
Accommodative Monetary Policy and Macroprudential Safeguards

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

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The views expressed today are my own and not necessarily
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Introduction

Thank you. It is truly a pleasure to be here today and have the opportunity to speak to the Detroit Economic Club. And it is a particular pleasure to be introduced by Carl (Camden, president and chief executive officer of Kelly Services). This past December, Carl completed his service as the chair of the Detroit Branch of the Chicago Fed after previously serving as a member of our board and on our advisory council. Carl has always been exceedingly generous in sharing his time and perspective on a wide range of issues. We are very grateful for his contributions, and it's terrific to be able to continue that association through events like this. There are also a number of our current and former Detroit directors in the audience today, and it is great to see you all as well.

We have made much progress since the financial crisis began and the economy dropped into a deep recession. Since 2008, short-term interest rates have been near zero and are likely to remain at that level for some time. Over that period, the Federal Reserve's balance sheet has expanded more than fourfold to over \$4 trillion. Yet, in recent months, we've seen growth in economic activity gain some additional traction, and the Federal Open Market Committee (FOMC) has begun to taper its asset purchases. This afternoon, I would like to discuss our recent policy actions and some of the issues we face. As always, I will be giving my personal perspective, which is not necessarily shared by my colleagues on the FOMC or in the Federal Reserve System.

In a refreshing departure from the past several years, growth in economic activity in 2013 actually did not fall short of our forecasts made at the beginning of the year. Labor markets improved substantially, and the economy is entering 2014 with much better momentum. In light of this improved performance, the Federal Reserve began in December to adjust the mix of its monetary policy tools modestly. We started to taper our asset purchases, but we indicated that the fed funds rate would be near zero for quite some time — quite likely well into 2015. Barring any changes to our outlook, this would translate into seven years in which short-term interest rates would be at their zero lower bound. But policy likely will need to remain highly accommodative for such a time to ensure we make adequate progress toward maximum employment and price stability — the two congressionally mandated goals for U.S. monetary policy.¹

¹ Four times a year, participants in the FOMC submit their economic projections, including projections for the future path of the federal funds rate under their assessments of appropriate monetary policy. In the latest projections, published on December 18, 2013, 15 of the 17 participants anticipated that the first increase in the target federal funds rate would not be warranted until 2015 or later.

The deep recession, financial distress and prolonged slow recovery clearly called for such unusually accommodative monetary policy. Nonetheless, we need to be wary of any potential risks that might accompany the prolonged period of low interest rates. Most critical analysts often highlight two risks: unacceptably high inflation and financial exuberance that leads to instability. These are legitimate risks to consider. By my assessment, the risk of high inflation is fairly remote. In fact, today inflation in the U.S. and other advanced countries is too low, and I am concerned that inflation will run too low for too long. Regarding potential financial instability risks, I think the scenarios are more nuanced. But by my reading, these risks currently do not warrant altering the stance of monetary policy.² In fact, altering the current trajectory of monetary policy in order to mitigate these risks would likely degrade progress toward achieving maximum employment and price stability. If broad risks to financial stability were to become more prominent, the Federal Reserve has more effective tools to contain them than adjusting interest rates.

Recent Monetary Policy Actions

In my remarks this afternoon, I will discuss recent monetary policy actions and financial stability risks. Let me begin with recent economic developments and monetary policy.

As you all know, in response to the unusual economic circumstances generated by the financial crisis and the Great Recession, the FOMC brought down the target federal funds rate, its traditional policy tool, to near-zero levels — as low as it can go — and has kept it there since 2008. 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: namely, large-scale purchases of long-term Treasury securities and agency mortgage-backed securities, as well as forward guidance about how long short-term interest rates would 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 rates. Through arbitrage and portfolio rebalancing, lower rates in one market — whether it's the fed funds market or the Treasury and mortgage-backed securities markets — are transmitted to other rates faced by investors, nonfinancial firms and consumers, as well as across the asset and maturity spectrum. There is significant evidence that the FOMC's policies have been helpful in lowering rates paid by firms and consumers and, more generally, in supporting aggregate demand in the face of the substantial headwinds the economy has faced over the past six years.

Most recently, economic activity picked up momentum in the second half of 2013. Overall, real gross domestic product (GDP) grew at over a 3-1/2 percent rate in the second half, up from an average pace of growth of about 2 percent over the previous

² Recently, the FOMC conducted a survey of the participants regarding the marginal costs and marginal efficacy of asset purchases. Most participants judged the marginal benefits of the program to outweigh the costs. The survey results are summarized in Federal Open Market Committee (2013)..

three years. Moreover, we've seen a marked pickup in 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 — 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. 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 adjusted the mix of its tools in December and last week, but maintained the overall highly accommodative stance of policy. The Committee modestly reduced the pace of its monthly asset purchases from \$85 billion to \$65 billion in two separate \$10 billion steps. In addition, the FOMC strengthened its forward guidance on the future path of short-term interest rates by emphasizing that rates are likely to remain at very low levels well past the time the unemployment rate declines below the 6-1/2 percent threshold that was established in December 2012 — especially if inflation is expected to run below the 2 percent target.

Notwithstanding these modest changes to the mix of tools, monetary policy will remain highly accommodative for some time. Asset purchases have expanded our balance sheet more than fourfold to over \$4 trillion dollars. Moreover, by the time rates increase, they will have been near zero for about seven years, according to the FOMC's projections and the latest market expectations. These are startling facts and certainly get your attention. As prudent policymakers, we would be AWOL 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 assesses 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 prolonged period of low rates raise the risk of financial instability and also the risk of producing higher inflation. What can go wrong? Do we have the appropriate infrastructure and tools to adequately assess and manage the 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 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 \$100 trillion Zimbabwe notes (which I can assure you are worth less than the \$20 gift limit we have as Federal Reserve employees). The monetary policy mandates of the Federal Reserve are clear: to 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 the risk for high inflation?

Despite many earlier predictions of unacceptably high inflation, total PCE inflation has been hovering around just 1 percent. Other inflation measures, like the well-known Consumer Price Index (CPI), are also well below their related benchmarks.³ 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 total inflation. Our progress toward the 2 percent target is not noticeably faster by this metric either. Core PCE inflation was just 1.2 percent over the past year and has stayed 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 curve⁴ show that investors' inflation expectations at the three-year horizon are below 2 percent and have been below 2 percent for several years.

All told, the potential 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. More restrictive monetary policy conditions would work to reduce inflation to further unacceptably low levels.⁵

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 Congress. Financial stability risks are more complicated. How does financial stability dovetail with the Fed's dual

³ Because of some differences in product coverage and statistical methodologies, total CPI inflation tends to average one-quarter to one-half 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.

⁴ The yield curve is the line plotting the interest rates of assets of the same credit quality but with differing maturity dates at a certain point in time.

⁵ 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).

mandate? There is clearly an interdependent relationship between them. A strong and robust economy with low inflation provides a key stabilizing force for beneficial credit intermediation and robust financial markets. At the same time, stable and well-functioning financial markets are essential for achieving maximum employment and price stability. Our 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?

With inflation running well below our 2 percent long-run target and the unemployment rate still well above its long-term normal 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. This assertion is made from a mainstream macroeconomic perspective. Nonetheless, it is common to hear the 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.⁶ (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, the incentive exists 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.

So, 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. The existing large shortfalls in aggregate demand call for highly accommodative monetary policies and historically low interest rates. Yet, 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 and is unlikely to survive a broader analysis that takes

⁶ 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).

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 on those pockets of the financial system prone to inappropriate risk-taking without, at the same time, significantly damaging 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 stability 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 financial stability risks.

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. After all, any decision to rely on more-restrictive interest rate policies to achieve financial stability at the expense of poorer macroeconomic outcomes must pass a cost–benefit test. Such a test should clearly illustrate that the economic outcomes from more-restrictive interest rate policies — which could include much higher unemployment and even lower inflation than at present — 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.

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 risk. 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 efforts that analyze individual institutions with 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 has greatly expanded its surveillance efforts to financial markets outside of the traditional banking sector, such as the insurance industry and the financial market utilities. These more intense monitoring 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 issues that arise associated 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

Let me reiterate that 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 these supervisory and regulatory tools to adequately address potential financial stability risks, arguing that a broad 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. This conclusion is particularly vexing if supervisory, macroprudential and market-discipline tools are inadequate. If the only way we can achieve financial stability is to raise interest rates above where the forces of demand and supply in the real economy put them, then the cost–benefit calculus of our policy choices becomes much more complex. The possible benefit of such a restrictive rate move would be to reduce risks that might potentially be forming in the nooks and crannies of a highly complex financial system. But the cost would be higher unemployment; a risk of choking off the economic recovery; even lower inflation below our objective; and, somewhat paradoxically, the introduction of new financial risks by reducing asset values and credit quality. When weighing the costs and benefits of alternative policy actions under these circumstances, I would have to question whether the financial system has become too complex — perhaps complex enough to generate negative marginal social value. Rather than degrading our macroeconomic performance through suboptimal monetary policies, I also 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 staff'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 stronger and 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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