A Case for Monetary Policy Accommodation

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Long-Run Strategy for Monetary Policy (January 2012)

- $\pi^* = 2\%$ PCE inflation
- $U_t^* \sim 5.25\% - 6\%$ time-varying

SEP long-run central tendency

- **Balanced approach** to reducing deviations of inflation and employment from long-run objectives
Current and Expected Policy Losses

**Loss Function**

\[ L = (\pi - \pi^*)^2 + 0.25 (y - y^*)^2 \]

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

- **2014 FOMC Forecast** (March 20, 2013)
  - Current Value: \( u = 9\% \)
  - \( \pi = 5.5\% \)
  - September 2011 Value: \( \pi^* = 2\% \)
Subdued Actual and Expected Inflation

Source: Inflation forecasts are from the March 20, 2013 FOMC Summary of Economic Projections

Source: FRB-Chicago Staff Calculations
Recent Policy Actions

- **Open-ended Treasury and MBS purchases**
  - $85 billion per month
  - Until there is substantial improvement in labor markets

- **Low fed funds rate at least until:**
  - Unemployment < 6.5% or
  - Inflation forecast > 2.5%

- **Highly accommodative policy even after the recovery strengthens**
Alternative Policy Prescriptions

Federal Funds Rate (percent)

Taylor Rules:
\[ R_t = 2.0 + \pi_t + 0.5(\pi_t - 2) + \alpha \text{ gap}_t \]

Taylor 1999: \( \alpha = 1.0 \)
Taylor 1993: \( \alpha = 0.5 \)

Optimal Control:
\[ \text{Min} \ (\pi_t - 2)^2 + (u_t - u^n)^2 + \Delta R_t^2 \]

Source: Janet L. Yellen, “Perspectives on Monetary Policy,” Boston, June 6, 2012
Progress toward the Dual Mandate Goals with Alternative Policies

Unemployment Rate (percent)

PCE Inflation (4-quarter percent change)

Source: Janet L. Yellen, “Perspectives on Monetary Policy,” Boston, June 6, 2012