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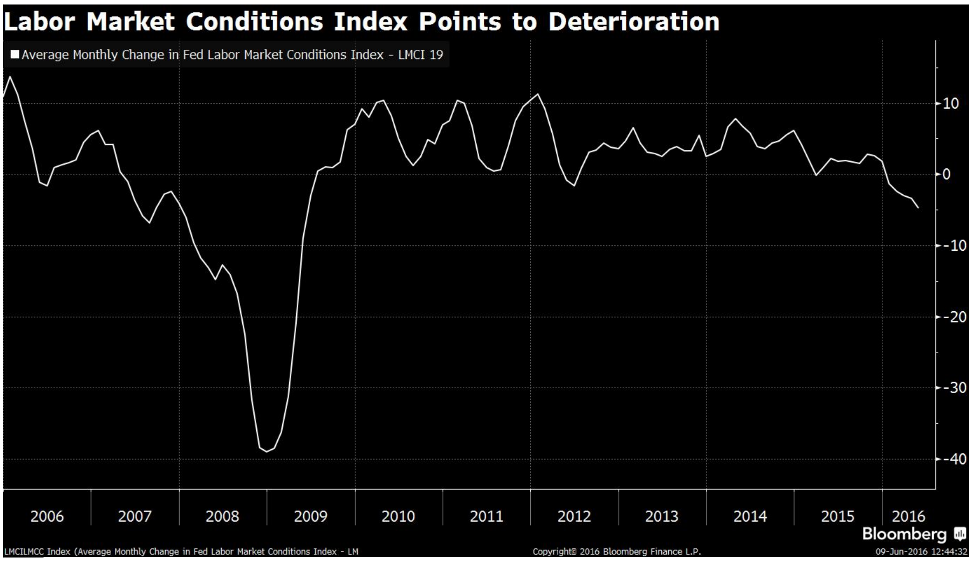
Next week's meeting of the Federal Open Market Committee (FOMC) includes a press conference with Chair Janet Yellen. These are five questions I would ask if I had the opportunity to do so in light of recent events.

## 1. What's the deal with labor market conditions?

You advocated for the creation of the Federal Reserve's Labor Market Conditions Index (LMCI) to serve as a broader measure of the labor market and as an alternative to a narrow measure such as the unemployment rate. The LMCI declined for five consecutive months through May, the most recent release:




Source: Bloomberg

On June 6, however, you said that "...the job market has strengthened substantially, and I believe we are now close to eliminating the slack that has weighed on the labor market since the recession."

The LCMI signals that although the economy may be operating near full employment, it is now moving further away from that goal. Is it appropriate for the Fed to still be considering interest rate hikes when your measure is moving away from the goal of full employment? Or have you determined the LMCI is not a useful measure of labor market conditions?

## 2. Has the effect of QE been underestimated?

Since the Fed began and completed the process of ending quantitative easing (QE), the dollar has risen in value, the stock market rally has stalled, the yield curve has flattened, broader economic activity has slowed, and now we are experiencing a slowing in labor market activity. These are all traditionally signs of tighter monetary policy, but you have insisted that tapering is not tightening and that policy remains accommodative. Given these signs, is it possible or even likely that you have underestimated the effectiveness of QE and hence are now overestimating the level of financial accommodation?

## 3. Optimal control or no?

The Fed appears determined to hit its inflation target from below. In other words, the central bank is positioning policy to tighten despite inflation currently running below the 2 percent target in order to avoid an overshoot at a later date. In the past, however, you argued for an 'optimal control' approach that anticipated an explicit overshooting of the inflation target in order to more rapidly meet the Fed's mandate of full employment. Under optimal control, it seems that given stalled progress on reducing underemployment, coupled with deteriorating labor market conditions, the Fed should now be explicitly aiming to overshoot the inflation target by keeping policy loose. Do you believe the optimal control approach you previously advocated is wrong? If so, what caused you to change your mind?

## 4. An Evans Rule for all?

Chicago Federal Reserve President Charles Evans remains concerned about asymmetric policy risks. Persistently below target inflation risks undermining the public's belief that the Fed is committed to reaching its target. Such a loss of credibility hampers the ability to subsequently meet the central bank's target. In contrast, the well-known effectiveness of traditional policy tools means there is less upside risk to inflation. Consequently, he argues for an updated version of the Evans Rule (or an earlier commitment to not hike rates as long as unemployment exceeded 6.5 percent and inflation was below 2.5 percent).

Specifically, Evans said:

> "In order to ensure confidence that the U.S. will get to 2 percent inflation, it may be best to hold off raising interest rates until core inflation is actually at 2 percent. The downside inflation risks seem big — losing credibility on the downside would make it all that more difficult to ever reach our inflation target. The upside risks on inflation seem smaller."

Recall that in your most recent speech you indicated unease with inflation expectations and — at least implicitly — recognized the asymmetry of policy risks:

> "It is unclear whether these indicators point to a true decline in those inflation expectations that are relevant for price setting; for example, the financial market measures may reflect changing attitudes toward inflation risk more than actual inflation expectations. But the indicators have moved enough to get my close attention. If inflation expectations really are moving lower, that could call into question whether inflation will move back to 2 percent as quickly as I expect."

This — especially when combined with your past support for an optimal control approach to policy — suggests that you should be amenable to adopting Evans' position. Do you support Evans' proposal that the Fed should stand down from rate hikes until the inflation target is reached? Why or why not?

## 5. Just how much do you care about the rest of the world?

Earlier this year, Federal Reserve Governor Lael Brainard suggested that the many developed economies operating at or below zero percent interest rates reduces the central bank's capacity for raising rates. "Financial tightening associated with cross-border spillovers may be limiting the extent to which U.S. policy diverges from major economies," she said.

At last September's FOMC press conference, you said that you thought the global forces were insufficient to restrain the path of U.S. monetary policy. In response to a question about "global interconnectedness" preventing the U.S. from ever moving away from zero percent interest rates, you said:

> "I would be very surprised if that's the case. That is not the way I see the outlook or the way the Committee sees the outlook. Can I completely rule it out? I can't completely rule it out. But, really, that's an extreme downside risk that in no way is near the center of my outlook."

Given the events of the past six months — especially the refusal of longer-term U.S. Treasury yields to rise despite repeated hints of monetary tightening — have you reassessed your opinion? Do you view the risks of such an outcome as greater or lower than your assessment made last September?

**Bottom Line**: Most of these questions try to push Yellen to explain her past positions in light of the current data and actions. I think understanding how and why her positions change is critical to understanding how the Fed reacts to the conditions facing it. Making the so-called 'reaction function' clear remains the most important piece of the Fed's communication strategy.