

Ensuring robustness with a simple policy rule: The Fed's post-pandemic inflation experience

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A simple rule as a cross-check: Jan Qvigstad's criterion 6

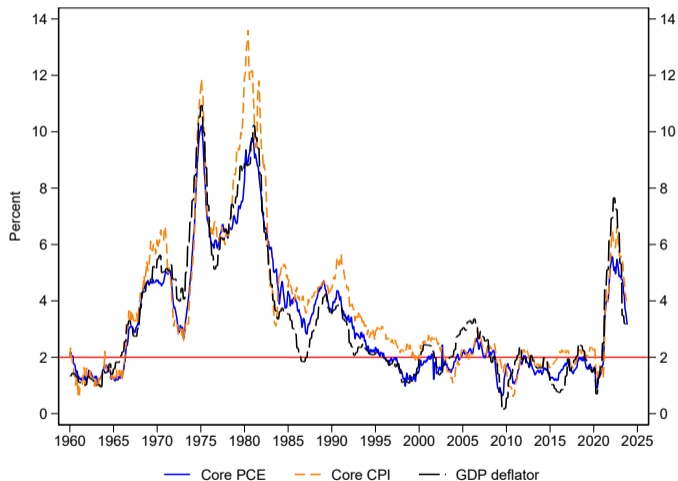
6. It may also be useful to cross-check by assessing interest rate setting in the light of some simple monetary policy rules. If the interest rate deviates systematically and substantially from simple rules, it should be possible to explain the reasons for this.

Norges Bank, *Inflation Report with monetary policy assessments*, 1/2005, p. 28.

Qvigstad, Jan. When does an interest rate path “look good”? Criteria for an appropriate future interest rate path. Norges Bank Working Paper 2006/5.



The post-pandemic inflation in historical context

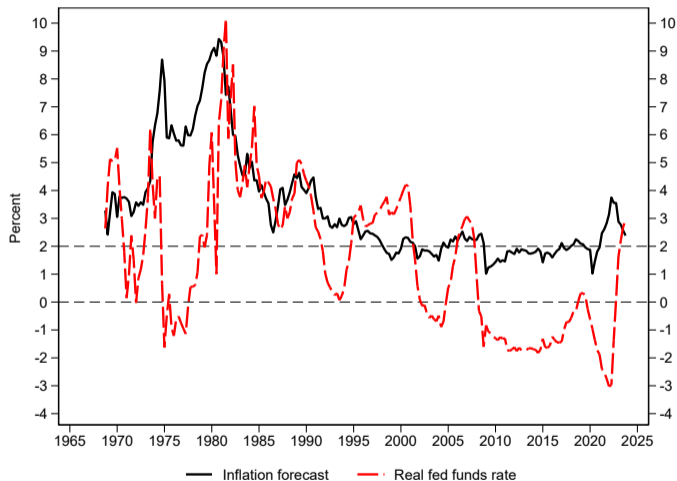


Alternative measures of inflation for the United States.

Year-on-year, monthly for PCE/CPI, quarterly for deflator.



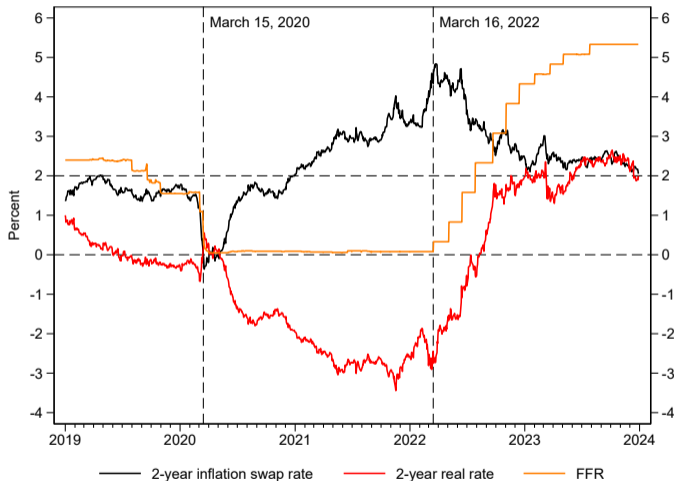
Inflation forecasts and real rates in historical context



Inflation forecast: Year-ahead SPF median GNP/GDP deflator, growth from previous quarter. Real fed funds rate is quarter-average rate minus inflation forecast.



The Fed's post-pandemic policy error and recovery



Real rate is the two-year OIS rate minus the two-year inflation swap rate.

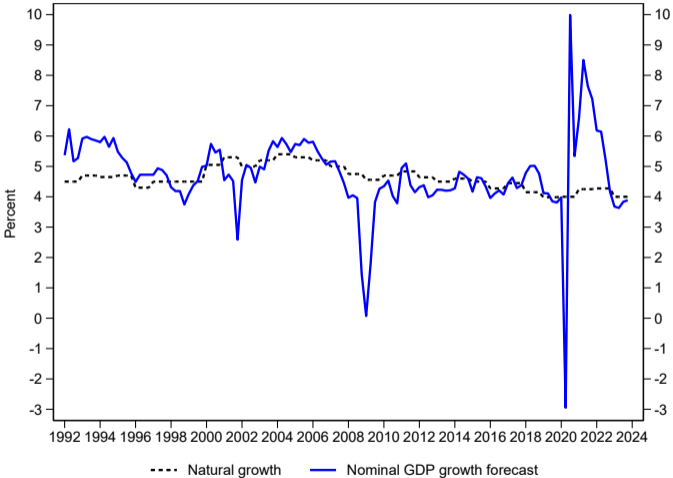


A Natural Growth Targeting rule

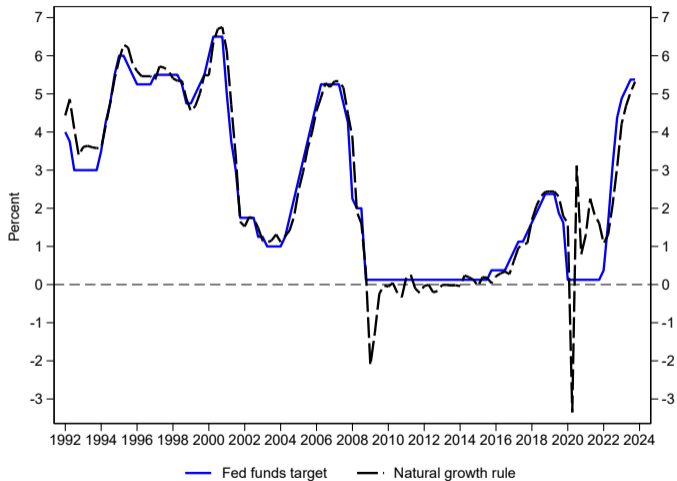
- ▶ Let $(n - n^*)$ be the deviation of nominal income growth from normal.
- ▶ Rule has the form of a one-parameter “difference” rule:
$$\Delta i = \theta(n - n^*)$$
- ▶ To ensure rule is operational need to also:
 - ▶ specify real-time data/projections for n
 - ▶ define “normal” growth, n^* , accounting for variation of real potential output growth to ensure the rule delivers price stability consistently over time.
- ▶ An illustration based on FRB Philadelphia SPF (median forecasts):
 - ▶ Use nominal GDP, year-ahead growth from previous quarter, for n .
 - ▶ Use long-term real GDP forecast plus Fed's 2% inflation goal for n^* .
 - ▶ Set $\theta = 0.5$.



Inputs to Natural Growth Rule

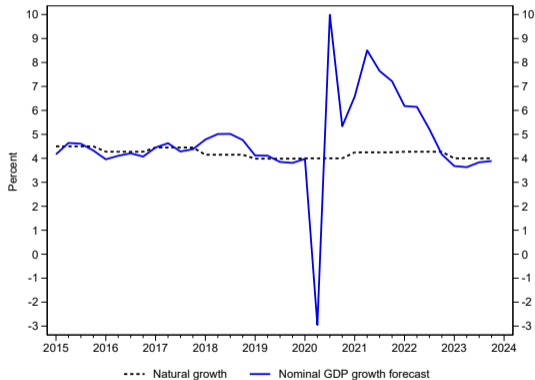


Natural Growth Rule



A simple rule have helped avoid the post-pandemic inflation

Inputs



Prescription

