Risk Management in Monetary Policy

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Thank you very much for inviting me to speak with you this afternoon. I'd like to take a moment to share some thoughts on monetary policy, specifically how risk management principles inform our approach. Before I say more, I have to note that the views I express are my own and not necessarily those of my colleagues on the Federal Open Market Committee (FOMC) or in the Federal Reserve System.[1]

I joined the Richmond Fed last January after a 30-year career in consulting at McKinsey, where—in addition to consulting—I had multiple roles including serving as our chief risk officer.

We had a lot of risks to manage—the media, unhappy clients, cybersecurity defense, individual behavioral issues and even crises such as an Ebola outbreak. So you might imagine that retiring and moving to public service has been a relief.

But the Fed has its own risks to contend with, and the stakes are high. We're concerned about cybersecurity. We face operational risks when it comes to processing payments and implementing monetary policy. We oversee risk in the financial system. Any of these topics could be a speech in themselves, but today I'd like to talk in more detail about one I hope you'll find interesting: risk management in monetary policy.

Economic Update

Let's start with a baseline look at the economy. Overall, if you look at the data, things are good. GDP has been pretty solid, averaging 2.7 percent over the past two years. The labor market is very strong, with unemployment at 50-year lows. Although the pace of job creation has slowed some, we're still averaging around 160,000 new jobs per month since the beginning of the year, well above the pace necessary to accommodate growth in the workforce. Bolstered by the strong labor market, consumers are confident and are spending.

We are facing several headwinds, however. There is a great deal of uncertainty around trade and politics, which matters for business confidence. Confidence is critical for businesses to want to invest and for markets to be willing to finance that investment. So I'm particularly concerned about the roller coaster we've been on recently. Between Brexit, the ongoing negotiations with China, tensions in the Middle East and the political headlines—to name just a few—it's been tough for businesses to feel like they're on solid ground. That might be why business investment shrank 0.6 percent in the second quarter. I watch that number closely because eventually lower investment affects jobs.

The headwinds are having an impact overseas as well; GDP growth has slowed in China and stalled in the eurozone. In the second quarter, growth was negative in Germany, Europe's largest economy. There's a risk that weakness will affect us.

At just 1.6 percent over the past 12 months, inflation has been running persistently below the FOMC's 2 percent target.[2] We're not that far away—if we just rounded, we'd be at target—but it's also possible that the uncertainty I've discussed is limiting firms' ability and willingness to raise prices.

And the bond market has sent some concerning signals recently. The yield on 10-year treasuries has been very low given the overall strength of the economy and has actually been lower at times than the yield on 2-year treasuries. As you probably know, such an inversion of the yield curve is historically a good predictor of a recession. But is that what the yield curve is signaling now, or are we just seeing a move toward higher-yielding safe assets at a time when international rates are historically low?

Monetary Policy Response

Overall, I think it's safe to say the economy is giving us conflicting signals. The strength of the labor market might be saying "hold" or even "raise rates," while inflation and the bond market might be saying "lower rates." How should policymakers think about it?

In 2018, the risk seemed to be the economy "overheating." With interest rates well below "normal" levels, strong GDP growth, fiscal stimulus and a tight labor market, we raised the target rate four times, with many FOMC participants projecting additional rate increases the following year.

But in early 2019, political and global turmoil signaled more risk to the downside, so the committee decided to pause and take a patient approach, with a much flatter projected rate path.

Then, over the last two meetings, with inflation muted, continued uncertainty and international weakness, we took the target rate down 50 basis points. This doesn't mean a recession is imminent, nor that we are in a prolonged period of easing. As Chair Powell said after last week's meeting, the change was intended "to provide insurance against ongoing risks." There is a lot of uncertainty about the outlook, particularly with respect to global growth and the impact of trade, so it seemed prudent to take out some insurance—which I'm sure a room full of risk managers can appreciate.

The Risk Management Problem

We have a difficult risk management situation. We have a dual mandate, which means that right now we are trying to close the gap on our inflation target while avoiding policy that's too accommodative, pushing inflation too high or causing financial instability. And we battle constant uncertainty. The dynamics of the economy are complex and constantly evolving, and the information we get about those dynamics comes with a lag and are often revised. Add the fact that monetary policy can take a while to have an effect on the economy, and you see the challenge.

Further complicating matters, we face risks in multiple directions.

Easing isn't risk free. It's tricky to stimulate the economy to a precise level, and we run the risk of overshooting our objective, as one could argue we did in the late 1960s.

Even if lowering interest rates doesn't end up overstimulating inflation, it could affect other areas of the economy.[3] For example, it's possible for low interest rates to distort markets by shifting resources into the most interest-sensitive sectors or encouraging firms to over-substitute capital for labor. Or low interest rates could fuel an asset price bubble, as some have suggested happened last decade.

But there are risks to not easing. We undermine the credibility of our 2 percent inflation target, which could lead to a decline in inflation expectations and thus to even lower inflation.[4] In addition, if economic activity does slow further, we could find ourselves behind the curve, wishing we had moved more and sooner. This is especially relevant given how close we are to the effective lower bound.[5]

In addition to the risk of missing on the upside or downside, we also have a trade-off between short and longer term. Any rate move can be seen as facilitating a choice between consuming or investing today or tomorrow. At lower rates, you might accelerate a car or house purchase; at higher rates, you might defer.

So we also face the question, should we move quickly in order to have more impact? Or does that waste vital ammunition we might need for the next downturn? Economist William Brainard famously said that when uncertainty is high, proceed with caution—but sometimes caution is a risk in and of itself.

Managing the Risks

How do we manage these risks? Five themes: First, we try hard to specify a clear risk strategy. We release each January a "Statement on Longer-Run Goals and Monetary Policy Strategy." This statement articulates a balanced approach to our dual mandate and gives the public a sense of our risk appetite. We also communicate our reaction function through speeches, press conferences and other media so that markets understand what we're doing and work alongside us.

Second, our governance and culture help us. We operate by committee, which gives voice to a range of views, and the presence of regional Reserve Banks, with regional perspectives, helps us avoid "group think."

We are data-focused and invest in having the best analysis possible so we can make decisions with confidence. There are around 350 economists on staff at the Board of Governors, and each regional Bank has a team of economists as well. To test and supplement the data, each Bank also maintains very strong external networks, so we are constantly out talking to businesses to gauge their sentiment and gain a real-time perspective on the economy. We also have a number of surveys to develop a richer understanding of trends in our District.

Third, we have a deep commitment to risk modeling. Every Tealbook, which FOMC participants receive before each meeting, details a range of scenarios for how the economy could evolve and fully tests the potential upsides and downsides of possible policy changes. We also conduct a similar risk assessment of our financial system on a quarterly basis; key elements of which we've recently started publishing twice a year as a Financial Stability Report.

Fourth, we constantly review and revise what we do in order to evolve along with the economy. That is helped by the constant attention we get from the entire macroeconomics profession, the media and the markets. We get a lot of help! That said, we listen and we change. For example, in an effort to tame inflation in the late 1970s and early 1980s, the Fed began targeting monetary aggregates (the quantity of money). When financial innovations made monetary aggregates a less useful gauge of the state of the economy, the Fed shifted its attention away from them and now targets the federal funds rate (the price of money). More recently, we have been using the interest rate paid on excess reserves to influence the federal funds rate rather than the traditional tool of open market operations. In the last downturn, we introduced more specific forward guidance, an explicit inflation target and quantitative easing.

Finally, we push outside our borders to enable an environment less susceptible to risk. When we anchor inflation expectations, we reduce the chance that a few volatile inflation readings will have an adverse effect. When we properly supervise the banking system, we reduce the risk of financial market distress. And there's some history of Fed chairs (like Alan Greenspan) calling out deficits or "irrational exuberance." I do worry now about the impact of today's large federal budget deficits on our resiliency in the next downturn.

All that said, we've made mistakes. Modern scholars generally attribute the severity of the Great Depression to errors in monetary policy, and we accept much of the blame for the Great Inflation of the late 1960s and 1970s as well. But I hope you believe we've learned from those mistakes. The lessons of the Great Depression guided the Fed's response to the financial crisis. The Great Inflation taught us the importance of maintaining the credibility of the Fed's commitment to price stability.

Currently, in the spirit of continuous improvement, the Fed is reviewing its monetary policy strategy, tools and communication practices to ensure that we can continue to achieve our dual mandate given low inflation and the risk of returning to the effective lower bound. As part of that review, we've been holding a series of "Fed Listens" events to get input from business leaders, community members, academics and other stakeholders. We're talking about a range of approaches, and the insights we've gained from these discussions have been invaluable. Now, in the spirit of continuous learning, I'm looking forward to learning from you.

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[1] Thank you to Jessie Romero for assistance preparing these remarks.

[2] Based on core PCE inflation.

[3] For example, see Esther George, "Is Low Inflation a Problem for the United States?" Speech at the Economic Club of Minnesota, Minneapolis, Minn., May 14, 2019.

[4] For example, see James Bullard, "President Bullard Explains His Recent FOMC Dissent," June 21, 2019.

[5] For example, see John Williams, "Living Life Near the ZLB," Speech at the 2019 Annual Meeting of the Central Bank Research Association, New York City, July 18, 2019.