Charles I Plosser: A longer-term view of the US economy and monetary policy

Speech by Mr Charles I Plosser, President and Chief Executive Officer of the Federal Reserve Bank of Philadelphia, to the Charlotte Economics Club, Charlotte, North Carolina, 3 December 2014.

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The views expressed are my own and not necessarily those of the Federal Reserve System or the FOMC.

Highlights

- President Charles Plosser gives his views on the U.S. economy and discusses why it is important to take a longer-term view of economic data.
- President Plosser shares some thoughts about the stance of monetary policy and the advantages of raising rates gradually and starting sooner rather than being forced to raise them abruptly later.
- President Plosser also discusses how policy rules can offer useful guideposts for policymakers and the public in assessing and communicating the stance of monetary policy.

Introduction

Thank you for the invitation to be here today. The Charlotte Economics Club has welcomed many leading Federal Reserve voices to this podium over the years, including a number of my fellow Fed presidents. You have heard from President Jeff Lacker of the Richmond Fed, which has its Charlotte Branch over on East Trade Street, as well as Presidents Richard Fisher of Dallas and Dennis Lockhart of Atlanta. So I am pleased to have been included among your distinguished guests.

On November 16, the Federal Reserve observed the 100th anniversary of the opening of all 12 Federal Reserve Banks around the country on the same day. These institutions along with the Board of Governors in Washington, D.C., comprise our nation's decentralized central bank. This decentralized structure is one of the System's great strengths. Not only does it promote a diversity of views, but it also helps to build public trust and preserve independence. However, it requires that I begin by reminding you that the views I express today are my own and do not necessarily reflect those of the Federal Reserve System or my colleagues on the Federal Open Market Committee (FOMC).

Your program chair, Professor Rob Roy McGregor, has spent a great deal of his academic career studying the workings of the FOMC – including the use of power by the Chair and the nature of consensus building and dissent within the Committee. Interestingly, some of this work has been coauthored with a former colleague of mine at the Philadelphia Fed, Todd Vermilyea, who now works at the Board of Governors.

Today, I plan to talk about the importance of taking a longer-term view in setting monetary policy. We live in a 24-hour news cycle that focuses a lot of time and energy on analyzing the tea leaves from the daily onslaught of new economic data at our disposal. Yet, I believe it is a mistake for policymakers to focus too intently on the most recent numbers to justify a policy decision. Our data are always noisy and often subject to substantial revision, as we just witnessed with last week's GDP revisions and as we see regularly with the monthly employment report. Instead, we must focus our attention on the underlying trends and the likely path of the economy over the intermediate to longer-term horizon.

One reason why policymakers must think long term is that the effects of monetary policy actions on inflation and employment may not be felt for many quarters and maybe years in the future. Thus, the near term path of the economy is unlikely to be altered in any significant way by today's policy choices. We must look further ahead in assessing the appropriate stance of monetary policy. Of course, there is a great deal of uncertainty about the future and that too has implications for how we should approach policy.

I will begin with a brief overview of the economy as one policymaker sees it as we near the end of 2014.

Economic conditions

Over the past year, we have seen encouraging signs in the economy. The most recent estimate of annualized real GDP growth in the third quarter was 3.9 percent, which followed strong growth in the second quarter of 4.6 percent. Taking a longer view, growth from the third quarter of last year to this year was 2.4 percent. But this includes a negative 2.1 percent growth rate in the first quarter of 2014 that was a consequence of a severe winter and was largely transitory in nature. We are seeing continued strength in personal consumption, especially in durable goods, as well as business fixed investment, which marked the strongest two quarter growth in investment by businesses in nearly three years.

GDP growth has averaged 2.3 percent over the 21 quarters of the recovery since mid-2009. That is a half point below the 5-year growth rates measured during most of the 2000s before the recession, which is, in part, why this recovery is often seen as being moderate or modest from an historical perspective.

Nonetheless, we have seen a sustained improvement in the manufacturing sector. The November reading from the Philadelphia Fed's *Manufacturing Business Outlook Survey* indicated very strong growth in manufacturing activity. Even more encouraging are the sustained increases we have witnessed in this sector. After a mediocre performance from mid-2011 to mid-2013, the index has now been positive for nearly 18 consecutive months, with the only aberration in February 2014 during the depths of our severe winter weather. Our index is often viewed as a useful indicator of national manufacturing activity, and indeed the national ISM manufacturing index has also shown solid performance over the past 18 months.

The labor market has also strengthened over the year. Employers added jobs at an average rate of 229,000 per month in the first 10 months of the year, which is 18 percent higher than the rate in 2013, and it's the highest we have seen at any point in the recovery. This acceleration in job growth has helped bring the unemployment rate down to 5.8 percent as of October, compared with 7.2 percent a year ago.

Over the course of this recovery, the unemployment rate has fallen from a peak of 10 percent in October 2009 to 5.8 percent today. Other measures of unemployment have also declined. For example, the measure called U6, which includes marginally attached workers and those working part time for economic reasons, has fallen from its peak of 17.2 percent to 11.5 percent.

Inflation, for the moment, remains well contained. The personal consumption expenditures, or PCE, price index, the measure of inflation preferred by the FOMC, registered a 1.4 percent increase over the 12 months through October. It is running somewhat below the FOMC's stated longer-term target of 2 percent, but it remains above the level that should stoke concerns of sustained deflation.

Falling energy prices are generally good news for consumers and a favorable development for the economy going forward. In the short term, the decline in the relative price of energy will show up in lower headline inflation, but as energy prices stabilize, headline inflation will increase. Policymakers tend to look through such volatile and transitory price changes to assess the underlying trend in inflation. The core PCE index, which excludes food and energy, is a bit higher than the overall measure, increasing 1.6 percent over the 12 months through October. Other measures of inflation, including those that attempt to reduce the weight given to large outliers in any given month, all tend to suggest that inflation is running between 1.5 percent and 2 percent. Given the precision with which we can measure such things, I find this outcome satisfactory. Nevertheless, I anticipate that the FOMC will conduct policy over time in such a manner that inflation will gradually move toward the Fed's 2 percent target. Private sector forecasters seem to share this view as the Philadelphia Fed's most recent *Survey of Professional Forecasters* shows that long-term inflation expectations remain stable at 2 percent.

Monetary policy

In my discussion of the economy, I have emphasized the longer-run path of the recovery rather than the month-to-month fluctuations. Viewed in this context, it is clear that the economy has come a long way since the recovery began in June 2009. To me, that means we should no longer be conducting monetary policy as if we were still in the midst of a financial crisis or in the depths of a recession.

The financial crisis was an extraordinary event, and much of the commentary on monetary policy has focused on the actions of central banks in response to the financial crisis. That is appropriate and understandable. Yet, there is another lesson to be learned from the past six years that I think is important to recognize. And that is how difficult it is for monetary policy to fine-tune real growth in the economy. Despite the FOMC's stated desire and aggressive actions to accelerate the pace of the recovery, growth has proceeded at a moderate pace since the end of the crisis. Monetary policy has simply not proved to be the panacea that many had hoped. As I have argued on a number of occasions, I believe we have come to expect too much from monetary policy. We would be better served by greater humility and lowered expectations of the potential for monetary policy to manage real economic growth and employment.

Ten years ago, I suspect most commentators would have told you that six years of a near-zero federal funds rate target and more than $3.5 trillion of long-term asset purchases by the Fed would likely produce an economic boom in the near term and would risk inflation in the longer term. Well, although we have experienced modest growth, we have not experienced a boom, and the jury remains out as to whether inflation will materialize as a consequence. Some argue that the absence of the boom is because the Fed didn't do enough – more was needed to offset the constraint of the zero lower bound on nominal interest rates. Of course, there is an alternative hypothesis: Monetary policy was not capable of offsetting or mitigating the sorts of real challenges the economy was facing. Distinguishing between these two hypotheses will undoubtedly be the subject of intense research in the coming decades. After all, economists are still studying the policy choices and their effects during the Great Depression eight decades ago.

But let me turn our attention to how monetary policy should evolve going forward. I began my remarks by noting that monetary policy should focus on the intermediate to longer term and be less sensitive or reactive to short-run and transitory movements in the data. To that end, I see the economy continuing to improve with real growth averaging about 3 percent in 2015 before coming back down to its long-term trend growth rate of about 2.4 percent. Employment will continue to expand, and inflation will move closer to our 2 percent target. While people can disagree about the extent to which the labor market has healed, it is clear that the labor market is in much better shape than it was in 2009 when unemployment reached its peak of 10 percent. The economy has come a long way, and monetary policy should reflect such progress.

This progress suggests that monetary policy should begin to normalize. Keeping the funds rate target near zero when inflation is close to our goal and the economy is near full employment is both unprecedented and risky in my view. Waiting too long to begin the process of raising the policy rate risks facing the possibility that the rate may have to increase rapidly when the time comes and that could prove unnecessarily disruptive. And waiting could also risk a more rapid pickup in inflation.

Of course, policymakers face many uncertainties, and so they must be prepared to adjust policy as the underlying trends in inflation and the real economy evolve. So, how should a central bank best inform the public about those uncertainties and the prospective path of policy?

The appropriate way to communicate the future of policy is to describe in a general way a reaction function. That is to describe what key economic variables influence the setting of policy and to give a sense of how policy will change in response to changes in those variables. Over the past several years, I have criticized policy messages that suggest that calendar time is a relevant metric for determining a policy action. We must avoid such date-based forward guidance, whether it uses specific calendar dates or more vague references alluding to a “considerable period” of time. As policymakers, we do not know what the future holds, so forward guidance in this form cannot be very credible.

Unfortunately, it is unlikely that policymakers will adopt a specific reaction function in the near term. Yet, there are numerous examples of such systematic approaches or reaction functions that can help us to gauge the stance of policy. Some of these reaction functions have been shown to be robust in a variety of circumstances and useful in describing past monetary policy behaviors. They can, I believe, provide useful guidelines for assessing the stance and the likely path of monetary policy. They can also be useful in communicating policy to the public. I frequently consider such reaction functions as I think about policy. These are typically Taylor-like rules named for the Stanford University economist John Taylor who first proposed them in the early 1990s. These policy rules typically call for the targeted funds rate to respond to deviations of inflation from some desired target and to deviations of output from some measure of potential – sometimes referred to as economic “slack” or the “gap.” Sometimes such gaps are translated into deviations from full employment.

These policy rules can offer useful guideposts for policymakers and the public in assessing the stance of monetary policy, and communicating more about such guideposts would enhance transparency and help make policy more systematic. Thus, there is no need to mechanically follow any particular rule, and judgment will always be required. Yet, policymakers and the public should be very cautious when they call for policy rates to deviate in important or significant ways from these guideposts. Making such judgments should require careful analysis, and the justification for deviating from such guidelines should be clearly communicated to the markets and to the public.

A monetary policy strategy such as I have just described could be communicated through a regular Monetary Policy Report, perhaps published quarterly. The report would offer an opportunity to reinforce the underlying policy framework of the Committee and how it relates to current and expected economic conditions.

Publishing a Monetary Policy Report with an assessment of the likely near-term path of policy rates, in conjunction with its economic forecast, would also provide added discipline for policymakers to stick to a systematic, rule-like approach. Communication about that path, in turn, gives the public a much deeper understanding of the analytical approach that guides monetary policy, thus making policy more transparent and predictable.

In the current environment, an assessment of a variety of these robust rules suggests that the funds rate target is no longer constrained by the zero lower bound. These rules indicate that liftoff of the funds rate target from zero should have already occurred or should occur in the very near future. It is important to point out that all of these rules recognize and take into account the fact that the inflation rate remains somewhat below the FOMC’s target of 2 percent. Nevertheless, they do not call for maintaining the funds rate target near zero.

These rules are helpful because they not only suggest when liftoff should occur, but they offer guidance about the future path of rate changes, given the likely direction of the economy – that is, forecasts of inflation and employment “gaps.” Even more important is that if the forecasts of the future change, these guideposts can highlight how the entire policy path is likely to evolve. As such, they are capable of better aligning the public’s expectations of policy with those of the FOMC, making the conduct of monetary policy more accountable and more efficient.

Conclusion

In conclusion, the U.S. economy continues to recover at a moderate pace. Although we have not witnessed the strong bounce back from the depths of the recession that some anticipated, the recovery has been somewhat remarkable in the steadiness with which it has progressed. Labor markets continue to heal, and their stronger-than-expected recovery should serve to underpin continued economic expansion. Consumer balance sheets are much improved, and individuals have regained significant fractions of the wealth they lost during the crisis. That gives me additional confidence that the economy is now operating fairly normally and that policy should reflect that normalization.

Policy can also be made more transparent and effective by specifying more completely the variables that guide policy and the general way that one can expect policymakers to react to those variables. To this end, I believe the FOMC should move forward to describe in a qualitative way its reaction function and then communicate our actions and decisions in terms of this reaction function. A detailed Monetary Policy Report could be a useful vehicle for such enhanced communication by discussing a range of robust policy rules. Placing policy choices in such a context will lead to a more systematic approach to policy and one that is more transparent and predictable.