

Lessons from History, Policy for Today

Mary C. Daly, President and Chief Executive Officer
Federal Reserve Bank of San Francisco

Economic Club of New York Virtual Webinar
New York, NY
March 2, 2021
02:00 PM EST

Remarks as prepared for delivery.

Introduction

In February of last year, right before COVID-19 hit our shores, I was in Ireland. Walking around Dublin one day, I happened upon a converted warehouse with artists selling their work. One of the artists had a wall of beautifully colored, tiny framed prints. Each one was etched with the phrase “History Will Repeat Itself” followed by an arrow pointing to the future. It seemed a pessimistic, almost fatalistic view, so I asked him if he had painted it out of prophecy or fear. He answered, somewhat gruffly, “Both.”

As an unrelenting optimist, I saw something different in his work—the potential for agency. For people and institutions to learn from the past and use those lessons to shape a better future.

At the Federal Reserve, we have a practical test before us. With much welcomed light at the end of the COVID tunnel, we must work to return the economy to full employment and price stability. This is a tall order. Millions of Americans are out of work and inflation remains well below our target.

At the same time, a swell of market and academic commentary has started to emerge about a quick snapback, an undesirable pickup in inflation,

and the need for the Federal Reserve to withdraw accommodation more quickly than expected.¹ I see this as the tug of fear. The reaction to a memory of high and rising inflation, an inexorable link between unemployment, wages and prices, and a Federal Reserve that once fell behind the policy curve.

But the world today is different, and we can't let those memories, those scars, dictate current and future policy. We need to learn from history without letting it drive our actions. We must consider all the lessons from our past, not just the ones that frighten us.

This is what I will tackle today.

But before I go further, let me remind you that my remarks are my own and do not necessarily reflect the views of anyone else within the Federal Reserve System.

Students of History

The Old Normal

I started at the Federal Reserve Bank of San Francisco in 1996 and became deeply steeped in the standard macroeconomic logic that many of us learned. It goes like this. There is a level of unemployment in the economy below which wage and price inflation will start to pick up. Once that begins, the feedback loop between prices and wages and wages and prices will spiral and be hard to control. So, prudent central bankers should avoid that situation, even try to stave it off. Given that monetary policy works with a lag, this means we need to be forward-looking and respond to expected future inflation to ensure that actual inflation remains close to target.

¹ See, for example, discussion in Casselman (2021) and Irwin (2021).

In this simple model, our key tool was, among others, the Phillips Curve, which captures the tradeoff between unemployment and inflation. The Phillips Curve had the additional feature of delivering a non-accelerating inflation rate of unemployment, or NAIRU, which could be used to gauge the level of full employment. We also applied expectations theory, which posits that future inflation depends largely on *expectations* about future inflation.

With these tools in hand, it felt straightforward to assess where the economy stood relative to the Federal Reserve's dual mandate goals. If unemployment was below or projected to be below NAIRU, wage and price inflation would start to build and economic agents would begin to expect higher future inflation. A responsive and proactive Fed would pull the reins on growth and the labor market and broader economy would settle at our full employment and price stability goals.

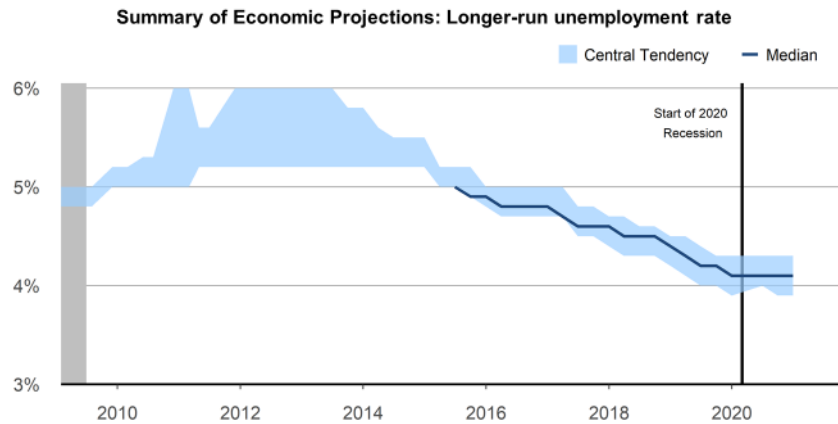
Of course, many other factors made this very simple system work. First, the real neutral rate of interest, or r -star, was well above zero, roughly in the range of 2 to 3 percent. Combined with inflation expectations above 2 percent, the Fed had plenty of room on both sides of the business cycle to adjust the federal funds rate and stimulate or restrain growth. Second, inflation was highly responsive to economic activity. In other words, the Phillips curve was steep. So, changes in policy that impacted growth and employment had a concurrent and significant effect on inflation.

The New Normal

Compared with this old normal, our new normal is almost an "opposite world." Here is what I mean. There is still some level of unemployment below which wage and price inflation will pick up, but it's hard to know, a priori,

where it is. We saw this in the last expansion, when Fed policymakers continuously lowered their estimates of the longer-run rate of unemployment in the face of modest inflationary pressures.

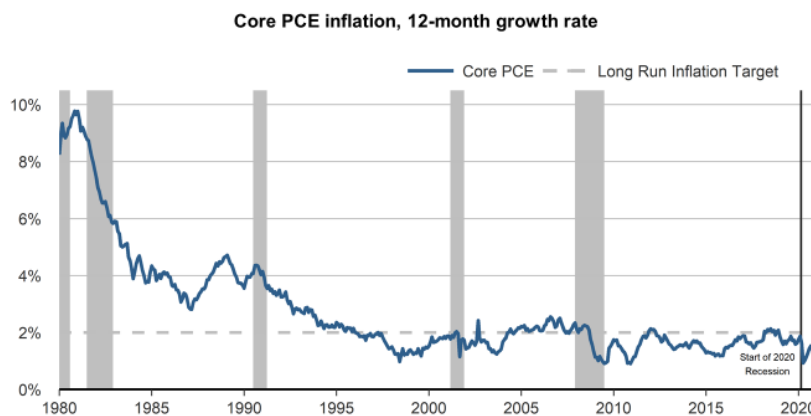
Maximum employment is a moving target



Source: Federal Reserve Board.

The dynamics of inflation have also changed. Inflation is far less responsive to movements in output and employment than in previous decades. Indeed, despite a near eleven-year expansion and historically low unemployment, inflation has remained stubbornly below our 2 percent target since the Great Recession.

Inflation has rarely surpassed 2% in recent years



Source: Bureau of Economic Analysis.

This reflects, in part, a weakening of the traditional links between unemployment, wages, and prices. A large literature confirms this, showing that the Phillips Curve has become quite flat in recent years.² Declines in bargaining power for workers, fierce competition in product markets (think Amazon), and a labor force that is far more elastic than most imagined have all played a role.³ Each of these factors are likely to continue to persist in the coming years, requiring us to adjust our policies to adapt to the new environment.

We will need to make these adjustments in an environment that also looks quite different than the old normal. The real neutral rate of interest is expected to remain at very low levels, not much above zero, for some time. In this world, keeping inflation expectations well-anchored at 2 percent will be essential. As I noted earlier, inflation expectations are an important determinant of future inflation.⁴ So any drift down translates into lower inflation, a lower nominal funds rate, and fewer rate cuts when the economy needs them. In this context, long periods of below-target inflation, like the one we are experiencing, are costly.

Adapting for Today

The lessons of the last decade and projections of our future conditions tell us that, for the foreseeable future, the Federal Reserve will face an uphill battle using conventional monetary policy to keep the economy healthy, the labor market strong, and inflation at our 2 percent goal.⁵

² See for example Blanchard (2016), Lansing (2019), Leduc, Marti, and Wilson (2019).

³ Daly (2019a, b).

⁴ Jordà et al. (2019a, b).

⁵ Mertens and Williams (2019), Amano, Carter, and Leduc (2019).

The Federal Open Market Committee’s new policy framework is an explicit recognition of these realities.⁶ It reflects the learnings of current and past FOMC participants, as well as inputs from our year-long review process that included evidence from research and feedback from the businesses and communities we serve.⁷

The resulting revised framework reemphasizes our commitment to maximum employment and stable prices and makes changes to our policy strategy that will make each of these goals easier to achieve.

Clarifying Maximum Employment

Starting with maximum employment, the new framework states that policy decisions will be informed by “assessments of the shortfalls of employment from its maximum level” rather than by “deviations from its maximum level.” In other words, in the absence of inflationary pressures, we will not pull back the reins on the economy in response to a strong labor market.

The statement also emphasizes that maximum employment is a broad and inclusive goal. In assessing whether it has been reached, there is no single number that tells the story. Instead, we will examine a wide range of indicators—measures like unemployment, labor force participation, job finding, and wage growth—across a broad distribution of workers.

As we apply this strategy, our most important virtue will be patience. We will need to continually reassess what the labor market is capable of and

⁶ See Board of Governors (2020)

⁷ See the discussion of the *Fed Listens* initiative on the Board of Governors website: <https://www.federalreserve.gov/monetarypolicy/review-of-monetary-policy-strategy-tools-and-communications.htm>

avoid preemptively tightening monetary policy before millions of Americans have an opportunity to benefit. These efforts are critical to support the broad economy and aid the inclusion of historically less advantaged groups, including people of color, those lacking college degrees, and others who face systemic barriers to equitable employment and wages.⁸

Getting to 2 Percent Inflation

Regarding price stability, the new framework reaffirms the committee's commitment to a 2 percent inflation objective but adds that this means achieving inflation that averages 2 percent over time. To achieve this, the FOMC will employ flexible average inflation targeting. Specifically, following periods when inflation is below 2 percent, appropriate monetary policy will aim to move inflation above 2 percent for some time.

This will ensure that inflation expectations remain well-anchored at 2 percent, even when policy is more frequently constrained by the zero lower bound. This approach helps put a floor under inflation expectations, enhancing our ability to achieve our full employment and price stability goals.

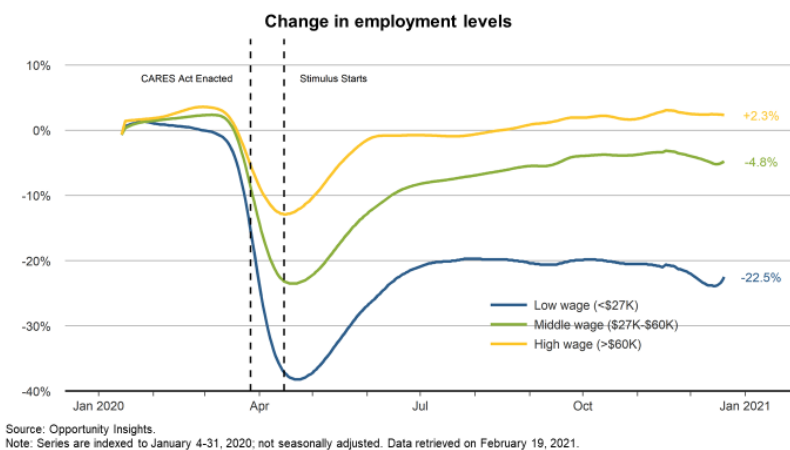
Practically, the new framework allows us to retain our vigilance against inflation that is too high, while improving our ability to keep inflation from falling too low. It applies the lessons from all of our history and recognizes that persistent misses on either side of the target can leave lasting damage on expectations and the economy.

An Unwanted Test

⁸ Aaronson et al. (2019), Petrosky-Nadeau and Valletta (2019).

Although the evolution of the framework I just described predates the pandemic, it is exactly what we need to support the economy through this difficult time. In addition to its wrenching toll on health, the virus has severely depressed economic activity. Millions of workers remain unemployed and hundreds of thousands of businesses shuttered, some of them permanently. Digging beneath the aggregate numbers shows that a disproportionate share of affected workers come from the lower half of the wage distribution.⁹

Job losses more severe for low-wage workers



Consistent with historical barriers to education and employment, these losses are also concentrated among communities of color.¹⁰

Inflation has also been pushed down by the pandemic. After falling sharply last year, it has improved as the economy has rebounded. But COVID-sensitive sectors remain a drag on overall inflation.¹¹ And even when those sectors have fully recovered, it will likely be some time before inflation is sustainably back to 2 percent.

⁹ Similarly, losses are concentrated among those with less than a college degree, Daly, Buckman, and Seitelman (2020).

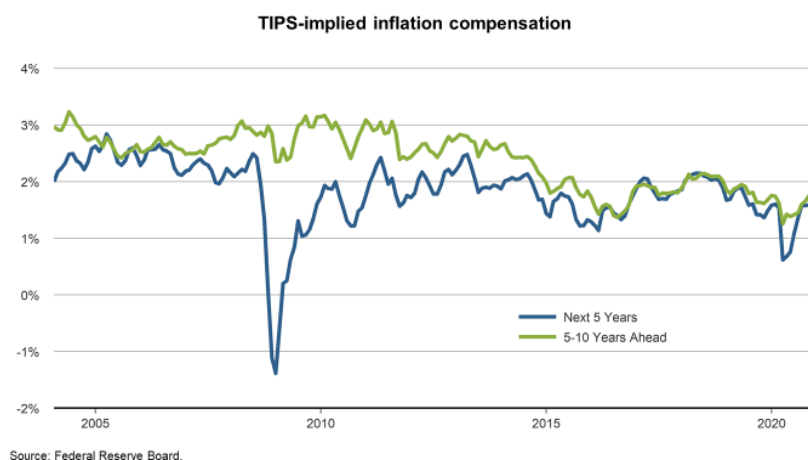
¹⁰ Gould and Wilson (2020), Kochhar (2020), Powell (2021a).

¹¹ Shapiro (2020).

Getting fully past this crisis and back on track to achieve our dual mandate goals will require monetary policy to be accommodative for some time. We must make sure that everyone who lost their job or left the labor force to care for children or other family members has an opportunity to return.¹² We also need to offset the downward inflation pressures created by the pandemic and get back to moving inflation towards our average 2 percent goal.

And this brings me back to the fearful swirl about spikes in inflation and the need to preemptively offset them. Of course, we need to be vigilant against all the risks in the economy, but we also must weight them by their likelihood and expected cost. As for the likelihood of runaway inflation, I don't see this risk as imminent, and neither do market participants.

Investors are not worried about inflation



Instead, I view the recent rise in inflation compensation to roughly 2 percent as encouraging and in line with our stated goals. It suggests that our

¹² Lofton, Petrosky-Nadeau, and Seitelman (2021). Chair Powell also alluded to this issue in the Q&A following his most recent Congressional testimony (Powell 2021b).

FINAL

commitment to flexible average inflation targeting has already gained substantial credibility.

But what about the costs? The memory of the 1970s and 1980s and the painful correction it required looms large. But that was more than three decades ago, and times have changed. Today, the costs are tilted the other way. Running inflation too low for too long can pull down inflation expectations, reduce policy space, and leave millions of Americans on the sidelines along the way.

History Will Repeat Itself, Unless We Learn

So, I'll end by returning to my Irish artist friend. I bought one of his prints and put it on my office bookshelf. I keep it as a reminder that the weight of the past can be a powerful force, pulling us back to what has been. To shake its grasp requires diligence and intention, an active commitment to be students of history but not victims of it.

To do otherwise will fall short, leaving us like the picture, destined to repeat ourselves.

References

- Aaronson, Stephanie, Mary C. Daly, William Wascher, and David W. Wilcox. 2019. "Okun Revisited: Who Benefits Most from a Strong Economy?" *Brookings Papers on Economic Activity* Conference Draft, Spring. <https://www.brookings.edu/bpea-articles/okun-revisited-who-benefits-most-from-a-strong-economy/>
- Amano, Robert, Thomas J. Carter, and Sylvain Leduc. 2019. "Precautionary Pricing: The Disinflationary Effects of ELB Risk." FRB San Francisco Working Paper 2019-26. <https://doi.org/10.24148/wp2019-26>
- Blanchard, Olivier. 2016. "The Phillips Curve: Back to the '60s?" *American Economic Review* 106(5), pp. 31–34.
- Board of Governors of the Federal Reserve System. 2020. "Statement on Longer-Run Goals and Monetary Policy Strategy." August 27. <https://www.federalreserve.gov/monetarypolicy/review-of-monetary-policy-strategy-tools-and-communications-statement-on-longer-run-goals-monetary-policy-strategy.htm>
- Board of Governors. 2021. "Federal Reserve issues FOMC statement." Press release, January 27. <https://www.federalreserve.gov/newsevents/pressreleases/monetary20210127a.htm>
- Carvalho, Carlos, Andrea Ferrero, and Fernanda Nechio. 2016. "Demographics and Real Interest Rates: Inspecting the Mechanism." *European Economic Review* 88, pp. 208–226.
- Casselmann, Ben. 2021. "On the Post-Pandemic Horizon, Could That Be ... a Boom?" *New York Times*, February 21. <https://www.nytimes.com/2021/02/21/business/economy/pandemic-economic-boom.html>
- Daly, Mary C. 2019a. "The Bumpy Road to 2 Percent: Managing Inflation in the Current Economy." Remarks to The Commonwealth Club, San Francisco, CA, March 26. <https://www.frbsf.org/our-district/press/presidents-speeches/mary-c-daly/2019/march/the-bumpy-road-to-2-percent-managing-inflation-in-the-current-economy/>
- Daly, Mary C. 2019b. "A New Balancing Act: Monetary Policy Tradeoffs in a Changing World." Speech at the Reserve Bank of New Zealand, Wellington, NZ. August 29. <https://www.frbsf.org/our-district/press/presidents-speeches/mary-c-daly/2019/august/a-new-balancing-act-monetary-policy-tradeoffs-in-a-changing-world/>

- Daly, Mary C., Shelby R. Buckman, and Lily M. Seitelman. 2020. "The Unequal Impact of COVID-19: Why Education Matters." *FRBSF Economic Letter* 2020-17 (June 29).
<https://www.frbsf.org/economic-research/publications/economic-letter/2020/june/unequal-impact-covid-19-why-education-matters/>
- Gould, Elise, and Valerie Wilson. 2020. "Black Workers Face Two of the Most Lethal Preexisting Conditions for Coronavirus—Racism and Economic Inequality." Report, Economic Policy Institute, June 1. <https://www.epi.org/publication/black-workers-covid/>
- Holston, Kathryn, Thomas Laubach, and John C. Williams. 2017. "Measuring the Natural Rate of Interest: International Trends and Determinants." *Journal of International Economics* 108, supplement 1 (May), pp. S39–S75.
- Irwin, Neil. 2021. "The Clash of Liberal Wonks That Could Shape the Economy, Explained." *New York Times*, The Upshot, February 8.
<https://www.nytimes.com/2021/02/08/upshot/the-clash-of-liberal-wonks-that-could-shape-the-economy-explained.html>
- Jordà, Òscar, Chitra Marti, Fernanda Nechio, and Eric Tallman. 2019a. "Inflation: Stress-Testing the Phillips Curve." *FRBSF Economic Letter* 2019-05 (February 11).
<https://www.frbsf.org/economic-research/publications/economic-letter/2019/february/inflation-stress-testing-phillips-curve/>
- Jordà, Òscar, Chitra Marti, Fernanda Nechio, and Eric Tallman. 2019b. "Why Is Inflation Low Globally?" *FRBSF Economic Letter* 2019-19 (July 15).
<https://www.frbsf.org/economic-research/publications/economic-letter/2019/july/why-is-inflation-low-globally/>
- Kochhar, Rakesh. 2020. "Hispanic Women, Immigrants, Young Adults, Those with Less Education Hit Hardest by COVID-19 Job Losses." Fact Tank, Pew.
<https://www.pewresearch.org/fact-tank/2020/06/09/hispanic-women-immigrants-young-adults-those-with-less-education-hit-hardest-by-covid-19-job-losses/>
- Lansing, Kevin J. 2019. "Improving the Phillips Curve with an Interaction Variable." *FRBSF Economic Letter* 2019-13 (May 6). <https://www.frbsf.org/economic-research/publications/economic-letter/2019/may/improving-phillips-curve-with-inflation-output-gap-interaction-variable/>
- Leduc, Sylvain, Chitra Marti, and Dan Wilson. 2019. "Does Ultra-Low Unemployment Spur Rapid Wage Growth?" *FRBSF Economic Letter* 2019-02 (Jan. 14).
<https://www.frbsf.org/economic-research/publications/economic-letter/2019/january/does-ultra-low-unemployment-spur-rapid-wage-growth/>
- Lofton, Olivia, Nicolas Petrosky-Nadeau, and Lily Seitelman. 2021. "Parents in a Pandemic Labor Market," FRB San Francisco Working Paper 2021-04.
<https://www.frbsf.org/economic-research/publications/working-papers/2021/04/>

- Mertens, Thomas M., and John C. Williams. 2019. “Monetary Policy Frameworks and the Effective Lower Bound on Interest Rates.” *American Economic Association Papers and Proceedings* 109 (May), pp. 427–432.
- Petrosky-Nadeau, Nicolas, and Robert G. Valletta. 2019. “Unemployment: Lower for Longer?” *FRBSF Economic Letter* 2019-21 (August 19).
<https://www.frbsf.org/economic-research/publications/economic-letter/2019/august/unemployment-lower-for-longer/>
- Powell, Jerome H. 2021a. “Getting Back to a Strong Labor Market.” Speech to the Economic Club of New York, (via webcast), February 10.
<https://www.federalreserve.gov/newsevents/speech/powell20210210a.htm>
- Powell, Jerome H. 2021b. “Semiannual Monetary Policy Report to the Congress.” Remarks delivered to the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, February 23.
<https://www.federalreserve.gov/newsevents/testimony/powell20210223a.htm>
- Shapiro, Adam Hale. 2020. “Monitoring the Inflationary Effects of COVID-19.” *FRBSF Economic Letter* 2020-24 (August 24). <https://www.frbsf.org/economic-research/publications/economic-letter/2020/august/monitoring-inflationary-effects-of-covid-19/>