Charles I Plosser: A perspective on the economy and monetary policy

Speech by Mr Charles I Plosser, President and Chief Executive Officer of the Federal Reserve Bank of Philadelphia, to the Greater Philadelphia Chamber of Commerce, Philadelphia, Pennsylvania, 14 January 2015.

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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 the importance of four principles to sound monetary policy.
- President Plosser believes that the appropriate way to make policy systematic, or rule-like, is to base policy decisions on economic conditions. Monetary policy should be data dependent, not date dependent.
- He thinks policymakers should describe the reaction function that determines how the current and future policy rates will be set depending on economic data.
- President Plosser proposes the creation of a regular monetary policy report to help improve communication while enhancing the transparency and accountability of the Fed.

Introduction

Thank you, Richard (Green, CEO and vice chairman of Firstrust). I am delighted to speak with so many of Philadelphia's business leaders this morning. A couple of years ago, Richard served on the Philadelphia Fed's advisory council of community bankers and as our District's representative to a similar council at the national level. So, he knows firsthand about the intricacies of the Fed's structure as America's decentralized, central bank, with 12 independently chartered Federal Reserve Banks, overseen by the Board of Governors in Washington, D.C.

It is a model that has worked for a century, bringing together a rich mosaic of perspectives as we discuss policy. Yet, it requires that I remind the audience 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).

I will begin with a brief overview of the economy. Yet, because you have already heard several views of the year ahead – including the report of your membership survey – I plan to spend most of my time giving you a longer-term perspective on what I think is a sound approach to monetary policy.

Economic overview

We began 2014 with a severe winter, which led to a first-quarter decline in GDP of 2.1 percent. After that bleak start, though, we saw robust GDP growth in the second and third quarters of 4.6 percent and 5.0 percent, respectively. The third-quarter estimate was the strongest quarterly growth in more than a decade. More important, four of the past five quarters have seen growth rates of 3.5 percent or more, with only the wintry first quarter as the exception. The Philadelphia Fed's Survey of Professional Forecasters estimated that fourth-quarter growth would moderate to 2.7 percent. Some recent tracking estimates are now placing it over 3 percent. We won't know what the official first estimate will be until the end of this month, but even that slight slowdown would lead to full-year growth in 2014 that is a bit higher than many had expected.

Looking forward, I believe we will see growth averaging about 3 percent in 2015 before edging down to a long-term trend growth rate of about 2.4 percent.

Recent data also show a stronger contribution from consumer spending, which accounts for more than two-thirds of the GDP. Significant improvement in household balance sheets and a stronger employment picture have helped support a more confident consumer. Real personal consumption expenditures (PCE) have grown at a 4.5 percent annual pace over the past three months.

Manufacturing also continues to show strength. Recent figures from the Philadelphia Fed's *Manufacturing Business Outlook Survey*, the national ISM manufacturing index, and industrial production all indicate that the manufacturing sector is expanding at a healthy pace.

Strong consumer and business spending has supported consistent gains in the labor market. Nonfarm employment expanded by 252,000 jobs in December, giving us 11 consecutive months of 200,000-plus job growth. For the full year, we had average monthly gains of 246,000 in 2014, compared with 194,000 in 2013. In fact, we added nearly 3 million jobs in 2014, the most in a calendar year since 1999. Those job gains have led to a steady decline in the unemployment rate, which is now 5.6 percent, down more than a point from a year ago. Even the broader measure of unemployment, referred to as U-6, which includes marginally attached workers and those working part time for economic reasons, has fallen to 11.2 percent.

Inflation is running at about 1.5 percent, which is below the Fed's long-term target of 2 percent, as measured by the year-over-year change in the price index for PCE. Yet, I and many other economists anticipate that inflation will gradually move toward the target as the transitory effects of lower oil prices fade.

In summary, I believe the economy has returned to a more normal footing, and as such, I believe that monetary policy should follow suit. In doing so, I believe we should strengthen our commitment to four fundamental principles of sound central banking. During the past eight years, I have spoken and written frequently about ways to improve the framework we use for making monetary policy decisions. In my view, the monetary policy framework is most effective when the central bank:

- commits to a set of clearly articulated objectives that can be feasibly achieved by monetary policy;
- conducts monetary policy in a systematic, rule-like manner;
- communicates its policies and actions to the public in a clear and transparent way; and
- protects its independence by being transparent and credible in pursuit of its goals.

Clearly articulating objectives

Let's consider these four principles, beginning with clearly articulating the objectives of monetary policy. Congress set our monetary policy goals in the Federal Reserve Act, which specifies that the Fed "shall maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates." Since moderate long-term interest rates generally result when prices are stable, many have interpreted these goals as a dual mandate to manage fluctuations in employment in the short run while preserving price stability in the long run.

In my view, this dual mandate has contributed to a view that monetary policy can accomplish far more than perhaps it is capable of achieving. I believe that assigning multiple objectives for the central bank has opened the door to highly discretionary policies, which can be justified by shifting the focus or rationale for action from goal to goal. That is why I have argued that Congress ought to redefine the Fed's monetary policy goals to focus solely, or at least primarily, on price stability. I base this on two facts: Monetary policy has a very limited ability to influence real variables, such as employment. Even the FOMC's own statement of longer-run goals adopted in 2012 notes that the maximum level of employment is largely determined by nonmonetary factors, such as changing demographics and changing tax and regulatory policies that influence the labor market. Conversely, in a regime with fiat currency, only the central bank can ensure price stability. Indeed, it is the one goal that the central bank can achieve over the longer run.

Setting clear, achievable objectives is the first part of the framework. Asking policymakers to pursue those objectives in a systematic, rule-like approach is the second key principle.

The benefits of systematic monetary policy

So, what do I mean by a systematic approach to policy? Quite simply, I mean conducting policy in a more rule-like manner. You often hear Fed officials say that policy decisions are "data dependent" and, indeed, they are. This means that future policy actions are conditional on how the economic data unfold. We may not know what the future holds or what future policy decisions will be, but we can choose to make those decisions in a systematic way based on the incoming economic data. I have long advocated this approach to "rule-like" policymaking.[1]

Of course, the alternative to rule-like policy is discretionary policy, in which policymakers are free to choose whatever action seems appropriate or convenient at the time. Rules act as restrictions on policymakers' choices – limiting the degree of discretion. But this is not a bad thing; rather, it can result in better economic outcomes in the long run. This is accomplished in part by reducing the risk of very bad discretionary decisions, such as those that occurred in the 1970s. Moreover, for more than 30 years, we have known that a credible commitment by policymakers to behave in a systematic rule-like manner leads to better outcomes than discretion by reducing policy uncertainty.[2]

More specifically, rules work better than discretion because they are transparent and therefore allow for simpler and more effective communication of policy decisions.

This allows households and businesses to more accurately form expectations and thus make better decisions. As a result, systematic policy promotes a more stable, predictable, and efficient economy.

I want to emphasize that monetary policy should be data dependent, not date dependent. In my last vote as a member of the FOMC in December, I dissented, in part because I believe the language of the statement was still trying to communicate policy in terms of time. Whether the Committee states that it will be "patient" or that it will wait a "considerable time," the language continues to stress the passage of time as a key determinant of policy, rather than making clear that policy will depend on the data. Describing policy in terms of time could also risk limiting the Committee's flexibility to respond to the data if we continue to see an improving economy.

Instead, I believe we should describe how we will respond to the data; that is, we should describe a reaction function. I frequently consider such reaction functions as I think about policy. These are typically Taylor-like rules, named for Stanford University economist John

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1 See Charles I Plosser, "The Benefits of Systematic Monetary Policy," speech given to the National Association for Business Economics, Washington Economic Policy Conference, Washington, D.C. (March 3, 2008).

2 Finn E Kydland and Edward C Prescott, "Rules Rather Than Discretion: The Inconsistency of Optimal Plans," *Journal of Political Economy*, 85 (June 1977), pp. 473–491.

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 goal 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.

Such robust rules recognize that data are measured imprecisely and are subject to revision. Moreover, they have been shown to perform well in a variety of models and conditions. I believe these robust rules can be useful guideposts for policymakers and the public in assessing the stance of monetary policy and its expected path. Communicating about such guideposts would enhance transparency and help make policy more systematic.

However, I don't believe that we need to follow rules mechanically. Judgment will always be required. Yet, policymakers and the public should be very cautious when they call for policy rates to deviate in significant ways from these guideposts. Making such judgments should require careful analysis, and the justification for deviating from the guidelines should be clearly communicated to the markets and to the public. Thus, policymakers will still be able to exercise discretion, but using rules as guideposts will enhance transparency and effective communication.

Improving transparency

This leads me to my third important principle for monetary policy – communicating in a clear and transparent way. In recent speeches, I have proposed that the FOMC could improve communication and transparency by publishing a more comprehensive monetary policy report on a regular basis, perhaps quarterly.[3]

This report could incorporate a discussion of such robust systematic rules I referred to a moment ago in its description of the underlying policy framework. The rules could serve as a benchmark for the current stance of policy and the expected path of policy, based on economic data.

At the end of December, the Philadelphia Fed issued an example of what such a discussion might look like in a monetary policy report. We used a set of policy rules to benchmark the current stance and path of policy and discussed the implications.[4]

The report showed that the federal funds rate is no longer constrained by the zero lower bound under a number of these rules. In fact, the rules indicate that maintaining the federal funds rate at the zero lower bound is unusually accommodative by historical standards. The benchmarks suggest that as the economy transitions to full employment and moves closer to its long-run inflation target, we should begin to gradually reduce accommodation by raising the funds rate target. Delaying liftoff runs the risk of requiring more aggressive future monetary policy than would otherwise be needed.

However, if the Committee felt it was desirable to further delay the initiation of interest rate increases, such a report would provide the opportunity, indeed the obligation, for a thorough and thoughtful discussion about why discretionary deviations from the guideposts were appropriate.

Thus, publishing a monetary policy report with an assessment of the likely near-term path of policy rates, in conjunction with its economic forecast, would be a useful exercise and

[3] See Charles I Plosser, "Systematic Monetary Policy and Communication," remarks to the Economic Club of New York, New York, NY, June 24, 2014; and Charles I Plosser, "Monetary Rules: Theory and Practice," remarks to the Hoover Institution, Stanford, CA, May 30, 2014.

[4] See http://www.philadelphiafed.org/research-and-data/publications/special-reports/2014/1231-using-rules-for-benchmarking.pdf.

enhance communications. It would also provide added discipline for policymakers to stick to a systematic, rule-like approach. And it would force policymakers to think more deeply and systematically about policy and the justification for significant deviations from the guideposts.

Preserving independence

I believe such communication would ultimately strengthen the independence of the central bank, which is the fourth and final principle of sound central banking. Central bank independence leads to better economic outcomes. But in a democratic society, independence must be accompanied by accountability.

Transparent and clear communication of monetary policy goals and a decision-making framework help ensure accountability and preserve central bank independence. Transparency can also enhance a central bank's credibility. A central bank that is transparent will be less willing to make promises it cannot keep. And accountability is more easily achieved when there is transparency. The public can best hold a central bank accountable when its goals are clearly stated and achievable. Broad, ill-defined goals, on the other hand, reduce accountability and invite discretionary policies that can undermine the public trust and thus jeopardize independence. This is one reason why I have been concerned about credit allocation initiatives by the Fed that treated some creditors more favorably than others in bailouts and that sought to provide special support to the housing sector through its purchases of mortgage-backed securities. Such credit allocation decisions more appropriately rest with the fiscal authorities, not the central bank. By pushing these boundaries, the Fed puts its independence at risk.

Conclusion

In conclusion, the U.S. economy continues to improve. Although we have not witnessed the strong bounce back from the depths of the recession that some anticipated, the recovery has been remarkably steady.

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 households have regained much of the wealth they lost during the crisis. That gives me additional confidence that the economy is now operating normally and so should monetary policy.

As we normalize policy, I believe we should follow four principles. The Fed should ensure that it has clearly articulated objectives that can be achieved by monetary policy, with price stability as the primary objective. It should pursue its objectives in a systematic, rule-like manner and help the public understand how policy will react systematically to changes in economic conditions.

I believe a detailed monetary policy report could be a useful vehicle for such enhanced communication of policy, which will improve the transparency and predictability of monetary policy, which ultimately reduces policy surprises. Businesses and consumers are more informed about the course of monetary policy because they understand how policymakers are likely to react to changing economic circumstances, even if they are not certain what those economic conditions might be.

Equally important in my view is that greater clarity about policymakers' reaction function strengthens accountability. So, systematic policy, communicated transparently, strengthens accountability and credibility and, thus, serves to preserve the central bank's independence.