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Panel Discussion on "Monetary Policy: Many Targets, Many Instruments. Where Do We Stand?"

Remarks by

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at

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Thank you to the International Monetary Fund for allowing me to take part in what I expect will be a very lively discussion.[1]

Only five or six years ago, there wouldn't have been a panel on the "many instruments" and "many targets" of monetary policy. Before the financial crisis, the focus was on one policy instrument: the short-term policy interest rate. While central banks did not uniformly rely on a single policy target, many had adopted an "inflation targeting" framework that, as the name implies, gives a certain preeminence to that one objective. Of course, the Federal Reserve has long been a bit of an outlier in this regard, with its explicit dual mandate of price stability and maximum employment. Still, the discussion might not have gone much beyond "one instrument and two targets" if not for the financial crisis and its aftermath, which have presented central banks with great challenges and transformed how we look at this topic.

Let me start with a few general observations to get the ball rolling. In terms of the targets, or, more generally, the objectives of policy, I see continuity in the abiding importance of a framework of flexible inflation targeting. By one authoritative account, about 27 countries now operate full-fledged inflation-targeting regimes.[2] The United States is not on this list, but the Federal Reserve has embraced most of the key features of flexible inflation targeting: a commitment to promote low and stable inflation over a longer-term horizon, a predictable monetary policy, and clear and transparent communication. The Federal Open Market Committee (FOMC) struggled for years to formulate an inflation goal that would not seem to give preference to price stability over

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[1] The views I express here are my own and not necessarily those of my colleagues in the Federal Reserve System.

[2] See Gill Hammond (2012), *State of the Art of Inflation Targeting*, Centre for Central Banking Studies, CCBS Handbook No. 29 (London: Bank of England), www.bankofengland.co.uk/education/Documents/ccbs/handbooks/pdf/ccbshb29.pdf.

maximum employment. In January 2012, the Committee adopted a "Statement on Longer-Run Goals and Monetary Policy Strategy," which includes a 2 percent longer-run inflation goal along with numerical estimates of what the Committee views as the longer-run normal rate of unemployment. The statement also makes clear that the FOMC will take a "balanced approach" in seeking to mitigate deviations of inflation from 2 percent and employment from estimates of its maximum sustainable level. I see this language as entirely consistent with modern descriptions of flexible inflation targeting.

For the past four years, a major challenge for the Federal Reserve and many other central banks has been how to address persistently high unemployment when the policy rate is at or near the effective lower bound. This troubling situation has naturally and appropriately given rise to extensive discussion about alternative policy frameworks. I have been very keen, however, to retain what I see as the key ingredient of a flexible inflation-targeting framework: clear communication about goals and how central banks intend to achieve them.

With respect to the Federal Reserve's goals, price stability and maximum employment are not only mandated by the Congress, but also easily understandable and widely embraced. Well-anchored inflation expectations have proven to be an immense asset in conducting monetary policy. They've helped keep inflation low and stable while monetary policy has been used to help promote a healthy economy. After the onset of the financial crisis, these stable expectations also helped the United States avoid excessive disinflation or even deflation.

Of course, many central banks have, in the wake of the crisis, found it challenging to provide appropriate monetary stimulus after their policy interest rate hit the effective lower bound. This is the point where “many instruments” enters the discussion. The main tools for the FOMC have been forward guidance on the future path of the federal funds rate and large-scale asset purchases.

The objective of forward guidance is to affect expectations about how long the highly accommodative stance of the policy interest rate will be maintained as conditions improve. By lowering private-sector expectations of the future path of short-term rates, this guidance can reduce longer-term interest rates and also raise asset prices, in turn, stimulating aggregate demand. Absent such forward guidance, the public might expect the federal funds rate to follow a path suggested by past FOMC behavior in “normal times”--for example, the behavior captured by John Taylor’s famous Taylor rule. I am persuaded, however, by the arguments laid out by our panelist Michael Woodford and others suggesting that the policy rate should, under present conditions, be held “lower for longer” than conventional policy rules imply.

I see these ideas reflected in the FOMC’s recent policy. Since September 2012, the FOMC has stated that a highly accommodative stance of monetary policy will remain appropriate for a considerable time after the economic recovery strengthens. Since December 2012, the Committee has said it intends to hold the federal funds rate near zero at least until unemployment has declined below 6-1/2 percent, provided that inflation between one and two years ahead is projected to be no more than 1/2 percentage point above the Committee’s 2 percent longer-run goal, and longer-term inflation expectations continue to be well anchored. I believe that the clarity of this commitment to accommodation will itself support spending and employment and help to strengthen the recovery.

Asset purchases have complemented our forward guidance, and the many dimensions of different purchase programs arguably constitute "many instruments." In designing a purchase program, one must consider which assets to buy: Just Treasury securities or agency mortgage-backed securities as well? Which maturities? The Federal Reserve, the Bank of England, and, more recently, the Bank of Japan have emphasized longer-duration securities. At what pace should the securities be purchased? And how long should they be held once purchases cease? Each of these factors may affect the degree of accommodation delivered. Two innovations in the FOMC's current asset purchase program, for example, are that it is open-ended rather than fixed in size like past programs, and that the overall size of the program is explicitly linked to seeing a substantial improvement in the outlook for the labor market.

In these brief remarks, I won't thoroughly review the benefits or costs of our highly accommodative policies, emphasizing only that I believe they have, on net, provided meaningful support to the recovery. But I do want to spend a moment on one potential cost--financial stability--because this topic returns us to the theme of "many targets" for central banks. As Chairman Bernanke has observed, in the years before the crisis, financial stability became a "junior partner" in the monetary policy process, in contrast with its traditionally larger role. The greater focus on financial stability is probably the largest shift in central bank objectives wrought by the crisis.

Some have asked whether the extraordinary accommodation being provided in response to the financial crisis may itself tend to generate new financial stability risks. This is a very important question. To put it in context, let's remember that the Federal Reserve's policies are intended to promote a return to prudent risk-taking, reflecting a normalization of credit markets that is essential to a healthy economy. Obviously, risk-taking can go too far. Low interest rates may induce investors to take on too much leverage and reach too aggressively for yield. I don't see pervasive evidence of rapid credit growth, a marked buildup in leverage, or significant asset bubbles that would threaten financial stability. But there are signs that some parties are reaching for yield, and the Federal Reserve continues to carefully monitor this situation.

However, I think most central bankers view monetary policy as a blunt tool for addressing financial stability concerns and many probably share my own strong preference to rely on micro- and macroprudential supervision and regulation as the main line of defense. The Federal Reserve has been working with a number of federal agencies and international bodies since the crisis to implement a broad range of reforms to enhance our monitoring, mitigate systemic risk, and generally improve the resilience of the financial system. Significant work will be needed to implement these reforms, and vulnerabilities still remain. Thus, we are prepared to use any of our many instruments as appropriate to address any stability concerns.

Let me conclude by noting that I have touched on only some of the important dimensions of monetary policy targets and instruments that have arisen in recent years. I look forward to a discussion that I expect will explore these issues and perhaps raise others.