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The "Evans Challenge" for Central Bankers

Charles Evans, President of the Chicago Fed, has built a reputation for supporting an outcomes-oriented approach for monetary policies. In 2011, he argued for aggressive monetary accommodation at least as long as the unemployment rate remained above a predetermined level, unless inflation rose uncomfortably high. His proposal became part of official Fed guidance from late 2012 to early 2014. Earlier this week, Evans issued a new challenge for policymakers, calling for a "strategic commitment" to a policy that not only lifts inflation to 2%, but generates a real possibility that inflation will moderately exceed 2%. In support of that commitment, he argued that there should be no additional Fed rate increases until there are "clear signs" of building wage and price pressures.

Charles Evans has developed a reputation for linking monetary policy actions to specific outcomes tied to the Fed's dual mandate for maximum employment and price stability. During the recovery from the last recession, he argued that the Fed should continue with aggressive monetary accommodation so long as the unemployment rate remained above a certain numerical threshold, and unless the forecast for inflation rose above a separate threshold that was well above the Fed's objective. In December 2012, the FOMC, led by Chair Bernanke, adopted a version of the "Evans' Rule", calling for the federal funds rate to remain close to zero at least as long as the unemployment rate remained above 6½% unless the forecast for inflation between one and two years ahead rose above 2½%.[1] This version of the Evans' Rule was part of official FOMC guidance until January 2014.

More recently, Evans has argued that the Fed must do much more to support a rise of inflation consistent with its symmetric, 2% inflation objective, in part to support the credibility of that objective and, more broadly, to reinforce confidence in the Fed's ability and willingness to pursue both aspects of the dual mandate with equal fervor. In large part, his approach reflects concern that the long period of generally sub-2% inflation will cause inflation expectations to soften below 2%, if they have not done so already. This would complicate the Fed's task of raising inflation to 2%, reduce the capacity of the Fed to provide interest-rate stimulus in the event of future adverse shocks, and increase the risk of future encounters with the zero lower bound.

Several passages from a speech on September 25 summarize the essence of what one could deem the "Evans' Challenge":[2]

I. "I am more concerned about our ability to get inflation back up to target within a reasonable period. One reason is, as I mentioned, the natural rate is difficult to measure and changes over time. So, it is possible that there is actually greater slack in labor markets than we currently estimate. However, there is another, more troublesome potential development: I am concerned that inflation expectations — the third element in the standard inflation model — may be too low."

[1] In the FOMC statement from December 12, 2012, "In particular, the Committee decided to keep the target range for the federal funds rate at 0 to 1/4 percent and currently anticipates that this exceptionally low range for the federal funds rate will be appropriate at least as long as the unemployment rate remains above 6-1/2 percent, inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee's 2 percent longer-run goal, and longer-term inflation expectations continue to be well anchored." Similar language appeared in FOMC statements until January 2014.

[2] Charles Evans, "The Puzzle of Low Inflation: Implications for Monetary Policy," remarks delivered at The Economic Club of Grand Rapids, Grand Rapids, Michigan, September 25, 2017.

II. "Our actions must strongly defend our strategic commitment to a symmetric inflation objective. This calls for communicating a policy path that truly generates the possibility that inflation will rise moderately above 2 percent during this rate cycle. This is because under a symmetric inflation objective, 2 percent is not a ceiling that inflation should never breech. Rather, it is a rate around which we should expect to see modest movements both above and below over time."

III. "As the FOMC comes to decision points over the coming months, I think we need to see clear signs of building wage and price pressures before taking the next step in removing accommodation. We should avoid taking policy steps that could be misread as a lack of concern over the inflation outlook. In my view, that would be a policy misstep that would further delay achieving our inflation objective."

Evans calls for the Fed to remain on hold with no more rate increases until there are "clear signs" that inflationary pressures are building. The FOMC should support policies that envision not only a rise of inflation to 2%, but also a real possibility that inflation will rise moderately above 2%.

In the view of some, including Evans, a symmetric inflation objective at 2% can only be seen as fully credible if periods of inflation moderately below 2% are roughly matched by periods when inflation is moderately above 2%.[3] Given that inflation on a PCE basis has been below 2% for most of the last decade, he argues that the FOMC should adopt policies that could allow for a moderate overshoot of the 2% inflation objective. In his view, the absence of a moderate inflation overshoot would cause the public to view the 2% inflation objective as more akin to a ceiling than to a symmetric target, increasing the tendency for long-run inflation expectations to fall short of 2%.

So who is up for the Evans' Challenge? Not Presidents Mester and George, both of whom have expressed concern that the Fed could fall behind the curve if it does not continue to raise interest rates. Presidents Dudley and Williams have also called for another rate hike this year. In contrast, Governor Brainard and President Kashkari have expressed views that are broadly sympathetic to Evans. Kashkari dissented this year on both occasions when the FOMC raised the funds-rate target, establishing his "dovish" stance in the current environment.[4]

Where does that leave Janet Yellen? As we wrote recently, the Chair believes it would be "imprudent" for the Fed to remain on hold with respect to rate hikes, as it needs to balance the risk of undershooting on inflation with overshooting full employment and risking a sharper rise of inflation. The Chair has essentially resisted the Evans' Challenge, though not in name.

It should be remembered that it took some time in 2011 and 2012 for the original "Evans' Rule" to gain widespread support within the FOMC. Evans dissented in November and December 2011, in both cases in favor of additional policy accommodation. Eventually, in December 2012, the FOMC began to include a version of the Evans' Rule, specifying a continuation of its highly accommodative policies as long as the unemployment rate remained above 6½%. *Could it be that if inflation continues to languish below 2%, with few signs that inflationary pressures are building and limited risk of rising persistently above 2%, Evans' views on the need for a stronger commitment to the symmetric 2% inflation objective could win over other FOMC members?*

[3] In response to a question at her September 25th appearance at the 2017 Annual Meeting of the National Association for Business Economics, Janet Yellen was asked to comment on the credibility of the Fed's inflation objective in light of the shortfall of inflation. "It's extremely important that the public understand that we have a symmetric inflation objective. We would ideally like to be at 2%, but inflation is variable, and sometimes inflation is going to be below 2% and sometimes it's going to be above 2%. We feel identically about undershoots and overshoots of inflation. We have had an undershoot. It would not be a tragedy to see an overshoot. In fact, it is something that we ought to expect."

[4] In June, Governor Jerome Powell called for the FOMC to "continue to demonstrate a strong commitment to achieving our symmetric 2 percent objective." Unlike Evans, Powell did not call for the FOMC to hold off on additional rate hikes until there were clear signs that inflationary pressures were building. Similar to the Chair, he advocated a continued process of gradually increasing interest rates. See "Thoughts on the Normalization of Monetary Policy," remarks delivered at The Economic Club of New York, New York, New York, June 1, 2017.

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