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INSIGHT

Why Hasn't the Federal Reserve Tightened Monetary Policy in Response to Higher Inflation?

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Inflation (the rise in the price of goods and services) has been unusually high in recent months, reaching 4% as measured by the personal consumption expenditures index (PCE) over the 12 months ending in June 2021. For more information, see CRS Insight IN11644, *Is High Inflation a Risk in 2021?*, by Mark P. Keightley, Marc Labonte, and Lida R. Weinstock.

The Federal Reserve has a statutory mandate to achieve maximum employment and stable prices, which the Fed defines as 2% inflation as measured by the PCE. The Fed implemented monetary stimulus in response to the deep decline in economic activity caused by the COVID-19 pandemic, including reducing interest rates to near zero and purchasing trillions of dollars of assets, popularly referred to as "quantitative easing." For more information, see CRS Report R46411, *The Federal Reserve's Response to COVID-19: Policy Issues*, by Marc Labonte.

Higher inflation creates a conflict in how the Fed should approach its two statutory goals—it could tighten policy in response to higher inflation or maintain stimulus to address the employment shortfall. The Fed has signaled that it does not intend to withdraw monetary stimulus in the near term. In July 2021, it stated that it did not intend to raise interest rates above zero "until labor market conditions have reached levels consistent with the Committee's assessments of maximum employment and inflation … [and] is on track to moderately exceed 2 percent for some time" and also that it would not reduce its asset purchases for the time being.

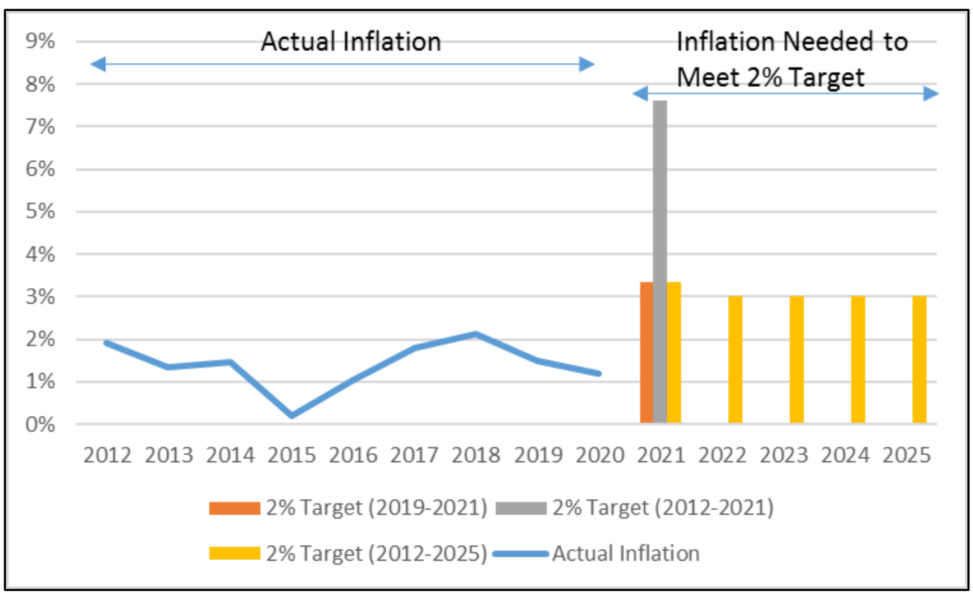
Rationales for Maintaining Stimulus

There are several reasons the Fed believes that maintaining current stimulus is necessary. First, employment—almost 7 million below its pre-pandemic level—is still below what the Fed believes maximum employment to be. Second, the pandemic, in the midst of the Delta variant surge, still poses risks to the economic recovery. Third, the inflation measure the Fed focuses on in the short term, core PCE, is closer to the Fed's target than the measure the media typically focuses on—the headline consumer price index, which is currently about two percentage points higher. Fourth, although higher inflation has already materialized, the Fed does not believe that high inflation will persist or that inflationary expectations will rise. Fed leadership projected in June that inflation will fall to around 2% by 2022.

A final reason the Fed has not tightened policy is that persistent undershooting of its inflation target has led the Fed to believe that too-low inflation is a greater risk to price stability than is high inflation. From 2012, when the Fed introduced its 2% target, to 2020, PCE inflation was modestly below 2% each year except for 2018. In response, the Fed changed its monetary policy strategy in 2020 by explicitly stating that it would try to overshoot 2% inflation after periods when inflation has been below 2% in order to achieve a 2% average over time.

Because inflation has been below 2% in most years since the 2007-2009 financial crisis, a period of inflation above 2% is needed to return to an average inflation rate of 2%. How much higher and for how long depends on the starting point. For example, the last time headline PCE exceeded 2%, it was 2.1% in 2018. If 2019 is taken as the starting point, average inflation would average almost exactly 2% from 2019 to 2021 if the Fed's median projection for 2021 (3.4%) is correct (see **Figure 1**). In other words, an inflation rate of 3.4% in 2021 is necessary to achieve a three-year average inflation target of 2%. Since inflation was below 2% for several years before 2018, one could also pick an earlier starting point for the average inflation target. To average 2% inflation over the 2012-2021 period, inflation would have to be 7.6% in 2021 to make up for the shortfall. Alternatively, inflation would have to be 3% every year from 2022 through 2025 to reach an average of 2% (assuming the Fed's projection for 2021 is correct). One can disagree with the Fed's strategy, but if the Fed reacted to the current increase in inflation by tightening policy, it would make it less likely that average inflation would reach its target of 2% because of past shortfalls.

Figure 1. Average Inflation Target Under Various Assumptions



Source: CRS calculations using Bureau of Economic Analysis data.

Notes: See text for details.

Risks of Current Fed Strategy

The Fed's decision to not withdraw stimulus in reaction to inflation that is already above its 2% target underlines how its strategy for achieving price stability has changed. From the 1980s to the financial crisis, the Fed's strategy was to tighten monetary policy preemptively *before* higher inflation had emerged. It believed that this was necessary because of lags in the time it took for a change in monetary policy to affect inflation and in order to keep inflationary expectations contained. Now, the Fed is signaling it would wait until *after* higher inflation has proven to be persistent to raise rates.

The Fed may be correct in its assessment today that higher inflation will not persist, but if it is wrong, it might not realize until it is too late and higher inflation has become embedded in people's expectations. In that case, it could be costly to the economy to get the "inflation genie back in the bottle" down the road. To some critics, this change in philosophy is a sign that the Fed no longer has the same commitment to ensuring price stability. This could be problematic, because if individuals believe the Fed is no longer committed to low inflation, it makes it harder for the Fed to achieve low inflation because inflationary expectations could become unmoored.

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