A Perspective on the Current Economy:

Some Thoughts on Monetary Policy and Inflation

Charles L. Evans
President and Chief Executive Officer
Federal Reserve Bank of Chicago

BB&T Speaker Series on Capitalism
Darla Moore School of Business
University of South Carolina

Columbia, South Carolina
March 28, 2011

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It is my pleasure to return to South Carolina to speak to you about my views on the progress of the recovery, inflation and the course of monetary policy. I would like to thank Dean Teegen for that kind introduction.

Before offering my perspective on the U.S. economy and monetary policy, let me emphasize that the views that I am presenting today are my own and not necessarily those of the Federal Open Market Committee (FOMC) or my other colleagues in the Federal Reserve System.

The Fed has a dual mandate from Congress to encourage conditions that foster both maximum employment and price stability, and monetary policy decisions are made by the FOMC with these objectives in mind. In normal times, the FOMC operates by appropriately setting the federal funds rate, which is the interest rate on overnight loans between banks. Other actions may be taken during unusual times, such as those we have faced over the past several years. The voting members of the FOMC are members of the Board of Governors of the Federal Reserve System in Washington and a rotating group of the 12 regional Fed presidents. Chairman Bernanke presides over the Committee, and I am currently a voting member.

So, where do we stand today relative to our dual mandate of maximum employment and price stability?

Following a deep and lengthy recession, the U.S. economy is now in its second year of recovery. The recent data have been encouraging. But when we look at the past two years as a whole, the improvements have been disappointing. Too many people remain unemployed — some for extended periods — and too many businesses have not yet returned to full operations. Over the course of the recession, the economy lost more output, shed more jobs and experienced more wealth destruction than at any other time since the Great Depression. U.S. real gross domestic product (GDP) declined by more than 4 percent. Over 8.5 million jobs were lost; the unemployment rate doubled to 10 percent; and the household sector lost more than $13 trillion in wealth.

Recent data indicate that growth has picked up and suggest a more sustainable, though still moderate, economic expansion. There are many reasons to be optimistic. Improvements in labor markets and reductions in debt burdens are supporting household spending. Businesses' balance sheets have improved — indeed, many have ample cash reserves to finance spending. Those looking for external funding can obtain low-cost financing from capital markets, and the availability and terms of bank lending have improved notably from crisis levels. Monetary policy remains accommodative. And the recently enacted federal payroll tax reductions and investment expensing provisions help prop up spending.

Of course, there are still weak spots. Both residential construction and commercial construction remain at very depressed levels of activity. Some borrowers who are dependent on bank lending might still be constrained in their access to credit. Budgetary concerns weigh on state and local governments' capacity to spend. And higher energy prices represent a reduction in domestic purchasing power, though at current prices this effect is still a modest one.

More recently, the earthquake and tsunami in Japan have taken a tremendous human toll. It is too early to assess the ultimate economic cost of these events to the Japanese and U.S. economies. However, certain segments of the U.S. economy that rely on goods imported from Japan — such as the auto and electronics sectors — will see interruptions in their supply chains, at least in the short run.

So, given these upside and downside risks to economic activity, what is my outlook for growth and inflation?

At our FOMC meetings, my colleagues and I discuss recent developments and provide our forecasts for key measures of economic activity. These forecasts are reported four times a year in the minutes of the FOMC meetings. The most recent forecasts were published in January. Most of the projections for real GDP growth in 2011 were in the range of 3.4 to 3.9 percent this year. Growth is expected to move higher still in 2012, and most forecasts for 2013 fall between 3.7 and 4.6 percent. Incoming information suggests slightly lower growth this year than what had been predicted in January, but not a marked difference in the outlook. This is a welcome improvement over the roughly 2-1/2 percent annual growth since the recession trough in the middle of 2009.

Despite clear signs of progress, I am not yet satisfied with the pace of improvement. After all, my projection of about 4 percent growth is only moderately higher than the growth rate of potential output. It thus implies only a moderate improvement relative to the levels of activity that we would expect to see if the recession had not occurred.

This shows through in the outlook for the unemployment rate. To be sure, the unemployment rate has fallen almost 1 percentage point in just the past three months. Even so, at its current level of 8.9 percent, the unemployment rate is well above the 5 percent at which it stood shortly before the economy slipped into recession. Historical experience tells us that 4 percent GDP growth would chip away something on the order of three-quarters of a percentage point a year from the unemployment rate — meaning it could be quite a while before we near the pre-recession rate.[1]

[1] This calculation uses Okun's Law, which is a simple summary of the historical relationship between GDP growth and the change in the unemployment rate. Even in normal times this relationship is a rough approximation, and in the current situation, it is also compounded by the presence of emergency unemployment insurance programs and other structural factors that may be affecting the functioning of labor markets.

Furthermore, most of the recent reduction in the unemployment rate is due to fewer people losing jobs. This is a good thing, but not as good as if we were also seeing more unemployed people moving back onto payrolls. Indeed, employment growth has been disappointing throughout the recovery. Employment still stands about 7.5 million jobs below its peak at the onset of recession. And over the past three months, payrolls have risen at a rate of only 125,000 per month. In my view, unemployment will remain uncomfortably high for too long relative to our employment objective. So accommodative monetary policy continues to be warranted to address this part of our dual mandate.

Let me now discuss the price stability element of our mandate. As the FOMC statement after the March meeting noted, “measures of underlying inflation continue to be somewhat low relative to the levels that the Committee judges to be consistent, over the long run, with its dual mandate.” Put more simply, the Committee considers the current level of underlying inflation to be too low.

Given the recent sharp increases in food and energy prices, the statement that inflation is too low might make some of you wonder if the Committee members ever eat or fill up their own gas tanks. Let me assure you that we do. Indeed, my daughter takes special pleasure in giving me daily updates on how much it costs to fill up her car. Stepping back from my own family’s experiences, I do recognize that in the past three months, energy prices rose at an annual rate of 29 percent. And food prices are up nearly 14 percent. Such increases clearly put a dent in consumers’ purchasing power, and some households have had to make some difficult adjustments.

What accounts for the recent run-up in these prices? Rising demand plays an important role. Economic development continues to reach more and more people throughout the world, pushing up their demand for food and industrial commodities. On the supply side of the ledger, we’ve experienced some unique conditions over the past year that temporarily constrained output. The list of events is extraordinary: The flooding in Australia and drought in Russia all put upward pressure on food prices, and uncertainty over petroleum supplies due to the turmoil in the Middle East and North Africa have boosted oil prices.

In such cases, there is not a direct role for monetary policy. Monetary policy cannot affect the scarcity of resources. Indeed, think about what happens when the price of a commodity rises but other prices do not change. We call this a change in the relative price of the commodity. Changes in relative prices provide an important signal to market participants, encouraging consumers to find ways to economize and giving suppliers an incentive to increase production. Changes in relative prices are not inflation. Inflation, by definition, is a continuing increase in the general level of prices of all goods and services in the economy.

So relative price changes become inflationary only if they somehow spur price increases for a broader range of other goods and services. And if this were to happen, monetary policy would have a critical role to play. I will return to this point in a moment.

The Committee considers a wide variety of inflation measures when it evaluates the appropriate stance of policy. For our long-run policy goal, we concentrate on the Price Index for Personal Consumption Expenditures (PCE), which measures prices for a broad basket of the goods and services that households purchase. In the shorter term, however, we tend to focus on what we call core PCE inflation, which removes the volatile food and energy components from the total index. This does not mean that we think these prices are irrelevant. But food and energy prices are very volatile — both up and down. Being free of this volatility makes the core measure a better indicator of underlying broad inflation trends — and therefore a better guide of where inflation is heading. Of course, as I just alluded to, we monitor food and energy prices carefully with a particular eye out for whether they are influencing the broader pricing decisions that affect all goods and services.

Most of us on the FOMC have said that a PCE inflation rate of about 2 percent is consistent with our price stability mandate. Yet, core inflation — as measured by the change in the index over the past year — has been running well below this 2 percent rate for about two years. It has been under 1 percent for the past several months, and even total inflation has just reached 1.5 percent.

A whole host of measures that attempt to exclude the volatile and transient components of price changes to focus on the persistent underlying trends in inflation — trimmed mean PCE, trimmed mean Consumer Price Index (CPI), adjusted trimmed mean CPI, median CPI, just to name a few — tell the same story.[2] (These indexes do not exclude food and energy per se, but instead use various other methodologies to try to eliminate irrelevant statistical noise and get at the underlying trends in the data.) In the January FOMC forecasts, most participants predicted that both core and overall inflation would be in the range of 0.9 to 1.6 percent at the end of 2013 — still below the 2 percent mark. Of course, that was in January. Because we've seen further increases in food and gasoline prices since January, some of the recent readings on core measures have been a bit higher. The new information has caused me to bump up my personal forecast for core inflation, but only by a couple of tenths. And while I think food and energy prices will push the total PCE index up faster this year — maybe at about a 2 percent rate — I do not see total inflation running very far from core for very long.

How do I come to this forecast? Forecasts of inflation depend on a number of factors. I will focus on three of them: commodity costs, resource gaps and inflation expectations. Let me start with something that appears to be on everyone's mind as a risk to the

[2] The following websites provide details: http://www.clevelandfed.org/Research/data/US-Inflation/cpi.cfm?DCS.nav=Local, http://www.kc.frb.org/Publicat/econrev/PDF/2q01clar.pdf and http://dallasfed.org/data/pce/index.html.

inflation outlook — commodity prices. How do the recent sharp increases in oil and other commodity prices influence my forecast for inflation?

Commodity price increases do not necessarily portend future broad inflation. In fact, despite the views aired by pundits, the historical evidence is that today's commodity price increases will likely have little discernible effect on future core inflation. Although they are quite important for some products, commodities only contribute a minor portion to the total cost of bringing most items to market. And for commodity cost increases to influence consumer prices, firms must be able to pass cost increases on to customers. In today's economy with many sectors still experiencing lax demand, many firms may not be able to pass on these cost increases. Instead, rising input costs will put a squeeze on their profit margins.

This brings me to the second factor I mentioned: resource gaps. Prices tend to rise when increases in demand push up resource utilization and put broad-based pressure on firms' costs of production. However, in today's economy, resource gaps are large. Importantly, as I mentioned before, there is still substantial slack in labor markets — the high unemployment rate and other indicators, such as the low labor force participation rate and the high number of people working part time for economic reasons — all point to weak overall labor demand. This is translating into very small increases in wages and salaries; as measured by the Employment Cost Index, they rose just 1-1/2 percent for the past year — the lowest recorded increase since the series began in 1983. Consequently, we are not seeing any upward pressure on prices coming from labor costs. And for the economy as a whole, labor represents by far the largest component of production costs. Additionally, in order for price increases to be sustained, demand must keep pace. This means wages must grow. The logic is simple: If consumers cannot afford to pay higher prices, demand falls, putting downward pressure on prices.

Under the forecasts for output and unemployment I just discussed, I expect significant resource slack to remain in the economy for some time to come, and I also am expecting that slack to exert an important downward influence on inflationary pressures. To get me to reassess this view, I would have to see real GDP growing much stronger than my 4 percent forecast, strong improvements in the labor market, and evidence that wage pressures on labor costs were starting to build. Today, there is no evidence of such pressures.

This leads me to the third — and final — point about forecasting inflation. Future inflation is determined in part by expectations of future inflation. Let me explain. Expectations of future inflation are an important element in businesses' and consumers' planning for the future. Right now, professional forecasters' expectations of long-run inflation are at about 2 percent. Such expectations are factored into current spending and investment decisions. But if some surprise event were to lead to higher expected inflation, businesses and consumers would internalize this new belief and take actions consistent with it. These actions would, in turn, put actual inflation on a higher path.

This brings me back to our earlier discussion of commodity prices. One thing we look for when we monitor the reactions to unexpected movements in commodity and oil prices is their impact on inflation expectations. If unforeseen price increases alter inflation expectations and these expectations for higher prices boost longer-run underlying inflation, then it may become appropriate to adjust policy.

That said, our historical experience over the past 25 years suggests that such adverse developments are unlikely. While they have had short-lived direct effects on the prices of energy and commodity-intensive products, commodity price increases generally have not had a long-lasting effect on overall inflation. Now, as a central banker, I'm paid to be cautious. The experience of the past 25 years might not accurately reflect what will occur today. And while the participants in futures markets for commodities currently do not expect a further run-up in prices (indeed, many expect price declines), they may be wrong. Unexpected supply disruptions or surges in demand could push up prices further. Recognizing these possibilities, the most recent FOMC statement noted that: "The recent increases in the prices of energy and other commodities are currently putting upward pressure on inflation. The Committee expects these effects to be transitory, but it will pay close attention to the evolution of inflation and inflation expectations."

To recap, current measures of underlying inflation are subdued and are running lower than what the FOMC judges to be consistent with long-run price stability. To be sure, we see some increase in headline inflation due to higher food and energy prices, but we do not expect these to materially boost underlying inflationary trends. Moreover, existing resource gaps are still exerting countervailing downward pressure on inflation. Nonetheless, we will continue to pay close attention to the evolution of inflation and inflation expectations, and we will adjust policy if developments move our forecast to rates incompatible with our inflation mandate.

With regard to policy today, slow progress in closing resource gaps and underlying inflation trends that are too low lead me to conclude that substantial policy accommodation continues to be appropriate. This accommodative policy will foster a return of economic conditions consistent with our dual mandate. We are providing this accommodation in two ways. The first is our commitment to keep short-term nominal policy rates low for an extended period. The FOMC's policy statements have been very clear on this and have included this characterization for the federal funds rate since March 2009. The second is our large-scale asset purchase program (LSAP) through which, by June, we most likely will have purchased all told $2.35 trillion of long-term Treasury and GSE issues. These purchases are aimed at directly influencing longer-maturity interest rates. They also play an important and useful communications role—they signal our commitment to keep short-term rates low for an extended period of time.

In closing, monetary policy evolves as economic circumstances change. It is vital to evaluate the impact of new information on our forecasts and to reassess the stance of monetary policy as circumstances warrant. Contemplating such adjustments in advance will help prepare us for the eventual time when a change in the stance of monetary policy will be necessary. Despite recent improvements to the outlook, we are not yet at that point.