Current Issues in U.S. Monetary Policy

Introduction
In this session on central bank policy, I know that Salvatore (Salvatore Rossi, Chief Economist, Bank of Italy) and I will be covering a lot of the same ground even though circumstances differ within our countries. That is because central bankers share a common responsibility—keeping the purchasing power of our currencies stable.

Over the past 30 years, monetary policymakers around the world have come to realize that a low and stable rate of inflation is absolutely critical for achieving other important objectives, like maximum sustainable economic growth, healthy labor markets, and financial stability. The Federal Reserve certainly has focused on maintaining price stability, as I will discuss this morning.

First, let me share a bit about my role in the U.S. central bank. As the president and CEO of the Federal Reserve Bank of Cleveland, I lead the Fourth Federal Reserve District, which includes all of Ohio and portions of three adjoining states. One important part of my job is to represent this diverse region at the FOMC, or the Federal Open Market Committee, meetings in Washington.

The FOMC consists of members of the Board of Governors and the 12 Reserve Bank presidents, and it meets eight times a year. The Committee decides on critical monetary policy issues, such as targets for short-term interest rates. Our objectives are to promote price stability and maximum employment. That is the dual mandate that the U.S. Congress has given the Federal Reserve.

Each of the 12 Reserve Bank presidents brings information about his or her region to the monetary policy process. While this regional input is important to understanding economic conditions, the Federal Reserve’s monetary policy is national in scope and responds to economic conditions in the entire country.

As you know, the U.S. economy is emerging from the worst recession since the Great Depression of the 1930s. This morning, I will talk about the Federal Reserve’s response to the deep recession. I will then turn to my outlook for U.S. economic growth and inflation, and I will conclude with some comments about the implications for U.S. monetary policy.

As always, the views I express today are mine alone and do not necessarily reflect those of my colleagues in the Federal Reserve System.
The Federal Reserve’s Response to the Deep Recession

To help you think about monetary policy in the United States today, I’d like to begin with a brief discussion of how the Federal Reserve has responded to the deep recession. As you know, the downward spiral in the United States began with the housing crisis, which led to the financial crisis. Financial markets froze, production collapsed, and employment plummeted.

This recent recession was the longest and deepest since the dark days of the Great Depression. It lasted 18 months, from December 2007 to June 2009. Industrial production fell 17 percent, which was the largest decline since 1939. At the end of the recession, businesses were using just about two-thirds of their existing production capacity.

Employment fell more than 6 percent, which is again a post-Depression record. The loss of nearly 9 million jobs during the recession led unemployment rates to soar from under 5 percent to more than 10 percent. In addition, the value of U.S. homes fell sharply, in some areas more than 30 percent. This decline in economic activity also had dramatic effects on underlying consumer price inflation, which dropped from about 3 percent in late 2007 to 0.5 percent in the middle of last year.

During the financial crisis, the Federal Reserve responded aggressively and creatively to the rapidly changing outlook for growth and inflation. From September 2007 to December 2008, the Federal Reserve lowered its short-term interest rate target, known as the federal funds rate target, from $0.5 percent to effectively zero, where it stands today. As the financial crisis deepened, we had to provide more support to financial markets and the economy than we could deliver by using interest-rate actions alone.

Initially, our actions were focused on establishing programs to provide liquidity to financial markets and to get credit flowing again. Later, to support economic activity more broadly, we sought to lower longer-term interest rates by purchasing $1.7 trillion worth of mortgage-backed securities, government agency debt, and Treasury securities. Last fall, we initiated a second round of large-scale asset purchases to further bolster economic growth and lessen the risk of inflation falling below zero for a sustained period. As a result of our actions, our own balance sheet expanded enormously, from roughly $900 billion before the crisis to approximately $2.6 trillion today.

It is fair to describe the Federal Reserve’s policy stance as highly accommodative. I believe this stance has been effective. We avoided the worst possible scenario, a repeat of the Great Depression worldwide. Yet, today, many challenges remain.

The Outlook for Growth and Inflation

With that background on the recession and our monetary policy response, I would now like to turn to today’s outlook for the U.S. economy and inflation. In preparing for FOMC meetings, I look closely at the outlook for GDP growth, employment, and inflation. I want to emphasize that it is the outlook that is critical in pursuing our monetary policy objectives, not current economic conditions, because there is a significant delay between policy actions and when those policy actions affect the economy.

For almost two years since we emerged from the deep recession, the U.S. economy has been recovering, but at a gradual and bumpy pace. In terms of national output, it has taken us two years just to make up the ground we lost since the recession began. More recently, though,
the U.S. recovery appears to have established a firmer footing. The pace of hiring has picked up, and more industries have been adding workers. These are encouraging signs that should point to stronger job growth in the coming months. Also, consumer spending has shown more strength than most forecasters expected. These are good signs that the recovery is entering a virtuous cycle of growth. Rising employment, incomes, and profits are supporting growth in retail sales and business demand, which in turn should fuel further growth in employment, incomes, and profits.

Up to this point, the recovery has been supported significantly by strong growth in exports, manufacturing, and business investment in equipment and software. Since the recession ended, exports have grown at a double-digit rate, and manufacturing production has grown at an annual average of 8 percent. The recovery of U.S. exports and manufacturing is part of the global recovery of trade following its collapse during the recession. The acceleration in U.S. exports has been led by a range of goods, including industrial equipment, automobiles and parts, and computer equipment.

Despite these sources of strength, not all Americans are sharing equally in the recovery. Unemployment continues to be a significant problem. At this point, the U.S. economy has added back only 1.5 million of the 9 million lost jobs. Also, the continuing problems in the housing sector pose a significant drag on economic growth. Historically, investments in new home construction and improvements to existing homes help the economy to snap back quickly from recessions and help to spur GDP growth. However, since the last recession ended, instead of helping to support the recovery, housing investment has fallen by more than 2 percent.

Looking ahead, I expect the U.S. economy to continue to expand at a moderate rate, a bit above its long-term average growth rate of 3 percent per year. Of course, there are potential risks to this outlook, most notably the recent sharp rise in energy and commodity prices. For example, increases in energy prices would effectively tax consumers, reducing their purchasing power, and in turn would modestly slow the pace of GDP growth. Fortunately, these effects would likely be mild as long as the U.S. economy remains on a firmer footing.

Nevertheless, if energy and commodity prices continue to increase sharply, people could start to worry about the consequences for inflation. The natural question in these times is whether the recent surge in oil prices will be enough of a driving force to cause a lasting increase in the rate of inflation in the United States. At this point, I don’t think it will, and let me explain why.

First, large increases in food or energy prices tend to be temporary. History shows that they are often followed by sharp declines. For example, in 2006, oil prices in the United States rose significantly over the first eight months of the year but then dropped in the remainder of the year. Second, to cause a lasting rise in inflation, the increases in food or energy prices have to be large enough and persist long enough that they spill over and cause sustained increases in a wide array of other consumer prices. At this point, there is no evidence of a broad spillover, but as a central banker, I keep a close eye on this.

To assess the underlying trends in a broad array of consumer prices, my staff at the Federal Reserve Bank of Cleveland calculates and publishes an indicator known as the median CPI. This index is designed to provide a reliable measure of the average increase in a wide set of consumer prices. Research at the Bank has shown the median CPI to be a superior predictor of future inflation rates. To this point, inflation in the median CPI remains very low: just 1
percent over the past year. Based on the behavior of the median CPI, I don’t expect recent rises in food and energy prices to cause a broad spillover into a wide array of consumer prices, or in other words, a lasting increase in inflation. Specifically, I expect the underlying trend in broad consumer prices to rise only gradually toward 2 percent by 2013. Of course, just as I consider the risks to economic growth, I also need to consider the risks to my inflation outlook.

My outlook assumes that several important factors will keep inflation in check. One of these factors is the continuing slow growth in wages, which helps determine the cost of producing goods and services and, in turn, the prices set by firms. Another factor is retailers’ reluctance to raise prices in the face of strong competition and soft business conditions. The U.S. economy still has a way to go to more fully recover from the steep recession, which will restrain growth in wages and retail prices.

Another important factor in my outlook for inflation is the public’s expectation that the Federal Reserve will keep inflation contained. While it may sound like a self-fulfilling prophecy to say that we will have low inflation because we collectively expect low inflation, the relationship between actual and expected inflation has been borne out over history. One reason is that expectations of inflation play a crucial role in the price-setting decisions of firms. When firms expect lower inflation, they raise prices more slowly. Despite the recent surge in food and energy prices, measures of longer-run inflation expectations remain below 2 percent. These measures come from bond yields and surveys of economic forecasters.

Implications for Monetary Policy
So, with my outlook for a moderate recovery and underlying inflation gradually moving toward 2 percent, I’d like to turn to the implications of the outlook for U.S. monetary policy.

Eventually, the FOMC will begin to remove our policy accommodation. This process will involve raising the target for short-term interest rates, draining bank reserves to prevent an undue rise in the broad money supply, and reducing the size of our balance sheet to more normal levels. I believe that when the time comes, we have all the tools we need to make an exit from our current policy stance.

More immediately, as the FOMC’s most recent statement indicated, the Committee is watching carefully for any signs of an unanticipated spillover from oil and other commodity prices into underlying inflation measures. A key to preventing this spillover is to keep long-run inflation expectations anchored because, as I mentioned earlier, inflation expectations are an important determinant of inflation. The current stability in inflation expectations was not achieved just by good fortune. The public’s expectation that inflation will remain low and stable over the long run comes from their expectation that the Federal Reserve’s monetary policy will deliver low and stable inflation over the long run. As a Federal Reserve policymaker, I believe that it is my responsibility to do everything I can to underscore confidence in our commitment to maintain price stability. But I understand that price stability can mean different things to different people. Today, the concept is vague and the FOMC has not established a formal inflation objective.

With the potential for inflation expectations to be more volatile in the face of energy and commodity price shocks, I think it could be an opportune time for the FOMC to be more specific and publicly announce an explicit numerical inflation objective.

Adopting an explicit numerical objective would have to be the
decision of the whole FOMC. My own preference is 2 percent over the medium term, an inflation objective that is quite similar to the targets of many central banks around the world. As much as the concept of “zero inflation” appeals to me, 2 percent is a much more practical numerical objective than zero. An objective set much below 2 percent increases the likelihood that the FOMC would need to push short-term interest rates down to zero for an extended time to head off a deflation or to fulfill its mandate for maximum employment. As we are seeing today, keeping interest rates near zero complicates the monetary policy process. Although I remain committed to fulfilling both aspects of our dual mandate for price stability and maximum employment, I think it would be unwise for the Federal Reserve to establish a corresponding numerical objective for unemployment. The long-run sustainable rate of unemployment can move around for a variety of reasons, such as the demographic makeup of the population and changes in how labor markets function. Since the Federal Reserve cannot know what the sustainable level of unemployment is, or how it will evolve over time, it should not set a numerical objective for unemployment.

Establishing an explicit inflation objective need not imply any material change in the current conduct of monetary policy. The U.S. economic expansion is still quite uneven, and it has considerable ground to make up. History suggests that the effects of recent commodity price pressures on consumer price inflation are likely to be transitory. From my perspective, economic conditions, including low levels of resource utilization, subdued inflation trends, and stable long-term inflation expectations, warrant the continuation of our current monetary policy stance. Indeed, my outlook for economic growth and inflation assumes that we complete our asset purchase program as originally scheduled, and keep our federal funds rate target at exceptionally low levels for an extended period. As always, if my outlook for economic growth or inflation changes, I stand ready to adjust my view about what constitutes appropriate monetary policy.

Conclusion
These are challenging times for our economy, and they are compounded by the unrest we are seeing in the Middle East and North Africa, and the devastating human tragedy in Japan. In these times, it is important not only to develop a view of the most probable path for the U.S. economy, but also to consider potential risks to the economy and to be prepared to respond to them. For my part, I will continue to study the financial and economic situation to determine the right policy actions to fulfill the Federal Reserve’s dual mandate of price stability and maximum employment.