Assessing Monetary Policy

Global Interdependence Center's Fifth Annual Rocky Mountain Economic Summit

Jackson Hole, WY

July 12, 2013

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President and CEO
Federal Reserve Bank of Philadelphia

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OF PHILADELPHIA

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Highlights:

President Charles Plosser outlines the Fed's policy tools and offers three steps for a more systematic approach to policy.

The Fed's policy tools include the traditional federal funds rate, which has been near zero since December 2008; the purchases of longer-term Treasuries and mortgage-backed securities to put downward pressure on longer-term interest rates, since the fed funds rate cannot go below zero; and the FOMC's forward guidance about policy, which has been an attempt to manage the public's expectations.

In June, the FOMC reaffirmed that policy will stay accommodative for some time to come. Fed Chairman Bernanke said in his press conference that if incoming data are broadly aligned with the central tendency of the Summary of Economic Projections, the Committee anticipates that it would moderate the pace of monthly purchases, perhaps ending them around mid-2014.

Plosser's forecast is more optimistic, especially for the unemployment rate, which he sees approaching 7 percent by the end of 2013 and 6.5 percent before the end of 2014.

Plosser notes it is important that we end purchases before we reach 6.5 percent; otherwise, this threshold for considering an increase in the funds rate target will lose meaning.

Plosser emphasizes that forward guidance can change expectations and affect the current economy only if policymakers credibly commit to follow that path.

Plosser offers the FOMC three steps for a more systematic approach to monetary policy:

1. Wind down asset purchases by the end of 2013 in a gradual and predictable manner.
2. Commit to the forward guidance on the fed funds rate path by treating the 6.5 percent unemployment rate and the 2.5 percent inflation rate as triggers rather than thresholds.
3. Explain how policy will evolve after the trigger is reached by committing to a robust policy rule.

Introduction

Good afternoon. It is great to be here in beautiful Jackson Hole and to have the opportunity to contemplate the economy and monetary policy with you today. I often say that one of the strengths of the Federal Reserve System's design is that it helps ensure that the perspective of those determining our country's monetary policy extends beyond the Washington beltway. I think you would agree that today's setting is not only beautiful but is far outside the beltway in more ways than one, I suspect.

Today, I would like to describe the current stance and rationale of monetary policy. I think current policy poses a number of challenges going forward. My view is that the time has come for us to exit our current asset purchase program and commit to a way forward that seeks to normalize monetary policy. As usual, my colleagues will be delighted to hear me assure you that these views are my own and do not represent the views of the FOMC or Federal Reserve System. Yet allowing for a diversity of views is, I believe, one of the great strengths of our Federal Reserve System. We should never think of this diversity of thought as an unfortunate flaw or an inconvenience when conducting policy. The structure of the Federal Open Market Committee and its ability to foster an open dialog among participants and transparency in the eyes of the public help prevent groupthink and preserve the FOMC's independence. These invaluable attributes of a sound central bank should never be taken for granted.

Our Monetary Policy Toolkit and the Current Stance of Policy

So let me begin by outlining the monetary policy tools we are using and the current stance of policy. The first tool is the traditional instrument of monetary policy, the federal funds rate. During the crisis and recession, the FOMC aggressively brought the target for the federal funds down and since December 2008 the rate has been near zero. Since the funds rate is constrained from going below zero, the Committee added a second policy tool. It began purchasing longer-term securities, both Treasuries and mortgage-backed securities, as a way to put downward pressure on longer-term interest rates.

Although it is related to the other two tools, one could consider "forward guidance," which describes our potential policy actions as the economy evolves, as a third tool of monetary policy. One rationale for using forward guidance is that it provides more clarity. By allowing the public to make more informed economic decisions, forward guidance can make policy more effective. Another rationale for using forward guidance is that in a number of economic models, when policymakers are stuck at the zero lower bound, promising to keep monetary policy more accommodative well into the future can affect the public's expectations about the future path of policy and therefore affect the current economy.

In its June statement, the FOMC reaffirmed that monetary policy will stay accommodative for some time to come. The forward guidance about the fed funds rate was unchanged from the guidance introduced last December. The FOMC stated that it intends to keep the target funds rate at its current 0 to ¼ percent range as long as the unemployment rate is greater than 6.5 percent, the inflation outlook one to two years ahead is no more than 2.5 percent, and long-term inflation expectations remain well anchored.

The forward guidance offered for asset purchases was also unchanged. The Committee stated the purchases will continue until there is substantial improvement in the outlook for the labor market, so long as inflation remains well behaved. This guidance signals that the labor market is a key determinant of the purchase program, but it does not specify how the Committee will assess such improvement.

In the June press conference, Chairman Bernanke added some clarification and more specifics regarding the forward guidance for the latest round of asset purchases, which are adding $85 billion a month to our balance sheet. He referred to the central tendency of the Summary of Economic Projections, which is prepared from submissions by all FOMC participants. He indicated that if the incoming data are broadly aligned with this central tendency outlook, the Committee anticipates it would moderate the pace of monthly purchases later this year, perhaps ending them around mid-2014. The Chairman indicated that at that point, the unemployment rate is likely to be near 7 percent. If this plan unfolds as described, this latest round of large-scale asset purchases would exceed $1 trillion and the Fed's balance sheet would grow to more than $4 trillion.

So what are the economic conditions that would lead the Committee to slow the pace at which we are expanding the balance sheet? The central tendency of the FOMC projections describes an economy accelerating in the second half of this year and into 2014. They anticipate growth of 2.3 to 2.6 percent for 2013 and accelerating to 3.0 to 3.5 percent in 2014. The central tendency projects that the unemployment rate will decline to 7.2 to 7.3 percent by the end of 2013 and reach 6.5 to 6.8 percent by the end of 2014. This is a faster pace of decline than previous FOMC projections anticipated. In essence, Committee participants have taken on board the steady pace of decline in unemployment over the past three years. Note that these projections suggest it could be as early as the end of 2014 when the unemployment rate reaches 6.5 percent. That is the threshold at which the Committee indicated it would consider raising the funds rate target. The Chairman noted that the asset purchase program is expected to end before the Committee begins raising the fed funds rate. So, ending the program by mid-2014, when the unemployment rate is anticipated to be around 7 percent, would be consistent with this.

As for inflation, which has been running below the Fed's longer-run objective of 2 percent, the central tendency projection calls for inflation as measured by the personal consumption expenditure (PCE) price index to gradually rise from its current level to 1.4 to 2 percent by the end of 2014.

This central tendency forecast is one in which growth is gradually accelerating, unemployment is falling, and inflation is gradually returning to our target. The Chairman also noted that if the economy improved more rapidly than anticipated, purchases could be wound down faster, and if it performed more poorly, the pace of reduction could be slowed or stopped.

By describing the path of purchases in terms of the evolution of economic conditions, the Chairman was offering some insight into the Committee's reaction function for its planned asset purchase program. I have long argued that the Committee should be more articulate about its policy reaction function, so I fully supported the Chairman's comments providing this added information. Nevertheless, I believe that a rules-based approach to policy would provide greater clarity to the public about our policy intentions and be considerably more effective than our current efforts at clarity or forward guidance. Before I turn to that, let me make a few points about interpretation of our policy communication and the reaction in the market.

Interpretation of Recent FOMC Communication

Some have associated a slowing of the pace of purchases with a tightening of policy. This is incorrect. The balance sheet will still grow if we reduce the pace of purchases, so the level of accommodation will still increase. This is similar to the way one would think of normal policy. Suppose the Fed had been cutting the funds rate by 50 basis points for two meetings and then decided to cut rates by 25 basis points. This would still be an easing move; we wouldn't say it was tightening policy. If we continue to purchase assets, albeit at a reduced pace, we would be continuing to add additional accommodation despite a gradually improving economy.[1]

It is also important to note that even the end of purchases is not the start of policy tightening. It simply means the effort to push rates even lower will cease, but policy will remain very accommodative. The prospect for actually tightening policy is provided by the Committee's forward guidance on the funds rate, which says that we will not contemplate raising the target rate until the unemployment rate reaches 6.5 percent. That message has not changed. But it is state-dependent forward guidance. Market participants might very well change their forecast of when 6.5 percent unemployment may be reached, which would cause rates to move. For example, as economic conditions strengthen, markets may begin to expect unemployment rates to fall more quickly and for the Fed to begin raising rates sooner. We would expect to see market interest rates rise in response. In fact, the steady increase in long rates that we've experienced over the past two months began before recent Fed communications. The increase

[1] I do not subscribe to the view that we need to apply ever-increasing accommodation until the economy returns to normal. For a discussion of the dangers of such accelerationist monetary policy, see Charles I. Plosser, "The Outlook and the Hazards of Accelerationist Policy," speech to the University of Delaware Center for Economic Education and Entrepreneurship, Newark, DE, February 14, 2012.

seems to have begun with the May 3rd employment report, which indicated an unexpectedly strong rise in April payrolls and significant upward revisions to the March and February data.

My Economic Forecast and Policy Views

My own forecast is in fact a bit more optimistic than the central tendency projections, especially as it pertains to the unemployment rate. Specifically, I see the unemployment rate falling somewhat more quickly than the central tendency projection. My forecast has the unemployment rate approaching 7 percent by the end of this year and 6.5 percent before the end of 2014. I also see inflation returning to our 2 percent target sooner than some do, as I believe the current period of low inflation is transitory and expectations remain relatively stable. In my view, it is important that we end purchases before we reach the 6.5 percent threshold for considering an increase in the funds rate target. If we don't, I believe the 6.5 percent threshold will lose meaning. Would anyone believe we would raise the fed funds rate at the same time that we are increasing the size of the balance sheet through asset purchases? Thus, consistent with my forecast and with the Committee's forward guidance, I favor starting to reduce the pace of purchases and ending the asset purchase program by year-end.

Policy Challenges Going Forward

I believe the recent efforts to clarify the state-contingent nature of the asset purchase program are a step in the right direction, but the Fed still faces significant challenges going forward. The challenges arise as much, if not more, from the policy choices that the Fed has made, rather than from a failure to communicate or a misunderstanding by the market.

Let me begin by recapping some of the issues that have concerned me for some time. There is ample commentary about the risks of removing accommodation too soon. I believe there is too little discussion about the risks of keeping too much accommodation in place for too long. Unwinding from a very large and growing balance sheet of long-duration assets will be difficult, potentially disruptive, and pose significant risks.

Failing to execute a graceful exit and falling behind the curve could risk significant inflation or a rapid increase in interest rates that may be counterproductive. I have often said that financial markets are unlikely to be patient as we unwind from this extraordinary accommodation. The recent volatility in interest rates may be a taste of things to come. It illustrates just how difficult the task will be when we truly begin to unwind. Aside from these challenges, some have argued that the prolonged period of near-zero interest rates and our direct intervention in the financial markets through our purchases could be contributing to the misallocation of capital and other distortions that could result in financial instability. Growing threats of this nature are extremely hard to identify before it is too late — so we need to be wary of the unintended consequences of our actions and stay vigilant. Just because financial markets like what we are doing at the moment does not necessarily mean that it is the best thing for the long term.

As I have mentioned on many occasions, the risks associated with unwinding a very large balance sheet and with the potential financial distortions caused by extremely low interest rates have led me to conclude that our current asset purchase program fails the cost-benefit test. The benefits have been meager at best. A great deal of the impact seems to have manifested itself in various forms of financial reengineering or capital structure arbitrage; it has yielded little in the way of real business investment that would translate into greater labor demand. It is time to exit from the asset purchase program in a gradual and predictable manner.

Just as the unconventional asset purchases have presented challenges, so too has the Committee's use of forward guidance. Economic theory and experience tell us that expectations about the future can have an important impact on economic decisions made today. The FOMC has been using forward guidance in an attempt to manage the public's expectations of the future course of monetary policy as one of its policy tools. As I noted earlier, the theory suggests that when interest rates are constrained by the zero lower bound, offering forward guidance to keep interest rates low for an extended period can substitute for lowering short-term rates. Indeed, if such forward guidance were truly effective, there would be no need for an asset purchase program. One way such forward guidance might work is by temporarily raising inflation expectations, which would induce consumers to save less and spend more today. Another channel would be by raising expectations about future economic prospects, which again would make consumers confident to spend more today rather than to save for a rainy day. But managing expectations in this manner is much easier said than done. In particular, forward guidance about the future policy path can change expectations and thereby affect the current economy only if policymakers credibly commit to follow that path. Everyone must believe that the central bank will actually deliver on the promise embodied in the forward guidance.[2] If the commitment to the forward guidance is not credible, it will not have the desired effect.

While the FOMC has offered some forward guidance on future policy, it has been unwilling to make a clear commitment to its forward guidance. Instead, the FOMC has offered a variety of changing targets or signals about future behavior. Although the aim was to clarify our policy intentions, I believe the repeated changes have likely caused more confusion than illumination. In August 2011, the Committee began using dates to signal when the policy rate might increase, but it changed those dates at subsequent meetings. The FOMC then opted to formulate its forward guidance in terms of thresholds for unemployment and inflation. This is preferable to calendar dates because it is state contingent. Yet, the FOMC has specifically said that the thresholds are not triggers — they are not firm commitments and they may change. The Committee has repeatedly opted for language that allows a great deal of discretion to behave as it chooses, depending on the circumstances. But effective forward guidance demands commitment. When the Committee stresses the general flexibility of its policy decisions or makes vague references to data dependency, it does little to clarify the FOMC's intentions about future policy, even though clarity is what the FOMC wants to provide to the markets through its forward guidance. Thus, there is a fundamental tension between wanting to provide clarity as to the forward course of policy and wanting to maintain complete discretion.

[2] For further discussion of forward guidance, see Charles I. Plosser, "Forward Guidance," speech at the Stanford Institute for Economic Policy Research's (SIEPR) Associates Meeting, Stanford, CA, February 12, 2013.

The Committee has failed to address this tension, which undermines the effectiveness of its policy.

I would add that this tension is not new. The Committee has typically preferred discretion over systematic policy. Yet, in normal times, the conduct of policy was more predictable and the public had come to expect policy to play out in mostly understandable ways. Since the crisis, the old "rulebook," so to speak, has been thrown out, but we haven't replaced it with anything except some vague promises that have changed over time. This naturally leads to a lack of clarity in the eyes of the public and undermines the effectiveness of the forward guidance the Committee offers.

A Strategy for Moving Forward

In my view, rather than try to maintain discretion, policymakers would achieve better economic outcomes and greater clarity by taking a systematic approach to policy. But how do we get there from here? I think we could vastly improve policy going forward by doing three things, which would begin to normalize monetary policy.

- The first step is to wind down our asset purchases by the end of the year in a gradual and predictable manner. As I said, I see little if any benefit from these purchases, and growing costs.
- The second step is for the FOMC to commit to its forward guidance on the fed funds rate path, that is, to begin treating the 6.5 percent unemployment rate and the 2.5 percent inflation rate in the guidance as triggers rather than thresholds.
- The third part of the strategy is to provide information on how our interest rate policy will evolve after the trigger is reached. A commitment to a robust policy rule, perhaps consistent with the way policy was conducted prior to the crisis, would provide needed clarity on how the Committee intends to vary its policy in response to changes in economic conditions.

These steps form part of a systematic approach to policymaking. They embody clarity and commitment. By helping the public and market participants form more accurate judgments about the future course of policy, systematic policymaking can improve the efficacy of monetary policy. Moreover, such an approach would help mitigate some of the risks inherent in navigating an exit from this period of extraordinary accommodation. I believe the benefits of the systematic approach that I have outlined here could be substantial, and I believe it is worth the effort to achieve the necessary consensus to implement such a strategy.