# Charles L Evans: Thoughts on accommodative monetary policy, inflation and financial instability

Speech by Mr Charles L Evans, President of the Federal Reserve Bank of Chicago, at the Credit Suisse Asian Investment Conference, Hong Kong, 28 March 2014.

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## Introduction

Thank you, Mr. Naqvi. It is truly a pleasure to be here today at the Credit Suisse Asian Investment Conference, and I thank the organizers for including me in this impressive program.

Today, I would like to make three points concerning the U.S. economy and accommodative monetary policy. First, the U.S. economy continues to improve, and accommodative monetary policy will remain a strong support for this recovery for quite some time. Second, although highly accommodative monetary policy can lead to increasing inflation risks today, inflation in the United States is too low. And this is true throughout much of the world. Third, while low interest rates could lead to financial exuberance in principle, monetary policy is not the best tool to mitigate this risk. Instead, macroprudential policies are more appropriate tools to address the risk of financial instability.

Before turning to the details of these three points, I need to note that, as always, the standard Fed disclaimer applies: I will be giving my personal perspective, and that is not necessarily shared by my colleagues on the Federal Open Market Committee (FOMC) or in the Federal Reserve System.

## Recent Monetary Policy Actions

As you all know, in response to the unusual economic circumstances generated by the financial crisis and the Great Recession, the FOMC lowered our traditional policy tool – the target federal funds rate – to near-zero levels in December 2008 and has kept it there since. With the fed funds rate constrained at this lower bound, and economic conditions requiring additional policy accommodation, the Committee also deployed nontraditional policy tools to stimulate activity. We embarked upon large-scale purchases of long-term Treasury securities and agency mortgage-backed securities. We also used new communications tools to provide forward guidance about how long short-term interest rates will essentially remain at their lower bound of zero.

While large-scale asset purchases and forward guidance are unconventional tools, their effect on interest rates and real economic activity is quite conventional. Both tools are aimed at stimulating economic activity through lower long-term interest rates. Through arbitrage and portfolio rebalancing, lower rates in one market are transmitted to other interest rates faced by investors, nonfinancial firms and consumers. Lower rates are also transmitted across the asset and maturity spectrum. There is significant evidence that the FOMC's policies have been helpful in reducing financing costs rates paid by firms and consumers and, more generally, in supporting aggregate demand in the face of substantial economic headwinds over the past six years.

It should be noted that economic activity picked up momentum in the second half of 2013. Overall, real gross domestic product (GDP) grew at a bit under a 3-1/2 percent rate in the second half, up from an average pace of growth of about 2 percent over the previous three years. Moreover, we've seen some more solid consumer spending, which should provide further impetus to overall growth this year. In the labor market, job growth has been solid and the unemployment rate is down to 6.7 percent. That is well below the 8.1 percent rate that prevailed when we instituted the latest round of large-scale asset purchases in September 2012.

However, we aren't out of the woods yet. The harsh weather of this past winter – by which I mean the North American polar vortex – makes the recent data difficult to interpret. That said, some of them have been on the soft side. Balance sheet scars from the financial crisis are still weighing on the economy. Fiscal policy is a restraint on economic growth. And economic activity abroad is not robust. The good news is that all of these headwinds appear to be dissipating. But risks remain. And we still have large resource gaps. For example, the unemployment rate is still well above the 5-1/4 percent rate I think it should be in the long run. At the same time, inflation is only 1 percent – well below the FOMC's longer-run target of 2 percent. Accordingly, monetary policy is highly accommodative, and needs to remain so for some time.

Given these developments, the FOMC began adjusting the mix of its tools in December. The Committee, however, is maintaining the overall highly accommodative stance of policy. The Committee modestly reduced the pace of its monthly asset purchases from $85 billion to $55 billion in three separate $10 billion steps. In addition, with the unemployment rate approaching the 6-1/2 percent threshold that was established in December 2012, the Committee decided it was time to update its forward guidance on the future path of short-term interest rates. Our policy statement now emphasizes that when deciding how long short-term rates will remain at their current level, the Committee will use a wide range of information to assess the realized and expected progress toward our dual mandate goals of maximum employment and price stability. The statement also indicates that given the Committee's current assessment of these factors, it likely will be appropriate to keep the fed funds rate at its current level for a considerable period after the asset purchase program ends. Furthermore, even after the economy lifts off and employment and inflation are near mandate-consistent levels, economic conditions likely will warrant keeping short-term rates below their typical long-run level for some time.

The various asset purchases the Fed has undertaken since 2008 have expanded our balance sheet more than fourfold, to over $4 trillion dollars. Moreover, according to the FOMC's projections and the latest market expectations, by the time the policy rate increases, it will have been near zero for about seven years. These are startling facts and should certainly get your attention! As prudent policymakers, we would be remiss if we failed to carefully assess potential risks that might arise from these unusual and extraordinary policies.

As the FOMC's communications indicate, the Committee has fully reviewed the potential costs of its policies and it reassesses them regularly. I think that the benefits of our policy choices continue to far outweigh the potential risks. However, we must repeatedly think long and hard about two risks that are mentioned often – namely, that our expanded balance sheet and the prolonged period of low rates raise 1) the risk of higher inflation; and 2) the risk of financial instability. What can go wrong? Do we have the appropriate infrastructure and tools to adequately assess and manage these risks? To address these questions, we must evaluate these risks within the context of the goals of monetary policy and the current state of the economy and financial markets.

## Inflation risks

Let me start with the risk of high inflation. As far back as mid-2009, Fed critics warned that our near-zero policy rate and trillions of dollars in asset purchases risk generating very high inflation. On several occasions, to underscore this risk, I have been presented with a gift of a Zimbabwe 100 trillion dollar note. As someone who is subject to a 20 U.S. dollar limit on gifts, I can assure you it is within the guidelines to accept one of these notes.

The monetary policy mandates of the Federal Reserve are clear: We must foster monetary and financial conditions that support maximum employment and price stability. Since January

2012, the Fed has set an explicit goal for inflation of 2 percent, as measured by the price index for total personal consumption expenditures, or PCE. So, how are we doing with respect to this 2 percent target and our Zimbabwean risks?

Despite many earlier predictions of unacceptably high inflation, total PCE inflation has been hovering around just 1 percent since early 2013. Other inflation measures, notably, the well-known Consumer Price Index (CPI), are also well below their related benchmarks.[1] Forecasters often look at core inflation, which excludes volatile food and energy prices, because it is a better predictor of where overall prices are headed than is total inflation. Our progress toward the inflation target is not noticeably faster by this metric either. Core PCE inflation was just 1.1 percent over the past year and has been at this rate since last spring. Most private sector forecasts and survey measures of inflation expectations have remained well anchored and do not ring any alarms of high inflation. Expectations embedded in asset prices tell a similar story. Sophisticated models that extract inflation expectations from the yield curve show that investors' inflation expectations at the three-year horizon are below 2 percent and will be below 2 percent for several years.

All told, the risk of high inflation seems very low. In fact, I am concerned that inflation will not pick up quickly enough. As I noted, we have been stuck at 1 percent inflation since early 2013, and there is little indication of a pickup in the recent data. Low inflation is just as economically costly as high inflation. When we set an inflation target of 2 percent, we need to hit our target without too much delay. Simply put, we need to average 2 percent inflation over the medium term.

Accordingly, the current 1 percent inflation situation calls for extended policy accommodation. If the Fed embarked prematurely on more restrictive monetary policy conditions, these adverse actions would work to reduce inflation to further unacceptably low levels. That's going in the wrong direction.[2]

### Financial stability and monetary policy

It is easy and most natural for a Fed policymaker to talk about inflation. Price stability is one of the explicit goals of monetary policy as mandated by the U.S. Congress. Financial stability risks are more complicated. How does financial stability dovetail with the Fed's dual mandate? There is clearly an interdependent relationship between them. A strong economy with low inflation provides a key stabilizing force for beneficial credit intermediation and robust financial market functioning. At the same time, stable and well-functioning financial markets are essential for achieving maximum employment and price stability. The global experience since 2008 reinforces this critical interplay between monetary and financial conditions.

However, beyond these basic principles, what is the appropriate monetary policy stance for achieving both financial stability and the dual mandate of maximum employment and price stability?

With inflation running well below our 2 percent longer-run target and the unemployment rate still well above its normal long-term level, appropriate monetary policy dictates that low real interest rates should prevail until the economy is further along a sustainable path to its potential level and inflation is closer to target. Nonetheless, it is common to hear the

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1 Because of some differences in product coverage and statistical methodologies, total CPI inflation tends to average 1/4 to 1/2 percentage points higher than total PCE inflation. Hence, the FOMC's 2 percent target on total PCE inflation would translate to a 2.3 percent to 2.5 percent target for total CPI inflation.

2 I recently discussed the costs of too-low inflation and the implications of having a 2 percent inflation target in a January 15 speech; see Evans (2014).

argument that these highly accommodative monetary policies might sow the seeds of financial instability.

The fear is that excessive and persistently low interest rates would lead to excessive risk-taking by some investors. For instance, some firms, such as life insurance companies and pension funds, are under pressure to meet a stream of fixed liabilities incurred when interest rates were higher.[3] (And perhaps these liabilities were offered at somewhat generous terms to begin with.) To meet commitments like these in the current low interest rate environment, some firms have an incentive to reach for yield by investing in excessively risky assets. Furthermore, with the costs of borrowing at historically low levels, other investors might simply decide that this is a good time to cheaply amplify the risk and return in their portfolios by taking on more leverage.

One could reach the conclusion that historically low and stable interest rates pose a threat to financial stability. This creates a seeming paradox for policymakers. On the one hand, the existing large shortfalls in aggregate demand call for highly accommodative monetary policies and historically low interest rates. On the other hand, such policies have the potential to raise the likelihood of financial instability in the future.

So, the questions that I'm often asked regarding these matters are as follows: Do the regulators and the Fed have adequate safeguards in place to mitigate this potential financial risk? If not, should the FOMC step away from what we thought was the best monetary policy with respect to our dual mandate? Should we discard our nonconventional tools and raise the fed funds rate in order to reduce the possibility of undesirable financial imbalances in the future?

I don't believe that such monetary policy adjustment is the right approach. I think the inference that persistently low interest rates pose a danger to financial stability is based on a narrow view of the economy. This narrow view is unlikely to survive a broader analysis that takes into account all the interactions between financial markets and real economic activity.

If more restrictive monetary policies were pursued to generate higher interest rates, they would likely result in higher unemployment and a sharp decline in asset prices, choking the moderate recovery. Such an adverse economic outcome is unlikely to set a favorable foundation for financial stability. Moreover, our short-term interest rate tools are too blunt to have a significant effect only on those pockets of the financial system that are most prone to inappropriate risk-taking. At the same time, these blunt tools could significantly damage other markets, as well as the growth prospects for the economy as a whole. Therefore, stepping away from otherwise appropriate monetary policy to address potential financial instability risks would degrade progress toward maximum employment and price stability. This approach would be a particularly poor choice when other tools are available, at lower social costs, to address the risk of financial instability.

Let me be clear. I am not saying that financial stability concerns are not relevant for the economy or that policymakers should not take decisive action against developments that threaten financial stability. Rather, I am saying that the macroprudential tools available to policymakers are better-suited safeguards to addressing financial risks directly. These macroprudential actions can be dialed up or down given the appropriate setting of monetary policy tools; so, undesirable macroeconomic outcomes are less likely than if we were to resort to premature monetary tightening. Indeed, any decision to instead rely on more-restrictive interest rate policies to achieve financial stability at the expense of poorer macroeconomic outcomes must pass a cost–benefit test. And such a test would have to clearly illustrate that the adverse economic outcomes from more-restrictive interest rate

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3 I should note that increases in interest rates since last spring have increased discount factors and thus lowered the present value of pension fund and other fixed nominal liabilities. For instance, see Fitch Ratings (2013).

policies would be better and more acceptable to society than the outcomes that can be achieved by using enhanced supervisory tools alone to address financial stability risks. I have yet to see this argued convincingly.

## Macroprudential tools

Let's discuss some of these macroprudential tools.

One simple but important tool is enhanced monitoring. Even before the recent financial crisis, central bankers were well aware of the key role played by stable financial markets in economic activity. Since the crisis, however, the analysis of financial stability issues has been greatly expanded and given a more prominent role in the FOMC's deliberations. We comb through reams of data looking for evidence of incipient risks to financial stability.

The Federal Reserve also has revamped its approach to bank supervision substantially to expand the focus on macrofinancial risks. Traditional bank supervisory tools are being used more intensively, and new tools have been developed. Bank capital stress tests are one well-known addition to our supervisory toolkit. Another is the augmentation of traditional microprudential supervisory work that analyzes individual institutions with efforts that take a wide-angle view of the banking industry. Supervisors look to identify common trends across institutions and emerging concentrations of risks that might pose systemic threats to the financial system. This broad view also allows supervisors to better identify sound practices among firms and incorporate them into supervisory reviews and the feedback provided in them.

The Federal Reserve also has greatly expanded its surveillance efforts to financial markets outside of the traditional banking sector, such as the insurance industry and financial market utilities. These efforts are not confined to financial institutions per se, and reach a range of activities that might pose a potential threat to financial stability. For instance, staff members from the Chicago Fed are actively engaged in assessing the role of high-frequency computerized trading in securities and derivatives markets and associated risks that might arise with it.

These are just a few examples of regulatory tools available to monitor and promote financial stability. And there are a host of other instruments in our toolkit, such as resolution plans, liquidity requirements and single counterparty credit limits. All are examples of improvements in supervisory practices aimed at reducing the likelihood of systemic disruptions and containing the impact should such disruptions occur.

## Conclusion

To reiterate, I currently expect that low inflation and still-high unemployment will mean that the short-term policy rate will remain near zero well into 2015. In this environment, some have questioned the ability of our supervisory and regulatory tools to adequately address potential financial instability risks. They argue that a broad tightening of interest rate policy might be more effective in catching incipient risks that might fall through the cracks. It is certainly true that higher interest rates would permeate the entire financial system. But this is just another way of saying that raising interest rates is a blunt tool. Higher interest rates would reduce risk-taking where it is excessive; but they also would result in a pullback in economic activity in sectors where risk-taking might already be overly restrained. That's how a blunt tool works.

If you believe that financial stability can only be achieved through higher interest rates – interest rates that would do immediate damage to meeting our dual mandate goals at a time when unemployment is still unacceptably high – then we ought to at least ask ourselves if the financial system has become too big and too complex.

Think about how problematic the cost-benefit calculus becomes if the only way we can achieve financial stability is to raise interest rates above the level where the forces of demand and supply in the real economy put them. The possible benefit of such a restrictive rate move would be to reduce risks that might be forming in the nooks and crannies of a highly complex financial system. But the costs would be 1) higher unemployment; 2) a risk of choking off the economic recovery; 3) even lower inflation below our objective; and, somewhat paradoxically, 4) the introduction of new financial risks by reducing asset values and credit quality. Given such cost-benefit trade-offs, I would have to question whether the financial system has become too complex – perhaps complex enough to generate negative social value. Rather than degrading our macroeconomic performance through suboptimal monetary policies, I would have to consider whether we should contemplate big changes to the financial system – a lot more rules, substantially higher capital requirements for all institutions and maybe even fewer financial products.

However, I have a more favorable view of the social value of our financial system and the efficacy of supervision and regulation. Since the financial crisis, the Federal Reserve has expanded its macroprudential toolkit and enhanced its microprudential tools. We have also reoriented our approach to supervision to take full advantage of the Federal Reserve System's wide-ranging expertise on macroeconomic and financial developments and risks.

I believe that these regulatory efforts can effectively minimize the risks of another crisis and increase the resiliency of the financial system. We can achieve these objectives without having to resort to wholesale changes to the financial system and without degrading our monetary policy goals. Maintaining the effectiveness of the financial system for generating more-robust economic growth continues to be a crucial objective for public policy. Thank you for your time, and I would be happy to take your questions.

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