The Nominal Anchor, *In Originali*, and the Fed

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Let’s Answer Five Important Questions!

1. Who First Developed the Nominal Anchor Concept?
2. What is the Nominal Anchor’s Original Meaning?
3. Does the Fed Have a Nominal Anchor?
4. Does the Fed’s Use of the Concept Differ from the Original?
5. (Why) Did the Fed’s Nominal Anchor Go Wobbly in the Post-Pandemic Period?

#1 Who First Developed the Nominal Anchor Concept?

Robert J. Barro, "Money and the Price Level Under the Gold Standard," The Economic Journal, 1979.

- Noted in Dallas Fed publication
- Also cited in Ben McCallum's (former SOMC colleague) 1984 Jackson Hole Presentation

"Blind" checked by Edward Nelson

- Others before used the term "anchor"

#2 The Nominal Anchor's" Original Meaning?

Since ***the "central bank" supports the nominal price of a reserve commodity*** *such as gold under these systems,* ***the determination of the absolute price level amounts to the determination of the relative price of the reserve commodity. In this sense the absolute price level becomes a determinate quantity*** *that is amenable to usual supply and demand analyses, ... changes in the ratio of "money" to its commodity backing or shifts in velocity can influence the price level,* ***the system possesses an important nominal anchor*** *in the fixed price of the reserve commodity. p. 13*

“By way of contrast the absolute price level is determinate under a fiat (government-issue) currency system only up to the determination of the quantity of the fiat currency. Analysis of the price level involves, as its major element, a theory of government behaviour with respect to the quantity of money. In particular, there is no obvious nominal anchor that prescribes some likely limits to changes in the absolute price level.” p. 13

…

“In relation to a fiat currency regime, the key element of a commodity standard is its potential for automaticity and consequent absence of political control over the quantity of money and the absolute price level.” p. 31

Barro (1982) p. 105

*"Since the move in 1971 toward flexible exchange rates and the complete divorce of United States monetary management from the objective of a pegged gold price, **it is clear that the nominal anchor for the monetary system—weak as it was earlier—is now entirely absent.***

*Future monetary growth and long-run inflation appear now to depend entirely on the year-to-year **"discretion"** of the monetary authority, that is, the Federal Reserve."*

Takeaways

- Barro's search for a nominal anchor must be understood in the context of the high inflation, post gold-standard time-period of the 1970's.
- It sought a nominal policy variable, in a fiat money world, that could promote and establish price stability.
- The nominal anchor needed to be in a system that provided effective constraints to make policy responses systematic and eliminate discretion.
- Otherwise, a nominal anchor without an effective policy chain would just be a hunk of metal laying at the bottom of the ocean.

#3 Does the Fed Have a Nominal Anchor?

*"Today the **nominal anchor** in the United States is the Federal Open Market Committee's (FOMC) **explicit objective** of achieving inflation at the rate of 2 percent per year over the longer run. This goal is supported by a **policy strategy** by which the FOMC responds to economic developments in a way that **systematically** aims to return inflation to 2 percent over time. By aiming to achieve low and stable inflation (as opposed to maintaining a particular price of gold or foreign exchange or a particular growth rate of the money supply), the FOMC has the **flexibility to adapt its strategy** as its understanding of the economy improves and as economic relationships evolve."*

The Federal Reserve's website devoted to "Monetary Policy Principles and Practice: Historical Approaches to Monetary Policy"

#4 Does the Fed's Use of the Concept Differ from the Original?

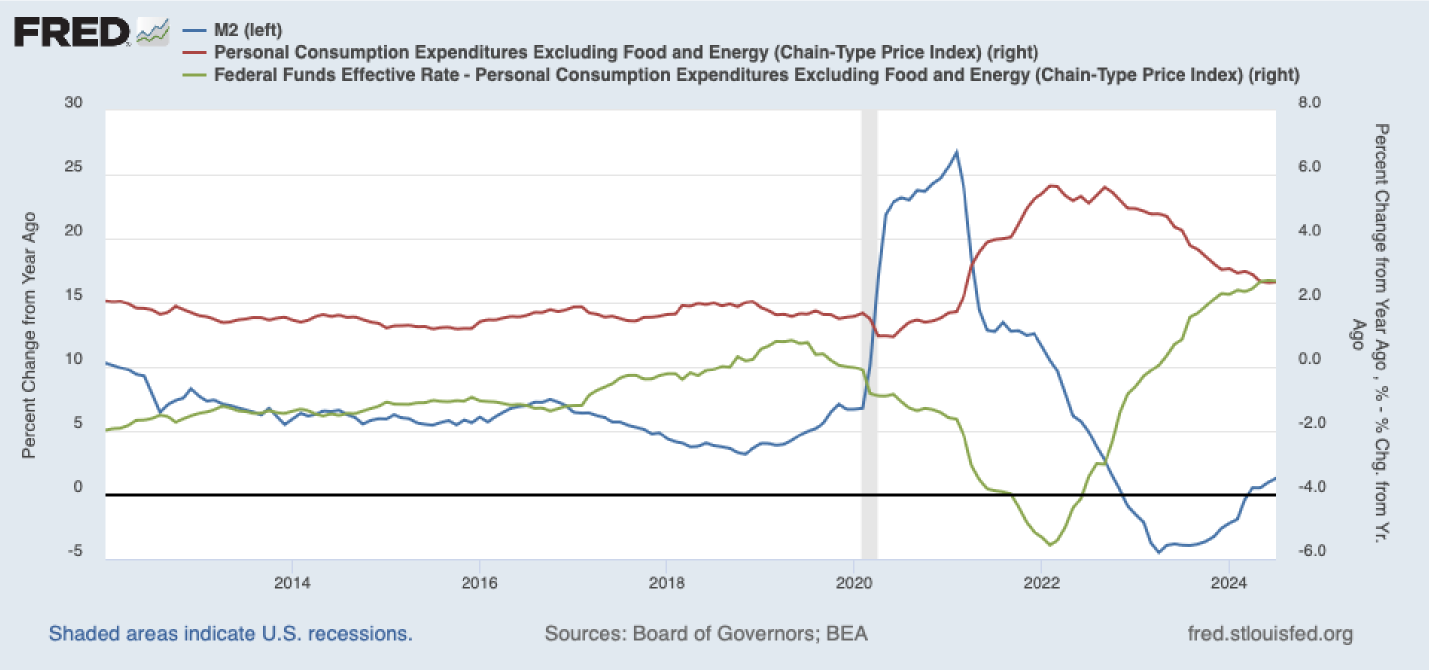
- Original: A nominal variable that can deliver price stability with effective constraints to make policy systematic and eliminate discretion.

- Fed: The nominal anchor is the empirical understanding of price stability. Policy strategy is flexible, but systematically returns inflation to the nominal anchor.

#5 (Why) Did the Fed's Nominal Anchor Go Wobbly in the Post-Pandemic Period?

1. The Forward Guidance Trap – Orphanides (2023)

- Change to Outcomes-Based from Forecast-Based Policy
- Pre-Commitments on Balance Sheet Policy
- The Great Delay



2. The Transitory Inflation Call

- Historically, Inflation is VERY persistent ("sticky")
- Figure 1: Preceding Monetary Growth was substantial, the real federal funds rate was exceptionally negative, Inflation surged, and the Fed waited almost a year to raise rates.
- The Great Denial

Concluding Thoughts

- A nominal anchor as a system must be capable of delivering long run price stability and appropriately constrain monetary policy to be systematic and discretion free.
- The Forward Guidance Trap reveals that the Fed placed inappropriate constraints on monetary policy that limited its ability to pursue appropriate policy tightening.
- The Transitory Inflation Call reveals that the Fed has not sufficiently constrained discretion from its decision making.
- Taylor (1993) rules and their descendants would have helped in guiding Fed policy. Marvin Goodfriend’s (1993) advice also should have been heeded.
- A sturdier nominal anchor ***system*** for the Fed should be a key topic for discussion as it reviews its Longer Run Goals and Monetary Policy Strategy.