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

_Columbus State University_

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_The views I express here are my own and do not necessarily reflect the views of the Federal Reserve Bank of Chicago, my colleagues on the Federal Open Market Committee (FOMC) or within the Federal Reserve System._
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
Long-Run Strategy for Monetary Policy
(January 2012, reaffirmed thereafter every January)

- $\pi^* = 2\%$ PCE inflation

- $U_t^* \sim 5.2\% - 5.8\%$ time-varying
  Central tendency of SEP longer-run normal rate

- Balanced approach to reducing deviations of inflation and employment from long-run objectives
Total PCE Price Index

Dec. 2007

2% Price-Line from December 2007

Average PCE Inflation (2000-2007): 2.3%

Path Implied by Current FOMC Inflation Forecasts

Inflation (percent)

Total PCE (36-mo. Average)

Core PCE (12-mo. Change)

Source: Inflation forecasts are from the December 18, 2013 FOMC Summary of Economic Projections
Inflation Is Low Globally

Consumer Inflation*
(Q4/Q4 percent change)

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<tr>
<td>Canada</td>
<td>2.0</td>
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<td>Japan</td>
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<td>U.K.</td>
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<td>U.S.</td>
<td>2.5</td>
<td>1.5</td>
<td>1.3</td>
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*Consumer inflation in the U.S. is as measured by the total price index for Personal Consumption Expenditures; in other countries, it is measured by the Consumer Price Index. Latest data is year-over-year change in the monthly index.
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Balanced Approach to the Dual Mandate Is Consistent with Mainstream Macroeconomics

Loss Function (percent)

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

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

FOMC Forecast (December 18, 2013)

Latest Value

\[ \pi = 5.5\% \]

\[ u = 9\% \]

September 2011 Value

Inflation vs. Unemployment
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

Fed Funds Rate
(percent)

History

Taylor (1999) rule based on inflation and output gap

Q4-2013
Policy Tools at the Zero Lower Bound

- Large Scale Asset Purchases

- Forward Guidance

- Features of Both Unconventional Tools
  - Lower long-term interest rates
  - Disciplined by economic conditionality
Asset Purchases: The Fed’s Balance Sheet

Federal Reserve Assets (Bil. $)

- All Other Assets ($301.5 bil.)
- Treas. Sec ($2,284.2 bil.)
- Agency Debt ($51.4 bil.)
- Agency MBS ($1,570.1 bil.)
- Lending and Liquidity Facilities ($2.2 bil.)

Mar. 5, 2014
Forward Guidance on the Federal Funds Rate

- Zero interest rate at least until $U < 6.5\%$ or $\pi > 2.5\%$

- Thresholds, not triggers

- Likely to remain near zero “well past” $U < 6.5\%$, especially if projected inflation continues to run below the 2% target.
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)

Q4-2013
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