Perspectives on the U.S. Economy and Monetary Policy

Monetary Policy and Banks and the Rise of Global Protectionism
Global Interdependence Center
Banque de France

Paris, France

March 10, 2014

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Federal Reserve Bank of Philadelphia

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Note: President Plosser presented similar remarks to the Official Monetary and Financial Institutions Forum in London, England, on March 6, 2014.

Highlights

- President Plosser expects growth of about 3 percent in 2014. He also expects the unemployment rate to continue its steady decline and to reach about 6.2 percent by the end of 2014. Inflation expectations will be relatively stable, and inflation will move up toward the FOMC target of 2 percent over the next year.
- President Plosser believes the Federal Open Market Committee has to revamp its current forward guidance regarding the future federal funds rate path because the 6.5 percent unemployment threshold has become irrelevant.
- President Plosser favors providing more information on policymakers' reaction function, which indicates how policy will evolve as economic conditions change.
- President Plosser favors a more systematic, less discretionary approach to monetary policy. He believes it is time to switch from an interventionist mode for monetary policy to one that is more systematic.

Introduction

I am delighted to return to the Banque de France and to join my friend Governor Christian Noyer on this panel. The Global Interdependence Center (GIC) has once again organized another opportunity to exchange views and discuss important topics on truly global issues.

The Banque de France is in its third century, having been founded in 1800. Last week, I spoke in London, where the Bank of England has been operating since 1694. So, I hesitate to mention that the Federal Reserve is marking its 100th anniversary this year. The Federal Reserve Act of 1913 created a uniquely American approach to a central bank – a decentralized central bank – with 12 independent Federal Reserve Banks around the country and a Board of Governors in Washington, D.C. This unique governance structure requires that I forewarn you that the views I express are my own and do not necessarily reflect those of the Federal Reserve System or my colleagues on the Federal Open Market Committee (FOMC).

Economic Conditions

The U.S. economy is now nearly five years into a recovery that began in June 2009. The recovery has been lackluster in many ways, yet it has made considerable progress nonetheless. The unemployment rate, for example, has fallen from its peak of 10.0 percent to 6.7 percent. Employment gains have restored some 8 million jobs since the trough, representing more than 90 percent of the jobs lost since the peak. Stock prices have recovered, housing prices are up, and earnings at many businesses are healthy. It is my general view that the U.S. economy is on firmer footing today than it has been in several years. This is a cause for some optimism for continued progress in 2014.

In recent weeks, there has been a blizzard of economic reports, which have come in weaker than expected. I believe that weakness largely reflects the severe winter weather rather than a frozen recovery. So, we must be wary of attaching too much significance to the latest numbers. As a monetary policymaker, I prefer to take a longer view rather than let our decisions be whipsawed by the most recent statistics, which are often noisy and subject to revision. Because monetary policy tends to work with a lag, we must keep our attention focused on the intermediate- to longer-term underlying trends if we are to make wise decisions.

Based on the latest GDP numbers revised last month, the U.S. economy performed noticeably better in the second half of 2013 than in the first half. Specifically, real output grew at a 3.3 percent pace in the second half of the year compared with 1.8 percent in the first half.

While this is far from the robust growth that many would like to see, it continues to represent steady progress and an improving economy. My forecast calls for about 3 percent growth in 2014. This is in line with the central tendency of 2.8 to 3.2 percent growth reported by my colleagues on the FOMC in December 2013.

There has been discussion of some recent weakness in consumer spending, housing starts, and housing sales. For instance, in January, total retail sales fell by 0.4 percent; housing starts dropped sharply in January by 2 percent compared with the level of a year ago; and existing home sales dropped about 5 percent from a year ago. While some softening in home sales might be expected from the rise in mortgage rates, those rates are still very low by historical standards, and new home sales surged in January, rising to their highest level since 2008. Despite the mixed housing data, continued household formation constitutes a source of growth in housing demand. So, I expect that housing will continue its recovery in 2014, once we get past the severe weather.

Consumer spending, which accounts for more than two-thirds of U.S. GDP, proved to be quite resilient in 2013, despite the rise in payroll taxes at the start of the year, a government shutdown, significant uncertainties about future tax policy, and the implications of health-care reform.

Going forward, I expect that there will be less fiscal drag on the economy in 2014 than we saw in 2013. Moreover, rising home prices and stock prices have helped improve consumer balance sheets. I have frequently noted that one reason for the less-than-robust growth in consumption during this recovery has been the deleveraging efforts by consumers. With consumers carrying too much debt, spending was inevitably going to give way to more saving as consumers attempted to restore the health of their balance sheets. That process has been playing out, and the drag from deleveraging is waning. In addition, steady, moderate job growth has led to modest increases in income. I foresee somewhat more robust spending by consumers in the coming year as these trends continue.

Weather also affected recent manufacturing numbers in the U.S. The Philadelphia Fed's Business Outlook Survey of manufacturers in our region has been a reliable indicator of national manufacturing trends in the U.S. In February, the diffusion index of current activity fell into negative territory for the first time in nine months. However, most respondents attributed the weakness to the severe winter weather. Consistent with such comments, expectations for manufacturing activity six months ahead increased in February.

On the job front, the February employment report posted payroll gains of 175,000 jobs, following an increase of 129,000 jobs in January, and 84,000 in December. All three of these numbers most likely reflected in part the effect of the unusually severe winter weather.

As we look at the employment averages over several months, the news remains positive. Based on the latest revision, firms added an average of 194,000 jobs per month in 2013, which is a somewhat better pace than in 2012. This consistent pace of job growth was enough to drop the unemployment rate to 6.7 percent in February, which is a full percentage point lower than a year ago. I expect that the unemployment rate will reach about 6.2 percent by the end of 2014, and, if anything, that may prove too pessimistic. Given the recent trends, an unemployment rate below 6 percent is certainly plausible.

In terms of the other part of the Fed's mandate, inflation has been running somewhat below the FOMC's long-run goal of 2 percent. The Fed's preferred measure of inflation is the year-over-year change in the price index for personal consumption expenditures, or PCE inflation. It came in at 1.1 percent last year. It is important to defend our 2 percent inflation target both from below and above. Yet, I anticipate, as the FOMC indicated in its most recent statement, that inflation will move back toward our target over time. Economic growth is firming, and some of the factors that have held inflation down, such as the one-time cut in payments to Medicare providers, are likely to abate over time.

An additional and important determinant of actual inflation is consumer and business expectations of inflation. I am encouraged that inflation expectations remain near their longer-term averages and consistent with our 2 percent target. Given the large amount of monetary accommodation that we have added and continue to add to the economy, I think there is some upside risk to inflation in the longer term.

Of course, with any forecast, there are risks. While there continues to be some downside risk to growth, for the first time in years, I see the potential for more upside risk to the economic outlook. We need to consider this possibility as we calibrate monetary policy.

Monetary Policy

So let me turn to some issues for monetary policy. The Federal Reserve has taken extraordinary policy actions to support the economic recovery. The Fed has lowered its policy rate — the federal funds rate — to essentially zero, where it has been for more than five years. Since the policy rate cannot go any lower, the Fed has attempted to provide additional accommodation through large-scale asset purchases. We are now in our third round of this quantitative easing.

Since September 2012, the FOMC has added about $1.3 trillion in long-term Treasuries and mortgage-backed securities to its balance sheet through this program, buying at a pace of $85 billion a month in 2013. This program, known as QE3, is already twice the size of the last round of asset purchases initiated in November 2010, known as QE2.

In December 2013, the Committee announced that it would reduce the pace of purchases from $85 billion to $75 billion per month. In January, it announced a further reduction to $65 billion. The FOMC is now on a path of measured reductions, which, if continued, will end the purchase program later this year. If the economy continues to improve, we could find ourselves still trying to increase accommodation in an environment in which history suggests that policy should perhaps be moving in the opposite direction.

In addition to asset purchases, the Fed is using forward guidance as a policy tool, which is intended to inform the public about the way monetary policy is likely to evolve in the future. In this dimension, the FOMC has indicated that it intends to leave the policy rate near zero well past the time that the unemployment rate falls below the 6.5 percent threshold. The FOMC had previously indicated that this was the earliest point at which it would consider raising interest rates, especially if projected inflation continues to run below the Committee's 2 percent target.

Even though the FOMC has said that it doesn't anticipate raising rates when the economy crosses that threshold, I believe that with the economy so close to the unemployment threshold, we face a communications challenge. In particular, we have not described how policy will be conducted after the unemployment rate falls below 6.5 percent.

Communication Challenges

But before we offer further forward guidance, it is important to be clear about what this forward guidance is supposed to accomplish. As that famous American baseball player Yogi Berra is reported to have said, "You have to be careful if you don't know where you're going because you might end up somewhere else."

One way to think of forward guidance is that it is just another step toward increased transparency and effective communication of monetary policy. This approach seeks to clarify how policymakers will alter policy as economic conditions change, that is, to describe a reaction function. By being more transparent about how policy will evolve as a function of economic conditions, this approach can help the public form more accurate expectations about the future path of monetary policy.

Economists have learned that expectations play an important role in determining economic outcomes. When businesses and households have a better understanding of how monetary policy is likely to evolve, they can make more informed spending and financial decisions. If policymakers can reduce uncertainty about the course of monetary policy, the economy is likely to perform more efficiently.

Of course, in order to communicate something about the reaction function, you have to have one. That means in order to succeed with this approach to forward guidance, policymakers must be able to agree on how they will systematically respond to changes in economic conditions. To be useful, however, the reaction function need not be mechanistic. Qualitative information about such a function and how it will be implemented can also be useful and meaningful. Nevertheless, some degree of commitment to abide by the specified reaction function is necessary if the communication is to achieve the desired result of reducing policy uncertainty and providing meaningful forward guidance.

A somewhat different rationale or view of forward guidance is that it is a way of increasing accommodation when the policy rate is at or near the zero lower bound. Some models suggest that when you are at the zero lower bound, it can be desirable, or optimal, to indicate that future policy rates will be kept "lower for longer" than might otherwise be the case. Thus, policymakers may want to deliberately commit to deviating from what they would otherwise choose to do under normal conditions, such as following a Taylor-like rule. In these models, such a commitment would tend to raise inflation expectations and lower long-term nominal rates, thereby inducing households and businesses to spend more today.

This approach asks more of forward guidance than just articulating a reaction function. It takes more credibility and commitment because it requires policymakers to directly influence and manage the public's beliefs about the future policy path that differs from how policymakers behaved in the past. As I have indicated in previous speeches, this approach to forward guidance can backfire if the policy is misunderstood.[1] For example, if the public hears that the policy rate will be lower for longer, it may interpret this news as policymakers saying that they expect the economy to be weaker for longer. If that is the interpretation of the message, then the forward guidance will not succeed and may even weaken current spending.

The FOMC has not been clear about the purpose of its forward guidance. Is it purely a transparency device, or is it a way to commit to a more accommodative future policy stance to add more accommodation today? This lack of clarity makes it difficult to communicate the stance of policy and the conditionality of policy on the state of the economy.

I believe there is another – perhaps more fundamental – tension underlying forward guidance and communication. Forward guidance in either of the two approaches I have discussed requires a degree of commitment to conduct future policy in some particular manner. Commitment is central to the success of either approach. Yet, I would suggest that the old "rules versus discretion" debate is alive and well. This, of course, is not a new tension within the FOMC, nor is it one that is likely to go away in the near term. But the heightened weight and prominence given to forward guidance as a policy tool has certainly shined a spotlight on this longstanding debate.

The desire to maintain flexibility to respond to "events on the ground" is a strong one. One can make the case that discretion is deeply ingrained in most policy institutions, particularly the Fed. Yet, the desire to maintain discretion is anathema to the commitment required for successful forward guidance. Policymakers cannot maintain discretion and simultaneously commit to forward guidance and expect that guidance to be effective.

[1] See Charles I. Plosser, "Forward Guidance," speech to the Stanford Institute for Economic Policy Research's (SIEPR) Associates Meeting, February 12, 2013, Stanford, CA.

Conclusion

In summary, I believe that the U.S. economy is continuing to improve at a moderate pace. We are likely to see growth of around 3 percent in 2014. Prospects for labor markets will continue to improve, and I expect the unemployment rate will continue to decline, reaching 6.2 percent or lower by the end of 2014. I also believe that inflation expectations will be relatively stable and that inflation will move up toward our goal of 2 percent over the next year.

On monetary policy, we must back away from increasing the degree of policy accommodation in a manner commensurate with an improving economy. Reducing the pace of asset purchases in measured steps is moving in the right direction, but the pace may leave us well behind the curve if the economy continues to play out according to the FOMC forecasts.

Even after the asset purchase program has ended, monetary policy will still be highly accommodative. As the expansion gains traction, the challenge will be to reduce accommodation and to normalize policy in a way that ensures that inflation remains close to our target, that the economy continues to grow, and that we avoid sowing the seeds of another financial crisis.

Let me conclude with this thought. Over the past five years, the Fed and, dare I say, many other central banks have become much more interventionist. I do not think this is a particularly healthy state of affairs for the central banks or our economies. The crisis in the U.S. has long passed. With a growing economy and the Fed's long-term asset purchases coming to an end, now is the time to contemplate restoring some semblance of normalcy to monetary policy.

In my view, the proper role for monetary policy is to work behind the scenes in limited and systematic ways to promote long-term growth and price stability. But since the onset of the financial crisis, central banks have become highly interventionist in their efforts to manipulate asset prices and financial markets in general as they attempt to fine-tune economic outcomes. This approach has continued well past the end of the financial crisis. While the motivations may be noble, we have created an environment where "it is all about the Fed." Market participants focus entirely too much on how the central bank may tweak its policy, and central bankers have become too sensitive and desirous of managing prices in the financial world. I do not see this as a healthy symbiotic relationship for the long term.

If financial market participants believe that their success depends primarily on the next decisions of monetary policymakers rather than economic fundamentals, our capital markets will cease to deliver the economic benefits they are capable of providing. And if central banks do not limit their interventionist strategies and focus on returning to more normal policymaking aimed at promoting price stability and long-term growth, then they will simply encourage the financial markets to ignore fundamentals and to focus, instead, on the next actions of the central bank.

I hope we can find a way to normalize the role of monetary policy to one that is less interventionist, less discretionary, and more systematic. I believe our longer-term economic health will be the beneficiary.