Monetary Policy Responses to Shocks

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- Most countercyclical monetary policy research focuses on Fed responses to the business cycle and whether MP appropriately smooths the cycle and achieves the Fed’s dual mandate
- This paper assesses shocks to the economy and how the Fed adjusts MP in response to them
- We consider the three big shocks (the Great Inflation, he Great Financial Crisis and Covid) and other smaller disturbances or constraints the Fed has had to deal with

Summary and Introduction

- Our findings show that the Fed has tended to respond to shocks in ways that often lengthen and increase the harm the initial shock imposed on the economy and inflation
- The Fed tends to respond to each shock unsystematically
- Its judgment on the impacts of the external disturbances to supply and demand, and the impacts of its policies, are unreliable
- The Fed typically does not carefully distinguish appropriate responses to shocks in supply and demand
- Monetary policy would benefit from a careful assessment of history

Different Types of Shocks

- Shocks to the economy can vary in character
- They can involve shocks to supply and/or demand
- Covid was a purely exogenous shock
- The Great Inflation of 1965-1982 combined the exogenous oil price shocks plus bad economic (fiscal, regulatory, etc.) policies
- The Great Financial Crisis was generated by or facilitated by bad monetary and economic policies
- Besides the big shocks, history is replete with different minor disturbances and disruptions

Appropriate Responses to Shocks

- Theory suggests that the Fed should “lean against” shocks to demand and “look through” supply shocks; that is,
- The Fed should ease in response to a negative demand impulse and tighten policy in response to a positive demand impulse with the goal of smoothing aggregate demand
- The Fed should not respond to supply shocks
- Monetary policy is an aggregate demand tool that is incapable of offsetting the economic impacts and distortions of supply disturbances
- Many shocks are temporary; while impacts are quick, monetary policy impacts lag; monetary accommodation may embed inflation and inflationary expectations

Consideration of Shocks and Disturbances

- We will now assess the three big shocks—the Great Inflation, the Great Financial Crisis, and the Covid pandemic—and consider an array of minor disturbances

The Great Inflation, 1965-1982

- The Great Inflation of 1965-1982 was much more than the two oil price shocks of 1973 and 1979
- It began in the mid-1960s and involved decided misguided economic policies
- Surges in government spending & purchases relating to Vietnam War and Great Society programs generated big increase in demand
- President LBJ pressured Fed Chair William McChesney Martin to to raise rates; Fed gives in to pressure, raises rates less than 1-for-1
- Fed accommodation of fiscal excesses generates rise in inflation from 1.5% in 1965 to 6% in 1969; ends dozen years of low inflation

Inflation, Arthur Burns and Labor Strikes

- Monetary tightening post-LBJ generates slump in demand and economic weakness in 1970
- Burns becomes Fed Chair in February 1970
- U.S. Postal System strike in 1970Q1 temporarily harms economy and then GM strike in Q4 generates one-quarter recession
- Burns aggressively lowers rates from 9% in early 1970 to 3.7% in early 1971, below inflation
- Burns believes inflation is due to non-monetary factors and doesn’t trust monetary policy

The Nixon Shock & Burns-Nixon in 1972

- Rising inflation and associated fall in US dollar led to significant repatriation of gold from U.S., threatening U.S. stock of gold reserves
- Nixon abandons gold standard (August 1971); this effectively eliminates anchor of price stability; new anchor of low inflation
- Imposition of wage and price controls—a decidedly non-monetary solution
- Burns's easy monetary policy that aimed to help Nixon's re-election in 1972 leads to sharp acceleration in money and aggregate demand
- Wage and price controls initially restrain inflation; boom in real economic activity

The 1973 Oil price shock

- Inflation overpowered wage and price controls, and inflation rose to 8% *before* the first oil price shock in November 1973
- 3-fold spike in oil prices shocks supply & demand and triggers deep recession through 1975Q1
- Inflation falls to 5.5% in 1977, but reaccelerates, boosted by accommodative MP
- Rising inflationary expectations and loss of Fed and government credibility triggers US dollar crisis (dollar crisis, Carter bonds, etc.)
- Inflation was already 9% before the second oil price shock unfolded in 1979

Volcker and the Fed’s Disinflationary MP

- Volcker-led Fed shifts to aggressive monetary tightening in October 1979, raising rates to 17% by April 1979
- President Carter forces Fed to impose credit controls, despite Volcker’s opposition
- Deep one-quarter recession (1980Q2) leads Fed to reduce rates to 9%; dramatic recovery when controls are lifted and Fed resumes aggressive tightening
- Regaining inflation-fighting credibility difficult and complicated by misguided credit controls
- Short-run costs of braking inflation: back-to-back recessions

The Great Financial Crisis

- The GFC was not an exogenous shock; it had been brewing for years as a culmination of the debt-financed housing bubble facilitated by a sustained period of low rates, Fannie and Freddie, lax credit conditions, a proliferation of complex MBS derivatives, and poor financial supervision
- Fed's earlier fears of a Japan-style deflation led it to tilt toward easier policy in the early 2000s that would avoid inflation at all costs
- Too-low-for-too-long rates facilitated debt-financed housing bubble, along with lax credit and expanded balance sheets of GSEs
- Fed lacked necessary understanding of complex MBS derivatives and bank leverage and capital—a failure of supervision

GFC and Fed Responses

- The Fed provided alternative liquidity facilities to financial “hotspots”, but argued that the housing financial crisis would be contained
- After Lehman Brothers’ failure, financial markets unraveled
- Congress enacted the Emergency Stability Act of 2008, including TARP
- The Fed lowered rates to zero and initiated QEI, which involved large purchases in MBS
- Besides its monetary policy, the Fed coordinated with the Treasury to purchase credit and otherwise be involved in credit allocation

The GFC and the Fed

- The Fed’s activist monetary and credit policies helped to end the financial crisis
- The scope of the Fed had been expanded by its crisis-management
- Following QEI, Bernanke emphasized that QEI was emergency credit policy (MBS only) and Fed would unwind on a timely basis
- Fed projected very strong recovery from GFC, based on fiscal and monetary policy stimulus
- Anemic recovery, with soft aggregate demand and low inflation, likely constrained by wealth effect on consumption and investment

Modest Recovery and Fed’s Evolving Tilt

- Fed engages in QEII, operation twist, and QEIII
- QEIII transformed emergency, unconventional policy of LSAPs to conventional use to stimulate employment
- Zero interest rates sustained until December 2015
- Fed’s concerns about weak employment evolves toward worries about low inflation
- Fed attributes “too low” inflation to a flatter Phillips Curve rather than wealth effect and inability to stimulate aggregate demand
- Fed’s fixation on too low inflation and effective lower bound leads to asymmetries that prioritized employment and favored higher inflation

The Covid Pandemic

- Covid was an exogenous and unique shock that was accentuated by government-mandated shutdown
- Negative shock to both supply and demand
- Fed lowers rates to zero and engages in massive purchases of Treasuries and MBS in response to dysfunctional Treasury market
- Unprecedented fiscal stimulus: CARES Act (March 2020), Reconciliation Act (Dec 2020) and American Rescue Plan (March 2021) totals deficit spending of 25% of GDP
- Strong recovery, driven by surge in demand, even before vaccines, reopening of economy and restored order in intl supply chains

Fed’s MP Excesses Extend Costs of Pandemic

- Recovery gathers steam and inflation accelerates, but Fed sustains zero rates and asset purchases
- Fed’s MP elongates and magnifies negative costs of pandemic (price level, distortions to mortgage and housing market, etc.)
- Fed’s misguided MP based on poor economic and inflation forecasting and presumption that inflation would stay low, just as it did post-GFC
- Fed’s “transitory supply shocks” argument ignored unprecedented growth of demand (NGDP)

Fed Shortcomings

- Fed shortcomings in its conduct of MP:
- Failure to understand sources of inflation and (similar to post-GFC),
- Failure to estimate the impact of fiscal and monetary stimuli based on standard macroeconomic models (neoKeynesian, monetarist, etc.)
- Near-unanimity among FOMC members and no diversity of thought
- Lack of scenario analysis in MP deliberations
- Failure to learn from history (need to raise Fed funds rate above inflation to reduce inflation)

Other Shocks, Disturbances and Contraints

- Regulation Q and the 1966 credit crunch
- President Carter’s credit controls of 1980
- The Stock market crash of 1987
- The Gulf War
- Greenspan and the productivity boom of the late 1990s
- The Asia financial crisis of 1997-1998
- Y2K and the Fed’s excessive fine-tuning
- The Shock of 9/11

Summary and Concluding Remarks

- An assessment of Fed responses to an array of shocks finds a predictable pattern in which the Fed tends to adjust MP to offset short-term impacts of the shock, largely without regard to the type of shock or LR consequences
- This parallels Fed’s historic pattern of prioritizing employment rather than inflation objective
- Fed has not heeded advise to “pass on” supply shocks and disturbances, instead pursuing activist MP and fine-tuning
- In many cases, most notably Covid, Fed’s MP responses to shocks have elongated and accentuated the economic costs of the shock

Summary and Concluding Remarks

- In some cases, the shocks resulted from poor economic and sometimes monetary policies
- The Fed would benefit from heeding the lessons of history and acknowledging that monetary policy is an aggregate demand tool incapable of correcting the distortions of supply shocks

Table 1. Shocks and Fed Responses

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Period / Shock	Type of Shock	Monetary Policy Response	Outcome / Observation
I. The Great Inflation		Accommodation	Ratcheting up inflation & inflationary expectations
a)	Mid-1960s, Fiscal Stimulus	Accommodation	Rising inflation & inflationary expectations
b)	Burns and Labor Strikes	Accommodation	Beginning of excess demand pushes up inflation and interest rates
c)	Nixon Shock	Ease	Discards gold standard; Price stability anchor replaced by expectations of inflation; wage and price controls fail and distort economy
d)	Oil Shocks	Accommodation	Oil price spikes distort production and depresses supply and demand
II. Great Financial Crisis	MBS debt and funding markets unravel	Zero rates QE I, II, & III	Collapse in stock market, MBS, real estate = slow recovery; Fed's QE III extends unconventional MP to conventional goal of boosting employment
a)	Source: Worries about Japan-style deflation; GSEs	Extended zero rates and QE I, II & III	Debt-finance housing bubble; poor Fed supervision of banks and complex MBS derivatives leads to collapse

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III. The Covid Pandemic	Exogenous Supply & Demand	Unprecedented ease: extended zero rates and QE	Dramatic rebound, sharply higher inflation
a)		Fed delays normalizing interest rates and balance sheet	"Transitory supply shock": Fed ignores surge in demand generated by unprecedented fiscal and monetary policy
IV. Other Disturbances			
a) Credit Crunch of 1966	Financial Policy Constraint	Temporary Fed ease	Credit crunch: Fed in a no-win situation
b) President Carter's Credit Controls of 1980	Economic Policy Constraint	Temporary Fed ease	Credit controls interrupt Volcker's disinflationary MP
c) Stock Market Crash, October 1987	Financial Shock	Fed provides liquidity; cuts	Fed provides valuable support
d) The Gulf War, 1991	Disruptions	Fed ease	Responsible Fed policy
e) Productivity surge	Positive shock	Greenspan doesn't raise rates	Wise response
f) Asian Financial Crisis, 1997-1998	External Threat	Fed monitors	Responsible Fed policy
g) Fed blunders on Y2k	Fed misperception	Fed delays rate increase	Excess fine-tuning
h) 9/11	External Shock	Fed provides liquidity; cuts	Responsible Fed policy