
Back to the Future of Monetary Policy

Charles L. Evans
President and Chief Executive Officer
Federal Reserve Bank of Chicago

Prepared for the Central Bank of Argentina Conference
Dealing with Monetary Policy Normalization
Buenos Aires, Argentina
September 3, 2018

FEDERAL RESERVE BANK OF CHICAGO

The views expressed today are my own and not necessarily those of the
Federal Reserve System or the FOMC.

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Introduction

It's been ten years since the Lehman Brothers crisis in the U.S. and the plunge of economies around the globe into the throes of the financial crisis and Great Recession. Monetary policymakers grappled with huge economic and financial stresses. In response to the turmoil, policymakers soon reduced short-term policy rates to somewhere around zero, with the precise values depending on what individual central banks saw as the practical effective lower bound (ELB) for their respective policy rates.

To provide further accommodation, central banks adopted many innovative unconventional monetary policies. You are all familiar with these tools. In the U.S., after hitting the effective lower bound on the federal funds rate, the Federal Open Market Committee (FOMC) turned to large-scale asset purchases and forward guidance about the future path for the funds rate. Eventually, the U.S. economy grew slowly but reasonably surely once our open-ended QE3 asset purchase program took effect and we communicated—and followed through on—delaying interest rate increases until we were adequately assured that the recovery had gained traction.

Personally, the most important lesson I learned from this process was that policymakers have to promise to use all available means to bring inflation and employment back to their objectives within a reasonable period of time. And, crucially, this promise has to be credible. Failing to back it up with actions and communications all along the way would have rendered our unconventional policies stillborn and ineffective.

This lesson is important to remember because in our current environment of lower trend growth and low equilibrium real interest rates, the effective lower bound looms closer than should feel comfortable. Despite our best efforts, we will likely have to resort to alternative policies again in the future.

Now, having said all of that, after a protracted period of slow and uneven progress, over the past few years the U.S. economy has finally returned to a path with strong growth fundamentals and inflation closer to target on a sustainable basis. Monetary policy needs to be recalibrated accordingly, and this is well under way in the U.S. We are well past the time when out-of-the-box thinking was needed to provide monetary accommodation, and we are pretty much back to monetary policy that is conventional, standard, mainstream—whatever you want to call it—with the important caveat of a higher risk of hitting the ELB.

¹ My comments are my own and do not necessarily reflect the views of the Federal Reserve System or the Federal Open Market Committee (FOMC).

A description of conventional monetary policymaking

Now that it's been over a decade, we need to remind ourselves what such monetary policy looks like. A basic tenet of good conventional, mainstream monetary policy in the U.S. is that it is a supporting actor: The lead roles in the economy are played by households and competitive private businesses making their best saving, investment, and employment decisions and by governments at all levels (federal, state, and local) doing their best to design and execute effective public policy programs.

As a supporting actor, monetary policy focuses on 1) assessing the various headwinds and tailwinds influencing the economy and 2) moving policy into a modestly accommodative or modestly restrictive stance, when appropriate, to help the main actors achieve maximum employment and price stability. I am not saying monetary policy can fine-tune outcomes—the world is far too complicated for that. The broad goal is for policy settings that—in the absence of unforeseen shocks to the economy—are consistent with reaching these employment and inflation objectives within a reasonable amount of time.

This seems to describe the U.S. experience between 1984 and 2005, the period dubbed as the “Great Moderation.” Similar to today, the beginning of that time is marked by the exit from a difficult stretch of unusual economic and monetary circumstances—the challenge back then having been the defeat of the “Great Inflation” in the U.S. of the 1970s and early 1980s. Many monetary policy adjustments were made during the Great Moderation. These were designed to gradually move inflation trends downward toward something like a 2 percent objective; to mitigate headwinds or tailwinds that might be interfering with households and businesses achieving full employment; and, sometimes, to provide a dose of risk-management insurance against asymmetric risk to our policy goals.

Outside of the recessions of 1990 and 2001, these adjustments usually were gradual—and even during these recessions, all of them were accomplished by use of our federal funds rate target. Indeed, the moves over this era are generally well described by simple policy rules, with deviations often associated with risk-management behavior by the FOMC.² Examples of such deviations were the Fed's response to the global financial turmoil following the Russian default in 1998 and our aggressive actions in the fall of 2001—this latter case in part reflecting a recognition of the asymmetric policy risks posed by the ELB.

Monetary policymaking is finally returning to normal

Today, long after the financial crisis and the Great Recession, we find ourselves stepping back into this role of supporting actor: With the unemployment rate at 3.9 percent and core inflation at 2 percent, our job is to facilitate the long-run, sustainable achievement of maximum employment and price stability.

² See Evans et al. (2015).

Given the outlook today, I believe this will entail moving policy first toward a neutral setting and then likely a bit beyond neutral to help transition the economy onto a long-run sustainable growth path with inflation at our symmetric 2 percent target.

Of course, we may need to tighten somewhat further if currently unexpected tailwinds emerge that push the economy well beyond sustainable growth and employment levels, potentially leading to unacceptably high inflation beyond our symmetric objective. For example, we might discover that we underestimated the forward momentum imparted by earlier monetary accommodation. Another possibility might be that we experience greater-than-expected fiscal impetus from the recent tax cuts and spending increases in the U.S. that is not accompanied by gains in the economy's underlying productive potential.

Conversely, the emergence of currently unexpected headwinds could dictate a shallower policy path. One example would be if continued uncertainties over the international trade situation generated adverse effects on business sentiment and spending. Another downside risk is that the firming in inflation expectations could stall out before expectations are clearly centered about 2 percent—as such an alignment is a necessary condition for sustainable achievement of our symmetric 2 percent inflation objective.

Low equilibrium interest rates are challenging

There is, however, an important difference between the boring conventional monetary policy of today and the boring policy of the 1984–2005 period. Today, equilibrium interest rates are a good deal lower than they used to be. As a result, the risk of hitting the effective lower bound is now higher.

Trend economic growth is much lower than we would like. And, as standard economic theory teaches us, all else being equal, equilibrium real interest rates will be lower in a low-trend-growth economy.

The reasons for the slowdown in trend growth in the U.S. are well known. Growth in labor input has moderated with slower population growth and a downtrend in labor force participation. Furthermore, labor productivity has been disappointing, especially when compared with the large gains seen in the second half of the 1990s and the early 2000s.

At the Chicago Fed, we see the longer-run growth potential of the U.S. at a bit under 2 percent. I hope this assessment turns out to be too pessimistic. Higher sustainable growth would be great. However, we can't get there without boosting the underlying trends in labor input or productivity. As a nation, we should work on public policies that could be effective in doing so. But such policies are clearly outside the realm of monetary policy.

There are other reasons why equilibrium interest rates are lower now. One is the large demand—from both domestic and foreign sources—for U.S. Treasuries and other high-

quality assets.³ And, of course, low inflation also reduces equilibrium nominal interest rates. I should note, too, that the U.S. isn't alone here; most advanced economies are experiencing similar downward pressures on equilibrium interest rates.

All told, lower equilibrium interest rates mean monetary policy will have less headroom to provide adequate rate cuts when large disinflationary shocks hit the economy. In other words, the risks of returning to the ELB are higher than we would like.

Analyses done in the 1990s and early 2000s indicated that the odds then were not large; for example, in 2000 Reifshneider and Williams (2000) estimated them at about 15 percent.⁴ But this calculus has changed; more recently, a 2017 Brookings paper by Kiley and Roberts found that, given today's low productivity trends and a 2 percent inflation target, the probability of hitting the ELB is closer to 40 percent.⁵

Now, there are lots of model-specific factors and other assumptions underlying these numbers, so you don't want to take them too literally. But the result that the odds of hitting the ELB are notably higher today than they were in that period between the 1980s and the early 2000s is pretty solid. During that earlier era, when mitigating economic downturns, we typically reduced short-term policy rates something in the neighborhood of 500 basis points. Today, given an equilibrium federal funds rate in the range of, say, 2-1/2 to 3 percent, we simply do not have that kind of rate-cutting capacity.

This fact may require some rethinking of our monetary policy strategies. A number of alternative monetary policy frameworks have been proposed to address the risks of returning to the ELB: Examples include an explicitly higher inflation target; nominal gross domestic product (GDP) targeting; temporary, state-contingent price-level targeting; and unconditional price-level targeting.⁶

I would note, though, that none of these alternatives necessarily free us from the use of forward guidance or large-scale asset purchases. Alternative frameworks might lessen the odds of hitting the ELB, but they cannot drive them to zero. And whenever we are at the ELB, the question of alternative policy tools becomes relevant again.

Indeed, the FOMC has made clear that it stands ready to use alternative policies if needed. In an addendum to our Policy Normalization Principles and Plans made a little over a year ago, the Committee stated it would be ready to use its full range of tools if future economic conditions warranted more accommodative policy than could be achieved by use of the federal funds rate alone.⁷ You can find this point reiterated in the

³ In contrast, an increasing supply of safe assets with larger fiscal deficits could push equilibrium interest rates higher.

⁴ Reifschneider and Williams (2000).

⁵ Kiley and Roberts (2017).

⁶ For my thoughts on the monetary policy framework, see Evans (2018).

⁷ Federal Open Market Committee (2017).

minutes of our meeting last month.⁸ And in his Jackson Hole address a couple of weeks ago, Chair Powell reiterated the importance of the “do whatever it takes” approach to policy when faced with a difficult situation such as the risk of a protracted period at the ELB or if inflation expectations were to move into material conflict with our inflation objective.⁹

The future of conventional monetary policy

Let me finish with a brief description of the possible path for rates over the next few years as we return to more mainstream policymaking. In the FOMC’s most recent Summary of Economic Projections (SEP),¹⁰ which are from June, the median participant’s forecast showed the economy growing at a solid pace, the unemployment rate falling to a percentage point below its long-run normal level, and inflation edging slightly above our 2 percent target. I generally agree with this assessment. The current range for the federal funds rate target is between 1-3/4 and 2 percent. The median participant envisions the federal funds rate to be 2.4 percent by the end of 2018 (implying two more increases of 25 basis points each this year); 3.1 percent by the end of 2019; and 3.4 percent by the end of 2020. At the same time, in the background, we have a gradual reduction in the Fed’s balance sheet as securities acquired during our asset purchase programs mature.

As you can see, when compared with an assessment for the long-run neutral funds rate generally in the range of 2-1/2 to 3 percent, this path has policy becoming a bit restrictive sometime next year and tightening a touch further in 2020. Given an unemployment rate forecast below the natural rate, such a policy stance is quite natural and would be consistent with some moderation in growth and a gradual return of employment to its longer-run sustainable level.

Of course, in the end, actual policy will differ from this path depending on the headwinds and tailwinds arising from the various shocks that inevitably will hit the economy. We also will be alert for developments informing our views on trend growth or other factors affecting the equilibrium real interest rate benchmark for policy. And we necessarily will be attentive to the fact that the risks of encountering the effective lower bound are larger than they were in the past.

So even though we are returning to more conventional, standard, mainstream policymaking, there will be many challenges facing the Fed—as well as other central banks, as they too make the transition. But, hopefully, these will prove more familiar and easier to deal with than those we experienced over the past ten years.

⁸ Federal Open Market Committee (2018a).

⁹ Powell (2018).

¹⁰ Federal Open Market Committee (2018b).

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