
The New Monetary Policy Framework and Some Implications for Financial Stability

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Federal Reserve Actions During the Coronavirus Pandemic
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Introduction

Thank you for the introduction and the opportunity to participate alongside these distinguished panelists in today's important discussion. I had hoped to welcome all of you to Chicago in person, but, well, here we are in our virtual world. Wherever you are, I wish you a happy and healthy new year. Before I begin my remarks, I should note that these views are my own and do not necessarily represent those of my colleagues on the Federal Open Market Committee (FOMC) or others in the Federal Reserve System.

The current upsurge in Covid cases is a serious problem. But progress on the vaccine front has been very positive, and it looks like the health crisis will be brought under control as we move through the year. So as we look forward to life after Covid-19, what is in store for monetary policy?

Of course, we'll be entering this period with policy rates at the effective lower bound (ELB), where we swiftly brought them last March in recognition of the severe impact the pandemic would have on economic activity and inflation.¹ We also took a wide range of classic lender-of-last-resort actions to address the massive shock in financial markets. My fellow panelists undoubtedly will have more to say about these actions. For my

¹ See Federal Open Market Committee (2020e, 2020f).

remarks, though, I would like to look beyond the short-term financial market response and focus on longer-term macroeconomic and financial stability issues raised by the proximity of the effective lower bound.

The effective lower bound has become all too familiar. Indeed, we have been in a similar situation before—when we brought policy rates to the effective lower bound with the Great Financial Crisis and, in the end, held them there for seven years.² The threat of the ELB is now clearly a persistent feature of the economic landscape, and it poses profound challenges for central banks to provide sufficient accommodation to meet their monetary policy goals. One of these goals is hitting an inflation target. Recall that the Fed first announced a formal inflation target of 2 percent in 2012.³ In 2016, we clarified that the target was symmetric and that we would be concerned if inflation were running persistently above or below 2 percent.⁴ Yet, with only a few exceptions, inflation has consistently undershot our 2 percent objective ever since we announced that target.

This experience, together with a growing body of research, strongly shows that under traditional monetary policies, proximity to the effective lower bound imparts a downward bias to inflation expectations and actual inflation.⁵ This is a serious problem. The inflation rate over the longer run is primarily determined by monetary policy. It is the central bank's responsibility. So in my view we can't spend the next five years underrunning our target and just offer up explanations for why bringing inflation up to

² See Federal Open Market Committee (2008).

³ Federal Open Market Committee (2012).

⁴ Federal Open Market Committee (2016).

⁵ Adam and Billi (2007).

2 percent is so hard. Instead, we have to avoid such poor outcomes by using policy strategies that offset this downward bias.

With these challenges in mind, the FOMC recently revised our long-run monetary policy strategy that guides our policy responses.⁶ In the remainder of my remarks, I will review the new framework in a bit more detail. I will discuss how I see our new framework relating to recent research on how monetary policy can address the downward bias in inflation expectations and then discuss what this might actually look like in practice. I will finish up with some implications of these policies for risk-taking in financial markets.

The revised long-run framework

To me, the biggest impetus for updating our monetary policy strategy came from an undeniable realization: The effective lower bound on the federal funds rate was not just an anomaly we stumbled into during the Great Financial Crisis, but a persistent threat to the achievement of our dual mandate goals.

The research here is clear. For all the well-known structural reasons, the long-run equilibrium real fed funds rate⁷ is much lower now than it was in the 1980s and '90s. This means even average business cycle shocks will drive the funds rate to its effective lower bound—let alone the kind of shock we received in March. Research also shows that under traditional monetary policy strategies, the limits on reducing policy rates presented by the proximity of the ELB will impart a downward bias to inflation and

⁶ Federal Open Market Committee (2020d).

⁷ The equilibrium, or neutral, federal funds rate is the funds rate associated with a neutral monetary policy (policy that is neither expansionary nor contractionary).

inflation expectations relative to our 2 percent target. This bias is always present; it's not just an occasional risk associated with a large negative shock. In addition, these limits on reducing rates will also impede achievement of our maximum employment mandate.

These facts imply a couple of things. First, a systematic adjustment to monetary policy strategy is needed to offset the bias. Second, at times this bias-adjustment will require generating inflation above 2 percent in order to center inflation and inflation expectations at target. I am happy to say that the new monetary policy strategy delivers on these two fundamental principles with its flexible inflation averaging goal and explicit recognition for the need, at times, for policy to purposely aim for inflation rates higher than 2 percent.

The new framework also emphasizes that our maximum employment mandate is a broad-based and inclusive goal and that monetary policy will seek to eliminate *shortfalls* from maximum employment. Recall that the old strategy sought to minimize *deviations*—both positive and negative—from maximum employment, not just shortfalls. This was an important refinement. The new framework recognizes that we should not rush to raise rates and risk ending a vibrant, more inclusive job market unless inflation threatens to become uncomfortably high. Such an approach can help ensure that the many individual and community benefits that come with high employment are more effectively reaching a broader share of the population. Furthermore, as we all are well aware, the link between unemployment and inflation pressures is subject to a great deal of uncertainty—just think how before the pandemic, inflation was running below target despite a historically low 3-1/2 percent unemployment rate.

Now, the new strategy statement does not include specific operational details for how to achieve our goals. I think that is a feature, not a bug. I have long thought that no specific formulaic monetary policy rule will be robust to all of the changes in the economic environment that inevitably will occur. The strategy statement is, instead, a commitment to an outcome-based policy approach—a philosophy that I have supported throughout my tenure on the FOMC. The precise policy tools and their settings may vary with economic conditions, but the ultimate policy goals remain the same.

Policy research

Now let me take a step back and talk about the academic literature. I believe our new framework is quite consistent with researchers' conclusions about optimal monetary policy in the presence of the ELB.

This literature has established that the ELB induces a downward bias to achieving an inflation target under standard symmetric policy responses. It also has proposed a range of alternative monetary policy frameworks to address this bias. Such frameworks include flexible average inflation targeting, as the Federal Reserve has adopted; price level targeting; so-called dovish policies, such as described by Thomas Mertens and John Williams; and also asymmetric reaction functions and target ranges, as found in work by Francesco Bianchi, Leonardo Melosi, and Matthias Rottner.⁸

Now, these types of models involve very strong assumptions: completely rational and forward looking agents, complete credibility of the monetary authority, and no

⁸ See Mertens and Williams (2019) and Bianchi, Melosi, and Rottner (2019).

adjustment lags or other inertias in the economy. Under such conditions, these models offer clear policy prescriptions and their implementation works perfectly. Rational agents immediately align their views with the bias-corrected distribution of inflation generated by the new policy rule.

Of course, this idealized setting is unrealistic when it comes to actually implementing monetary policy. I view our new flexible average inflation target strategy as a way to implement the spirit of some of these models while acknowledging the complexities of the real world. Importantly, in the real world, actual outcomes are needed to build credibility. Some actors will need to see inflation actually average 2 percent in practice before they fully adjust their expectations. Real-world implementation also will require extensive and ongoing communication so that the public understands our efforts to offset the inflation bias. Well-articulated outcome-based forward guidance will be a key part of this process.

Policy under the new framework

This naturally brings us to the forward guidance the Committee issued in September.⁹ This guidance created a two-pronged plan. The first prong calls for the federal funds rate to remain at the effective lower bound until our employment mandate is met and inflation reaches 2 percent and is on target to overshoot. Then, the second prong involves increasing the federal funds rate slowly enough to maintain the accommodation needed to achieve moderate overshooting for some time, so that inflation actually

⁹ Federal Open Market Committee (2020c).

averages 2 percent. And last month we augmented this with guidance saying we will maintain our current pace of asset purchases until substantial further progress has been made toward our maximum and inclusive employment and price stability goals.¹⁰ For this approach to be successful, economic agents must have strong confidence that policy will remain sufficiently accommodative to generate these outcomes.

How will this work out in practice? After all, there are multiple paths that could achieve 2 percent average inflation, depending on the horizon and the extent of overshoot tolerated. Let me give you a couple of examples. Suppose that we take as our benchmark the average of inflation beginning in the first quarter of 2020. According to the most recent Summary of Economic Projections, core PCE inflation is projected to be 1.4 percent in 2020 and to gradually rise to 2 percent in 2023.¹¹ Suppose then that core PCE inflation reaches 2-1/4 percent in 2024 and stays there. In this scenario, average core inflation would not reach 2 percent until late 2025 or early 2026. A 2 percent average could be achieved about a year sooner if inflation rose to 2-1/2 percent in 2024.

Now, we are not going to follow a strict numerical formula for moving policy. Still, these examples illustrate an inevitable bottom line: It likely will take years to get average inflation up to 2 percent, which means monetary policy will be accommodative for a long time. This translates into low-for-long policy rates, and indicates that the Fed likely will be continuing our current asset purchase program for a while as well. So economic

¹⁰ Federal Open Market Committee (2020b).

¹¹ Federal Open Market Committee (2020a). While our objective is stated in terms of overall inflation measured by the Price Index for Personal Consumption Expenditures (PCE), 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.

agents should be prepared for a period of very low interest rates and an expanding Fed balance sheet as we work to achieve both our dual mandate objectives. Of particular relevance for this session, financial market participants and financial market regulators are going to have to operate against this backdrop.

Financial stability

What are the implications of this monetary policy accommodation for financial markets?

Low interest rates for extended periods of time and a relatively flat yield curve¹² amid ongoing asset purchases by the Federal Reserve raise concerns that a reach for yield in markets could generate financial instability risks. Institutional investors, such as life insurance companies and pension funds that have nominal return targets, may have an incentive to take on extra risk to meet a stream of fixed liabilities. Other investors may simply decide that low interest rates provide an opportunity to cheaply take on more leverage and, consequently, operate with more risk.

Of course, looser financial conditions are part of the monetary policy transmission channel. By providing more accommodation, central banks encourage private risk-taking and investment that would not have otherwise been optimal for private-sector decision-makers. In such cases, the public policy goal of maximum, inclusive employment and average 2 percent inflation may be achieved sooner and more assuredly. So the concern is not just whether more risk is being taken by private agents,

¹² A yield curve is the line plotting the yields or interest rates of assets of the same credit quality but with differing maturity dates at a certain point in time. These assets, such as U.S. Treasury securities, typically yield incrementally more at longer maturities.

because of course it is. Rather, the concern is whether excessive risk-taking gives rise to marketwide financial instability by accelerating negative shocks when they arise or by otherwise imparting some negative economic externality that limits the attainment of maximum, inclusive employment and average 2 percent inflation.

Suppose that monetary policymakers were to respond to these financial stability concerns and raise interest rates or reduce asset purchases preemptively, before being on track to meet their policy objectives. The result could be a lose-lose scenario. A premature tightening of monetary policy could not just threaten the achievement of our dual mandate objectives, but might not even improve financial stability either, given that financial stability is bolstered by a strong economy. Furthermore, if forced to react to highly uncertain and fast-moving financial stability concerns, monetary policy could become less predictable and, therefore, potentially less credible and effective. This lack of predictability would also raise the level of risk premiums in financial markets being generated by policy uncertainty instead of by underlying economic fundamentals. This is especially important in our revised framework, with its strong reliance on clear and consistent forward guidance.

With these considerations in mind, my view is that financial stability objectives are best addressed through supervision and regulation rather than through monetary policy tools. Since the financial crisis, the Federal Reserve and other regulators have made progress in macroprudential supervision, including enhanced monitoring of financial stability and the development of new tools, such as stress tests in the supervision of banks. But more can and should be done. The reality that the effective lower bound is no longer an unusual occurrence prompted the FOMC to embark on a comprehensive

review of its monetary policy framework and make changes in our monetary policy strategy. Perhaps it is time for financial institutions and their supervisors to do the same—that is, review their business models and make their supervisory and regulatory strategies as robust and resilient as possible—in this low nominal interest rate environment.

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