that began in 2008, inflation has seemed quite low. I had Greg Mankiw on the show in an earlier episode, he said, "There are two huge puzzles about inflation over the past decade." Why there wasn't deflation, that is negative inflation during the great recession of 2008 and 2009 when we had really high unemployment. And then, after the robust recovery, when we got down to very low unemployment in, say, 2018 and 2019, why inflation didn't rise? But, it stayed close to its 2% target in both episodes.

Greg said, "He didn't really have a good answer to why this occurred, but he sort of suspected that inflation expectations may have become well anchored," as the Fed really convinced people that 2% is what they're aiming for. Jeff, as I mentioned, you're one of the world's leading experts on the dynamics of
inflation. What are your views about these puzzles about inflation and about increasing of inflation? And, could you just start off by mentioning what is it meant by anchoring inflation and why is that important?

Jeffrey Fuhrer:
So, there are many people who believe that expectations about the future of inflation are important in determining current inflation. I have to say, "Both from the perspective of research and the perspective of common sense, how closely those are linked is an open question." I mean, to think about, to what extent the average household or the average small businesses expectations of what the Fed will do with inflation over the next two, five or 10 years. How much that affects their setting of prices or what prices they're willing to accept, is a little bit murky. But I will say this, Greg's examples definitely point out that over the last 10 or even 15 years, the sensitivity of the inflation rate to economic activity is much smaller.

Michael Klein:
That's known as the Phillips curve, right?

Jeffrey Fuhrer:
That's the Phillips curve. How sensitive is inflation to real activity, [inaudible 00:15:13] employments to employment to output. I think that is a pretty well-established empirical fact at this point, that is whether it's due to anchored expectations or not, we can do more research on that. A hot economy is less likely to produce rising inflation, and a cool economy or recession is less likely to produce significant declines in inflation. I think that's with us to stay.

I do think the question about expectations deserves further research. For one thing, we don't have great measures of the relevant expectations in the United States, and exactly how those expectations are formed and how those feed into the inflation process, is something I and many others are continuing to work on. But the less responsiveness of inflation to real activity, that seems to be a thing. And, I don't think that's going away soon.

Michael Klein:
So, that's a good thing for the Fed, right. Because of this dual mandate, you don't have to worry as much about inflation sparking up, given that it's less responsive, and the Fed can focus more on the unemployment. And as we were discussing, in fact, having unemployment run really low, because of its salutary effects on inequality.

Jeffrey Fuhrer:
Their unresponsiveness is a two-edge sword. It certainly means that running a hot economy is less risky, it's less likely to cause high inflation. On the other hand, in circumstances like today, when inflation is below 2%, when the Fed would like to see it go at least back to 2%, that's harder to accomplish as well. Because, inflation is less responsive to the real economy unless that means it's somewhat less responsive to monetary policy as well. So, that's a two-edge sword.

Michael Klein:
So Jeff, we read sometimes or one reads sometimes in the financial press, when they talk about inflation of asset prices. Now, we know that's not what inflation really means, but some people would argue that there are concerns when the Fed does run these hot economy policies, it can lead to financial excesses and bubbles, and ultimately the possibility of a crisis, like what we saw in 2008. So, how do you balance those concerns with the other ones that we've been discussing?
Jeffrey Fuhrer:
Well, that's not an easy tight rope to walk. So just to recap a bit, so if you want to run a hotter economy, on average what that means is, you're going to be running easier monetary policy, keeping interest rates lower than they might have been otherwise. And that kind of policy, low interest rates can drive investors to look for higher yield, almost always means they're going to be taking on higher risk as well. But if you look at history, hot economies and low interest rates don't always produce financial market problems. Sometimes they do, sometimes they produce bubbles, sometimes they produce excessive risk [inaudible 00:17:45], but not always. But, what I would suggest is that running an economy too hot, for too long is likely to produce some kind of an imbalance. It may not be inflation these days. It may be financial instability sometimes. It could be a significant misallocation of real resources, like building too many houses, we certainly saw that, back in 2008 and 2009. So, it's a balancing act.

I think the desire to pay attention to employment and worry more about unemployment than a little bit of overheating is probably wise, but it does bring with it some risks. And, those are ones that are not easy to balance. But the Feds, I think, pretty good at trying to strike that balance appropriately.

Michael Klein:
Well, one role that the Fed plays that we haven't talked about yet is the role of regulation. Can that be used to try to prevent financial excesses?

Jeffrey Fuhrer:
It might be, although it's a tricky thing to figure out exactly what to do. So, the first thing you need to do is identify when you're in this period in which, say, financial markets are getting a little out of whack or banks are taking on too much risk on their balance sheet. That is always a matter of debate. You can think back to 2006, seven, when some people were saying, "Hey, things are getting a bit frothy here." And other people said, "No, no, no, no, this is just the way it's supposed to be."

So, first identifying this instability is difficult. And then, what do you do when you identify that instability is tricky. Suppose you think that, say, the stock market or housing prices are getting way too high. Well, do you raise interest rates to slow down the economy and risk bursting the bubble and causing the very problem you're worried about? Do you clamp down on regulation on banks, so that they don't lend as much? And also similarly, perhaps cause a slow down, which is what you're trying to avoid. Paul Samuelson famously said, "It's very risky to play with avalanches." So, if you think there might be avalanche out there, yeah, you might think you could carefully manage it, and not have the snow all fall on top of you. But on the other hand, you might end up at the bottom of the hill on a big heap of snow and be in big, big trouble.

So yes, I think it's a thing to think about. I think it's better to think about ex-ante, building in robustness into the financial system rather than trying to tailor particular regulatory approaches during what might be a buildup of financial imbalance. That's a really hard thing to do.

Michael Klein:
Well, the Fed is faced with lots of hard things to do, almost all the time. And, I'm really appreciative for one, that we have people of your quality and your commitment to public service who served in the Federal Reserve System. So Jeff, thanks very much for both speaking with me today and for all your years of public service.
Jeffrey Fuhrer:
Well, my pleasure on both counts.

Michael Klein:
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