Lessons *from a* Fed Insider

By Richard H. Clarida

Post-pandemic global inflation, disinflation, and central bank policy responses.

The 2021–2022 surge in global inflation—in both advanced and emerging economies—was a distinctive and distressing feature of the post-pandemic global economy that triggered a belated, correlated, and aggressive monetary policy response. By the summer of 2024, underlying inflation in most advanced economies had fallen back to below 3 percent, inflation expectations appeared anchored at central bank inflation targets, and central banks, including the Fed, were confident enough in the prospects for further disinflation to began cutting interest rates. Moreover, this global easing cycle continued in 2025, notwithstanding the regime change in U.S. tariff policy. The goal of this article is to summarize and highlight important facts, survey and distill the findings of relevant empirical research, assess the cross-country policy responses of advanced-economy inflation-targeting central banks, highlight some lessons learned for the Fed, and offer some initial thoughts on the Fed's August 2025 revisions to its monetary policy framework statement.

THE GLOBAL INFLATION SURGE

The post-pandemic inflation surge of 2021–2022 was remarkably correlated across advanced economies both in terms of timing and magnitude. Inflation

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in these economies, which had been running below inflation targets in the years before the pandemic and in 2020, spiked sharply in 2021–2022, peaking at levels not seen since the 1970s. The correlated surge in world inflation was not a coincidence, and was certainly not a U.S.-specific phenomenon; it was a global event, driven by a confluence of common factors that empirical research can now, with the passage of time, better identify than was possible in the "fog of war."

A growing body of recent applied research surveyed in the NBER working paper that accompanies this article indicates there were three primary, common drivers of the global inflation surge in 2021–2022. First, there were adverse shocks to aggregate supply. The pandemic disrupted labor markets profoundly, not only in 2020, but also depressed labor force participation in the United States and in most other countries long after vaccines became available. Another independent adverse supply shock was of course triggered in 2022 by Russia's invasion of Ukraine, which pushed up energy and food prices especially in Europe, but also globally.

The second shock was an endogenous fiscal and monetary policy response to the initial exogenous pandemic public health shock which represented a correlated boost to aggregate demand. Central banks and governments went "all-in" with monetary and fiscal measures to support their economies. While fiscal responses varied—ranging from $5-plus trillion in three pandemic fiscal packages in the United States to more modest support in other jurisdictions—monetary policy was broadly accommodative across advanced economies. Interest rates were slashed to the effective lower bound, and quantitative easing programs were expanded. The Fed, for instance, lowered the federal funds rate to 0–0.25 percent in March 2020 and initiated what became an open-ended QE program.

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Tolerating a Modest Inflation Overshoot

While as expected the Federal Open Market Committee will no longer aim for inflation to average 2 percent over time, it continues to be prepared to act forcefully to insure that longer-run inflation expectations remain well anchored at the 2 percent target. Presumably, this could include a policy of tolerating a moderate inflation overshoot following a period when inflation had been running persistently below target as was adopted by the Fed under the inflation targeting regime in place in December 2012.

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The third major shock was an unprecedented increase in the relative demand for goods versus services which resulted in a sizable rise in the equilibrium relative price of goods versus services. Goods inflation soared as demand shifted from services—such as travel and dining—to durable goods like electronics and furniture, exacerbated by supply-chain bottlenecks that developed as a consequence of the demand shift.

The Fed was widely criticized in 2021 for failing to hike the policy rate as U.S. inflation surged to 5 percent and the unemployment rate fell to 3.9 percent. However, no advanced-economy inflation-targeting central bank raised interest rates before inflation in its country well exceeded its inflation target. Moreover, with the exceptions of Switzerland and Norway, all other advanced-economy central banks delayed hiking rates until after core inflation had already surpassed the inflation target. And so, if the Fed's "falling behind the inflation curve" in this episode is an indictment of flexible average inflation targeting, or FAIT, it also an indictment of inflation targeting more broadly as practiced in the United Kingdom, Canada, Australia, Sweden, and the eurozone. But the evidence does not indicate that central bank frameworks in place in 2021–2022, *per se,* deserve indictment for the inflation surge.

THE FEDERAL RESERVE'S FRAMEWORK AND RESPONSE

In August 2020, the Federal Open Market Committee unanimously adopted the FAIT framework, a robust evolution from traditional flexible inflation targeting. FAIT sought to address the challenge of anchoring inflation expectations at the 2 percent target in a world where the effective lower bound frequently constrains policy and where inflation remained persistently below target for the decade before the pandemic. The Fed's 2020 *Statement on Longer-Run Goals and Monetary Policy Strategy* explicitly stated that following periods of persistently below-target inflation, it would likely be appropriate for inflation to run "moderately above" 2 percent for some time. However, this feature that appropriate Fed policy following periods of below-target inflation would aim for inflation to run "moderately above" the target for some time was not novel to FAIT. Indeed, it was a centerpiece of Fed forward guidance in the inflation targeting regime under Ben Bernanke starting in December 2012.

A second element of FAIT emphasized the Fed's dual mandate by focusing on "employment shortfalls" rather than "deviations"—as in the original formulation of inflation targeting in 2012—from maximum employment in either direction. Critics have argued that this focus on shortfalls in and of itself delayed the Fed lift-off. However, the record tells a different story. The Fed's *Monetary Policy Report,* published semi-annually, includes in each issue a suite of policy rules, including a "shortfalls" Taylor-type policy rule that reacts to unemployment only when it is above the rate estimated to be consistent with the "maximum employment" mandate. By September 2021, inflation had risen sufficiently above 2 percent that standard policy rules signaled liftoff even with unemployment still above the FOMC median estimate of its natural level. In other words, according to the standard monetary policy rules the Fed consults, the "shortfalls" standard the Fed highlighted in the new framework was not a binding constraint on lifting off according to such "FAIT-consistent" policy rules.

If the Fed's "falling behind the inflation curve" is an indictment of FAIT, it also an indictment of inflation targeting more broadly as practiced in the United Kingdom, Canada, Australia, Sweden, and the eurozone.

So why did the Fed not raise rates in 2021? The delay was not a direct result of the FAIT framework itself, but rather of the FOMC's chosen implementation of the framework, particularly the forward guidance it offered on both the federal funds rate and the balance sheet. At its September 2020 meeting, just a month after adopting FAIT, the FOMC introduced muscular forward guidance, stating it would not consider liftoff until labor market conditions reached the Committee's assessment of maximum employment, inflation hit 2 percent, and was on track to "moderately exceed" 2 percent for some time. This guidance went beyond what FAIT required. Indeed, two voting FOMC members, Robert Kaplan and Neel Kashkari, dissented at that meeting, arguing the guidance was overly restrictive and was not necessary to achieve the goals of the new framework as articulated in an August 2020 consensus statement. Minneapolis Fed President Kashkari, in particular, preferred guidance that tied liftoff to core inflation reaching 2 percent on a sustained basis—a simpler, more inflation-focused threshold consistent with FAIT.

The FOMC's forward guidance on QE further constrained liftoff. At the December 2020 FOMC meeting, the Committee indicated that QE would continue until "substantial further progress" was made toward its dual mandate goals. This was a discretionary choice not mandated by the new framework that, in the event, delayed policy

The Post-Pandemic Global Inflation Surge

The post-pandemic surge in global inflation and the belated but ultimately aggressive monetary policy responses forthcoming from advanced economy central banks reveal little about the relative merits of inflation targeting versus flexible average inflation targeting frameworks or single mandate versus dual mandate central bank charters. Instead, I believe that the post-pandemic inflation overshoot can best be thought of as a one-time price level increase that central banks perhaps should have better foreseen but that was largely inevitable given the magnitude of the covid shock to aggregate and sectoral supply, the land war in Europe, and the "all-in" response from fiscal and monetary authorities that these shocks triggered that certainly, *ex post,* boosted aggregate demand well north of available aggregate supply.

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normalization, as tapering did not begin until November 2021, with the first rate hike announced in March 2022.

Based on this analysis and the research surveyed in my accompanying NBER working paper, I have concluded that the post-pandemic surge in global inflation and the belated but ultimately aggressive monetary policy responses forthcoming from advanced economy central banks reveal little about the relative merits of inflation targeting versus flexible average inflation targeting frameworks or single mandate versus dual mandate central bank charters. Instead, I believe that the post-pandemic inflation overshoot can best be thought of as a one-time price level increase that central banks perhaps should have better foreseen but that was largely inevitable given the magnitude of the covid shock to aggregate and sectoral supply, the land war in Europe, and the "all-in" response from fiscal and monetary authorities that these shocks triggered that certainly, *ex post,* boosted aggregate demand well north of available aggregate supply.

The evidence also suggests that the rapid and relatively painless disinflation in many countries, if it continues on the other side of the U.S. tariff increases announced on April 2, 2025, reflects in no small part the unwinding and reversal of the adverse supply shocks that contributed to the initial inflation spike in the first place as well as the belated pivot to aggressive rate hikes once the inflation threat was recognized.

LESSONS LEARNED: FORWARD GUIDANCE AND QE

The tools of monetary policy are in general not exempt from the laws of economics—returns typically diminish and benefits usually incur costs. Forward guidance, especially threshold-based or calendar-based guidance, has both benefits and costs. In September 2020, the FOMC's muscular forward guidance tied liftoff to the threshold of maximum employment and a moderate inflation overshoot. Maximum employment is notoriously difficult to measure in real time and even years after fact, and this was especially the case during the pandemic when labor market dynamics were in flux.

In terms of central bank communication, there would seem to be important benefits to threshold forward guidance that limits itself to variables the central bank can directly influence, such as inflation, rather than less observable metrics such as maximum employment, for example as was suggested by President Kashkari in his dissent at the September 2020 FOMC meeting. This approach to forward guidance at the effective lower bound, akin to temporary price-level targeting at the effective lower bound—a concept earlier championed by Ben Bernanke and Charles Evans—would appear to be much more robust to the inevitable uncertainties about how to measure maximum employment or potential output.

Turning now to the balance sheet, four QE programs have been deployed by the Federal Reserve since the global financial crisis. However, the two "open-ended" QE programs, the Fed's QE3 and QE4 program, have proven in practice to be challenging to bring to a conclusion, for example as was evidenced not only in 2021–2022 as discussed above, but also in the "taper tantrum" episode in 2013. The Fed's communication in December 2020 that it would continue QE4 until "substantial further progress" toward its dual mandate goals was made delayed liftoff and, in the event, constrained policy flexibility. Based on the U.S. experience with QE3 and QE4 and the cross-country analysis of the post pandemic unwinding of QE programs in other advanced economies, it would seem there can be substantial benefits to clarifying beforehand the duration of a quantitative easing program aimed at easing broad financial conditions

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THE FED'S 2025 REVISIONS TO ITS MONETARY POLICY FRAMEWORK

As expected, the Fed rolled out in August 2025 at Jackson Hole a revision to its monetary policy framework as part of a scheduled five-year review. The changes are sensible and had been telegraphed in advance in previous Fed minutes

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and the chair's press conferences. Taken together, the changes to the framework will have no bearing on the path for Fed policy during the remainder of Jerome Powell's term as Fed chair, and perhaps even much longer, because the revised framework simply returns the Fed to the inflation targeting *status quo* of the original symmetric 2 percent inflation targeting regime put in place in 2012. The revised framework acknowledges realities in 2025 that are much different than the situation the Fed faced when it undertook it previous review in 2019–2020. It is no longer the case that the Fed expects the zero bound on the policy rate to be a frequently binding constraint nor does it expect the risks to inflation looking ahead to be skewed to the downside. The new framework statement also clarifies that maximum employment is the highest level of employment that can be achieved on a sustained basis in the context of price stability, and that employment may at times run above real-time estimates of maximum employment without posing risks to price stability, although it no longer makes specific reference to employment "shortfalls."

Finally, while as expected the FOMC will no longer aim for inflation to average 2 percent over time, it continues to be prepared to act forcefully to insure that longer-run inflation expectations remain well anchored at the 2 percent target. Presumably, this could include a policy of tolerating a moderate inflation overshoot following a period when inflation had been running persistently below target as was adopted by the Fed under the inflation targeting regime in place in December 2012. ◆

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