FEDERAL RESERVE BANK of CHICAGO

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Monetary Policy in Times of Financial Stress

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Introduction

Thank you for inviting me to share my thoughts about the economy and the financial circumstances we are currently facing. About a month ago I was in New York to discuss monetary policy in light of financial market conditions. As part of a very lively discussion, the group addressed the question of whether the Federal Reserve had appropriate tools to address financial market disruptions. Since that time, we have seen ongoing turmoil in financial markets as well as indicators of weakening real activity, and the Fed has responded by lowering the fed funds rate and by taking a number of innovative steps to target liquidity conditions in financial markets.

In the course of my remarks today, I will address how I have approached policymaking in this challenging environment. I will then go on to discuss current economic conditions and our expectations for future developments in light of the policies that we have implemented since August. As always, these are my own views and not those of the FOMC or my other colleagues in the Federal Reserve System.

During both normal times and periods of financial stress, monetary policy decisions depend on the prospects for our mandated policy goals of stable prices and maximum employment. Fortunately, periods of financial stress are relatively rare in economies with strong commitments to price stability and low variability in economic activity. During normal times, the conduct of monetary policy will account for financial conditions as part of our standard evaluation of macroeconomic prospects, and the usual approaches to policy generally serve us quite well. However, during the rare periods of emerging or even actual financial stress, policy actions that are more directly related to the changing circumstances in financial markets may need to be taken. Even in such cases, monetary policy must focus on our macroeconomic goals over the medium term. But now the weighing of risks to growth and inflation must also carefully account for the risk that poorly functioning financial markets will disrupt real economic activity.

When thinking about policy adjustments during normal times, a useful benchmark is the line of research on policy rules pioneered by John Taylor. This research indicates that most historical policy actions have been *systematic responses to changes in the prospects for our goal variables* of output growth, employment, and inflation. The main ideas are the systematic response component, and that particular rules are benchmarks for typical policy. Financial developments typically play a role in these systematic responses through the normal effects of changes in the funds rate on other credit conditions that affect the real economy.

Of course, even Taylor's research points out that periods of financial stress may require policy responses that differ from the usual prescriptions. It's not that we downgrade our focus on the policy goals. It is that during these times we often are highly uncertain about how unusual financial market conditions will influence inflation and economic activity. In some cases, the baseline outlook may be only modestly affected by these conditions, but there may be risks of substantial spillovers that could lead to persistent declines in credit intermediation capacity or large declines in wealth. These in turn would reduce business and household spending. In such cases, policy may take out insurance against these adverse risks and move the policy rate more than the usual prescriptions of the Taylor Rule. If the downside spillovers do materialize, then policy may have to be recalibrated further.

Part of our job as a central bank is to properly price these insurance premiums against the achievement of maximum employment and price stability over the medium term. And if further policy adjustments become necessary, they need to take into account the insurance that is already in place. In addition, when risks subside, promptly moving policy to appropriate levels will reiterate and reinforce our commitment to our fundamental policy goals.

Now, let me discuss how I see financial markets and financial stability fitting into our policy goals. There is no analogy in financial markets to macroeconomic price stability. The prices of financial products may change quite substantially when new information arrives. Indeed, one of the most important activities of financial markets is price discovery—the efficient assimilation of all available information into asset values. This promotes the appropriate allocation of capital among competing demands and supports maximum sustainable growth. And it is this efficient functioning of markets that is our concern with regard to financial stability.

Most of the time, monetary policy and financial markets intersect directly at our primary policy tool, the federal funds rate. To alter the trajectory of inflation and economic growth toward their goals, changes in the federal funds rate directly alter short-term risk-free rates of interest. Perceptions of our willingness and ability to adjust future policy then may also alter risk premiums in fixed-income markets and result in a change in the cost of financial credit to numerous other borrowers.

When the economy is weak and we lower rates to stimulate activity, projects that previously had too much risk relative to their expected return become more attractive for two reasons: The future returns may look better, and the financing costs are lower. And this may be a good thing if, for example, it can help stimulate an economy that is mired in a situation where overcautious businesses or households are holding back on investment and spending.

As an aside, gauging the appropriate level of caution by businesses and households at any given time is difficult. Simply observing decisions and investments as they are made is not enough. For example, in an environment where uncertainty is high and market liquidity is low, only investment projects that reduce the overall risk profile of the firm or that have a very high probability of success may seem worthwhile. Of course, in the end, the investment strategy may turn out to be more cautious than had been understood *ex ante*. The greater caution could be due to overly negative assessments of the size of the investment payoffs, or the level of diversification achieved by the portfolio as the returns to the various investments turn out to be less correlated than had been feared and market conditions normalize.

Now, let me return to how policy can deal with financial disruptions. At times, adjusting the federal funds rate may not be enough to address the special circumstances we face in financial markets, particularly with regard to liquidity and the smooth functioning of markets. When markets are illiquid, uncertainty about asset values is large. In these circumstances, lenders are often unwilling to accept hard-to-value and illiquid assets as collateral, and as a result, market participants find it increasingly difficult to convert these illiquid, but otherwise sound, assets into cash or cash-like instruments. This in turn complicates the process of price discovery, increases uncertainty, and poses additional risks to real economic activity. Our recent policy innovations have been designed to address these effects of illiquidity directly.

We have several ways to add liquidity to the economy in addition to normal open market operations: the discount window, extended to term borrowing, and the new and now expanded Term Auction Facility, as well as foreign exchange swaps to help enhance liquidity abroad. In these operations, we accept collateral others see as less readily marketable. I should note that we apply the standard discount window "haircuts" in our treatment of the collateral.

More recently, the establishment of the Term Securities Lending Facility (TSLF) extended the term of the existing dealer securities lending program from overnight to 28 days and expanded the set of acceptable collateral. On March 16, we created a lending facility to extend overnight credit directly to primary dealers. This facility, known as the Primary Dealer Credit Facility, or PDCF, will be in place for at least six months and may be renewed as conditions warrant. These loans would be collateralized by a broad range of investment-grade debt securities, again with appropriate "haircuts." Since the primary dealers include some nondepository institutions, the PDCF required the Fed to invoke its authority under section 13(3) of the Federal Reserve Act to lend to nonbanks in "unusual and exigent circumstances," when the borrower is not able to "secure adequate credit accommodations from other banking institutions." The Fed's policy actions in mid-March represented the first invocation of this authority since the Great Depression.

Together these policy actions expand our role by providing liquidity in exchange for sound but less liquid securities. These policy innovations share important features of increasing both the term and the quantity of our lending and making additional quantities of highly liquid Treasury securities available to financial intermediaries. This is intended to reduce uncertainty among financial institutions and allow them to meet the liquidity needs of their clients.

While these policy actions represent major innovations in practice, they are in the spirit of the oldest traditions of central banking. As described by Walter Bagehot in his 1873 treatise *Lombard Street*, the job of the central bank is to "lend freely, against good collateral" whenever there is a shortage of liquidity in markets.

Review of the Current Economic Situation

Let me now turn to our assessment of the current economic situation and how the policy actions I've been discussing could impact the outlook going forward.

In assessing the extent of the current slowdown, I find it useful to look at an index we developed at the Chicago Fed several years ago to summarize the information in a large number of monthly indicators of economic activity. The index is the Chicago Fed National Activity Index, or CFNAI. An index value of zero is consistent with trend growth in overall GDP. The three-month moving average of the CFNAI was -0.87 in February, suggesting little or no economic growth over the last few months.

These challenges are evident in other recent indicators as well. The labor market, for example, weakened substantially in February with overall nonfarm payroll employment dropping 63,000 and private employment falling by 101,000. The unemployment rate edged down to 4.8 percent, but this was due to a drop in the labor force.

Consumption growth is also below its long-run average, growing at an annual rate of 1.9 percent in the fourth quarter of 2007 and softening further early this year. Slower income growth, falling consumer sentiment, high food and energy prices, lower housing and equity wealth, and tighter credit conditions are all restraining consumer activity and are likely to do so for at least the near term.

Growth in business investment likely is moderating as well, reflecting tighter credit conditions and less need to expand capacity in a slower economic environment. However, some impetus to demand should come from advances in high-tech equipment. One plus for recovery is that inventory-sales ratios remain low. This suggests that any inventory corrections may be limited.

And a bright spot has been net exports. The weaker dollar (down 30 percent since 2002) and continued growth abroad has kept exports growing at a healthy rate. We have seen notable contributions to growth from the declining trade deficit in 2007, and prospects are good for additional contributions as we move through 2008.

Taking all of this into consideration, our outlook at the Chicago Fed is for weakness in real GDP this year, particularly in the first half of the year. However, we think conditions will improve in the second half of the year.

A number of factors will likely hold back activity for some time. The strains on credit intermediation and financial balance sheets mean that credit conditions will likely restrict spending. The large overhang of unsold homes will continue to restrain residential investment. Greater caution on the part of businesses and consumers will likely limit increases in their discretionary expenditures as well. Because financial issues are being worked out against the backdrop of a soft economy, we also have to recognize the risk that interactions between the two might reinforce the weakness in the economy.

Nonetheless, other factors point to improvement later in the year. We have lowered the federal funds rate by 300 basis points since September. At 2.25 percent, the current federal funds rate is accommodative and should support stronger growth. Indeed, because monetary policy works with a lag, the effects of last fall's rate cuts are probably just beginning to be felt, and the cumulative declines should do more to promote growth going forward.

The effects of the fiscal stimulus bill also are likely to boost spending in the second and third quarters of 2008.

In addition, there is productivity. Productivity is the fundamental determinant of growth in the longer run—it determines how we can turn labor and capital inputs into the goods and services we consume and invest. The good news here is that, while it is not as robust as it was in the late 1990s and early this decade, the underlying trend in productivity in the U.S. economy is still solid. This trend provides a sound base for production and income generation to move forward over the longer haul.

The economy's inherent resiliency and internal adjustment mechanisms will also work to support growth. One part of the internal adjustment process centers on housing. As house prices fall, more buyers will find it worthwhile to enter the market. Eventually, price adjustments will stabilize supply and demand, and the drag from residential construction on the economy will subside. In the current situation, another important part of the internal adjustment process is the work the financial sector is doing in "price discovery," that is, the process of determining the proper valuation of assets in light of changes in their expected cash flows and risks to these flows. In addition, intermediaries will do more work in restoring their balance sheets. Together, these activities will eventually reduce strains on the real economy from financial conditions. While there are ongoing challenges, this process has and will be facilitated by our recent initiatives to bolster liquidity and promote orderly market functioning.

Although most of the recent concern about the U.S. economy has been focused on growth, we must also be mindful of inflationary pressures. The news here has been somewhat disappointing. We have experienced large increases in food and energy prices, and other commodity prices are high. In addition, we are hearing numerous anecdotes of firms passing on cost increases to their downstream customers, and some indicators of inflation expectations have risen. The recent numbers on core inflation—that is, inflation excluding food and energy—have also moved up some over the past several months. Core PCE inflation is now at 2.2 percent—a higher rate than I would like to see in the long run.

I want to emphasize here that, while we often talk about inflation in terms of the core measure, we are concerned about maintaining the purchasing power over all of the goods and services consumed by households. Accordingly, our goal of price stability must be defined in terms of total inflation. Traditionally, we have found it useful to concentrate on the core measure because it gave us a less noisy reading of longer-run trends in inflation; in turn, this reflected the tendency for food and energy prices to be volatile in the short run, but to generally average out to the same as core over the medium term. However, if outsized increases in food and energy prices persist, then core becomes a less useful medium-term guide to inflation trends. Furthermore, persistent food and energy price increases will find their way into inflation expectations, which in turn would boost core measures. So the recent developments in food and energy prices are a concern that deserves careful monitoring.

That said, our forecast is for inflation to moderate over the next two years with a leveling out of energy and commodity prices and an easing of pressures on resource utilization due to the slower pace of economic activity. Still, our uncertainty about the inflation outlook has increased, and we will continue to monitor inflation developments very carefully.

To conclude, it is important to remember that the Federal Reserve has a dual mandate—working to foster financial conditions that help the economy obtain maximum sustainable employment and price stability. As the Committee noted in the policy statement following the March FOMC meeting, though downside risks to growth remain, the policy actions taken in March, in combination with earlier moves, should help to promote moderate growth over time and moderate the risks to economic activity. Looking ahead, my policy views will depend on the evolution of these risks, as well as how developments influence the price stability component of our dual mandate over the medium term.

Note: Opinions expressed in this article are those of Charles L. Evans and do not necessarily reflect the views of the Federal Reserve Bank of Chicago or the Federal Reserve System.