Monetary Policy 2.0?

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

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Introduction

Today, I would like to briefly share with you my outlook for the U.S. economy before turning to my views on some of the key factors that will likely influence U.S. monetary policy in the future. Naturally, my comments are my own and do not necessarily reflect the views of the Federal Reserve System or the Federal Open Market Committee (FOMC).

This is not a mystery novel, so let me preview some of my comments.

- The U.S. economy is firing on all cylinders: Growth is strong, unemployment is low, and inflation is approaching our 2 percent symmetric target on a sustained basis.[1] Like my colleagues on the FOMC, I expect this good performance to continue over the next few years. While there are some risks to the outlook, I see them as being balanced.

- Given the strong near-term growth fundamentals and positive inflation outlook, it is time for the Fed to return to something akin to the conventional monetary policymaking of yesteryear. Such policy will rely on gradual adjustments in interest rates to meet our mandated objectives of maximum employment and 2 percent inflation, rather than the unconventional tools we had to use in response to the financial crisis and ensuing Great Recession.

- There is, however, an important way this policymaking regime will differ from that in the past. I am not talking about over the immediate future. I am talking about when, at some inevitable time down the road, the next economic downturn occurs. As I will discuss in a moment, it is all too likely that policymakers would then again face a difficult monetary policy environment in which our traditional interest rate tool will prove inadequate and financial instability issues could be germane. So, with the economy close to both our goals of maximum employment and price stability, now is a good time to take a hard look at whether—and how—the Fed's strategic monetary policy framework might be modified to better deal with these potential challenges.

[1] In January 2012, the FOMC set 2 percent inflation—measured by the annual change in the Price Index for Personal Consumption Expenditures (PCE)—as the explicit symmetric inflation target consistent with our price stability mandate (Federal Open Market Committee, 2012). For more on the Federal Reserve's dual mandate, see our dual mandate webpage, https://www.chicagofed.org/research/dual-mandate/dual-mandate.

- Currently, economists are discussing a number of alternative monetary policy frameworks that might do so.
    - These frameworks all share the feature that during meaningful economic downturns, they would likely entail extended periods with short-term policy rates at the effective lower bound (ELB) and the aggressive use of nonconventional policies. In the U.S., this means forward guidance about future policy rates and large-scale purchases of financial assets. And as the economy recovers, these frameworks also likely would require an extended period of inflation above 2 percent—perhaps substantially so for some time.
    - How will policymakers communicate the use of these tools and these inflationary outcomes to the public? How will the public react, and how will this reaction in turn influence the efficacy of the policy? How should we assess the interplay in any particular alternative framework between aggressive monetary accommodation, financial instability risks, and the stance of financial regulatory oversight and supervision? These are all important questions that I will talk about in more detail today.
    - Now, even if no sweeping changes are made to our monetary policy framework, there are opportunities to improve our existing strategy. My personal view is that we should concentrate more explicitly and publicly on outcome-based policy settings aimed at delivering maximum employment and 2 percent inflation on average through the business cycle. Bolstering the credibility that the FOMC will deliver on its policy mandates makes those goals more readily achievable—whether operating in something like our current framework or when executing any of the alternative frameworks under consideration.

The current economic situation and outlook

With that preview, let me briefly discuss my economic outlook. As we approach the tenth year of the expansion, the fundamentals for growth in the U.S. are solid. We're moving through 2018 with a good deal of momentum, with real gross domestic product (GDP) increasing at a very robust 3.2 percent annual rate in the first half of the year. Consumer spending and business investment have been key drivers of growth. This dynamism reflects healthy labor markets, asset price increases, favorable credit conditions, fiscal policy impetus, and relatively accommodative monetary policy. Forward-looking indicators of both consumer and business spending point to continued strength, but there are concerns that ongoing uncertainty over the international trade situation may impinge on some firms' investment plans. The one sector where activity has been a bit soft is housing, where higher mortgage rates and supply constraints have held back activity.

The Fed has a dual mandate to generate economic conditions consistent with maximum employment and low and stable inflation. So, what about inflation? I am more comfortable with the inflation outlook today than I have been for the past several years. Core consumer inflation averaged only 1.6 percent between 2010 and 2017—well below our symmetric 2 percent target.[2] However, core inflation picked up earlier this year and has been running close to 2 percent since last March.

My economic outlook is generally in line with those of my colleagues on the FOMC—as indicated by the median of the projections we all submitted during our regular quarterly forecasting exercise last week.[3] Most FOMC participants estimated that the economy's long-run potential growth rate is somewhere between 1-3/4 and 2 percent. The median participant expects GDP to expand more quickly than that over the next two years, and then sees growth slowing close to potential in 2020 and 2021. The unemployment rate is projected to average a little over 3-1/2 percent over the next three years, so nearly a full percentage point below the median assumption for its long-run normal rate of 4-1/2 percent. Inflation is expected to edge up to 2.1 percent over the next three years—which is consistent with our symmetric 2 percent target.

Implications for monetary policy

What does this outlook imply for monetary policy? As the FOMC's policy statement has said for some time, we expect that gradual increases in the federal funds rate target will be consistent with achieving our policy mandates. Last week we increased the target range 25 basis points, to between 2 and 2-1/4 percent. The median FOMC participant expects one more 25 basis point rate hike this year and then a slow rise in the funds rate to 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.

Note that most FOMC participants see the long-run neutral fed funds rate—that is, where the rate should settle at when policy is neither expansionary nor contractionary—somewhere in the range of 2-3/4 to 3 percent. Putting aside the uncertainties regarding the estimates of the neutral rate, this means that policy is expected to become mildly restrictive later in the projection period. Given an unemployment rate forecast below the natural rate,[4] such a policy stance would be quite normal and consistent with some moderation in growth and a gradual return of employment to its longer-run sustainable level.

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[2] While our objective is stated in terms of overall PCE inflation, core inflation—which strips out the volatile food and energy sectors—is a better gauge of sustained inflationary pressures and where inflation is headed in the future.

[3] Four times a year the FOMC releases its Summary of Economic Projections (SEP), which presents FOMC participants' forecasts of key economic variables over the next three years and for the longer run. Participants also provide their assessments of the appropriate monetary policy that supports those forecasts. For the most recent SEP, see Federal Open Market Committee (2018).

[4] The natural rate of unemployment is the unemployment rate that would prevail in an economy making full use of its productive resources. Consequently, it is the rate of unemployment that would predominate over the longer run in the absence of shocks to the economy.

Of course, these are just forecasts. In the end, we may need to tighten somewhat more if unexpected tailwinds emerge that push the economy too far beyond sustainable growth and cause inflation to rise too far above our symmetric 2 percent objective. Alternatively, we could face unexpected headwinds that threaten growth or inhibit inflation expectations from firmly centering around our 2 percent inflation target. In such a case we may need to take a more accommodative policy path.

The FOMC's stated intention of gradual increases in the federal funds rate target sounds pretty much like the more conventional, mainstream monetary policy that characterized the Fed's actions in the 20 years prior to the financial crisis. Considering the potential headwind or tailwind risks that might emerge, a gradual path gives us the flexibility to make appropriate risk-management adjustments to policy should they be called for.

A basic tenet of such good conventional monetary policy 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, along with 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 sustainable employment and price stability.

Obviously, from 2008 to 2014, the Fed did much more than this. These other actions were controversial and provoked criticism. However, financial turmoil, fiscal restraint, and the international situation required us to take such a course. We are now happily returning to our supporting actor role.

There is, however, an important difference between the conventional monetary policy of today and conventional policy prior to the Great Recession. Specifically, the potential growth rate of the economy and the neutral interest rate are a good deal lower than they used to be.

My colleagues and I have talked extensively in public about the factors that are driving neutral interest rates lower: slower population growth; a falling trend labor force participation rate; lower labor productivity growth; higher demand for safe assets by investors around the world; and lower inflation.[5] As you know, the U.S. isn't alone here; most advanced economies are facing similar situations.

This new reality has important implications for monetary policy. Between the mid-1980s and early 2000s, the Federal Reserve typically cut short-term policy rates something in the neighborhood of 5 percentage points when mitigating economic downturns. And at

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[5] A partial list of my speeches highlighting this point include Evans (2016a, 2016b, 2017, 2018a). Other colleagues have made this point as well. See, for example, Brainard (2016) and Williams (2017).

times we cut by even more: Between 1990 and 1992, we dropped rates by 6-3/4 percentage points, from 9-3/4 to 3 percent. Today, given a neutral 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.

So, unfortunately, the risks of returning to the ELB are higher than we would like. Although it's very hard to estimate, nearly 20 years ago one well-known study put these risks at about 15 percent; work done in 2017 put the odds today closer to 40 percent.[6] This represents a very high risk of experiencing a costly economic event that could compel the Fed to fall back on remedies policymakers often find difficult, if not downright distasteful, to implement.

This problem has led economists to think more about alternative frameworks that might improve the performance of monetary policy in a world with higher risks of returning to the ELB. Ideas include an explicitly higher inflation target (say, 4 percent); nominal-GDP targeting; temporary, state-contingent price-level targeting; and unconditional price-level targeting.[7]

It is not my intention today to offer any endorsements or critiques of these proposals. However, I would like to highlight some of the important issues to consider when evaluating the strengths and weaknesses of the various frameworks.

The implications of alternative frameworks for inflation

Let me begin with inflation. When the Federal Reserve started discussing an explicit inflation target in the 1990s, it certainly recognized that many factors play a role in determining the best inflation objective. I don't have time to go into them in any detail, but they included things like how inflation may influence labor market behavior, especially as downwardly rigid nominal wages can throw sand in the gears of labor markets and boost unemployment.[8] And, of course, another key consideration in target choice was how often we might encounter the effective lower bound. In the end, the Fed, like many other central banks around the world, ultimately settled on a 2 percent target.

The alternative monetary frameworks being discussed often allow for inflation much higher than 2 percent. Clearly, one way of reducing the ELB odds would be for inflation to average 3 or 4 percent over the long run, boosting the nominal neutral funds rate to 4 or 5 percent and providing more room to cut rates in a downturn. For this reason, a permanently higher inflation objective is on the list of possible alternative frameworks. The various level-targeting frameworks would produce temporary—though potentially protracted—periods of inflation above 2 percent. The reasoning is simple. Think about a price-level target. A period of subpar performance would open up a shortfall in the price level from its trend line target. To close the gap, policymakers would need to generate a period of above-trend-line inflation. Closing big gaps would require some big increases

[6] See Reifschneider and Williams (2000) and Kiley and Roberts (2017).
[7] See Evans (2018b) for remarks on alternative monetary policy frameworks.
[8] See Akerlof, Dickens, and Perry (1996).

in inflation.

What would be the public's reaction to such higher inflation rates? Would they believe the Fed would bring inflation back to 2 percent in the long run? Or would they figure that higher inflation was here to stay? Would they tolerate this change?

Naturally, a related set of issues would arise following a protracted period of overshooting a level target. Would the public support the monetary restraint required to deflate a large positive price-level or nominal-income gap? The experiences from applying such restraint in the 1980s were quite painful. But, because of the asymmetries inherent with the ELB and the ability of the Fed to confidently tighten monetary conditions by simply increasing short-term policy rates, I see such a scenario as less likely than a protracted undershooting of targets. Yet, it's still an important consideration.

In sum, these alternative monetary frameworks might be attractive in theory, but as a policymaker I must also consider how practical they would be to implement. I don't know the answer to that question yet.

Interactions between monetary and regulatory frameworks

Let's now turn to the interactions of monetary policy with financial markets and regulatory policies. Achieving our maximum employment and inflation mandates might require some long periods of strong monetary policy accommodation. Is the financial market system and regulatory environment robust enough to limit financial instability risks in those circumstances? Can the Fed conduct an effective and independent monetary policy strategy irrespective of the state of financial markets and regulatory policies?

Financial stability is an important goal of the Federal Reserve. As was all too apparent during the crisis, a breakdown in financial intermediation can have severe consequences for the real economy. So we must ask if some alternative monetary policy frameworks might be more (or less) prone to generating financial instability risks.

A robust financial market culture—in which excessive risk-taking is punished by market discipline first and regulatory restrictions second—would allow for stronger monetary strategies to be pursued. But a weak self-regulating market culture without adequate compensating public sector guardrails could prevent using the otherwise most effective monetary framework.

Of course, given the spectrum of competing incentives, these financial regulatory challenges are quite difficult to manage. And I should note that a robust macroprudential structure is relevant for any monetary policy structure, including our current one. But—and this is my point here—when designing strategies, we must understand the interactions between the monetary and regulatory frameworks. And we must recognize that these will change over time and over the business cycle.

Will strongly accommodative policies induce financial instability risks that require enhanced financial regulation? Or will market discipline alone be sufficient—regardless of the monetary framework we choose? The ultimate effectiveness of any strategy will depend on the answers to these questions. For example, suppose macroeconomic conditions called for an aggressive commitment to low policy rates and quantitative easing. If the regulatory regime was weak and financial instability risks were rising, then the public might doubt our will to carry through with these commitments. This loss of credibility would greatly diminish the efficacy of these policies. This quandary is not merely hypothetical. During the financial crisis, some opposed taking aggressive monetary policy actions over concerns about financial instability risks.

So policymakers will need to address the financial stability implications for each suggested alternative monetary framework. I certainly acknowledge that we have much important work to do on this front.

Conclusion: The need for outcome-based policies

I want to reiterate that I am not prejudging any alternative framework today. That being said, within the mix of possible outcomes, the Fed needs to give strong consideration to staying with our current monetary policy strategy. If we do so, we must ensure that it is as robust as possible. I believe an important way of achieving this is to emphasize outcome-based policy. One example of such policy is the threshold-based forward guidance we undertook in December 2012. Former Chair Yellen's lower-for-longer policy proposal to deal with ELB episodes can also be seen as falling into this category.[9]

Over the past several years most of my monetary policy commentary has emphasized the need for policy setting aimed at achieving our maximum employment and price stability objectives as quickly as possible—with an eye toward insuring against costly risk scenarios. Importantly, I think outcome-based policy actions should take precedence over faithful adherence to time-invariant instrument-based decision rules. One example of such a rule is the well-known Taylor rule, which uses fixed parameters to mechanically link the setting of the policy interest rate to deviations in inflation and employment from their long-run targets.[10]

But changes in the economic environment may reduce the effectiveness of such strict instrument-setting rules or, at times, even make them counterproductive. For instance, it clearly would be a mistake to insist on a 2 percent intercept in a Taylor rule when we think the neutral real federal funds rate is really closer to zero. Furthermore, such rules also do not allow for adjusting policy in one direction or the other as insurance against costly downside risks that might be evident to policymakers.[11] Focusing on hitting mandated outcomes with risk management against adverse scenarios can avoid such missteps.

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[9] Yellen (2018).

[10] Taylor (1993).

[11] See Evans et al. (2015) for a description of FOMC risk-management behavior.

To summarize, after many years, we finally are close to achieving our dual mandate objectives and are finally returning to a more conventional policy approach. This is good. But the economy has fundamentally changed, and there will be less headroom to cut policy rates when the next downturn occurs. We need to plan ahead. And when judging whether we stay with our current framework or move to an alternative, we need to remember that the key criterion is the ability to deliver on the central bank's mandated policy goals. Regardless of the policy framework, the goals of maximum employment and price stability remain unchanged—as does the Federal Reserve's mandate to meet them as best as it can.

Thank you.

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