

On Possible Changes to the Consensus Statement¹

1. Introduction

In its annual reconsideration of the *Statement of Longer-Run Goals and Monetary Policy Strategy* (Consensus Statement, or CS, hereafter) in January of this year, the FOMC noted that, because this was the third year in which the statement was being issued, the coming year would be an appropriate time to consider whether the statement could be enhanced in some way. On that occasion or at other times, participants have singled out a few specific issues that may warrant reconsideration, including: (1) whether to clarify that inflation below the Committee's 2 percent longer-run objective is considered to be equally undesirable as inflation the same amount above that objective; (2) whether and how to clarify the concept of following a "balanced approach" to promoting the achievement of price stability and maximum employment in circumstances in which the objectives are judged not to be complementary; and (3) how concerns for financial stability are linked with the formally mandated goals of maximum employment and price stability. The accompanying memo from the subcommittee on communications provides specific questions for discussion at the FOMC's October meeting. This memo, prepared by subcommittee staff, discusses these three topics in some detail in order to provide background information for the Committee to consider as it explores whether there is enough agreement on these issues to warrant revising the CS. It also provides some pros and cons of the more general question of whether to make changes to the CS.

Conceptually, the longer-run goals and strategies summarized in the CS can be viewed, in part, as a description of the basic objective function of policymakers—leaning on the *goals* part of the title—something that changes infrequently and is not necessarily tied to a particular view of how the world works. Each of the topics considered in this memo can be thought of as a refinement or clarification of the Committee's basic objectives; we find this a helpful organizing principle and the memo is structured accordingly. A second approach, stemming from the *strategies* part of the title, has more of a dynamic flavor, and is concerned with the tradeoffs among objectives over time. Considerations of this nature necessarily depend on policymakers' beliefs about the dynamic structure of the economy as well as on policymakers' preferences. Accordingly, the memo sometimes approaches the topics listed above from the perspective of dynamic tradeoffs.

In the remainder of this memo, the next three sections cover our topics in the order in which they are listed above and offer reasons for why the Committee might choose to amend the CS. Because the arguments for why the Committee might choose to leave the CS unchanged apply broadly to all three issues, they are presented together in a separate, fifth and final section.

¹ Prepared by Todd Clark (FRB-Cleveland), Robert Tetlow (Board of Governors) and Stacey Tevlin (Board of Governors). We thank Thomas Laubach, David Reifschneider and Glenn Rudebusch for helpful comments and suggestions.

2. Symmetry Around the Inflation Goal

As currently formulated, the CS establishes a longer-run goal of 2 percent inflation without addressing symmetry. Accordingly, some readers may be unsure of whether the 2 percent objective is a ceiling or a symmetric objective. Put another way, the CS does not clearly establish whether the Committee views inflation of 1 percent as equally costly, less costly, or more costly than inflation of 3 percent, all other things equal. In this respect, the Committee may wish to clarify the symmetry around the inflation goal, if applicable, in order to provide more information on the shape of the economic loss function underlying policy decisions. Most other inflation targeting central banks, although not all, explicitly describe their inflation objectives as symmetric.

The existing research literature on the goals of monetary policy may be seen as having limited practical implications for the merits of symmetry or asymmetry.² For example, much of the literature, which is focused on issues such as the optimal rate of inflation or the optimal choice of inflation measure, merely assumes the preferences of policymakers are symmetric around the inflation goal.³ While the research on the optimal value of inflation is certainly relevant to the question, the modeling framework is very narrow, and its efficacy in capturing costs of very low inflation associated with the zero lower bound seems particularly questionable in light of experience since the Great Recession.⁴

In broad terms, there are conceptual reasons why one might prefer either symmetry or asymmetry. A key argument for symmetry is that it will maximize the Committee's chances of achieving an average inflation rate of 2 percent, thereby fostering the FOMC's accountability and credibility. Symmetry provides a clear focal point for long-term inflation expectations, which should help to anchor those expectations and, in turn, inflation, at the longer-run goal. In contrast, with asymmetry and the 2 percent goal treated as a ceiling, inflation will presumably average less than 2 percent. Moreover, the magnitude of the shortfall of actual inflation from 2 percent will depend on how aggressively the Committee acts to limit the duration of episodes of inflation above 2 percent as well as on the size and persistence of shocks hitting the economy. In

² A 2005 staff study provided a detailed analysis of a wide range of considerations around an inflation objective, including a summary of the literature available at that time. See, Elmendorf, *et al.* (2005). However, symmetry or asymmetry of the objective did not play a large role in the analysis.

³ The analysis of Woodford (2003), among others, is commonly seen as providing a foundation for a quadratic approximation of the economic welfare-based loss function, which implies symmetry of the inflation goal. The existing literature on the optimal inflation rate generally puts that rate well below 2 percent, reflecting significant costs of inflation (due to nominal wage and price rigidities, the implicit tax of inflation on monetary assets, etc.) that mitigate the benefits of higher inflation (associated with the risks stemming from the zero lower bound and downward nominal wage rigidity). For example, Coibion, Gorodnichenko, and Wieland (2012) find a rate of 1.5 percent to be optimal (in a framework based on symmetry of the objective). However, as noted below, some may question the reliability of the guidance of this literature, in light of its limitations in fully capturing the costs of the zero lower bound.

⁴ For example, this line of research implies that, at the zero lower bound, monetary policy can manipulate inflation expectations to significantly reduce real interest rates and provide powerful stimulus to the economy. Some might argue that practical experience since the 2007 casts doubt on either the plausibility of such models or the actual strength of the mechanisms in practice.. In turn, some might argue that these models fail to adequately capture the costs of low inflation associated with the zero lower bound, including its potential indirect effects on employment.

addition, without a simply defined focal point, longer-term inflation expectations will likely gravitate toward recent historical levels, which would imply a level below 2 percent.

A related argument for symmetry is that it may facilitate clear communications or, put differently, reduce the scope for communications challenges. Symmetry seems likely to be easier to explain—and comprehend—than asymmetry. For example, the Bank of Canada declared their inflation target to be symmetric relatively early in its policy regime and appears to have effectively communicated this symmetry. In contrast, the communications of the European Central Bank have evolved over time as the ECB has sought to clarify its goal of inflation below 2 percent. Symmetry surrounding the inflation goal may also reduce the scope for questions from the public and Congress about the importance the FOMC places on inflation versus employment. Arguably, treating the inflation goal as a ceiling could be seen as suggesting that the Committee puts more weight on keeping inflation low than on achieving maximum employment.

Notwithstanding such possible concerns, some on the Committee might prefer an asymmetric objective in which 2 percent is a ceiling. Participants might favor this approach if, after considering the various costs and benefits of different rates of inflation, they conclude that, say, 3 percent inflation would be more costly than 1 percent inflation.⁵ For example, even if one agrees that the risks to economic performance from short-term interest rates being stuck at the zero lower bound are substantial, one might nonetheless argue that the associated benefits of higher inflation diminish fairly quickly as the inflation target rises above a low level, while other costs of inflation continue to rise, perhaps sharply, with the prevailing rate of inflation.

In addition, some might argue that the dynamics of inflation above the Committee's target pose more risk to the success and credibility of monetary policy than does inflation that spends a considerable amount of time below 2 percent. The post-war path to price stability in the United States was a long and challenging one, and households and businesses may remember that inflation above 2 percent was more persistent and more costly, on average, than more recent, lower inflation rates. Given this history, it is not unreasonable to infer that the risks that long-term inflation expectations could become unanchored upward, with inflation above 2 percent, are larger than the risks of their becoming unanchored downward, with inflation below 2 percent.⁶ This risk assessment could be predicated on concerns of model uncertainty—concerns that have more to do with the modeling of the dynamics of inflation expectations than with the policy preferences embedded in policymakers' objective function. Ultimately, policymakers must choose their inflation target, and in the dynamic context, the projected path for inflation, subject to a model of how inflation expectations are formed and how they evolve over time. History gives us little guidance on these questions.⁷

⁵ See Elmendorf, et al. (2005) and references therein, and Erceg, Kiley and Tetlow (2014) for more detailed discussions of the costs of inflation.

⁶ That said, the UK experience of large and persistent misses of the inflation target to the upside in recent years does not lend support to this view. In addition, the experience of the United States in the 1970s, and Japan more recently, would seem to suggest that changes in long-term inflation expectations arise gradually following a persistent deviation of inflation from prior expectations.

⁷ A memo circulated to the Committee for the September meeting discussed aspects of the the formation and evolution of inflation expectations. See, Laubach *et al.* (2014).

Other participants might agree on asymmetry around the inflation objective, but believe the asymmetry runs in the opposite direction. A primary rationale might be that, in light of the recent experience of a prolonged period of policy constrained by the zero lower bound, the costs of very low inflation associated with the zero lower bound could be far larger than previously believed. This reassessment of the costs of the zero lower bound underlies some of the recent debate surrounding suggestions to raise central bank inflation targets above 2 percent. In the context of the FOMC's current inflation objective, a reassessment of the zero lower bound-related costs of inflation could support a view that while 2 percent is still the best target, inflation below target by say, 1 percentage point, is on net more costly than inflation above target by 1 percentage point.

Finally, some participants may find it awkward to address symmetry around the inflation objective without simultaneously addressing symmetry around the maximum employment component of the dual mandate.⁸ One could argue that clarifying the symmetry on the inflation target without a concomitant treatment of maximum employment might induce the public to reassess the relative weights of those two goals. However, given the likely wide range of participants' views of the labor market conditions that would be associated with the achievement of maximum employment, the issues surrounding symmetry of the employment objective are likely more complicated than the issues surrounding symmetry of the inflation objective. Accordingly, consistent with the two-pronged approach identified in the accompanying memo from the subcommittee, this memo focuses on the inflation objective and defers discussion of symmetry around the employment objective.

The Case for Clarifying Symmetry or Asymmetry

If the Committee reaches consensus on treating the 2 percent inflation objective as symmetric or asymmetric, there are two related reasons to consider revising the CS to clarify the objective. First, an explicit agreement on symmetry or asymmetry of the inflation objective could facilitate the Committee's internal deliberations. Most immediately, as the economic recovery proceeds, the Committee's view of the symmetry or asymmetry around the 2 percent objective is likely to play an increased role in policy decisions. For example, if inflation nears 2 percent more rapidly than the labor market improves, the Committee would presumably tighten policy at a faster pace if the 2 percent objective were a ceiling than if the objective were symmetric.

Second, a revision of the CS to clarify the inflation objective could improve the Committee's communications with the public. A clarification would eliminate any public confusion surrounding the goal that may exist today and over time may help to better anchor inflation expectations at the appropriate level. For example, if the Committee agrees on a symmetric objective, explicit communication and improved anchoring of expectations could prove especially helpful to the efficacy of policy should inflation either remain below the 2 percent longer-run objective for some time into the future or rise above 2 percent for a time. If the Committee instead agrees on an asymmetric objective, explicit communication could be

⁸ A memo circulated to the Committee for the September meeting, Erceg, Kiley, and Tetlow (2014) provides some discussion of symmetry around both components of the dual mandate, with references to related research.

similarly helpful to the efficacy of policy.⁹ More narrowly, clarification of symmetry or asymmetry around the target could help the public understand the course of monetary policy as the economy recovery proceeds.

Were the Committee inclined to revise the CS's treatment of the inflation objective, it might consider a few approaches. To clarify symmetry around the objective, the CS could be expanded to draw on current language about shocks and say that, at times, inflation may temporarily rise above or fall below the 2 percent objective. To be more direct, the Committee could instead state a willingness to temporarily allow inflation to modestly exceed or fall short of 2 percent, perhaps tying the willingness to do so to economic conditions.¹⁰ Alternatively, the CS could more broadly say that the Committee is equally concerned about inflation above and below the objective. The monetary policy framework statements of the Bank of Canada and Bank of England provide two models for such an approach.¹¹

To clarify an asymmetric inflation objective, the Committee could add language to the CS to state more concern with inflation modestly above 2 percent than with inflation modestly below 2 percent (or vice versa, depending on the Committee's judgment of the direction of asymmetry). Alternatively, the Committee could revise the statement of the longer-run inflation objective to indicate a goal of inflation of 2 percent or less, providing a less direct statement or signal of asymmetry in the goal.¹² The European Central Bank's statement of its policy objective provides one such model.¹³

3. Balanced Approach

The current CS states that when the two legs of the mandate are not complementary, the Committee "follows a balanced approach in promoting them, taking into account the magnitude of the deviations and the potentially different time horizons over which employment and inflation are projected to return to levels judged consistent with its mandate." One way this

⁹ In the immediate circumstances, were the Committee to decide to treat the 2 percent objective as a ceiling, explicit communication to that effect could help the public understand that policy would likely be tightened at a faster pace than expected today should the ceiling be breached.

¹⁰ The Committee considered and ultimately discarded such language in the development of the current Consensus Statement. However, in his prepared remarks for the press conference following the release of the Consensus Statement in January 2012, then-Chairman Bernanke suggested symmetry around the inflation objective.

¹¹ For example, the Bank of Canada's statement includes the following, in a separate section on symmetry: "Canada's monetary policy functions *symmetrically* around the inflation target. In other words, the Bank is equally concerned about inflation rising above or falling below the target and will act to rein in or to boost demand in order to bring inflation down, or to push it back up, to 2 per cent. Such an approach guards against both high inflation and persistent deflation" (emphasis in original; see http://www.bankofcanada.ca/wp-content/uploads/2010/11/monetary_policy.pdf). The Bank of England's statement of its monetary policy framework takes a similar, if somewhat briefer, approach (see <http://www.bankofengland.co.uk/monetarypolicy/Pages/framework/framework.aspx>).

¹² While such wording would represent a change to the Consensus Statement, it has some precedent in FOMC communications. Before the FOMC issued its CS, Chairman Bernanke publicly characterized the FOMC's goal as inflation of "2 percent or a bit less."

¹³ Specifically, the ECB's objective states: "The ECB aims at inflation rates of below, but close to, 2% over the medium term."

statement can be interpreted is that it provides information about the relative weights that the Committee places on employment deviations versus inflation deviations in its objective function. A second, related interpretation is that “balanced approach” provides information on the Committee’s policy reaction function. This section dwells primarily on the loss-function interpretation of “balanced approach,” but with some attention to the reaction-function interpretation.

Arguably, most readers interpret the “balanced approach” portion of the CS as indicating the Committee places *equal* weights on both components of the dual mandate in the objective function (see, e.g., Svensson, 2014). Chairman Bernanke’s statement in the press conference after the first release of the CS supported an interpretation of equal weights. He stated that “the Committee always treats its primary objectives of price stability and maximum employment symmetrically.”

However, the language in the CS is quite broad, and some readers may not interpret it as specifying equal weights in the loss function. In his press conference, Chairman Bernanke followed up the statement about symmetry with this example: “if inflation did go above target by a modest amount, we would certainly try to get it back down to target, but if unemployment were very high, that would lead us to be more cautious and slower in returning to target.” Clearly, this example is consistent with any loss function that places *some* positive weight on both legs of the dual mandate—as required by law—and would appear to imply that both legs of the mandate “matter” at all points in time. (Of course, it also touches on the policy reaction function.) Accordingly, there may be different perceptions of the implied weights or their implications for the future conduct of monetary policy. In this regard it is worth noting that the Statement does not establish the extent to which the Committee would be willing to tolerate an inflation rate moving somewhat above 2 percent in order to foster somewhat more rapid progress in reducing underutilization in the labor market.

Any effort to communicate more directly about the FOMC’s loss function raises two broad, challenging issues: First, what is the appropriate loss function, including the weights; and second, how should the CS communicate the relevant aspects of the loss function? Of course, the Committee could find it much easier to identify implications of a more qualitative characterization of a consensus objective function than to identify a specific loss function, a point to which we return below.

As to the appropriate weights of the loss function over the goals of price stability and maximum employment, there is little that seems to provide concrete guidance. The lengthy academic literature on optimal monetary policy is not conclusive on the appropriate form of the loss function or its weights. Many aspects of the objective function, including its relative weights, depend crucially on features of the model (the degree of price flexibility, real distortions, the elasticity of substitution between consumption goods, etc.), about which there is not widespread agreement.¹⁴ Moreover, these models are typically fairly narrow in many respects, including an almost exclusive focus on quadratic loss functions.

¹⁴ For example, in recent work based on small dynamic stochastic general equilibrium models, the form of the policy objective function that maximizes household welfare often puts very large weight on inflation and small

An alternative way of specifying the loss function is to try align it with the dual mandate. Unfortunately, the dual mandate offers little direct guidance on the appropriate weights, saying only that monetary policy should “promote effectively the goals of maximum employment [and] price stability...” without more specifics. However, some might argue that, by putting the two objectives on the same footing, the legal statement of the dual mandate either points to equal weights or at least does not suggest one objective should receive significantly more weight than the other.

In the absence of clear guidance from theory or legislation, policymakers may end up choosing weights on the basis of other considerations. For instance, they might find the simplicity of equal weights easier to communicate. Moreover, some policymakers may believe equal weights to be appropriate from a broader perspective of public choice in a democratic society that seems to be at least as concerned with employment as with inflation. Alternatively, because (as the CS notes) in the long run, monetary policy determines inflation but not employment, some might consider weights that put more focus on inflation than employment to be more credible and appropriate.

Turning to the reaction-function interpretation of the “balanced approach” language, some Committee participants might also like to clarify the monetary policy reaction function rather than just the loss function. This is a more ambitious goal as it requires them to communicate policy trade-offs in a dynamic context. The current CS has some of this flavor already, in its statement that policy takes into account “...the potentially different time horizons over which employment and inflation are projected to return to levels judged consistent with its mandate.” This language obscures the fact that the projected time horizons are a function, at least in part, of the conduct of monetary policy. Clarifying “balance” in this context might take the form of indicating how the rate at which one variable might be projected to approach (or over- or undershoot) its target could be traded off against the rate at which the other is approached.

The case for changing the use of “balanced approach”

Broadly, the primary reason the Committee might determine that it would like to change the “balanced approach” sentence is that it is vague. The FOMC may consider that clarity and transparency would be furthered by a clearer statement of how it will respond in the event that the monetary policy path suggested by the inflation and unemployment gaps are not complementary. Moreover, the Committee may find the reaffirmation of the CS in January 2015 to be an opportune time for such a clarification because the meaning of the phrase is likely to come under more scrutiny as the economy continues to recover and is approaching conditions in which the two legs of the mandate are no longer complementary.

weights on economic activity (and any other variables in the objective function). But recent work using an estimated medium-scale model of the U.S. economy finds support for a larger weight on the employment objective. In particular, Debortoli, Kim, Linde, and Nunes (2014) find equal weights on annual inflation and the output gap; translating the output gap into an unemployment rate gap using Okun’s Law suggests a greater weight on this objective.

Were the Committee to reach some agreement on the appropriate loss function and its weights, it could revise the “balanced approach” component of the CS to make a more direct statement of the Committee’s loss function. The uniqueness of the Fed’s dual mandate among central banks makes it difficult to point to useful examples from other central banks. If the Committee agrees on loss function weights, it might add to the CS to state those weights in some qualitative way. For example, in the case of equal weights, the Committee might develop wording similar to the Bank of Canada’s explanation of symmetry in its inflation objective, such as: “The Committee is equally concerned about deviations of inflation from its longer-run objective and deviations of labor market conditions from levels consistent with maximum employment.”

In the event that communicating a loss function and its weights proves difficult, the Committee may prefer to revise the CS to describe in a more qualitative way the implications of broader Committee agreement on some aspects of the appropriate loss function. That is, the Committee might seek to identify implications of a class of loss functions on which it agrees, and then expand the CS to describe some of the key implications. For example, following the example of Chairman Bernanke’s press conference cited above, the Committee might choose to shed light on its broader objective function by stating a willingness to permit some overshooting of inflation when the labor market is particularly weak.

4. Financial Stability

In this section, we consider how concerns for financial stability might influence the path for the federal funds rate that the Committee might choose, taking as given any supervisory actions or other tools that could be brought to bear on the topic by the Federal Reserve System and other financial regulators.¹⁵

There is a continuum of ways to express in the CS the role of financial stability as a concern for monetary policy. At one end of the continuum, the Committee could choose to employ what might be called a *target approach* and elevate financial stability to an explicit, primary goal of monetary policy, much like price stability and maximum employment. Given the absence of an explicit Congressional mandate for such an approach, this might seem extreme, but an elevation of this nature might be desirable and justifiable if the Committee found financial stability concerns so pervasive, and so inextricably tied to the fulfillment of the dual mandate, that financial stability as a goal of monetary policy were considered a necessary condition for achieving the dual mandate.¹⁶ On the other end of the spectrum, the Committee might treat financial stability like other factors—such as commodity price shocks or tax changes—that potentially affect the optimal stance of monetary policy. This *indicator approach* is in line with the pre-crisis view of the role of monetary policy with respect to financial developments, in particular, asset price bubbles: adjust monetary policy only insofar as the bubble affects the forecast but take no direct action to address the bubble itself (see, e.g., Bernanke and Gertler,

¹⁵ In all that follows in this section, we presume that for jurisdictional reasons if no other, the CS will not refer to macroprudential tools or bank supervision and regulation.

¹⁶ The discussion here assumes that financial instability has effects on real activity that could be severe but are temporary. If bouts of financial instability also have permanent effects on output then the case for protecting against such events is strengthened; in the limit, as these permanent effects get large, it might be optimal to design policy to rule out any chance of instability prior to any consideration of the dual mandate.

1999). There is also a range of middle-ground views. Many of these could be described as embracing a *constraint approach*. Included here could be the current CS language, which notes that “policy decisions reflect its...assessment of the balance of risks, including risks to the financial system *that could impede the attainment of the Committee’s goals*” (emphasis added).

Consider the difference in meaning and significance of the terms “financial conditions” and “financial stability.” Financial conditions generally refer to the quotidian ups and downs of asset prices and their implications for the forecast and hence for the stance of policy. Shocks of this nature can be naturally treated with the indicator approach to policy. Financial (in)stability, on the other hand, may be thought of as something that matters only episodically, but has potentially severe consequences when it does matter.¹⁷ By themselves, serious episodic and nonlinear events do not justify special monetary policy action.¹⁸ However, two other factors may make financial stability special for monetary policy. First, financial instability can itself impair the monetary policy transmission mechanism and thereby the power of policy to mitigate shocks to the economy. And second, as discussed below, in the run-up to a crisis, monetary policy might be able to affect the likelihood and severity of instability, either in conjunction with supervisory actions or as a “last-ditch” tool in case the latter prove insufficient. It is because monetary policy has the prospect of affecting the likelihood of the occurrence of a financial episode, or the costs of the episode when it does occur, or because the efficacy of monetary policy to “mop up” after the episode could be impaired by a bout of instability, that financial stability might warrant special attention from the FOMC and in the CS..

An emerging literature suggests that monetary policy can have a material effect on the likelihood of financial instability through what is called the risk-taking channel. The risk-taking channel of monetary policy posits that the propensity of financial actors to bid down the price of risk, to increase risk bearing, and to increase leverage, is a function of the stance of monetary policy.¹⁹ To the extent this risk-taking channel is operational, it follows that current and expected future monetary policy settings may be able to temper—or exacerbate—those incentives.²⁰ To cite one example, forward guidance that is taken by financial decision makers as implying that future settings of the federal funds rate will be *unconditionally* low could erroneously reduce the subjective probability of financial risks and thereby exacerbate the normal procyclicality of risk bearing. Other plausible mechanisms turn not on misperceptions but on the absence of

¹⁷ The theoretical literature emphasizes nonlinearities that might arise—in many cases, from occasionally binding constraints on financial decisionmakers—and lead to the amplification and propagation of shocks, enhancing the severity of their consequences. See, among other references, He and Krishnamurthy (2012) and Brunneimeier and Sannikov (2014). Hubrich and Tetlow (2014) provide some empirical evidence on financial stress and its nonlinear and episodic effects.

¹⁸ Svensson (2004) and Svensson and Williams (2005, 2008) show that certainty equivalence—that is, taking the best point forecast of one’s model and ignoring the distribution of outcomes around that forecast—is a good approximation of the best one can do, except when policy affects the distribution itself.

¹⁹ Indeed, in some versions of this view, there is no assurance that even the successful pursuit of price stability and maximum employment is achievable without sowing the seeds of future financial instability. It is sometimes said that the success of the Federal Reserve in stabilizing the economy in the years following the Volcker disinflation reduced the perceived level of macroeconomic risk, which induced financial decision makers to increase financial risk in order to re-establish higher levels of return, relative to risk-free assets. See Bean (2009) for an argument along these lines.

²⁰ See Adrian and Liang (2014) for a summary of this and related arguments, and references therein for details.

incentives for decision makers to internalize the increment to systemic risks that are implied by their decisions. And small adjustments in the probabilities of very adverse events can add up to large potential welfare changes. Still, the literature on risk-taking as a channel of monetary policy is a nascent one, and much of what we think we know now is likely to be modified by research and experience in the future.²¹

Taken together, these considerations lead us to the idea of financial stability as a constraint on monetary policy—albeit one that might be operational only at particular times.²² Still, there are a number of approaches that may fit under that rubric. One might, for example, assign monetary policy a role in combatting financial stability only as a “last resort,” leaving overarching responsibility to macroprudential tools. This could be justified on the intuitively appealing argument that financial objectives should be assigned to financial policy instruments and monetary objectives to monetary instruments. This argument is buttressed by noting that monetary policy is a crude tool that may affect the economy in ways that are broader than intended, while possibly having only modest benefits in reducing the risk or cost of financial instability.²³ Even so, while it seems clear that macroprudential tools should be expected to take the lead in bolstering the resilience of the financial sector, there are good reasons to temper expectations of their efficacy. First, not only are these tools largely untested in advanced economies in recent years, but also financial institutions have strong incentives to circumvent their effects. Second, macroprudential policy (as with monetary policy) operates with a lag, the length of which is unclear. Taken together, these factors may be seen as providing a *prima facie* case for considering the use of monetary policy to mitigate the buildup of financial vulnerabilities. Still, the limits on macroprudential efficacy do not necessarily mean that monetary policy can resolve the problem. Asking monetary policy to come in late to save the financial day is asking for deftness that monetary policy might not be able to deliver. That macroprudential policy might, itself, affect asset prices and lending conditions and thereby change both the stance of monetary policy and possibly the channels through which monetary policy operates, only compounds the issue by making monetary policy less dependable at such times than usual.²⁴

²¹ For example, Svensson (2011) strenuously argues that the Riksbank has focused *too* much on future risks of financial instability and too little on current inflation and activity.

²² The fact that financial instability is only a concern of operational significance during certain, relatively rare episodes argues against considering it to be a full-time goal of monetary policy. This conclusion is also supported by the fact that there are other nonmonetary instruments that can be brought to bear on the issue and the (likely related) point that the Congress has not seen fit to assign financial stability as a formal part of the Federal Reserve’s monetary policy mandate.

²³ And once the financial crisis is in train, the efficacy of monetary policy to ameliorate the damage may be undermined, meaning that the cost of tardiness can be very high. Hubrich and Tetlow (2014) show that conventional monetary policy is a weak tool during what they call “stress events” which can be taken as periods when financial instability is at hand.

²⁴ A slightly revised 2012 memo (re)sent to the Committee in March 2014 makes the point that if emerging instabilities are germane to a particular sector, it would tilt the argument toward macroprudential tools that are targeted on that sector; a corollary is that more widespread problems might call for a broader tool. See Duygan-Bump *et al.* (2014). Both Canada and the U.K. have turned to macroprudential tools to temper overheated conditions in housing markets rather than tightening monetary policy.

The Case for Changing the Treatment of Financial Stability in the CS

If participants were to choose to enhance the profile of financial stability in the CS, they would presumably have in mind some or all of the following purposes. First, policymakers might wish to advance the argument that financial stability is not merely another “balance of risk” issue as the current language suggests, for the reasons discussed above. Second, policymakers might choose to outline the key role of the endogeneity of the probability of a financial event and the role that monetary policy might be able to play in influencing—but not eliminating—that probability. Third, participants might think it is advantageous to signal—implicitly—a level of humility regarding the efficacy of macroprudential tools, in real time, given our current state of knowledge. And fourth, policymakers may believe that it is worth informing the public that the Committee has contingency plans for dealing with financial instability.

Were the Committee inclined to revise the CS to treat concerns of financial stability as a constraint on monetary policy, it could do so as an “escape clause” to the dual mandate. Whereas the current language lists “risks to the financial system” as one risk among possibly many that might “impede” policy, an escape clause might state more explicitly that when the Committee sees credible evidence that financial risks might be building, it may depart in some way from the *direct* pursuit of the dual mandate in order to forestall incipient instability—but only if supervisory tools are not sufficient and only for as long as is strictly necessary.²⁵ The departure of policy in this sense would probably need to be explained as the means to an end: Financial instability is, at times, such an impediment to the achievement of the dual objective that a workaround is no longer sufficient, and the impediment itself must be addressed. An adjustment of this nature might be achieved through a modest extension of the current CS language in paragraph 2 to distinguish the risks presented by incipient financial instability from the broader “balance of risks” issue. Participants might also wish to consider adding a more detailed statement in paragraph 5, where the CS currently discusses the implications of situations where the pursuit of individual legs of the dual mandate are not complementary, in order to clarify aspects of the operational significance of the revision.

5. The Case Against Changing the Consensus Statement

Even if the Committee reaches consensus on the three issues discussed in this memo, it may prefer to leave the CS unchanged, for a few reasons. First, any change to the CS has at least the potential to be viewed as signaling a shift in the Committee’s policy views or the likely future path of policy. At this crucial juncture in the normalization process, the Committee may view changes to key components of the CS as undesirable.

Second, to the extent it would be difficult to unwind any changes to the CS, the Committee might prefer to defer making changes now to preserve the option value of making future

²⁵ The Bank of England’s financial “knockout” permits the Bank to deviate from their policy if the Financial Policy Committee “judges that the stand of monetary poses a significant threat to financial stability that cannot be contained by the substantial range of mitigating policy actions available to the FPC, the Financial Conduct Authority and the Prudential Regulation Authority in a way consistent with their objectives.” <http://www.bankofengland.co.uk/monetarypolicy/pages/forwardguidance.aspx> A memo sent to the Committee in March 2014 summarizes the foreign experiences on the interaction of monetary and macroprudential policies; see Aikman *et al.* (2014).

adjustments. From a credibility perspective, changes should be viewed as at least somewhat costly because the CS presents longer-run goals and strategy, which should be relatively constant over time. Some might argue that, in light of these costs, events since the Great Recession have raised enough questions about the appropriate role of financial stability, inflation goals, and the tradeoffs between unemployment and inflation that it would be best to defer any changes to the CS until more information has been accumulated and the Committee has had more time to weigh the issues.

And finally, and more fundamentally, given the wide range of views on many issues, it is possible that the Committee simply does not agree on some or all of these issues. In that case, the current language may be considered appropriate because it can accommodate a broad range of views and so remains acceptable to the largest number of participants.

6. References

Aikman, David, Ozge Akinci, Mark Carey, Rochelle Edge and Andrei Zlate (2014) “Monetary and Macroprudential Policy in Foreign Economies,” memo sent to the Committee (March 5).

Adrian, Tobias and Nellie Liang (2014) “Monetary Policy, Financial Conditions and Financial Stability” Federal Reserve Bank of New York Staff Report no. 690 (September).

Bean, Charles (2009) “The Great Moderation, the Great Panic and the Great Contraction” Schumpeter Lecture given to the Annual Congress of the European Economic Association, August 25, Barcelona, Spain. <http://www.bis.org/review/r090902d.pdf>

Bernanke, Ben S. and Mark Gertler (1999) “Monetary Policy and Asset Price Volatility,” in *New Challenges for Monetary Policy: a symposium sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, WY, August 26-28, 77-128.*

Brunnermeier, Markus K. and Yuliy Sannikov (2014) “A Macroeconomic Model with a Financial Sector” *American Economic Review*, 104 (February): 379-421.

Coibion, Olivier, Yuriy Gorodnichenko and Johannes Wieland (2012) “The Optimal Inflation Rate in New Keynesian Models: Should Central Banks Raise their Inflation Targets in Light of the ZLB?” *Review of Economic Studies*, 79 (October): 1371-1406

Dibartoli, Davide, Jinill Kim, Jesper Linde and Ricardo Nunes (2014) “Designing a Simple Loss Function for the Fed: Does the Dual Mandate Make Sense?” unpublished manuscript. http://www.ricardonunes.net/DKLN_Paper_2014April14.pdf

Erceg, Christopher, Michael Kiley and Robert Tetlow (2014) “Potential Implications of Alternative Approaches to the Timing and Pace of Tightening,” memo sent to the Committee, (September 5).

Elmendorf, Douglas, Deborah Lindner, David Reifschneider, John Roberts, Jeremy Rudd, Robert Tetlow, and David Wilcox (2005) "Considerations Pertaining to the Establishment of a Specific, Numerical, Price-Related Objective for Monetary Policy," report sent to the Committee, (January 21).

Duygan-Bump, Burcu, Michael Kiley, Andreas Lehnert, Nellie Liang and Mark van der Weide (2014) "Using Monetary and Macroprudential Policies to Combat Financial Excesses," memo sent to the Committee (March 5).

He, Zhigu and Arvind Krishnamurthy (2012) "A Model of Capital and Crises" *Review of Economic Studies*, 79 (April): 735-777.

Hubrich, Kirstin and Robert Tetlow (2014) "Financial Stress and Economic Dynamics: the Transmission of Crises," *Journal of Monetary Economics* (to appear)
<http://www.sciencedirect.com/science/article/pii/S030439321400155X>

Laubach, Thomas; John Roberts, Jae Sim and Brad Strum (2014) "Long-term Inflation Expectations and Risks to the Inflation Outlook" memo sent to the Committee (September 5).

Svensson, Lars E.O. (2004) "Optimal Policy with Low-Probability Extreme Events," CEPR working paper no. 4218.

Svensson, Lars E.O. (2011) "Practical Monetary Policy: Examples from Sweden and the United States" *Brookings Papers on Economic Activity* (Fall): 289-332.

Svensson, Lars E.O. (2014) "How to Weigh Unemployment Relative to Inflation in Monetary Policy" *Journal of Money, Credit, and Banking*, 46 (October): 183-188.

Svensson, Lars E.O. and Noah Williams (2005) "Monetary Policy with Model Uncertainty: Distribution Forecast Targeting" CEPR Discussion Paper series no 6331.

Svensson, Lars E.O. and Noah Williams (2008) "Optimal Monetary Policy Under Uncertainty: a Markov Jump-Linear-Quadratic Approach" *Federal Reserve Bank of St. Louis Review*, 90 (July/August): 275-293.

Woodford, Michael (2003) *Interest and Prices: Foundations of a Theory of Monetary Policy*, Princeton: Princeton University Press.