
The Case for a Slow Return to Monetary Policy Normalization

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The views expressed today are my own and not necessarily
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Introduction

Good afternoon. Thank you.

My comments today will be about the U.S. economy and current monetary policy challenges. I will also have some specific thoughts on the auto industry, which is so important to this area and the rest of the Chicago Fed District. But before I begin, I should note that my commentary reflects my own views and does not necessarily represent those of my colleagues on the Federal Open Market Committee (FOMC) or within the Federal Reserve System.

As a little background, at the end of each meeting the FOMC issues a statement that provides some context for its monetary policy decisions. In addition to providing commentary on developments since the last meeting, the statement offers guidance on how the Committee expects monetary policy to evolve. In the most recent statement, released after the meeting in late October, the FOMC said that “in determining whether it will be appropriate to raise the target range at its next meeting, the Committee will assess progress — both realized and expected — toward its objectives of maximum employment and 2 percent inflation.”¹

Goals of Monetary Policy — Are We There Yet?

These objectives refer to the dual mandate Congress gave to us. More specifically, the Federal Reserve is charged with fostering financial conditions that achieve 1) stable prices and 2) maximum sustainable employment.

For the first goal, the inflation rate over the longer run is primarily determined by monetary policy. So the FOMC has the ability to specify a longer-run goal for inflation. Since January 2012, the Committee has set an explicit 2 percent inflation target as measured by the annual change in the Price Index for Personal Consumption Expenditures (PCE).²

For the second goal, quantifying the maximum sustainable level of employment is a much more complex undertaking. Many nonmonetary factors affect the structure and dynamics of the labor market. These factors can vary over time and are hard to measure. Consequently, the Committee does not set a fixed goal for employment, but instead considers a wide range of indicators to gauge maximum employment.

¹ Federal Open Market Committee (2015a).

² This was first acknowledged in Federal Open Market Committee (2012). It remains in the most recent statement of our longer-run goals; see Federal Open Market Committee (2015c).

Nonetheless, FOMC participants provide their individual view of the longer-run normal level of unemployment that is consistent with the employment mandate. The median estimate among FOMC participants is currently 4.9 percent.³ My own view is in line with this assessment.

Given these operational objectives, how close are we to achieving the goals of our dual mandate? There is no doubt that labor markets have improved significantly over the past seven years. Job growth has been quite solid for some time now. And today, at 5 percent, the unemployment rate is half what its peak was during the recession and just a tenth of a percentage point above the FOMC's median view of the long-run normal rate. That said, a few other labor market indicators lead me to believe that there still remains some additional resource slack beyond what is indicated by the unemployment rate alone: Notably, 1) a large number of people who are employed part time would prefer a full-time job; 2) the labor force participation rate is quite low, even after accounting for demographic and other long-running trends; and 3) wage growth has been quite subdued.⁴ In sum, I don't think we're quite there yet, but we have made good progress toward meeting our employment mandate.

To support activity during and since the Great Recession, the Fed has reduced the federal funds rate, our traditional policy instrument, as low as effectively possible. And we sought to provide additional accommodation through nontraditional means, such as our large-scale asset purchase programs.⁵ I believe these policies have been extremely important in supporting the economic recovery.

The motor vehicle industry certainly has benefited. As you know, the industry is highly cyclical. In difficult times households and businesses seek ways to cut spending. For many, purchasing an automobile is a significant commitment of resources. So, it makes sense to delay that acquisition when job prospects are poor, the business climate is uncertain, and financing is costly and hard to obtain. During the Great Recession, all of these forces were in full play. Therefore, it is little wonder that from 2006 to 2009, car and light truck sales fell by more than 45 percent to a rock-bottom 9-million-unit pace.

Well, the market certainly looks better today. Indeed, over the past few months light vehicle sales have averaged around 18 million units at an annualized rate — which is actually somewhat above where most analysts put the long-run sustainable trend. Federal Reserve policy has unquestionably helped. Of course, our actions were not aimed at the motor vehicle sector per se — monetary policy is set to improve conditions for the economy as a whole. That said, policy did contribute to lower borrowing rates for auto and truck loans and easier credit conditions for automakers and their suppliers, not

³ Four times a year the FOMC releases its Summary of Economic Projections (SEP), which give participants' forecasts of key economic variables over the next three years and for the longer run. See Federal Open Market Committee (2015b) for the most recent projections.

⁴ See Evans (2014a, 2014b, 2014c, 2015a, 2015b, 2015c).

⁵ The Fed embarked on multiple rounds of asset purchases (or quantitative easing) — and used forward guidance — to reduce longer-term interest rates. For details, see Board of Governors of the Federal Reserve System (2015a, 2015b).

to mention the overall improvement in job conditions and economic growth that are so critical to motor vehicle demand.

Now, for the first time in seven years, the FOMC is contemplating raising the federal funds rate.⁶ It has been so long since we have raised rates that we may have forgotten what this actually means! Because the fed funds rate is a key determinant of short-term financing costs for banks and other financial institutions, as it goes up, so will the borrowing rates paid by households and nonfinancial businesses. This includes rates on car and truck loans. With sales above trend and higher financing costs coming, we should expect sales to move down some from their current high pace. But against the backdrop of a healthy job market and steady economic growth, the declines shouldn't be too large. Indeed, many forecasters are looking for car and light truck sales to average a still solid 17-million-unit annual rate over the next five years or so.⁷

What can I say about the outlook more generally? In the FOMC's latest forecast, my colleagues on the Committee projected that real gross domestic product (GDP) growth would run in the 2-1/4 to 2-1/2 percent range over the next year and a half or so. My personal view is closer to the upper end of that range. Most of us — myself included — also expect the unemployment rate to edge down further and even fall slightly below its long-run sustainable level by the end of next year.⁸ I also anticipate the elements of extra labor-market slack that I mentioned earlier to dissipate over that time. So I see we are close to reaching our employment mandate.

However, I am far less confident about reaching our inflation goal within a reasonable time frame. Inflation has been too low for too long. Core PCE inflation — which strips out the volatile energy and food components and is a good indicator of underlying inflation trends — has averaged just 1.4 percent over the past seven years. Core PCE inflation over the past 12 months was just 1.3 percent. And inflation according to the total PCE Price Index — which does include food and energy prices — was just 0.2 percent over the past year.

Most FOMC participants expect inflation to rise steadily from these low levels, coming in just a shade under the Committee's 2 percent target by the end of 2017.⁹ My own forecast is less sanguine. I expect core PCE inflation to undershoot 2 percent by a greater margin over the next two years than do my colleagues. I expect core PCE inflation to be just below 2 percent at the end of 2018.

⁶ In December 2008, the FOMC reduced the federal funds rate to its current range of 0 percent to 1/4 percent, where it has remained since.

⁷ The consensus view of economic forecasters polled for the *Blue Chip Economic Indicators* is that the pace of auto and light truck sales will slow to around 17 million units per year from 2017 to 2021.

⁸ According to the median forecast of latest SEP, the unemployment rate is projected to edge down further next year to 4.8 percent and to remain at that level through the end of 2018. The median forecast for real GDP growth is 2.1 percent for 2015. It rises to 2.3 percent in 2016 before gradually edging down to 2 percent (the longer-run estimate of real GDP growth) in 2018 (Federal Open Market Committee, 2015b).

⁹ In the latest SEP, the median forecast for both core and total PCE inflation is 1.7 percent in 2016, 1.9 percent in 2017, and 2.0 percent in 2018 (Federal Open Market Committee, 2015b).

A Risk-management Approach to Monetary Policy

So why do I lack confidence in our ability to achieve our 2 percent inflation target over the medium term? One reason is that there exist a number of important downside risks to the inflation outlook. Now I recognize that “medium term” is somewhat vague. To a central banker it can mean two to three years or three to four years. It is more a term of art than science.

So what are these inflation risks? With prospects of slower growth in China and other emerging market economies, low energy and import prices could exert downward pressure on inflation longer than most anticipate. That’s a risk. In addition, while many survey-based measures of long-term inflation expectations have been relatively stable in recent years, we shouldn’t take them as confirmation that our 2 percent target is assured. In fact, some survey measures of inflation expectations have ticked down in the past year and a half. Furthermore, measures of inflation compensation derived from financial markets have moved down to quite low levels in recent months. These measures could reflect either lower expectations of inflation or a heightened concern over the nature of the economic conditions that will be associated with low inflation. Adding to my unease is anecdotal evidence: I talk to a wide range of business contacts, and virtually none of them are mentioning rising inflationary or cost pressures. No one is planning for higher inflation. My contacts just don’t expect it.

How does this asymmetric assessment of risks to achieving the dual mandate goals influence my view of the most appropriate path for monetary policy over the next three years? It leads me to prefer a later liftoff than many would like, followed by a very gradual normalization of our monetary policy. I think such a policy setting will best position the economy for the potential challenges ahead.

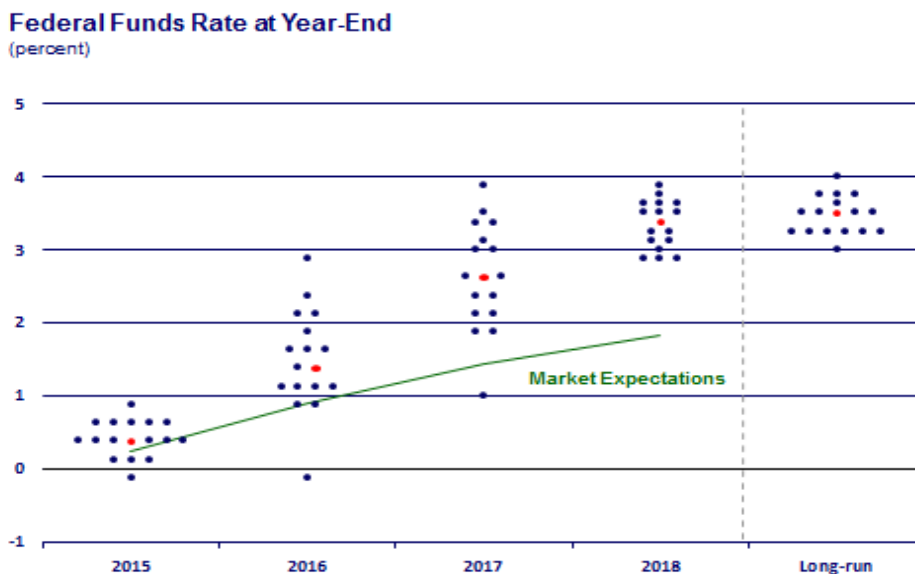
Now, I take seriously the view that I should go into every FOMC meeting with an open mind regarding the policy decision. And I will do so in our meeting two weeks from now. Should we raise rates or not? I admit to some nervousness about our upcoming decision. Before raising rates, I would prefer to have more confidence than I do today that inflation is indeed beginning to head higher. Given the current low level of core inflation, some evidence of true upward momentum in actual inflation would bolster my confidence. I am concerned, however, that it could be well into next year before the headwinds from lower energy prices and the stronger dollar dissipate enough so that we begin to see some sustained upward movement in core inflation.

That said, the exact timing of liftoff it is less important than the trajectory rates would follow over the next couple of years. Regardless of whether we liftoff soon or wait somewhat longer, I think it would be appropriate to raise the target interest rate very gradually. This would give us sufficient time to assess how the economy is adjusting to higher rates and the progress we are making toward our policy goals.

I’ll go into my reasoning on this in more detail in a minute. But first, let’s talk a bit more about what this gradual path might look like. In addition to economic and inflation

forecasts, FOMC participants also submit individual assessments of the appropriate monetary policy supporting their forecasts. These policy judgments are summarized in the Federal Open Market Committee’s well-known “dot plot.”

Appropriate Pace of Policy Firming



Source: Interest rate projections are from the September 17, 2015 FOMC Summary of Economic Projections. Market expectations are from OIS futures as of November 6, 2015.

This is the chart that shows FOMC participants’ views of the appropriate target federal funds rate by the end of each year for 2015 through 2018 and also over the longer run. Each participant’s fed funds rate forecast is shown as a distinct dot at each of these time horizons. The chart I’m showing here is the most recent one we did for last September’s FOMC meeting, so, with apologies, it’s a little dated.

Let us focus for a moment on the median policy projections, indicated by the red dots. Most of my colleagues thought that it would be appropriate to raise the target federal funds rate at least by our meeting in December. Over the next three years, these projections envisioned a slow increase in the rate, to about 3-1/2 percent by the end of 2018.¹⁰ On average, this path is consistent with the target federal funds rate increasing by 25 basis points at every other FOMC meeting over the next three years. By historical standards, this is certainly a gradual path. It is even slower than the so-called measured pace of increases over the 2004–06 tightening cycle, which was 25 basis points per meeting.

Of course, there is a dispersion of views around this median path, and, overall, my dots are among the most accommodative on the chart. Let me explain my thinking.

¹⁰ Specifically, the median projected path for the target federal funds rate is 0.4 percent at the end of 2015; 1.4 percent at the end of 2016; 2.6 percent at the end of 2017; and 3.4 percent at the end of 2018. The median projection for the longer-run level of the federal funds rate is 3.5 percent (Federal Open Market Committee, 2015b).

Historically, central bankers have established their credibility by defending their inflation target from above — to fight off undesirably high inflation. Today, policy needs to defend our inflation target from below. This is necessary to validate our claim that we aim to achieve our 2 percent inflation target in a symmetric fashion. Failure to do so may weaken the credibility of this claim. The public could begin to mistakenly believe that 2 percent inflation is a ceiling — and not a symmetric target. As a result, expectations for average inflation could fall, lessening the upward pull on actual inflation and making it even more difficult for us to achieve our 2 percent target.

Another factor underlying my thinking about policy is a consideration of policy mistakes we could make. One possibility is that we begin to raise rates only to learn that we have misjudged the strength of the economy or the upward tilt in inflation. In order to put the economy back on track, we would have to cut interest rates back to zero and possibly even resort to unconventional policy tools, such as more large-scale asset purchases. I think these policies can be effective, but they clearly are a second-best alternative to our traditional policy tools.

Both the defense of a symmetric inflation target and risk management against potential policy errors compel me to argue for taking a very gradual approach to policy normalization. The outlook for economic growth and the health of the labor market continues to be good. But the outlook for inflation remains too low. I think a gradual path of normalization would balance both the various risks to my projections for the economy's most likely path and the costs that would be involved in mitigating those risks if they indeed came to pass.

Now as I mentioned earlier, while I favor a somewhat later liftoff than many of my colleagues, the precise timing for the first increase in the federal funds rate is less important to me than the path the funds rate will follow over the entire policy normalization process. After all, today's medium- and longer-term interest rates depend on market expectations of the entire path for future rates, not just the first move. In turn, these medium- and longer-term rates are key to the borrowing and spending decisions of households and businesses.

Accordingly, when thinking about the initial stages of normalization, I find it useful to focus on where I think the federal funds rate ought to be at the end of next year. And right now, given my economic outlook and assessment of risks, regardless of the exact date for liftoff, I think it could well be appropriate for the funds rate to still be under 1 percent at the end of 2016.

There is a crucial caveat, though, to my comment downplaying the importance of the exact date of liftoff. To me, it is vital that when we first raise rates, the FOMC also strongly and effectively communicates its plan for a gradual path for future rate increases. If we do not, then market participants might construe an early liftoff as a signal that the Committee is less inclined to provide the degree of accommodation that I

think is appropriate for the timely achievement of our dual mandate objectives. I would view this as an important policy error.

Thank you.

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