A perspective on Monetary Policy II

Introduction

I could not begin my remarks this afternoon without offering a few words about the legacy of President Ronald Reagan, who is being honored and mourned across our nation today.

My tenure with the Federal Reserve System spans the entire two terms of Mr. Reagan's presidency, and I can tell you that I think one of his biggest successes was appointing Alan Greenspan as Chairman of the Federal Reserve Board in 1987.

As with so many of President Reagan's actions, this one had far-reaching positive effects not just for America, but for the world.

I am sure we all remember and thank President Reagan for the gifts of strength and optimism he brought to our nation.

This afternoon I will focus my remarks on the monetary policy process. Specifically, I will focus on the two principles that I believe should guide the monetary policy process, and I will conclude with a few remarks about the current state of the economy and monetary policy.

Price Stability Enhances Economic Welfare

Let me start with the two principles that I believe should guide monetary policy. First, price stability enhances economic welfare by creating an environment in which people can make better decisions. Indeed, I regard maintaining price stability as essential for optimum economic performance. That is why price stability is a primary objective of monetary policy.

Under the leadership of my predecessors, the Federal Reserve Bank of Cleveland established a strong commitment to the primacy of price stability. These leaders saw the pursuit of price stability as the key to achieving sustainable economic growth.

Their position, that the FOMC should establish a policy of "zero inflation," or price stability as it became known, seems much more reasonable today. Back then, though, their perspective was viewed as radical.

The conflict arose because some people thought that price stability and economic stabilization were not compatible goals.

Although price stability has been an explicit objective of monetary policy since the earliest Congressional mandate in 1946, the benefits of price stability were not widely appreciated until more recently.

Additional Information

Sandra Pianalto

President and CEO,
Federal Reserve Bank of Cleveland

Remarks to the Pennsylvania Economic Association

Robert Morris University, Moon Township, PA

June 11, 2004

Today, monetary policymakers routinely talk about the positive benefits gained from achieving price stability.

Moreover, I think most people now recognize that sustained inflation -- or deflation for that matter -- is a monetary policy phenomenon. In other words, I think the Federal Reserve owns the sole responsibility for achieving and maintaining price stability in the United States.

Acting Systematically and Transparently

Let me turn to my second principle: Central banks can be more effective when they act systematically and transparently. Only then will the public understand how to interpret individual policy actions.

I will elaborate on three behaviors that have made the Federal Open Market Committee (or FOMC) more systematic and transparent:

Anchoring inflation expectations
Acting predictably
Drawing on credibility to deal with unusual circumstances.
Anchoring Inflation Expectations
First, let me address the idea of anchoring inflation expectations. Economists and policymakers today agree that expectations play a key role in inflation dynamics. People who act on mistaken beliefs about future inflation make decisions that they may later come to regret.

Because central banks control the trend rate of inflation over time, it seems natural for central banks to do everything they can to inform the public about the trend rate of inflation and to convince the public to regard the information as credible.

During the 1990s, the FOMC paid close attention to managing inflation expectations. Chairman Greenspan and other Committee members talked regularly about their commitment to achieving price stability.

If you recall, some members spoke about "opportunistic disinflation," which was their way of saying that in the process of leaning against inflation, they were willing to take advantage of opportunities to lock in even lower rates of inflation when those situations presented themselves.

To me, this is simply evidence that the FOMC remained sensitive to the need to minimize undesirable fluctuations in the economy as it pursued the goal of price stability.

But the FOMC's intention regarding the direction of inflation was clear.

As a result of this strategy, inflation gradually drifted down during the 1990s, and core CPI inflation fell to 1 percent last year. Inflation that low, plus sub-par economic performance, prompted the FOMC to express concern about the remote possibility of a disruptive deflation.

As you are well aware, this time the FOMC worked hard to condition inflation expectations in a different direction, specifically to convince the public that further disinflation was unwelcome.

So has the FOMC really anchored inflation expectations? According to some financial market indicators and inflation surveys, the public's long-term inflation expectations have consistently drifted downward during the past decade. What's more, such assessments of inflation expectations appear to have become less variable.

My conclusion is that the public expects the trend rate of inflation to move within a fairly narrow and low range over the next decade. This expectation is largely attributable to the credibility the Federal Reserve has established.

Acting Predictably

This leads me to the second behavior: acting predictably. It is a good practice for central banks to act predictably in response to information about the state of the economy. Markets are surprised enough by non-policy events without central bankers adding more noise.

In the world of economic theory, this predictable behavior can result from following a policy rule. Consider the familiar Taylor rule. When John Taylor proposed his rule more than a decade ago, he did not intend for policymakers to adhere to it rigidly or slavishly.

On the contrary, he formulated it to capture a general set of principles which he found robust for stabilizing inflation and output in the course of building macro models. It was only later that he and others discovered that these principles seemed to roughly characterize FOMC behavior after the mid-1980s, a period of quite successful monetary policy.

You might ask why central banks are not more explicit about their policy rules. There could be benefits, of course. If a central bank could be more precise about what aspects of the environment it plans to respond to in every situation, and how it plans to respond, then the public might better anticipate and understand policy actions. In turn, the policies themselves might be more effective.

I am not ready to embrace a particular rule as part of a real-life monetary policy strategy, but I am encouraged that the design of policy rules is an enormously active research area right now. Economists are studying rules that respond to different kinds of circumstances, such as financial market developments. They are also studying different ways to respond to incoming information.

I think it's fair to say that the research community is far from reaching a consensus about how central banks should employ explicit rules in real-time policymaking. But if the past is a reliable guide, policymakers will benefit considerably from the insights that emerge from this research.

However, we don't have to wait for conclusive results to know that even without an explicit policy rule, central bankers are learning how to gain similar benefits through greater transparency and more effective public communication.

Over the past decade, the FOMC has provided more detailed and frequent information about its goals and the various impediments that may arise in achieving these goals. In just the past several years, the Committee has been paying particular attention to the wording of our press statements in an effort to be as transparent and predictable as possible.

Drawing on Credibility

The third behavior that has made the FOMC more systematic and transparent is the judicious use of credibility to deal with unusual circumstances. Some policymakers are skeptical about using a policy rule in part because the practice may hamper them from responding to unusual situations in which experience tells them to override the rule.

But I believe that the Committee's responses to such situations can be consistent with rule-like behavior.

The Taylor rule may be a reasonably good description of how monetary policy unfolds in normal times. But abnormal times, such as the 1987 stock market crash, the 1997-98 currency crises, and September 11, require policies that do not fit so neatly into the Taylor-rule box.

And these policies -- the normal policies in abnormal times, if you will – do not have to be viewed as a failure to deliver systematic policy as long as we are clear about the rationale for our actions.

We know that policymakers must operate with incomplete and imperfect information, so it is easy to see how tensions between predictable and uncommon policy actions could emerge.

Just how have such tensions been resolved in practice?

My evaluation of the past 20 years leads me to conclude that the behavior of the FOMC has deviated from the prescriptions of Taylor-type rules on several occasions, but that these excursions have not impaired the FOMC's credibility.

Indeed these deviations have served to build the FOMC's credibility. In fact, with experience, the FOMC has become more predictable in its response to financial market disruptions and in its communication about policy actions.

To develop these ideas more concretely, it is useful to review a series of policy episodes that added to the stock of the FOMC's credibility. The October 1987 stock-market crash, for example, forced the FOMC to temporarily relax its longer-term course of policy restraint -- a policy dictated by increasing inflationary pressures.

With only partial credibility, the Committee had to aggressively boost the funds rate after it had become clear that the market stabilized.

Ultimately, however, the FOMC gained additional credibility as inflation began to decline to a lower trend rate.

A second instructive episode is known as the "headwinds" period. During the early 1990s, it was well understood that financial intermediaries were finding it difficult to lend because their capital had been depleted from loan losses in commercial real estate.

The restricted credit supply persisted much longer than it would have in a normal recovery. Given the increased credibility of the FOMC, it turned out that the real fed funds rate that was effectively zero could be maintained at that low level for about 15 months.

This policy was somewhat more accommodative than a Taylor-type rule would have called for. Later, the FOMC quickly returned the federal funds rate to a more neutral stance and resumed its pursuit of price stability. This overall approach extended the credibility on which the Committee has been drawing recently.

The FOMC enjoyed the benefits of such credibility when international financial markets were hit with a trio of problems in the late 1990s: the Asian currency crisis, the Russian debt default, and the collapse of Long Term Capital Management.

Greater credibility at that time gave the FOMC the flexibility to implement a somewhat lower funds rate for a longer period than it otherwise might have. A similar deviation occurred during the period surrounding the terrorist attacks on September 11, 2001. In each of these cases, knowing when the shocks have passed obviously requires sound judgment.

These episodes convince me that the FOMC can draw on its credibility as a successful steward of price stability in order to deal with unusual circumstances. If the Federal Reserve has developed sufficient credibility, and if we explain ourselves clearly, then the public — like those of you in this room — will understand our intentions.

Before I turn to the current policy environment, let me summarize my thoughts. I am optimistic that the policy process will continue to evolve in the favorable way it has done over the past 20 years.

The basis for my optimism is straightforward. I believe that the three behaviors I described above -- anchoring inflation expectations, demonstrating consistent behavior, and judiciously drawing on our credibility to deal with unusual circumstances -- will be maintained as a permanent part of the policymaking process.

Current Policy Situation

Now let me shift my focus to the current policy environment. There's an adage among business cycle analysts: Steep recessions are usually followed by sharp rebounds and mild recessions are followed by less robust recoveries. This shoe seems to fit our nation's most recent recession and recovery period.

As you know, the recession that ran from March 2001 through November 2001 was fairly mild. The expansion is now 2½ years old, and the pace of this expansion has also been fairly moderate.

Personal consumption, residential investment, and government purchases supported the expansion in its early stages. More recently, business fixed investment has been steaming ahead, and the past few employment reports have been welcome news. The economy now appears to have its feet firmly planted.

Having said that, we also know that there are always unknowns in the outlook. Until recently, net job creation has been on a much slower track than virtually anyone would have imagined, given the actual strength in spending.

I am very encouraged by the strong labor reports for March, April, and May—together with other evidence like declining unemployment insurance claims and rising overtime hours in manufacturing, they indicate to me that employment opportunities will expand along with the economy.

We still do not know how quickly employment will grow because we don't know how productivity, which has been the hallmark of this expansion, will behave. We also don't know how much of the extraordinary productivity performance we have experienced is cyclical and how much is structural.

To the extent that this strong productivity growth is cyclical, we should expect productivity growth rates to move down toward a more normal rate, closer to 2 to 2½ percent, and for employment growth to remain vigorous. To the extent that it is structural, we should expect to see a smaller deceleration in productivity growth and a lower rate of hiring for the same level of output growth.

Unfortunately, it is difficult to know how much of each factor is involved. On the cyclical side of the debate, I hear that firms are still hesitant to add to their payrolls.

Lingering concerns about the economy's underlying strength may dissipate as the expansion continues, and the pace of hiring may intensify.

On the structural side of the debate, I hear from many of my district contacts that they are designing their business processes to take advantage of new technologies. They believe that they can continue to achieve robust productivity growth for quite some time.

We also see that one of the strongest components of capital spending is in the information technology sector. This is a sector whose products are used in business process re-engineering. Economists are still debating the relative strengths of these forces, and I'm afraid that we will simply have to wait somewhat longer before we know how the labor market situation will unfold.

A second unknown in the outlook is the evolution of the price level. The decade-long period of gradual disinflation in the 1990s culminated in the attainment of price stability. At the moment, although firm evidence of persistent inflationary pressures may be limited, recent price statistics give me reason for pause.

Prices of a wide range of commodities, such as steel, lumber, copper and energy supplies, have been rising steeply during the past year. These commodities remain important inputs for a variety of the businesses I follow. The CEOs of these companies indicate that for the first time in a long while, they are able to pass along some of these cost increases to their customers.

Prices of imported consumer goods have stopped falling and are now increasing. Against the backdrop of a depreciated dollar, it would not be surprising to see some further increases in imported goods prices.

It is easy to downplay the likelihood that these factors will lead to a sustained rise in inflation. Some of the increase in demand for commodities can be traced to strength in the Chinese economy in recent years, but the Chinese government has indicated its desire to moderate the pace of expansion there, suggesting that price pressures from that source might not continue to intensify.

Energy price hikes have also prompted concerns, but foreign producers appear to be taking steps to head off any further escalation of oil prices. Nevertheless, if you believe that the economy's momentum has turned and strengthened appreciably, then you might logically conclude that inflationary pressures are more likely than not to emerge as the expansion progresses, unless monetary policy adjusts.

I do know this -- the current federal funds rate, at 1 percent, is too low to be sustainable. Inflation expectations appear reasonably stable right now, but I am concerned about the potential for them to drift up in this environment. Preserving price stability will require the FOMC to increase the federal funds rate. Failure to respond in a timely fashion puts our hard-won credibility at risk.

This credibility has proved to be a valuable asset in dealing with the very unusual recovery we are experiencing. It has provided us with a somewhat lengthy chunk of time to analyze our situation and respond to it. Broad-based inflation pressures have yet to emerge, and I am confident that the FOMC will act, as necessary, to preserve the hard-won gains it has already achieved.

The FOMC has already responded to the improvement in economic conditions by flexibly signaling its readiness to take policy actions. Last August the FOMC said that due to the risk of inflation becoming undesirably low, the funds rate could stay low for a considerable period of time.

In January, the FOMC shifted its language, saying that since the risks of inflation and disinflation were now nearly balanced, it could be patient in removing its policy accommodation.

At our meeting last month, the FOMC indicated that with the risks of inflation and disinflation now balanced, policy accommodation can be removed at a pace that is likely to be measured. And earlier this week, Chairman Greenspan said that "should that judgment prove misplaced, however, the FOMC is prepared to do what is required to fulfill our obligation to achieve the maintenance of price stability...."

Financial markets now expect a federal funds rate increase at the June 30 FOMC meeting with a 95 percent probability (80 percent of that is for a 25-basis-point increase, and 15 percent is for 50 basis points).

At the moment, market participants, based on estimates from federal funds and Eurodollar futures, expect the federal funds rate to steadily move towards 4 percent over the next two years. Of course, the FOMC will determine the actual path for the federal funds rate on the basis of prevailing circumstances.

Conclusion

My goal today has been to convey to you some of my ideas about monetary policy. I am convinced that price stability enhances economic welfare by creating an environment in which people make better decisions -- decisions that are conducive to long-term economic growth and stability.

As I said earlier, I regard maintaining price stability as essential for achieving optimum performance of the economy.

I think that central banks can be more effective when they act as systematically and transparently as they can. Systematic and transparent behavior can easily accommodate extraordinary actions in extraordinary times.

But at all times, the Fed has the responsibility to explain what it is doing, why, and how its actions are consistent with its long-term objectives.

I hope I have convinced you that the credibility gained from successful monetary policy is a precious asset. In my role as a monetary policymaker, I plan to behave like a steward, maintaining and, where possible, building on this credibility.

1As always, the views expressed in this speech are those of the speaker and do not reflect official positions of the Federal Reserve System.