Monetary Policy Normalization: If Not Now, When?

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Introduction

I would like to thank Lakeland College for inviting me to speak this morning. It's always refreshing to reach directly into the communities in our District to gain valuable personal insights into what is going on in the economy and pick up information that sometimes get missed in dry reports and statistics. Opportunities such as this also give me a chance to talk to you about the state of the economy, the progress we have seen in repairing the damage from the Great Recession, and how Federal Reserve policy fits into the picture.

Of course, to gauge progress, we must measure economic performance. It's natural for us at the Federal Reserve to do so against the objectives that Congress has set out for us — what are known as the Fed's dual mandate. Namely, the Federal Reserve is charged with fostering financial conditions consistent with full employment and price stability.

Needless to say, the past seven years have been very challenging and we have struggled to achieve both our employment and inflation objectives. To accomplish our goals, the Federal Open Market Committee (FOMC) cut its traditional policy tool, the target federal funds rate, essentially to zero — what economists refer to as its zero lower bound, or ZLB. And when achieving the dual mandate called for additional monetary policy accommodation, the FOMC turned to other less conventional approaches, such as large-scale asset purchase programs — what many of you have heard referred to as "QE," or quantitative easing — and forward guidance about how long the fed funds rate is likely to remain near zero. I believe these efforts have been very beneficial in helping the economy make significant progress and bringing us back closer to our policy goals.

Today, with economic conditions much improved, many people are asking when Fed policy will return to normal. That is an excellent question. So in my remarks this morning I will discuss my outlook for the economy and how that outlook and the risks around it shape my views about the appropriate timing and pace of eventual policy normalization.

In particular, I expect that there will be further improvements in economic activity over the next three years and that these will be accompanied by additional declines in the unemployment rate toward more normal levels. At the same time, I expect inflation to rise gradually toward the FOMC's 2 percent target.

These forecasts are predicated on maintaining a highly accommodative stance of monetary policy for a considerable time. Indeed, given our recent experience, I feel that before the Fed raises rates, we should have a great deal of confidence that we won't be forced to backtrack on our moves and face another painful period at the ZLB. And once we start, at least initially, we should raise rates slowly to make sure the economy can weather less accommodative financial conditions. In sum, we should be exceptionally patient in adjusting the stance of U.S. monetary policy — even to the point of allowing a modest overshooting of our inflation target to appropriately balance the risks to our policy objectives.

Before I expand on these thoughts, let me note that the views I express are my own and do not necessarily represent those of my colleagues on the FOMC or within the Federal Reserve System.

Outlook

Improving Growth but Slack Remains

After many years of false starts, the economy now seems to be in the midst of more sustained solid growth. My forecast is that real gross domestic product (GDP) will increase at an average rate of about 3 percent over the next year and half.

The incoming data support this outlook. In the second quarter, consumer spending grew at a solid but unspectacular 2-1/2 percent pace, and it appears to have risen at roughly the same rate during the third quarter. The news from the business sector generally has been good. Reports from our business contacts have been improving for some months and are now almost uniformly positive. Underscoring this more positive sentiment, the data on new orders and shipments of machinery and other capital goods have been increasing at a good clip and surveys of business purchasing managers point to growth in both the manufacturing and nonmanufacturing sectors.

However, there are still some sectors — such as single-family housing markets — that continue to struggle. Starts of new single family houses are only about half of the way back to where they were even before the housing boom. In part, the weakness here reflects continued fallout from the financial crisis, as it is still the case that mortgage credit is hard to come by for those without the most pristine credit ratings.

So what does this economic outlook mean for the achievement of the Fed's dual mandate objectives?

Underutilization in the Labor Market

Let's consider labor markets first.

Output growth is key for producing healthier labor market conditions. Although the economic recovery generally has been weak, there has been enough cumulative progress to generate considerable improvement in the labor market. So where do we stand today? How much further do we have to go to fulfill our employment mandate?

We can point to several measures to mark the progress we have made to date. Employment has been growing over 200,000 per month for quite some time. With expanding employment, the unemployment rate has fallen relatively rapidly. In fact, now standing at 5.9 percent, the unemployment rate has fallen about 4 percentage points from its high — and a full percentage point over the last year. Other measures of labor market health also suggest significant improvements: Notably, layoff rates are low and job opening rates are back to their pre-recession levels.

But we still aren't back to full labor market health. At 5.9 percent, the unemployment rate remains above what most people think of as its long-run neutral level. For example, according to the central tendency in the FOMC's latest Summary of Economic Projections,[1] the estimate of the neutral unemployment rate is between 5-1/4 to 5-1/2 percent, with my own judgment at the bottom of this range. This leaves a significant gap between our goal and current conditions.

Moreover, the labor force participation rate has dropped a good deal. Most of the decline in labor force participation since 2000 is due to demographic trends, such as baby boomers moving into retirement age, and long-running trends, such as reductions in male and teenage labor force participation. These trends are structural in nature, and monetary policy is not the appropriate policy tool to address them. Nonetheless, the labor force participation rate has fallen somewhat more than what would be expected given these structural trends. And it is also lower than what would be expected from its historical relationship with the unemployment rate. Other indicators — such as long-term unemployment, the rate of involuntary part time work, and the job finding rate — also point to more slack in labor markets than that indicated by the unemployment rate alone.

In addition, it is hard to imagine a robust labor market without solid growth in wages. With productivity growth of around 1 to 2 percent and an inflation target of around 2 percent, we should be seeing wages and benefits rising at around a 3 to 4 percent rate. But that is clearly not the case. Although some in-demand occupations may be experiencing stronger wage growth, overall compensation growth has been around 2 percent over the past six years.

Taken altogether, these and other measures lead me to conclude that there remains significant underutilization of labor resources — and likely somewhat more slack than what is indicated by the unemployment rate alone. So, while good progress has been made, we have yet to achieve our full-employment goal.

Too-Low Inflation

The other element of our dual mandate is stable prices. The Fed defines its target as 2 percent inflation over the medium term, with inflation being measured as the rate of change in the Personal Consumption Expenditures (PCE) Price Index. Earlier in the year, the inflation rate had been well below that target, at 1-1/4 percent. It has moved up a little since then, but inflation is still only 1-1/2 percent, still leaving a significant gap from our 2 percent target.

Of course, there are alternative measures of inflation, such as the widely reported Consumer Price Index (CPI). The FOMC has set its inflation target in terms of the PCE Price index because relative to the CPI it covers a wider range of items that households

[1] Federal Open Market Committee (2014).

consume and because it better adjusts for changes in the spending patterns of households. CPI inflation is currently around 2 percent. But CPI inflation generally runs three to five tenths of a percentage point higher than PCE inflation, and so the CPI's performance should be measured against a higher inflation objective, such as 2-1/2 percent. So, an inflation gap remains for the CPI as well.

Looking ahead, I am concerned about the possibility that inflation will not return to our 2 percent target within a reasonable period of time. First, recent monthly inflation numbers have been low, so there is not much upward momentum. Second, as I mentioned earlier, wage growth has been relatively low for some time. While wages don't predict future inflation, the two often move together. So the subpar growth in wages we see today is consistent with continued subdued inflation. And, third, it does not appear as if inflationary expectations are exerting much of an upward pull on actual inflation at the moment.

That said, I expect inflation to rise slowly over the next three years toward the FOMC's 2 percent target. And as I mentioned earlier, I am expecting further improvements in economic activity, with real GDP growing at around 3 percent over the next 18 months and the unemployment rate declining further to a little over 5 percent by the end of 2016 — in line with what I think is its long-run neutral level. So I do see us getting back close to our policy goals over the next two to three years.

A Balanced Approach to Monetary Policy

It is important for me to say that this forecast is predicated on the assumption that the FOMC takes a very patient approach to reducing policy accommodation. Let me elaborate on why I think this is appropriate.

I see two important and divergent ways my forecast could go wrong. One is that I may be overestimating the underlying strength in the real economy, so that a successful and sustained exit from the ZLB may be more difficult than I currently believe. Guarding against this risk calls for a more patient removal of accommodation. The second is that I may be wrong about the inflation outlook, and we could be poised for a much larger rise in inflation than I am forecasting. This risk calls for more aggressive rate hikes.

How do I think policy should balance these divergent risks? How should they affect the FOMC's strategy of pursuing a balanced approach to achieving our policy goals?

In my mind, current circumstances and a weighing of alternative risks mean that a balanced policy approach calls for being extraordinarily patient in reducing accommodation — that is, being patient about when we first increase the federal funds rate and being patient about setting the pace of rate increases once we have begun to move.

Proceed Cautiously in Normalizing Policy

The first factor entering my analysis is that I see a number of downside risks to the growth and inflation forecasts.

For instance, as I look around the globe, I see many economies facing slow growth and low inflation. Europe and Japan are well-known cases among the advanced economies. Of course, slow or stagnant growth in advanced countries has negative spillovers onto emerging markets that are highly dependent on exports for their growth. Indeed, today China is confronting slower growth, and the Brazilian economy has fallen into recession.

For the United States, slower growth abroad reduces demand for our exports and, with it, U.S. production. In addition, weakness abroad could translate into a higher exchange value for the dollar against other currencies, further reducing net exports. A higher dollar also would result in lower prices for imports, which, in turn would hold down inflation and delay progress toward our 2 percent inflation target.

While the risks to the U.S. outlook emanating from abroad are worthy of notice, they are not the biggest thing on my mind. For me, the biggest and costliest downside risk is that in our haste to get back to “business as usual” monetary policy, we could stall progress and backtrack to the economic circumstances of recent years — an economy mired in the ZLB.

To say the least, conducting monetary policy at the ZLB has been a difficult experience that we all want to avoid repeating unnecessarily. In the winter of 2009, with the unemployment rate soaring to double digits, the Fed would have very much liked to lower the nominal federal funds rate an additional 300 basis points; but we couldn’t because the rate was already at zero.
Faced with a pressing need to provide additional accommodation, we were forced to turn to innovative, but controversial, unconventional monetary policies. These policies have been extremely helpful. But there is no denying that they were second-best options; the ZLB had made lowering the fed funds rate, which is our first-best interest rate tool, infeasible.

Everyone will welcome a return to more normal times and a reliance on the traditional policy framework of adjustments to the federal funds rate. But the decision about when to begin to raise rates shouldn’t be made prematurely. Rather, the decision for policy liftoff has to be made for the right reasons — that is, it should be dictated by economic conditions.

Like my colleague Minneapolis Fed President Narayana Kocherlakota,[2] I think that policy at all times must be goal-oriented. Our experiences since the crisis began and current economic conditions are highly unusual. The FOMC should not simply set its policy instruments by mechanically aligning them with historical norms if those norms are not currently relevant for the conditions needed to attain both of our dual mandate goals. Rather, our policy instruments should be set to achieve our ultimate goals as

[2] See, for example, Kocherlakota (2013).

efficaciously as possible given current and prospective economic conditions, all the while with an eye on managing against important risks to the outlook.

I believe that the biggest risk we face today is prematurely engineering restrictive monetary conditions. In this scenario, the FOMC could misjudge the presence and magnitude of economic impediments and misread the recent progress we have made as evidence of sounder economic trends. If we were to presume prematurely that the U.S. economy has returned to a more business-as-usual position and reduce monetary accommodation too soon, we could find ourselves in the very uncomfortable position of falling back into the ZLB environment. Such an outcome could be a serious setback to the timely attainment of our dual mandate policy objectives.

This risk consideration means that the decision to lift the funds rate from zero should be made only when we have a great deal of confidence that growth has enough momentum to reach full employment and that inflation will return to a sustainable 2 percent rate. We should also proceed cautiously and keep the path of rate increases relatively shallow for some time after we begin to raise rates. This approach will allow us time to assess how the economy is performing under less accommodative financial conditions and reduce the odds of overaggressive rate hikes choking off progress toward our policy goals.

History Shows That Premature Exit Is a Risk

Past experience with the ZLB also counsels patience. History has not looked kindly on attempts to prematurely remove monetary accommodation from economies that are in or near a liquidity trap. Three occasions come readily to mind: the Great Depression (which was resolved only with the massive fiscal expansion of World War II), Japan over the past 20 years, and the recent European experience. Indeed, both of the more recent episodes are ongoing today, though Japan finally appears to be making important headway toward raising inflation and eventually exiting the ZLB.

The U.S., Japanese and European lessons from monetary history strongly suggest that there are great risks to premature liftoff from the ZLB or near-ZLB conditions. Unless the economy is fundamentally strong and the previous impediments to growth have receded sufficiently, the odds remain high that some unforeseen shock could cause the monetary authority to retreat right back into the ZLB.

And the costs of being mired in the ZLB are simply very large. The ZLB prevents using our very best policy tools to address negative shocks. The ZLB means that interest rates cannot fall low enough to equate the supply of saving with the demand for investment, which, of course, significantly impedes capital formation, future economic growth, and the health of labor markets. And the ZLB often comes hand in hand with undesirably low inflation or even a falling price level, carrying with it the associated costs of debt deflation on the real economy.

The Risk of Too-High Inflation

What about the other risk to our policy goals that I mentioned — the risk that the U.S. economy could face pricing pressures that accelerate rapidly and ultimately leave inflation far above our 2 percent target for an unacceptably long period?

At some point, when the economy has clearly overcome the remaining impediments from the largest economic and financial downturn since the Great Depression, the odds of inflation rising noticeably above target could become palpable. But such a breakout is just not at all very likely today. Indeed, many Fed critics have been voicing this concern since 2009, and it hasn't even come close to happening.

What if inflation just ran moderately above target for some time? Well, I see the costs of this outcome as clearly being much smaller than the costs of falling back into the ZLB. First, I believe the U.S. economy could weather the modest increases in interest rates that would be needed to keep inflation in check. Such rate increases would be manageable for the real economy; this is particularly true if industry and labor markets have already made the most difficult reallocations of jobs and overcome other factors so that productive resources are more efficiently and fully employed. Second, as I've noted many times in the past, a symmetric inflation target means we should be averaging 2 percent inflation over time. We've averaged well under that 2 percent mark for the past six and a half years. With a symmetric inflation target, one could imagine moderately above-target inflation for a limited time as simply the flip side of our recent inflation experience — and hardly an event that would impose great costs on the economy.

The murky state of inflation expectations is another factor that enters my risk-management considerations. For inflation to take off rapidly, we would have to see a jump in inflationary expectations. But inflationary expectations certainly have not taken off. Indeed, we may be facing a quite different problem.

Many forecasters — myself included — assume that stable 2 percent inflation expectations will be an important factor helping to pull actual inflation up. Over the past five years, professional forecasters' projections for long-run inflation have been at the 2 percent target and the Treasury Inflation-Protected Securities (TIPS) break-evens generally have been flat. Yet actual inflation has only just recently made it back up to 1-1/2 percent. Moreover, we still have not seen much at all in the way of higher inflation compensation being built into interest rates or wages. So there is cause for concern that expectations might not produce as strong a pull on inflation as we hope. This unusual situation has precedent, for example, in Japan, where inflation expectations have remained stable, while inflation itself has lagged for a prolonged period. Of course, there is a risk, too, that inflation expectations themselves could fall—indeed, I would note that longer-dated TIPS break-evens have recently dropped to the lower end of their post-crisis range.

Conclusion

As I think about the process of normalizing policy, I conclude that today's risk-management calculus says we should err on the side of patience in removing highly accommodative policy. We need to solidify our confidence that our ultimate exit from the ZLB will occur smoothly — and that our escape can be sustained. A corollary to this conclusion is that we should not shy away from policy prescriptions that imply forecasts of inflation that moderately overshoot our 2 percent target for a limited time.

Such a policy strategy more properly balances expected costs and benefits. And it would leave me with much more confidence that inflation will not stall out below target once we start raising rates.

I agree with Atlanta Fed President Dennis Lockhart in thinking that we ought to be "whites of their eyes" inflation fighters.[3] The last thing we want to do is regress back into the ZLB. Indeed, such a relapse would be a sign there was something else going on that was preventing the economy from being as vibrant as we thought possible.

To summarize, I am very uncomfortable with calls to raise our policy rate sooner than later. I favor delaying liftoff until I am more certain that we have sufficient momentum in place toward our policy goals. And I think we should plan for our path of policy rate increases to be shallow in order to be sure that the economy's momentum is sustainable in the presence of less accommodative financial conditions. I look forward to the day when we can return to business-as-usual monetary policy, but that time has not yet arrived.

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[3] Lockhart (2014).