MarketWatch

Fed's Williams defends central bank's new average inflation targeting policy from criticism

Gregg Robb

November 18th, 2021

New York Federal Reserve President John Williams on Wednesday defended the central bank's new strategy for inflation from critics who say it is holding the central bank from taking obvious moves to bring cool prices.

"Have the fundamentals factors that drove us to change our framework – do I think those have changed? The answer is very clearly no," Williams said during a virtual discussion sponsored by the European Commission.

In the fall of 2019, well before the pandemic, the Fed adopted a strategy, called "flexible average inflation targeting" to allow for inflation "overshoots." While the Fed kept its goal for inflation that averages 2% over time, it said it would allow periods of higher inflation to make up for periods of inflation below target. Some economists said that, in essence, the Fed was raising its inflation target to 2.5%.

As inflation has soared these year, criticism of the Fed's new strategy has also risen. Consumer price rises are now running above 6%, the strongest level in 30 years.

In a column Thursday, Martin Wolf, the noted economic correspondent at the Financial Times, called the Fed's new framework nonsense.

"It has never made sense to me that the world's leading central bank should respond to its past failures by deliberately making opposite mistakes in future," Wolf wrote.

Wolf added the Fed's decision to keep monetary policy locked into the same settings introduced in March 2020 "seems wildly inappropriate."

At a conference sponsored by the Cato Institute on Thursday, Raghuram Rajan, the former head of India's central bank and now a professor at the University of Chicago Booth School of Business, said the Fed's new framework seemed to have caused a shift of behavior from time-honored ways of fighting inflation.

In the past, when the Fed saw inflation, regardless of how it was caused, “they would get in front of microphones, square their shoulders and say ‘we hate inflation, we’ll do something about it quickly’,” Rajan said.

This time, central bankers are making excuses for inflation, calling it transitory and saying it will go away, he added.

“The behavior of the past now seems aggressive. And there is a risk that we have “the wrong framework for the wrong regime” if the global economy has moved away from a low-inflation era, he added.

In his remarks, Williams said the goal of the Fed’s new strategy is to anchor inflation expectations at 2% target. In the wake of the 2008 financial crisis, financial markets came to expect inflation under 2% – this helps to keep economic growth sluggish.

Williams acknowledged that the U.S. is seeing a broader-based increase of inflation. this year and it is not just some special categories.

“We definitely have seen a pickup in underlying inflation in the U.S. that we are studying carefully,” Williams said.

Williams said that investor and market expectations of inflation over the long-run have moved up quite a bit — which he called a positive development.

“But you wouldn’t want those longer-run inflation expectations to move significantly further up,” he added.

Williams said the Fed is dealing with “a very unique set of circumstances.”

Demand is strong for goods and services and supply constraints are a factor in the labor market and shipping.

“I do think our framework is well suited for this because it does start from this point that we really want to make sure inflation expectations are well anchored at 2%,” he said.

“We just have to do what we always do – which is to make sure we do our very best to achieve these goals [of stable prices and maximum employment] consistently,” he added.

The good news is the economy “is roaring back, and “getting better faster,” Williams said.

However, the economy is still grappling with the negative affects of the pandemic. And high inflation is very difficult – especially for people on fixed incomes, he said.