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U.S. Monetary Policy

Good morning. I am glad to be here to share my thoughts on monetary policy. Today, I'd like to discuss how monetary policy is conducted in the United States and the critical role that communication plays in monetary policy.

But, first, I'd like to give you a little background on the Federal Reserve. Our goal is to foster monetary conditions that promote both price stability and maximum sustainable economic growth, as well as contain any systemic financial risks. We think of these goals as complementary — it is difficult to have maximum sustainable growth without price stability; similarly, uncontained systemic financial risk could threaten sustainable economic activity.

Like all central banks, we carry out this mission by conducting monetary policy. Unlike many others, we also support these goals by ensuring that the financial payments system works smoothly and efficiently and by supervising and regulating financial institutions. Our role in the payments system has helped us meet financial challenges, such as providing liquidity following the tragic terrorist attacks in New York City and Washington D.C. on September 11. Our supervision and regulation function gives us important insights into the developments in the banking system and the borrowers and lenders that it serves.

One of the Fed's distinctive attributes is its regional structure. The Federal Reserve System comprises twelve District reserve banks across the U.S and the Board of Governors in Washington D.C. This structure has two benefits for monetary policymaking purposes. First, the twelve regional banks give the Fed ready access to information from all parts of the country and all segments of business. And second, all twelve District Bank presidents serve on the Fed's key policymaking group, the Federal Open Market Committee, or FOMC, which assures that a variety of voices are heard.

I serve as president of one of these District banks, the Federal Reserve Bank of Chicago. The Chicago Fed oversees an area that contains most of five states — Illinois, Indiana, Iowa, Michigan, and Wisconsin — in the

Midwest. This area is heavily involved in manufacturing: with only 13 percent of the country's population, the District is responsible for 18 percent of the U.S.'s manufacturing output. The region produces an even larger proportion of durable goods output, which tends to make our economy more cyclical than other regions in the U.S.

Perhaps the best way for me to show the value of the Fed's regional structure is to walk you through how we prepare for each of the eight FOMC meetings we have each year and describe what happens at these meetings.

The first step in preparation is gathering non-quantitative and anecdotal information about the economy. Each District maintains a wide network of business and other contacts in their region. Through direct conversations and informal surveys, these contacts provide real-time, anecdotal insights on current and future trends in a wide range of economic indicators. These anecdotes are summarized in a document known as the Beige Book, which is then distributed to all of the FOMC members and released to the public two weeks before the meeting.

After the Beige Book is released, economists at most District banks produce national economic forecasts for their bank presidents. The staff at the Board of Governors also produces a forecast, which is distributed to FOMC members in a document known as the Greenbook. In making these forecasts, we use most of the same quantitative data that is used by private sector forecasters, and econometric models that utilize similar concepts. One thing that distinguishes Fed forecasts is that they also account for the additional, contemporaneous information that we gather through our wide network of business contacts.

Before each FOMC meeting, each bank president and the governors in Washington are extensively briefed by their staffs on the forecasts as well as a variety of other issues regarding the policy decision. Once we have gone through this process, it is time for the meeting in Washington.

Typically, FOMC meetings open with an update on financial market conditions and a presentation of the Greenbook by the Board staff. After some discussion of the forecast, each of the bank presidents gives a statement on economic conditions in their region and in the nation as a whole. Then the members of the Board of Governors offer their outlook for the national economy.

And by this time we're all a little tired, so we take a break for coffee.

After the coffee break, the Committee discusses two or three policy options that had been described in a document known as the Bluebook. Bluebook, Greenbook, Beige Book…who would have thought that a central bank could be so colorful? These policy options center on two things. One is what we do with our target for the federal funds rate, which is the interest rate that U.S. banks charge each other for overnight lending. The other is our statement on the balance of risks in the economy.

After some more questions and discussion, the FOMC chairman, Alan Greenspan, has developed a good sense of where the committee stands. He usually then offers his views on the economy and policy options, and lays out his sense of the consensus regarding the federal funds target and the balance of risk statement. There is more discussion among FOMC members, and after that, we are ready to vote.

When it comes to policymaking votes, the Federal Reserve is somewhat different from other central banks. Not through any specific policy or initiative, but perhaps just by its culture, the Fed has always placed a premium on uniting around the consensus policy action. While some in the FOMC might have expressed a different opinion from the consensus during the policy discussion, most of our votes are unanimous. In fact, in my nine years on the FOMC, the most votes in dissent for any given monetary policy decision has been two out of twelve voting

members. At other central banks, however, dissent is much more common. For example, in the Bank of England's policy decisions this year, dissents by at least three out of the nine policymakers has been more common than unanimous votes.

It is also worth noting, that, when we vote, District bank presidents vote on the policy that is best for the country as a whole. The United States shares a single currency and our financial markets are fluid and highly integrated. So, we have one monetary policy for the nation and it cannot be used to benefit one region over another. Still, the Fed was designed to allow regional voices to be heard. This is readily apparent by the design of the FOMC's voting structure: five district bank presidents vote on a rotating basis along with the 7 members of the Board of Governors.

When it is my turn to vote at the FOMC, a few economic principles shape my policy stance. Along with most economists, I think that monetary policy influences real economic activity in the short run. But long-run, or potential, economic output is determined by an economy's available labor and capital resources and their productivity. Central banks have little or no power to influence these variables in the long run. If a central bank consistently tried to push the economy above its potential for an extended period of time, it would generate increasing inflationary pressures and eventually fail to maintain the strong pace of growth. Conversely, if actual economic output persistently lingered below its potential, which economists refer to as an output gap, inflation would decline.

This second scenario currently applies for the U.S. economy, given its recession in 2001 and the moderate nature of its initial recovery. In the past two years, the unemployment rate has increased and capacity utilization rates in the U.S. have declined. Both movements suggest that the level of actual output has been falling short of potential, so there is an output gap like I described a moment ago.

The most recent data indicate that growth is picking up and the economy is beginning to close this gap. Real GDP increased 7.2 percent in the third quarter, the strongest growth rate in nearly 20 years and well above the 3 to 3½ percent range that most analysts perceive as the potential output growth rate.

While we probably will not see many, if any, more quarters with 7.2 percent growth, there are three reasons why real GDP should expand above its potential growth rate for some time. Solid trends in productivity growth, accommodative monetary policy, and fiscal stimulus are all providing important support for economic activity. So long as economic growth averages above potential growth rates for some time, the remaining output gap will close.

On the prices front, the existing output gap has contributed to falling inflation. In turn, the U.S. currently seems to be in the neighborhood of price stability — which is to say we appear to be at a point where inflation is not an important factor influencing business and household spending decisions. Considering both this apparent price stability and the existing resource gaps, the Fed is actually now slightly more concerned about inflation falling further and perhaps becoming undesirably low than we are about it becoming too high. Accordingly, it is appropriate to maintain an accommodative monetary policy stance, in order to provide some insurance against unwelcome disinflation.

To be sure, weighing these new disinflationary risks against inflationary risks has put the term "price stability" in a new light. The Fed and other central bankers used to only be concerned about inflation being too high, but, in recent years, economic conditions and the policy environment have changed so that the Fed also has some concern about inflation rates that are too low.

Effectively communicating this change to businesses and consumers has been a challenge for the Fed. But, since central banks need to clearly communicate policy, in order to help businesses and households make forward—looking decisions, it is critical that the Fed meet this challenge.

Interestingly, there is no consensus among central banks about the best way to communicate policy. Consider the different ways in which central banks reveal the proceedings of their policymaking meetings. The Federal Reserve issues a press release that contains its interest rate decision, the vote count, a brief description of economic conditions, and a balance of risks assessment; and FOMC meeting minutes are released after they are approved by the members at the following meeting. By contrast, the Bank of England issues a statement on only the interest rate movement and then releases their meeting minutes a few weeks later. The European Central Bank issues a brief statement and holds a press conference after the meeting, but does not release the minutes of their meetings.

Communication policy differences go beyond simply deciding whether or when to issue information after policymaking meetings. Some central banks adopt inflation targets or target ranges in order to clearly communicate their inflation policy goal. Some of these banks have found inflation targets useful for asserting their independence. And some have claimed targets useful in building credibility for their monetary policy, thus making it easier to reduce inflation.

Some economic research raises questions about that conclusion. In the late 1990s, according to such research, there are little difference in the level and stability of price inflation between inflation-targeters and non-targeters.

Those of us in central banking recognize that each central bank must decide for itself the best way to conduct monetary policy for the particular environment it faces. The Federal Reserve does not have an explicit numerical inflation target. We have a working definition of price stability — when inflation no longer is an important factor influencing the economic decisions of businesses and households — that serves as an implicit target. This gives us some flexibility. Not flexibility in the sense of allowing inflation or deflation to get out of hand, but flexibility in the sense of giving us room to accommodate changes in price measurement biases and transitory shocks to economic activity, like the terrorist attacks in New York and Washington on September 11. Since we have established our independence and credibility as inflation fighters, we can enjoy this flexibility.

The desirability of a specific inflation target or range has been the subject of public debate among FOMC members. Only time will tell whether this debate will influence Fed policy. But I think the fact that we are debating the issue shows our commitment to effectively communicating policy.

In closing, I'd like to say that despite all of our econometric models and equations, monetary policy is still more of an art than a science. We have to make substantial judgements when setting policy. Today, the Fed faces some distinct policy challenges. Responding to these challenges does not just entail setting the federal funds target rate at the right level, but also includes the critical element of clear communications, so that businesses and consumers can make informed forward-looking decisions. The Fed's policies will evolve as times change and new challenges arise. But our policies will always be anchored by our mandate of maximum sustainable growth and price stability.