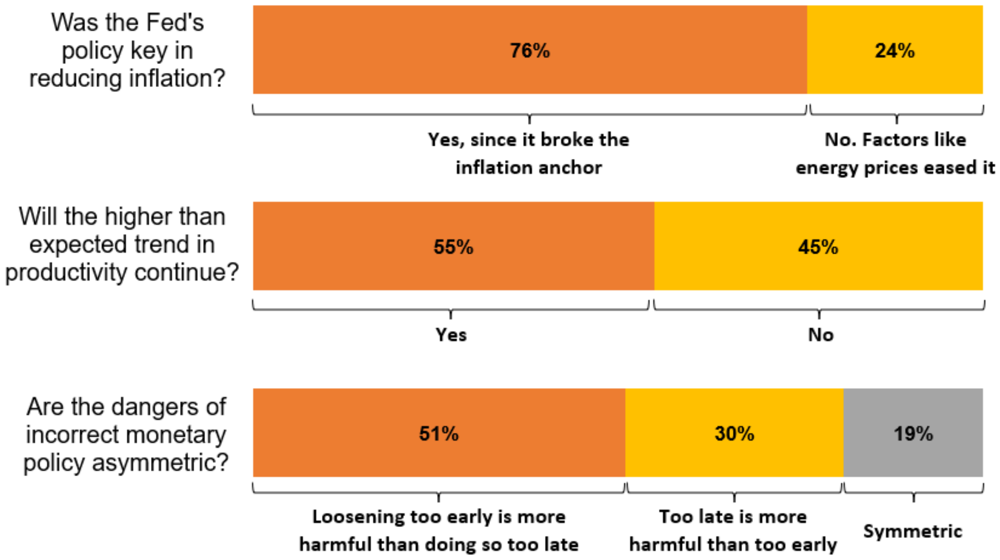
# Austan Goolsbee

On Thursday, February 29, Austan Goolsbee joined Markus' Academy for a conversation on, "Monetary Policy at an Unusual Time." Austan Goolsbee is the President and Chief Executive Officer of the Federal Reserve Bank of Chicago.

A few highlights from the discussion:

- **A summary in three bullets**
    - In 2023 we saw a virtually unprecedented decline in inflation without an associated recession. In a Phillips curve framework, 2023 saw one of the largest ever drops in inflation in a year, yet unemployment remained below the natural rate.
    - To understand why, we must consider the time it takes for the transmission of shocks to filter through to the economy. Supply chain shocks (repairs) take a while to work into inflation (disinflation), while it took until 2022 for the post-covid negative labor supply shock to contribute to inflation. We must also give credit to the higher than expected growth in productivity.
    - In contrast to the 80s, after covid the world believed the Fed would remain steadfast to combat inflation. By anchoring inflation expectations, this was fundamental for pulling off the "golden path." Thanks to Paul Volcker this time the Fed didn't have to fight the second dragon of getting inflation expectations back down.

- **[0:00] Markus' introduction and poll questions**
    - In a 2022 episode of Markus Academy Alan Blinder discussed soft landings, but the one we saw in 2023 was unusually soft. Why?
    - Were we lucky that energy prices declined or supply chain disruptions went away? Was it because of the large labor shortages we see (even in spite of the increase in immigration)? We are seeing an unusually vertical Beveridge curve, where job openings have declined without unemployment increasing.
    - Or was it monetary policy that reduced inflation? Policy rates have been constant since last summer while long term rates have first increased and then declined significantly, so borrowing has shifted away from the Fed's policy rate.
    - We also have unusually higher government debt, with the CBO projecting that the debt-to-GDP ratio will reach 181% by 2053. If there is fiscal dominance in this context, inflation may be driven more by fiscal than monetary policy. According to the fiscal theory of the price level, if the real value of debt is going up while deficits are expected in the long term, there must be a bubble.




- [8:06] **The Golden Path and Inflation Dynamics: (1) Supply chains and (2) the labor market**
  - In 2023 we saw a virtually unprecedented decline in inflation without an associated recession. If you are thinking about a Phillips curve, 2023 saw one of the largest ever drops in inflation in a year, yet unemployment remained below the natural rate.
  - One may argue that negative supply chain shocks can account for the spike in inflation coming out of Covid and supply chain recovery explains the big decrease in inflation in 2023 that occurred without an increase in the unemployment gap. With supply chains now healed, one might expect to see little further reduction in inflation as we head into 2024.
  - However, this argument fails to appreciate the persistence of inflation and how a supply chain shock takes time to work its way through different stages of production, spilling over to each step of the chain. As a result, the full impact of a negative supply chain shock on inflation takes some time to work its way through. With supply chain pressures only recently returning to normal, we might expect some additional disinflation to come.
  - In addition to supply chain shocks, it is also crucial to recognize the importance of labor supply shocks in contributing to the path of inflation. There was a significant negative labor supply shock early in the pandemic when the economy shut down and labor force participation fell steeply. Since then, the labor force participation rate has recovered to levels that exceed what pre-Covid demographic and other trends would have predicted. Some of this increase might also be due to labor markets being tight. The time lag for the full impact of labor supply shocks on inflation is probably longer than for supply chain shocks.
  - Be careful about interpreting wage-price dynamics when using wage data to interpret near term inflation. In the long run, inflation is equal to wage growth minus productivity growth. With wages stickier than prices, if a shock hits, it will impact prices before wages. So in the short-and medium-run, prices lead unit labor costs.

- [26:01] **The Golden Path and Inflation Dynamics: (3) Puzzles in housing inflation and (4) productivity growth**
  - Other puzzles emerge when we consider the composition of inflation. The supply chain disruption explains the surge in core goods inflation, and with the improvements in supply chains, core goods inflation has returned to about the level it was before the pandemic. We've seen substantial improvement in core services excluding housing too. What is puzzling is why there hasn't been as much improvement in housing inflation which remains very high. The return of the Zillow Observed Rent Index on new leases to below pre-Covid levels suggests some reduction in housing inflation is in train.
  - Productivity growth reduces inflationary pressures. Returning to the basic equation: Inflation = Wage growth – Productivity growth. Productivity measures are extremely noisy. However, there have been some recent improvements. For more than a year productivity had been weak and below its pre-Covid trend. Rapid productivity growth over the past year has returned productivity to a level a bit above trend and allowed for 2023 to be the "Golden Year" in which we saw robust GDP growth, a below-neutral unemployment rate, and inflation falling toward target.
  - If this productivity growth continues, it would be highly relevant for monetary policy.

- [37:52] **The Role of the Fed**
  - In the past when we had high inflation, inflation expectations rose too. That made the Volcker era extremely difficult and required a deep recession because the Fed needed to reduce both inflation and inflation expectations. The natural settling point for inflation is determined by inflation expectations. As the economy came out of the pandemic, inflation soared but longer-term inflation expectations barely moved. The Fed credibly stated it would return inflation to 2 percent and the world believed the Fed would remain steadfast. Keeping inflation expectations anchored at levels consistent with 2 percent is fundamental for pulling off the golden path. We have to be thankful to Paul Volcker for establishing Fed credibility.
  - The market believing that the Fed would effectively tackle inflation has also impacted the economy by driving down longer-term rates.
  - Markus' question: Has the Fed's Statement from August 2020 that it would target inflation over the average of several years been something that was not pursued? Not necessarily. It depends on how long of a year-window you consider. In Markus' view, the year-window should depend on the average maturity of debt contracts and the stickiness of wages. For example, if the average maturity of debts is three years, the window could be three years.
  - Rates are currently pretty restrictive as measured by the real federal funds rate and compared to the SEP median longer-term projection. If disinflation continues, real rates will increase further.
  - The longer the Fed remains restrictive, the more we will have to start thinking about the employment side of the dual mandate. We haven't needed to do that for quite some time.

    - Markus' comment: The key is how much is attributed to productivity growth. If productivity is permanently higher, then rates are not so restrictive because r* would be higher. If productivity growth is temporarily higher, say 3 to 5 years, things become more complicated.

- **[54:25] A note on non-bank financial institutions**
    - However we measure it, the rise of non-bank financial institutions is pervasive. Banks' share of non-real estate lending to nonfinancial businesses has declined from a high of over 45 percent in the 1970s to about 25 percent by the end of 2022.
    - How does this trend affect the transmission of monetary policy? This is a question we are still learning about. Its effect could go either way. If nonbank lenders are not as directly impacted by policy rates, it could attenuate the impact of monetary policy. However, if they are more risk-taking, it could amplify the effects of monetary policy. This is a fascinating and important line of research. See for example Elliot et al. (2022) for evidence from the auto loan market.

- **[59:18] This time, ending on a cautious note**
    - The job of a central banker is to worry about everything and to stay up at night. The most worrying risks are external shocks. This is a good position to be in, but easier soft landings in the recent past were derailed by external shocks. One can think of risks posed by China, the Middle East, commodities markets, and so on.
    - If it's possible for the golden path to continue in 2024, it would depend on the length of the transmission mechanism. Though we shouldn't expect to see much further recovery in supply chains and increases in the labor force participation rate, those past improvements could be beneficial as they work through the system. The year 2023 was extremely unusual.
    - "Team transitory" (which Goolsbee was on) got it wrong because the impact of supply shocks lasted longer than they anticipated. However, "Team stimulus" should also do some soul searching. They claimed victory because inflation spiked after the Covid stimulus, but they face reconciling the puzzle that once the aid packages were taken away, we didn't see disinflation.
    - One explanation is that individuals saved the money, but if this is the case, the stimulus shouldn't have been big enough to provoke a 9% inflation.
    - Markus' takeaway: let's hope that what we learned from this unusual time we can make usual, and what we don't want from this usual time we can avoid.

**Timestamps:**
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