SPEECH

Connecting Theory and Practice

May 03, 2024

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Remarks at Hoover Institution Monetary Policy Conference, Stanford, California

As prepared for delivery

Introduction

Good afternoon. It's wonderful to be back at Stanford—especially with John Taylor chairing this panel. John was my advisor during my studies here, and he hired me as his research assistant in the early '90s. It was an extraordinary privilege to have those two most wanted positions.

Based on some of my past speeches, you may expect me to give a few pop culture references from the '90s that capture my time at Stanford before I move on to the substance of my remarks. But the truth is, I was so focused on my studies that there wasn't time to rollerblade, listen to R.E.M., or go to the arcade just for fun. Instead, like many in this room, I chose to forsake fun for the study of economics. As a result, I am simply useless when it comes to '90s trivia.

What brought me to Stanford back then was a sense of purpose. Growing up in the '70s and '80s, I witnessed the toll that economic turmoil, high inflation, and slow growth took on families. By the time I arrived at Stanford in the fall of 1989, the Federal Reserve under Paul Volcker had tamed the very high inflation of the late '60s and '70s. But, the work was far from done. Inflation was around 4 percent—a level, I should note, that is well above today's 2.7 percent. And it was not yet clear how the lessons of the past would shape the policies of the future to ensure economic prosperity and stability.

But change was afoot, and it was an exciting time to be thinking about economic policy. With the advent of inflation targeting, the practice of monetary policy was on the cusp of a revolution. The Reserve Bank of New Zealand led the way in December 1989, and the Bank of Canada and Bank of England soon followed suit. I recall seeing the excitement around this change when I was a student, as I listened to policymakers from New Zealand and Canada describe their new frameworks.

At the same time, economists were reassessing what good policy looks like and how it could make a difference. In particular, John Taylor and others were reexamining the theory and evidence behind the ways policymakers could consistently deliver low and stable inflation in the post-Bretton Woods era. My introduction to this topic was running multicountry model simulations for John's book, *Macroeconomic Policy in a World Economy*, which built on years of research by many experts. The book provided a rigorous analysis of alternative monetary policy regimes in an open-economy context. This line of research culminated in John's seminal paper, “Discretion versus Policy Rules in Practice,” which brilliantly synthesized theory and experience to yield clear prescriptions for good policy.[1]

What I learned then and have carried with me these past 35 years is the importance of connecting theory and experience. The theories that shape good policy are derived from the experiences of the past, and therefore create lessons for the future. This prepared me well for my career, and it's what I'm going to talk about today.

Before I go further, I need to provide the standard Fed disclaimer that the views I express today are mine alone and do not necessarily reflect those of the Federal Open Market Committee (FOMC) or others in the Federal Reserve System.

Act I: The Past

Between the time I left Stanford and the onset of the pandemic in 2020, the theory and practice of monetary policy changed dramatically.[2] Policymakers sought to avoid the mistakes of the past and worked hard to create new frameworks for the future. And economists developed and refined theories to guide policy. The result was a prolonged period of price stability that spanned a quarter of a century.

We learned three key lessons from theory and experience. The first is that central banks must own the responsibility for price stability and have the ability to act as needed to achieve it. Policymakers have the tools to attain and maintain low and stable inflation. However, too often in the past—most notably in the '70s—central banks behaved as if they were powerless to control inflation. Although accountability for price stability is critically important, history also teaches us that central banks that have independence in their actions are more successful at delivering price stability and well-anchored inflation expectations.[3],[4] In short, our job is to be the protector of price stability.

The second lesson is the importance of transparency and, in particular, the clear communication of a goal for price stability in the form of an explicit numerical inflation target. Agreeing on a longer-run target reinforces public accountability for price stability and focuses the internal policy debate on how to best achieve that goal. Central banks that adopted inflation targeting led the way on this. And the FOMC announced its 2 percent longer-run inflation goal in January 2012 as part of its Statement on Longer-Run Goals and Monetary Policy Strategy.[5]

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That leads to the third lesson: the importance of well-anchored inflation expectations. By communicating an explicit inflation target—and then delivering inflation consistent with that target—central banks earn credibility with the public. That helps anchor expectations, which, in turn, contributes to low and stable inflation.[6],[7] This feedback loop between policy actions and communications, expectations, and price stability is now a core tenet of modern central banking, but it wasn't something that was fully appreciated or accepted 30 years ago.

It's important to note that anchoring inflation expectations at the target level is symmetric. Very low inflation—or, worse, deflation—can be as problematic as high inflation, presenting challenges for policymakers and harming the economy.[8]

act ii: The Present

As a result of the linkages between theory and experience, our three lessons became three principles. And they helped us achieve a quarter century of low and stable inflation and well-anchored expectations.

Then came the pandemic, which dealt the most dramatic shocks to the economy in generations. Severe imbalances between supply and demand, exacerbated by Russia's war in Ukraine, caused inflation to skyrocket in most countries across the globe. In 2022, inflation peaked at 7 percent in the United States, rose to 8 percent in Canada, and exceeded 10 percent in the euro area.

How did we, along with other central banks, address these spikes in inflation? In the United States, we stuck to our three key principles. First, the FOMC owned the responsibility for reining in inflation.[9] Achieving price stability and maximum employment are part of the FOMC's dual mandate, and we took strong, decisive actions to bring inflation down.

Second, we have been unequivocal and transparent in our commitment to achieving our 2 percent target on a sustained basis. This message has been emphasized over and over in the FOMC's post-meeting statements and policymaker communications.

Third, we have paid close attention to inflation expectations, and our actions and credibility built up over the preceding quarter century helped keep inflation expectations anchored.[10] Although medium- and especially short-term inflation expectations rose notably starting in 2021, they retraced those gains over 2022 and 2023.[11] Indeed, three-year-ahead expectations returned to pre-pandemic levels by late 2022, and short-term expectations did so late last year.

Act III: The Future

What do the lessons of the past mean for the future of monetary policy? I believe they prove, once again, the importance of theory and experience.

Years of experience—and years of careful analysis—have taught us that, first and foremost, central banks must own the responsibility for maintaining low and stable inflation and have the independence of action to achieve that goal. Price stability is absolutely essential for economic prosperity, and it's crucial for achieving and sustaining maximum employment over the longer run.

Theory and experience have also shown the importance of transparency and clear communication, including setting an explicit, numerical longer-run inflation target, and of taking appropriate actions to support the achievement of that goal. These are critical in anchoring inflation expectations—which, in turn, help keep inflation at its target level.

The future is uncertain. But as we continue to move closer to our 2 percent longer-run inflation goal, I'm confident that we have the foundation of theory and experience to guide us in restoring price stability and set the stage for sustained economic prosperity. We are committed to getting the job done.

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[1] John B. Taylor, "Discretion versus Policy Rules in Practice," Carnegie-Rochester Conference Series on Public Policy, 39 (1993) : 195-214.

[2] John C. Williams, The Dual Transformation of R&S and Monetary Policy, remarks at Research and Statistics at 100: A Look at the Past, Present, and Future, Board of Governors of the Federal Reserve System, Washington, D.C., November 08, 2023.

[3] Luis I. Jácome and Samuel Pienknagura, Central Bank Independence and Inflation in Latin America—Through the Lens of History, International Monetary Fund Working Paper Number 2022/186 (September 2022).

[4] D. Filiz Unsal and Chris Papageorgiou, Monetary Policy Frameworks: An Index and New Evidence, November 7, 2023.

[5] Board of Governors of the Federal Reserve System, Statement on Longer-Run Goals and Monetary Policy Strategy, as adopted effective January 24, 2012.

[6] John C. Williams, Inflation Targeting and the Global Financial Crisis: Successes and Challenges, Essay presentation to the South African Reserve Bank Conference on Fourteen Years of Inflation Targeting in South Africa and the Challenge of a Changing Mandate, Pretoria, South Africa, October 31, 2014.

[7] See Orphanides and Williams (2004, 2005, and 2007). There is a large theoretical and empirical literature on the formation of expectations. See, for example, Evans and Honkapohja (2001), Malmendier and Nagel (2016) , Coiboin et al. (2022), and references therein.

[8] David Reifschneider and John C. Williams, Three Lessons for Monetary Policy in a Low-Inflation Era, *Journal of Money, Credit and Banking*, Volume 32, Issue 4, pp. 936-66, November 2000.

[9] For example, see Jerome H. Powell, Monetary Policy and Price Stability, remarks at Reassessing Constraints on the Economy and Policy, Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming, August 26, 2022.

[10] John C. Williams, A Steady Anchor in a Stormy Sea, Remarks at SNB-FRB-BIS High-Level Conference on Global Risk, Uncertainty, and Volatility, Zurich, Switzerland, November 9, 2022.

[11] Federal Reserve Bank of New York, Survey of Consumer Expectations.

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