Economic Conditions and Monetary Policy

Additional Information

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Columbus, OH

October 19, 2005

Introduction

In times like these, when consumers and businesses are focusing a lot of their attention on higher energy prices and reports of higher inflation, it is understandable that the Federal Reserve's monetary policy moves are being examined more closely than usual.

Today I would like to discuss some of the issues that have been informing our recent policymaking process. I will begin with a brief explanation of the Federal Reserve and how monetary policy works. Then I will describe my views of the national economic landscape. Finally, I will take a look at how I view the monetary policy horizon and describe some possibilities that could come into play over the next few months.

Please note that the views I express today are mine alone. I do not presume to speak for any of my colleagues in the Federal Reserve System.

The Federal Reserve System and Monetary Policy

Let me begin, then, by offering some background on the Federal Reserve and monetary policy. The Federal Reserve has a unique role in our economy, and it has a unique structure that draws from both the public and private sectors. The Board of Governors in Washington is the public aspect of the system, while the 12 Reserve Banks across the country are its private aspect.

This decentralized, public-and-private structure is one of the Federal Reserve's greatest strengths. When Congress created the Federal Reserve System in 1913, one of its fundamental goals was to establish a central bank that was independent within government. The Federal Reserve is accountable to Congress, yet it is deliberately insulated from political pressures. The seven members of the Board of Governors are appointed by the President of the United States to 14-year terms. In addition to its monetary policy function, the Board of Governors regulates banks and helps to shape the policies that ensure the safety and soundness of our nation's banking system. The Board also oversees the activities of the 12 Reserve Banks to ensure they operate in the public interest.

The 12 Reserve Banks are more like private institutions, each with its own charter and board of directors. The Federal Reserve Bank of Cleveland comprises the Fourth Federal Reserve District, which includes all of Ohio, western Pennsylvania, eastern Kentucky, and the panhandle of West Virginia. Our headquarters is in Cleveland, and we have branch offices in Pittsburgh and Cincinnati.

The Reserve Banks conduct economic research, provide financial services to commercial banks and the U.S. Treasury, and supervise and regulate banks under delegated authority from the Board. Maintaining close links with the business community, we also gather information about national and regional business conditions, information that is used in the monetary policy process. We also receive a lot of input from our directors, who provide a recommendation every two weeks for the direction of monetary policy.

The twelve Reserve Bank presidents and the seven governors come together to form the Federal Open Market Committee, also known as the FOMC, which meets in Washington eight times a year. When the news media speak of interest rate decisions by "the Fed," they are really referring to decisions made by the FOMC.

My colleagues and I on the FOMC constantly review the latest national and international economic statistics. Our economists pore over the data, conduct research, and create models to project economic activity. Yet monetary policymaking is as much art as it is science. It always involves making judgment calls - finding the appropriate response to the economic trends that we are able to identify and explain. A significant part of my preparation for the FOMC meetings involves sifting through the different possible explanations about what might lie behind the national statistics.

The official data are often simply not up-to-date enough to guide monetary policy, which is a forward-looking enterprise. So I must rely not only on my team of economists - as talented as they are - but also on people who are closely in tune with the day-to-day pace of business on Main Street: our Bank's directors, members of our business advisory councils, and people in the community. Their input provides me with reliable information "in real time" about how the economy is performing and offers me a glimpse into economic trends long before the national statistics are announced.

During every FOMC meeting, we have what is known as a "go-round," where each Reserve Bank president reviews business developments in his or her region. These insights are a critical part of the policy- and decision-making processes.

At the end of each meeting, the FOMC arrives at a policy decision and provides a statement explaining it. The main policy tool we use is targeting the federal funds rate - the interest rate that banks charge each other for overnight loans. We do this through open market operations, in which the Federal Reserve buys or sells government securities from private security dealers in the secondary market. By doing so, we affect the liquidity of the banking system - effectively moving short-term interest rates either up or down, as needed - thus enabling us to hit our target for the federal funds rate.

The FOMC's mission is straightforward. We seek monetary and financial conditions that will foster price stability and promote sustainable growth in output. Amid all the fluctuations of the economy, these two goals always remain our policy objective. These goals go hand in hand: I am convinced that the only way that the Federal Reserve can contribute to our nation's maximum sustainable economic growth is by maintaining price stability.

Views of the Current Economic Landscape

So how are we doing in meeting these goals? One thing I have learned as an FOMC member is that things can change very quickly, and in ways that you may not expect. At the beginning of my tenure on the Committee, just 2-1/2 years ago, the economy was performing below our expectations - especially in terms of how many jobs were being created. In that environment, we became concerned about the rapid decline in inflation. If the economy remained sluggish and inflation fell further, then the country might risk falling into the sort of low-growth pattern that Japan had suffered through for years.

Fast-forward from those days to the situation we confront today. Now, my colleagues and I are focused on the emergence of rising inflation. What caused the inflation dynamics to change?

This past summer, the U.S. economy finally appeared to have gained a solid footing. Economic activity, including job creation, was expanding at a moderate pace, and growth was expected to remain steady for awhile.

Of course, there were concerns: There always are. For example, strong global demand had been pushing up energy prices for some time. But, all in all - at that time, in midsummer - I was generally encouraged about the economic outlook. With the economy moving steadily forward, my main concern when the FOMC met in early August was that even though core inflation was well-behaved, pressures on inflation had stayed elevated.

Let me spend just a moment explaining how I look at inflation. As a policymaker, I pay attention to the "core" measures of consumer price inflation as well as the overall "headline" measure of consumer price inflation, because the headline number can be somewhat misleading.

In the simplest measure of core inflation, changes in food and energy prices are eliminated from the calculation. More complicated core inflation measures eliminate prices that are growing both very quickly and very slowly. In any case, the idea is to strip away the "noise" of volatile price changes, so that we can see the underlying inflation trend more clearly.

Of course, the FOMC's mandate is to control overall inflation: the average of all prices, including food and energy, as well as all the other things you buy. But we have found that measures of core inflation tend to be better predictors of future inflation than the headline rate, giving us a better picture of the true inflation trend.

So, in early August of this year, although pressures on inflation had remained elevated, the core inflation numbers were more encouraging than the headline rate. At that time, headline inflation registered slightly above 3 percent, but most of the core measures had stabilized at around 2-1/4 percent.

Then came Hurricanes Katrina and Rita. The human toll of these events has been enormous. From a personal perspective, it has been heartbreaking to see the loss of life, property, careers, and communities all along the Gulf Coast states. From a policymaker's perspective, those disasters immediately heightened the level of uncertainty about our forecasts. Fortunately, our worst fears about the effects of the storms on the national economy appear not to have come to pass. There will clearly be some small - not trivial, but small - toll on economic growth over the last part of this year. We have already seen this to some extent in the latest employment report, which told us that job growth was less than it might have been otherwise. Yet the shortfall was far less than we had feared.

Rising oil and natural gas prices have caused economic forecasters to mark up their projections for inflation over the balance of this year. The effects of higher energy prices helped drive the headline rate of the Consumer Price Index, or CPI, to an eye-popping 15 percent annual rate for the month of September. That was the highest rate in 25 years. I do not, of course, expect the experience of that one month to be repeated. In fact, the core inflation rate was, by comparison, very tame. Excluding food and energy, the CPI rose at an annual rate of only 1.2 percent in September.

In this kind of situation, for a policymaker, careful nuances must come into play. I am not saying that the overall inflation number can be ignored. Even though the core rate of inflation in September was pretty good, we know that the core rate is not immune, over time, to large increases in oil and gas prices. As energy costs are passed through to consumers in the costs of other goods, we may very well see some upward drift in the core inflation rate. Those increases, however, should not be as dramatic as the headline numbers that we read about last week.

The important thing to recognize is that, unless energy prices continue to grow at the rate we saw this summer - something I consider very unlikely - their effects on the overall rate of inflation should prove to be temporary. The inflation statistics we see in the near term may look discouraging. However, most professional forecasters - the Blue Chip forecasters, the Congressional Budget Office, and others - share my expectation that inflation should moderate substantially next year.

Looking forward into 2006, the most probable course for the economy after the hurricanes is very close to the course that seemed likely before the hurricanes. We are likely to have a moderately expanding economy, in which the headline inflation numbers gradually slow down and move into line with the much-lower core inflation rate.

Likely, that is, if monetary policy does its part to keep those temporary pressures from translating into more persistent inflation. Temporary inflation will turn into longer-term inflation only if the FOMC allows expectations of persistent inflation to build. The key question is what course monetary policy should take to keep inflationary expectations from taking hold.

The Monetary Policy Outlook

That brings me to my outlook for monetary policy. I have come to think of monetary policy as a plan - a plan that contemplates the many paths that the economy might take, and that formulates an appropriate response in anticipation of those possibilities.

Following a strategy of removing our policy accommodation at a measured pace, the FOMC began raising its target for the federal funds rate in the summer of 2004. The plan was to begin the process of removing the policy accommodation that we had adopted in 2003 to combat disinflationary pressures. At that time, we had moved the federal funds rate target to the exceptionally low level of 1 percent.

We have continued with that plan of removing policy accommodation over the past year-and-a-quarter, as we have adjusted the federal funds rate target from 1 percent to 3.75 percent. As I said, Katrina and Rita did not change the broad contours of my forecast for continued economic growth and lower inflation into 2006. So, to me, the plan of continuing to remove the remaining amount of policy accommodation still looks like a sound one.

We have already removed a substantial amount of that accommodation, and it is fair to ask how much further we might have to go. Although the hurricanes did not change my best estimate of future economic activity, they did - as our last FOMC minutes indicate - increase the degree of uncertainty surrounding that estimate. The answer to how much higher the federal funds rate needs to go depends on how economic conditions unfold. So, let me share my thinking about a couple of possibilities that I have been contemplating.

First, it is possible that consumers will retrench their spending by a greater degree, and for a longer period of time, than we expect. Households have yet to experience the full impact of the recent energy-price increases, especially in the form of higher home-heating bills this winter. The long run-up in energy prices could finally prove to weigh heavily on consumers and significantly reduce their spending on non-energy items. In that case, the economy could become fragile and further increases in core inflation could prove to be even less of a worry than today. If consumer spending and inflation pressures appear to be weakening across the country, then the appropriate federal funds rate might prove to be lower than it would be otherwise.

Alternatively, total spending could bounce back more strongly than I anticipate - while at the same time consumers, businesses, and financial markets react to sustained increases in energy prices by raising their longer-term inflation expectations. In this case, a higher federal funds rate may be required, so that monetary policy does not unintentionally support an inflationary environment - one in which prices for a broad range of goods and services steadily rise.

Monetary policymaking requires managing risks. That means having a plan that is flexible enough to take into account sudden surprises and changing conditions. While I may be uncertain about which path the economy will take, I am clear about the goals of the central bank. I believe being prepared means, first and foremost, being in a position to respond if threats to price stability arise. Removing the remaining monetary policy accommodation puts us in the strongest possible position to react as evolving economic conditions require.

Conclusion

These are indeed complex and challenging times - and, because of that, I find it a fascinating time to be a Federal Reserve policymaker. In times like these, it is helpful to meet frequently and talk candidly with businesspeople throughout the region.

Just within the past two weeks, I have discussed economic conditions with businesspeople in Youngstown, Pittsburgh and Cleveland, as I have delivered speeches, held advisory council meetings, and participated in economic forums. I deeply value the input I receive from business and civic leaders who, like you, are on the economic front lines every day.

In recent weeks, I have heard a lot of concern about energy prices, increasing costs for raw materials, and prospects for weaker consumer spending and confidence. What is reassuring to me, however, is that most of our region's businesspeople are still expecting a relatively good year in 2006.

On November 1, as the FOMC again deliberates, I will be sitting at the table, providing my colleagues with the views from our region. This input will be factored into the discussions, along with comments from the other FOMC participants and the staff's forecast. As always, my colleagues and I will remain focused on achieving our core goals: ensuring price stability and achieving maximum sustainable growth.