Monetary Policy: Lessons from the Past and Looking Forward to the Future

The Federal Reserve at 100
Loyola University Chicago
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Charles L. Evans
President and CEO
Federal Reserve Bank of Chicago

Three Big Events in Fed History

- **The Great Depression (1929-1938)**
  - "Inept monetary policy" failed to adequately combat credit contraction, deflation, and depression
- **The Great Inflation (1965-1980)**
  - Monetary policy failed to recognize structural changes and expectational dynamics that led to double-digit inflation
- **The Treasury Accord (1951)**
  - An example highlighting the importance of central bank independence

Academic Foundations of Modern Central Banking

- **Great Depression: Central banks must address nominal crises**
  - Friedman and Schwartz (1963)
  - Bernanke (1983, 1985)

- **Great Inflation: Central banks must distinguish real from nominal cycles**
  - Friedman (1968)
  - Lucas (1972)
  - Kydland and Prescott (1982)

- **Central bank independence: Central banks must be able to act as necessary**
  - Kydland and Prescott (1977)
  - Barro and Gordon (1983)
  - Rogoff (1985)

Long-Run Strategy for Monetary Policy
(January 2012 and January 2013)

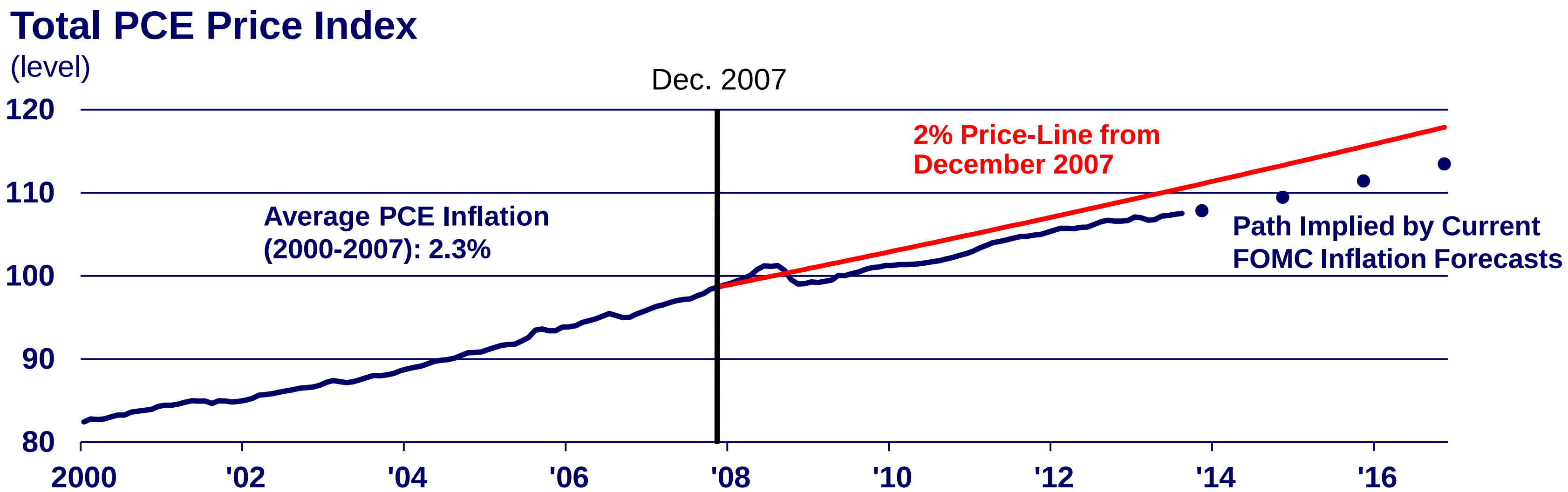
- **π^* = 2% PCE inflation**

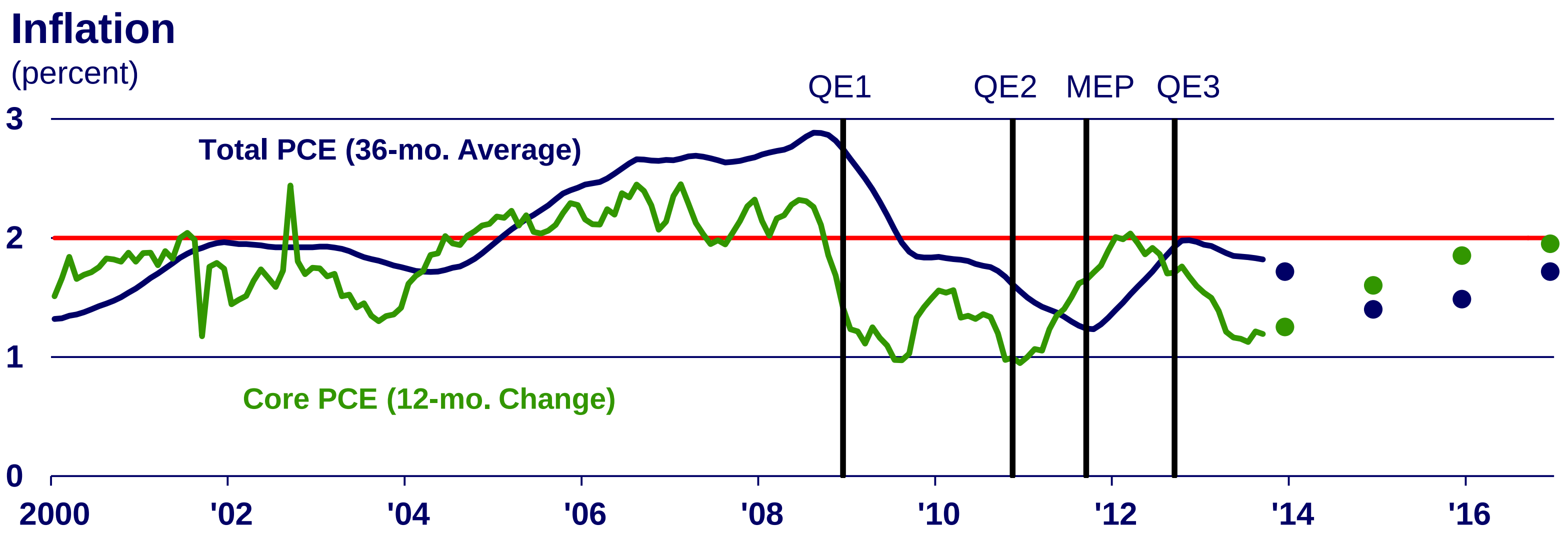
- **U_t^* ~ 5¼% - 6%** **time-varying**

  SEP long-run sustainable range

- **Balanced approach to reducing deviations of inflation and employment from long-run objectives**

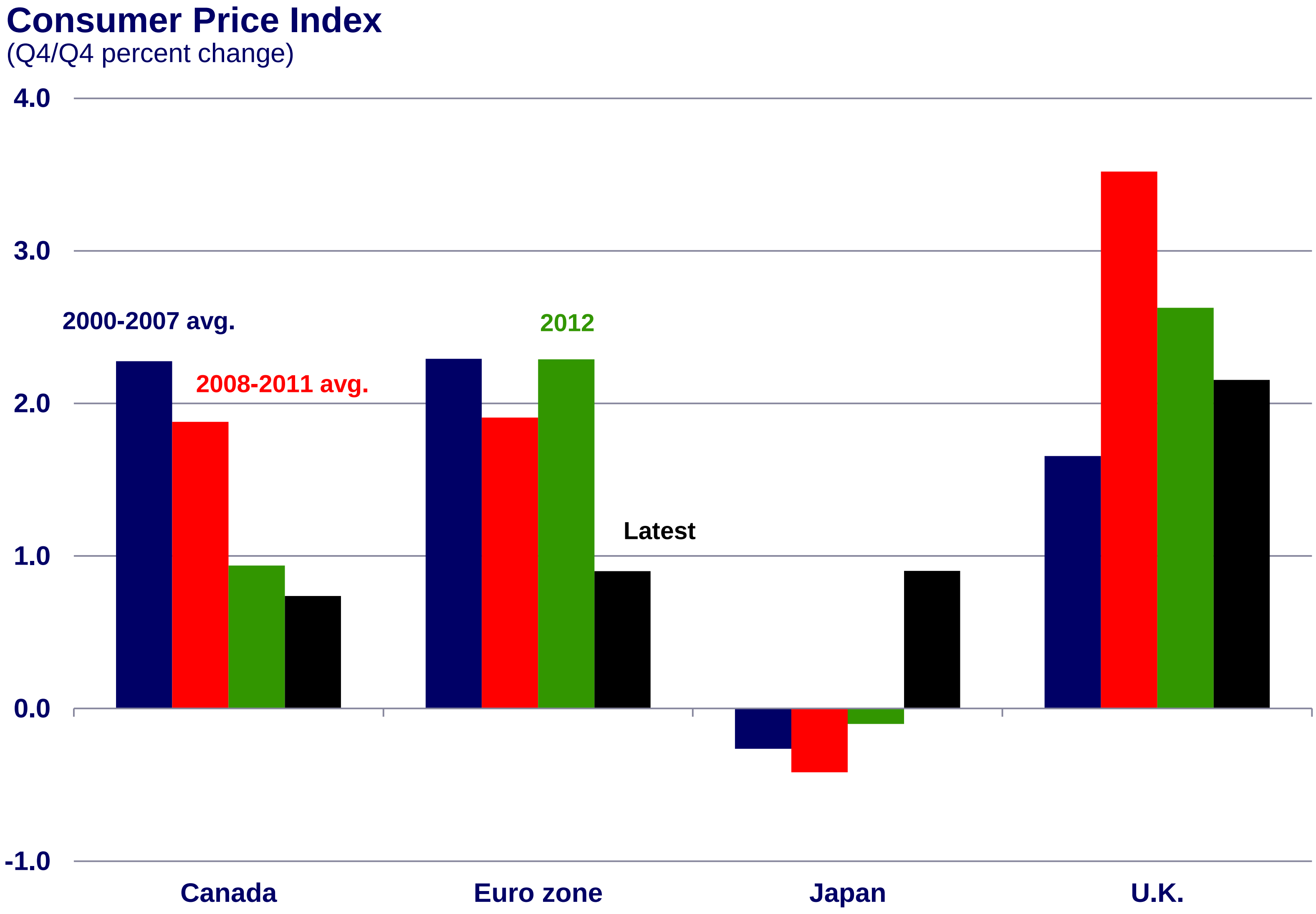
Would Today's Dilemma Be Different under a Single Mandate?





Source: Inflation forecasts are from the September 18, 2013 FOMC Summary of Economic Projections

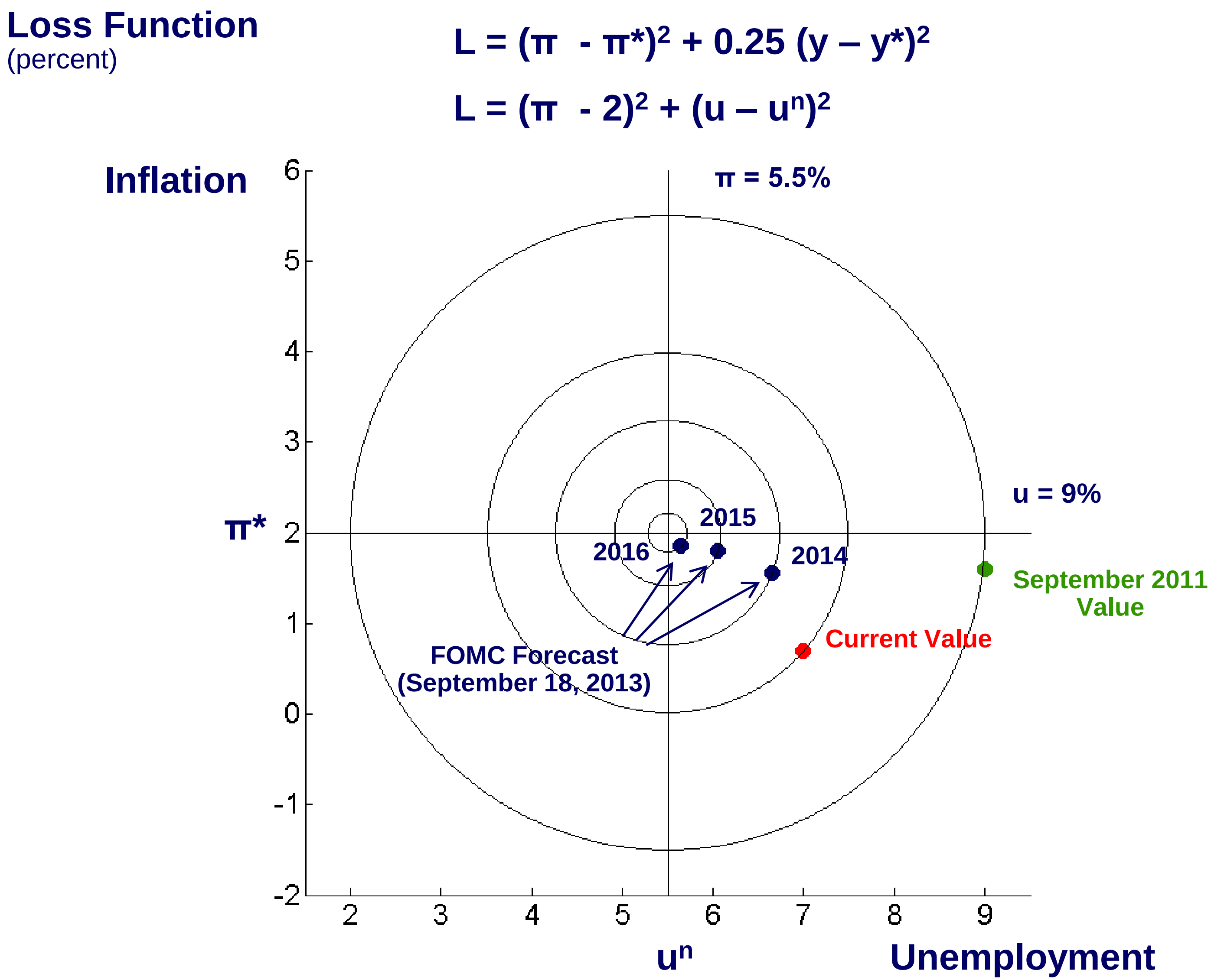
Inflation is Low Globally



Balanced Approach to the Dual Mandate Is Consistent with Mainstream Macroeconomics

$$L = (\pi - \pi^*)^2 + 0.25\,(y - y^*)^2$$

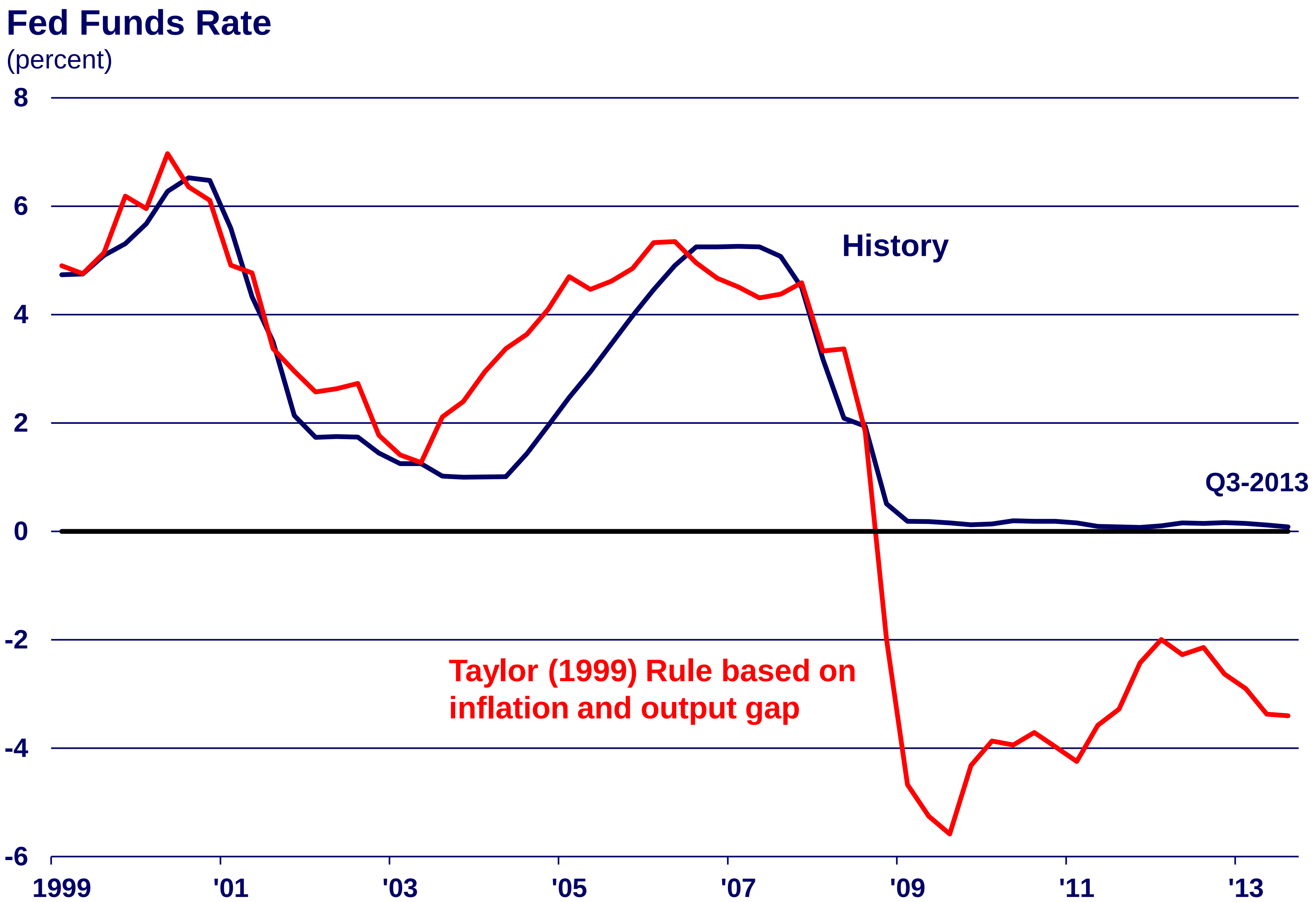
$$L = (\pi - 2)^2 + (u - u^n)^2$$



Why Has Achieving Dual Mandate Been So Hard?

- Deleveraging in the aftermath of the financial crisis
- Global risks
- Unusually restrictive fiscal policy
- Monetary policy constrained by zero lower bound

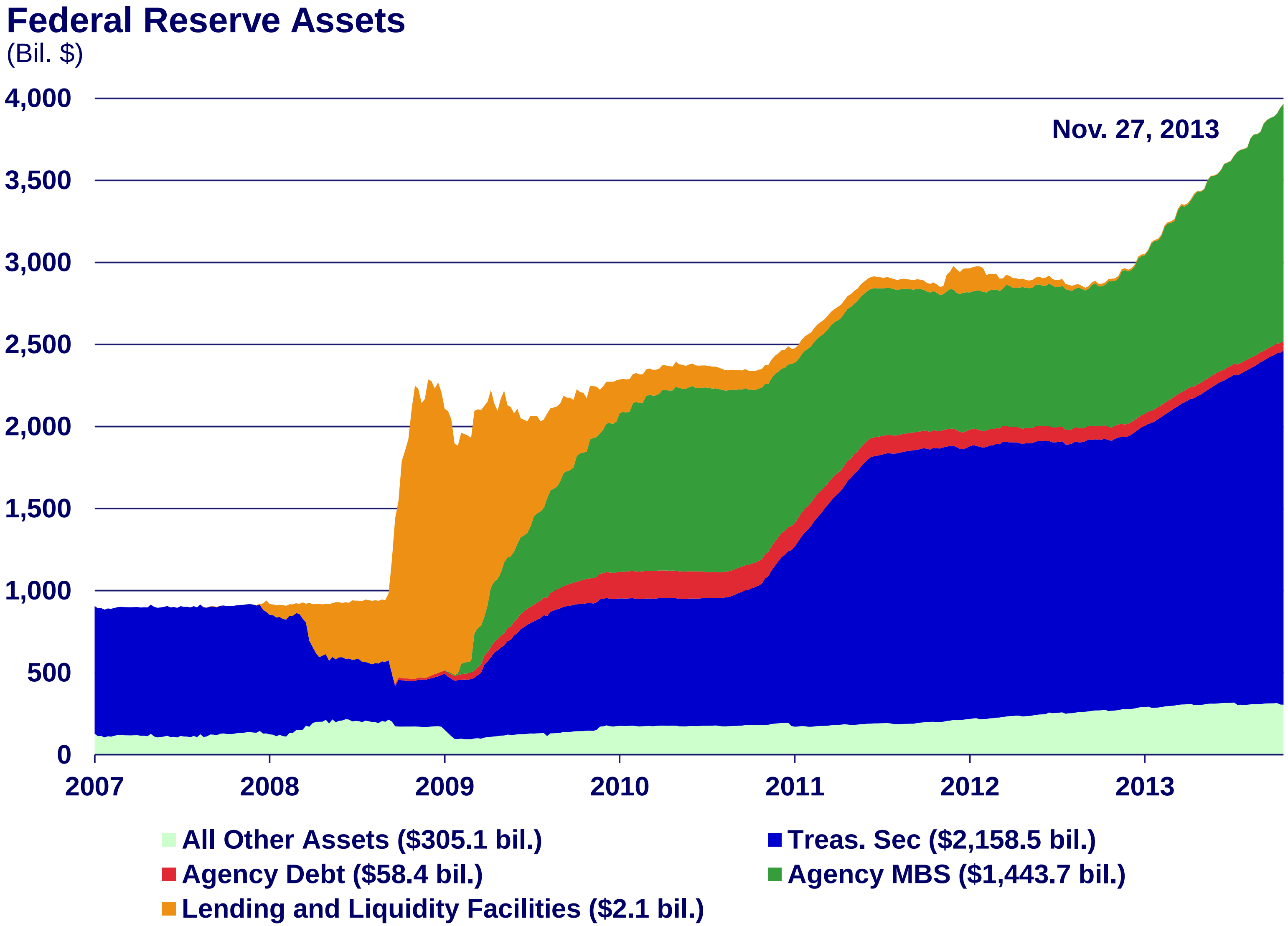
Policy Rate Constrained by Zero Lower Bound



Policy Tools at the Zero Lower Bound

- **Large Scale Asset Purchases**
  - \$45 bil. in Treasuries & \$40 bil. in agency MBS per month until substantial improvement in labor market outlook
- **Forward Guidance**
  - Zero interest rate <u>at least</u> until $U < 6.5\%$ or $\pi > 2.5\%$
- **Features of both unconventional tools**
  - Lower long-term interest rates
  - Disciplined by economic conditionality

Asset Purchases: The Fed's Balance Sheet



Forward Guidance on the Federal Funds Rate

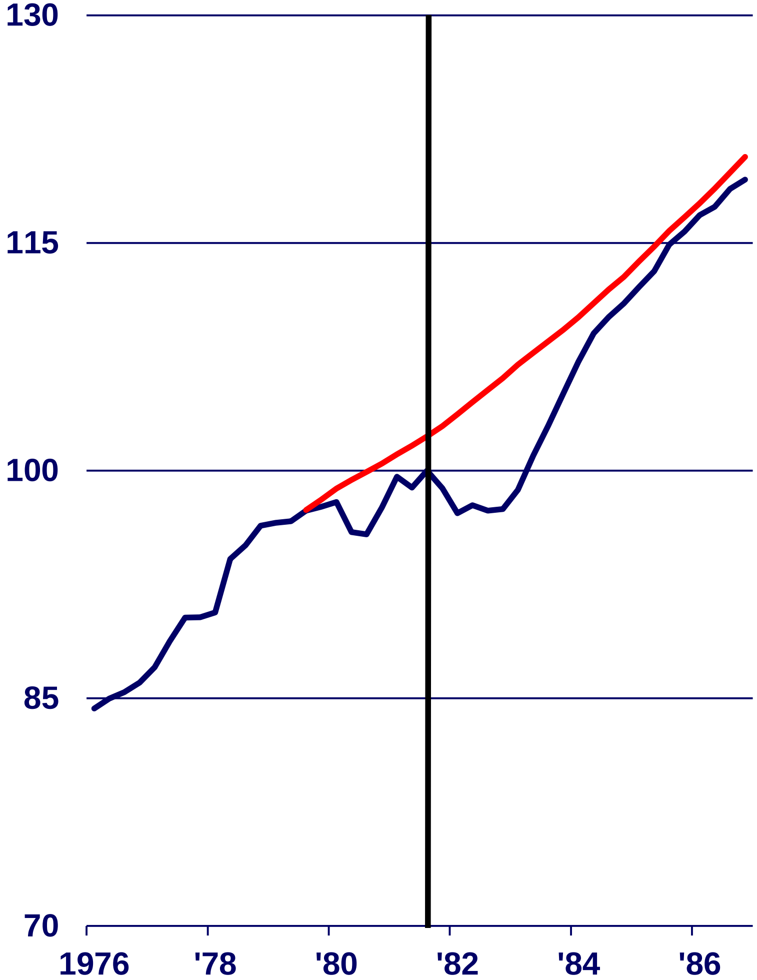
- **Zero interest rate <u>at least</u> until U < 6.5% or π > 2.5%**

- **Thresholds**

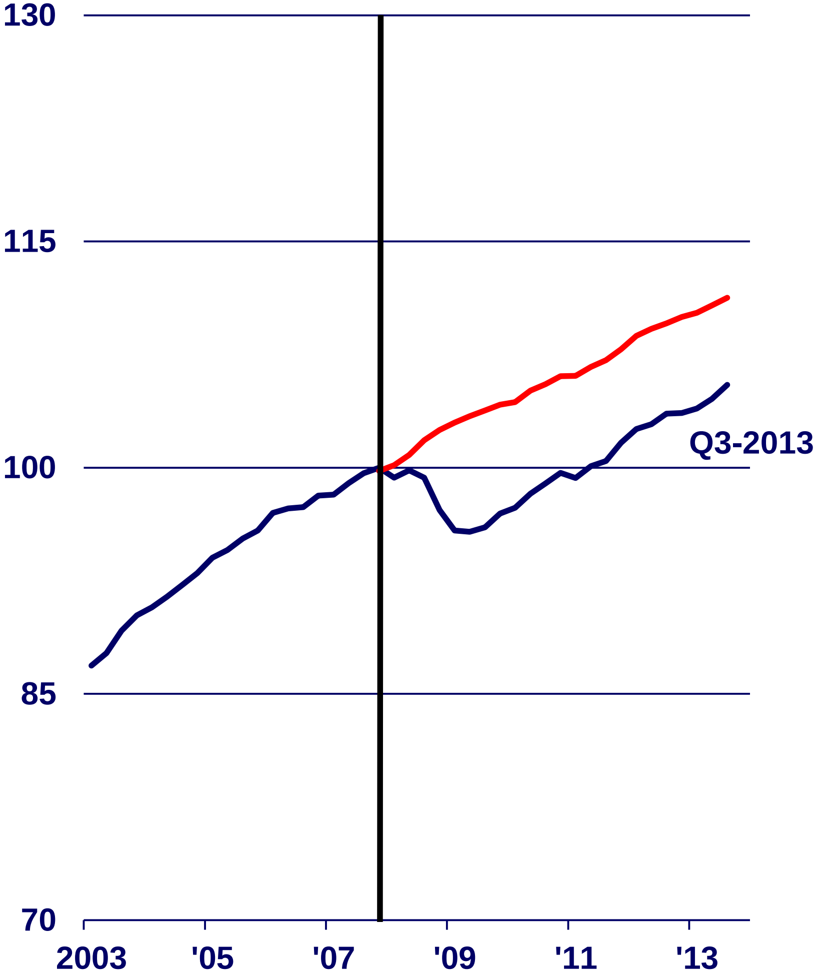
- **December 2012: "Economic conditions likely to warrant exceptionally low level of the funds rate at least as long as <u>the unemployment rate remains above 6-1/2 percent</u>, <u>inflation</u> between one and two years ahead is projected to be <u>no more than a half of a percentage point above</u> the Committee's <u>2 percent</u> long-run goal, and longer-term <u>inflation expectations</u> continue to be <u>well-anchored</u>."**

Output Gap: 1982 Recovery vs. Today

Actual and Potential GDP: 1982
(1981 Q3 = 100)

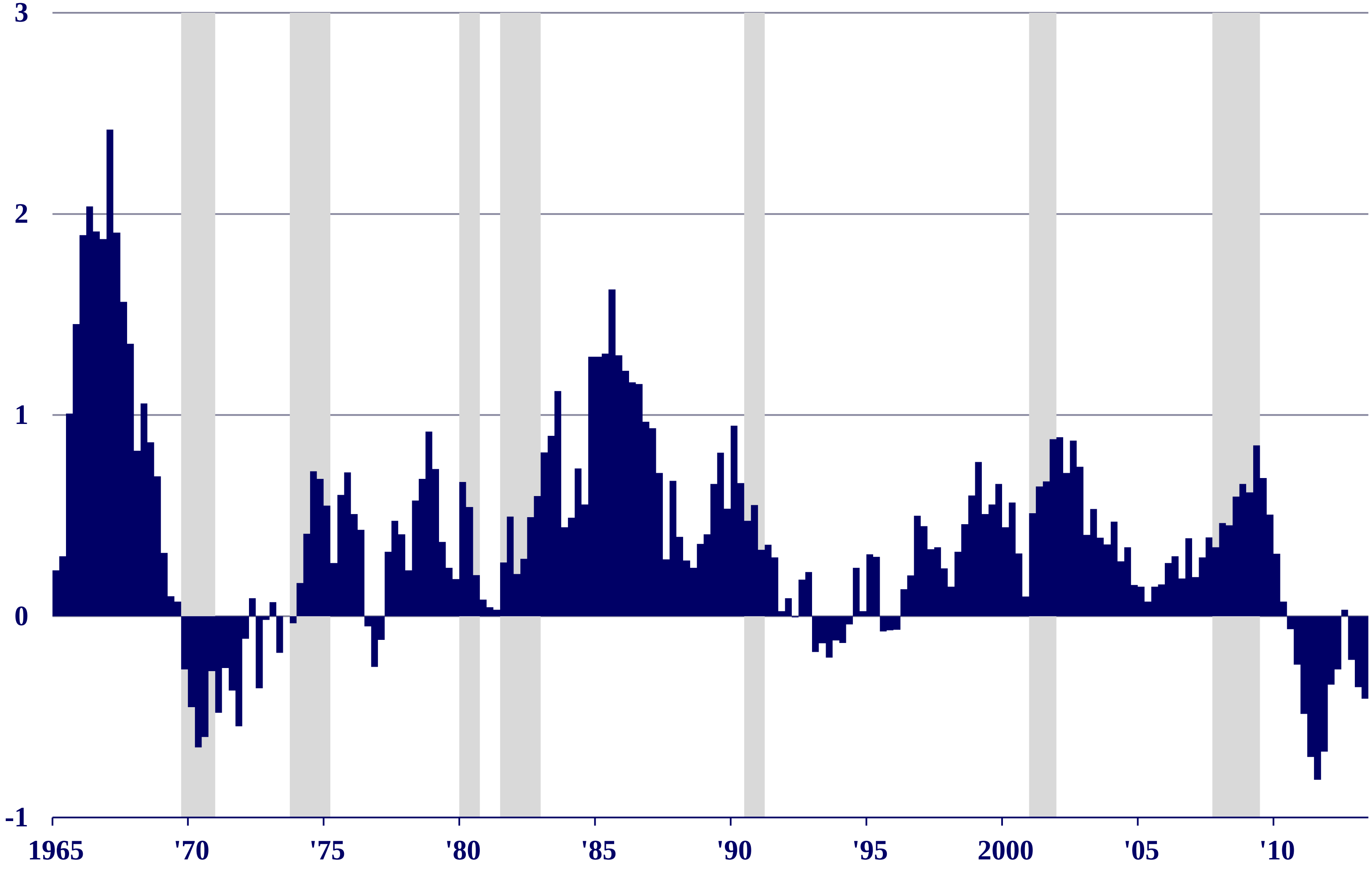


Actual and Potential GDP: 2007
(2007 Q4 = 100)



Fiscal Policy: Historically Unusual

Contributions of Government Purchases to Real GDP Growth
(percent)



Looking Ahead: Exit Principles (June 2011 Minutes)

- **Balance sheet size**
  - Smallest level consistent with efficient monetary policy operation
- **Balance sheet composition**
  - Treasury only
- **Likely normalization sequence**
  - Taper, then end LSAPs
  - Cease reinvestment of maturing securities
  - Begin raising rates and drain reserves
- **New tools: IOER, RRP Facility, term deposits**

Looking Ahead to the Future

- **Balanced approach to deviations from goals**
- **Inflation preferences should be symmetric**
- **Must recognize limitations of monetary policy during episodes in which real cycles dominate**