The Economic Outlook, Monetary Policy and the Federal Open Market Committee's Inflation Objective

Remarks by

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I'm delighted to join the long list of current and past Federal Reserve officials who have spoken before this distinguished group. With 17 participants currently sitting on the Federal Open Market Committee (FOMC), the public has access to a variety of perspectives and insights on the U.S. economy and monetary policy. Some have argued that communication from this large number of policymakers can confuse the public about our policy path. That potential exists. On net, though, I think the Federal Reserve System's transparency is a strength, giving financial markets and the broader public a sense of the diversity of views that come to bear on policy strategy, tactics and stance.

In my remarks this evening, I'll offer my views on the economic outlook and monetary policy, focusing in particular on how I think about our price stability mandate and related communications.[1] As central banks have done in other countries, the Federal Reserve announced last November its plans to review its monetary policy strategy, tools and communications practices.[2] This review strikes me as appropriate under any circumstance given the ongoing evolution of the economy. But it may be especially important now in a low interest rate environment given the real possibility of a future return to the zero lower bound. In the spirit of this review, I'll offer a few preliminary thoughts on the FOMC's inflation objective and policy strategies.

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[1] I would like to thank George Kahn for his assistance in preparing these remarks.

[2] Review of Monetary Policy Strategy, Tools, and Communications, https://www.federalreserve.gov/monetarypolicy/review-of-monetary-policy-strategy-tools-and-communications.htm. See also, Richard Clarida, "The Federal Reserve's Review of Its Monetary Policy Strategy, and Communication Practices, https://www.federalreserve.gov/newsevents/speech/clarida20190222a.htm.

Economic Outlook

I'll begin with a brief review of the economic outlook. Last year, the U.S. economy enjoyed robust growth boosted by accommodative monetary and fiscal policies. As the stimulus from these policies wanes, and global growth slows, I expect a deceleration this year toward the economy's longer-run growth trend of roughly 2 percent.

My outlook for continued, but somewhat more moderate growth, is tied to expectations that job gains, wage increases and consumer confidence will remain supportive of consumer spending. Although the monthly increase in payroll employment fell to just 20,000 last month, the previous two months were revised up and, averaging over the last three months, employment increased by a strong 186,000 jobs per month. Weaker aspects of the February jobs report suggest the unusually harsh winter weather negatively impacted construction employment and spending on entertainment. While I would expect to see a rebound in March, employment growth will likely slow to a rate more consistent with the net rate of entry into the labor force.

As the job market has tightened, labor compensation has steadily accelerated. Average hourly earnings have climbed from an annual rate of roughly 2½ percent last February to almost 3½ percent this February. And with low rates of inflation, workers are beginning to see significant real income gains. Real personal disposable income increased almost 4 percent last year on a twelve-month basis. Although consumer confidence has been buffeted by the government shutdown, financial market volatility, and a softening of employment growth in February, consumers continue to expect the economy to grow, albeit at a more moderate pace than last year. Moreover, given the relatively high personal saving rate (7.6 percent in December 2018), consumers have the wherewithal to maintain spending in the event of a temporary adverse shock.

Another reason I expect the economy to maintain its forward momentum in 2019 is that businesses have increased capital spending after the sharp slowdown in 2015-16. While I don't expect to see the same robust growth of business fixed investment that we saw last year, I do expect to see it make a positive contribution to overall growth. The waning of the fiscal stimulus, higher interest rates, and lower oil prices will all contribute to a slower pace of activity. Still, business optimism remains high, and the outlook for sales and profits over the medium term remains solid.

As always, there are risks to the outlook, and this generally positive outlook has several prominent downside risks. Tracking measures of first quarter growth appear to be weak, but could well reflect the influence of transitory factors such as the government shutdown, financial volatility, an unusually harsh winter, and heightened policy uncertainty. Over the medium term, I see the biggest risk coming from slower growth abroad, particularly in China, the euro area, and the United Kingdom. To the extent slower foreign growth and waning fiscal and monetary stimulus represent a stronger headwind than I am building into my baseline forecast, we could see somewhat slower growth. Right now the data are noisy, and we need more time and evidence to separate the signal from the noise.

Finally, the current outlook for inflation appears to be benign, and I consider the recent behavior of inflation to be broadly consistent with our price stability mandate.

Outlook for monetary policy

With the solid expansion experienced over the past few years and a generally positive outlook over the medium term, the Federal Reserve has been in a position to remove much of the policy accommodation that was put in place during the financial crisis and Great Recession. In addition to raising short-term rates 225 basis points, the Fed's balance sheet has been slowly shrinking as securities have matured. At its meeting last week, the FOMC noted it would conclude the reduction of its securities holdings by the end of September.[3] With high levels of employment and low inflation readings, the FOMC has judged it can be patient in determining whether it needs to take any further policy actions. I supported that decision.

Evaluating our inflation objective

Fostering a strong labor market while maintaining price stability is of course the core of the Federal Reserve's dual mandate from Congress. With the unemployment rate at a historically low level and inflation currently running just under the FOMC's objective, a longer-run policy issue is whether the persistent undershoot of our inflation objective is undermining its credibility and causing inflation to be anchored at too low a level. If inflation expectations fall persistently below 2 percent, the extent we could lower real interest rates by reducing our nominal target for the funds rate would be diminished. This could limit the accommodation we could provide if we were to return to the zero lower bound.

At the time the FOMC adopted its 2 percent inflation objective in 2012, monetary policy was highly accommodative, unconventional policy tools were being deployed, and inflation was running above 2 percent. Since then, inflation has run persistently below 2 percent. I have not viewed this as a major concern given that, aside from the effects of wide fluctuations in energy prices, inflation has remained low and relatively stable. Since 2012, core PCE inflation has fluctuated in a range of roughly 1½ to 2 percent, except during 2015 when a strong dollar pushed core inflation somewhat below 1½ percent

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[3] For information about the Committee's plans for the size of its securities holdings and the transition to the longer-run operating regime, see https://www.federalreserve.gov/monetarypolicy/policy-normalization.htm.

Should we be concerned about this low level of inflation? As I listen to business and community leaders around my region, I hear few complaints about inflation being too low. In fact, I am more likely to hear disbelief when I mention that inflation is as low as measured in a number of key sectors. I see this reaction to inflation as a good sign, and consider this performance consistent with the definition of price stability that Paul Volcker and Alan Greenspan preferred. Both of them judged price stability as an inflation rate that is sufficiently low [and stable] that it is not considered a key factor in the decisions of businesses or households.

Even so, I supported the FOMC's decision to adopt a 2 percent longer-run objective for inflation in 2012, and I support it today. I believe it has been effective in helping anchor longer-run inflation expectations. Arguably, though, adopting a point estimate instead of a range has placed considerable attention on a precise target and has exaggerated the precision with which monetary policy can achieve this particular numerical target.[4] It would seem reasonable that even somewhat persistent deviations from the objective, if they are limited to, say 50 basis points above or below the objective may be acceptable, depending on broader economic conditions.

I also support the idea that the objective should be symmetric so that deviations below and above the objective should be viewed as costly, taking into account deviations of employment from our employment objective. Consistent with the FOMC's "Statement on Longer-Run Goals and Monetary Policy Strategy," this suggests that when our objectives are not complementary, we follow a balanced approach in promoting them, taking into account the

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[4] Jon Faust and Eric Leeper describe the "disparate confounding dynamics" of inflation that makes it difficult to explain movements in inflation with a small number of "conventional summary statistics for headline aggregates" and "complicates the nature of appropriate monetary policy," in "The Myth of Normal: The Bumpy Story of Inflation and Monetary Policy," *Inflation Dynamics and Monetary Policy*, Federal Reserve Bank of Kansas City, Jackson Hole Economic Policy Symposium, August 2015, https://www.kansascityfed.org/~/media/files/publicat/sympos/2015/2015faust_leeper.pdf?la=en.

magnitude of the deviations and the potentially different time horizons over which employment and inflation are projected to return to mandate-consistent levels. In current circumstances, with an unemployment rate well below its projected longer-run level, I see little reason to be concerned about inflation running a bit below its longer-run objective. Moreover, I am not convinced that a slight undershoot of inflation below objective requires an offsetting overshoot of the objective. As I mentioned earlier, the current benign inflation outlook gives us the opportunity to test our assumptions about the degree of slack in the economy and the level of the natural rate of interest.

As we look ahead, however, there is a legitimate concern that monetary policy "space" could be limited in the next downturn because of the low level of interest rates.[5] This has led some to argue for a higher inflation target or the adoption of some kind of a price-level target. While I see little value in pursuing a higher inflation target given the credibility we have built over the last decade around 2 percent, evaluating alternative policy strategies is appropriate.[6] Some have promoted the use of a temporary price-level target that takes effect when the federal funds rate target hits the zero bound. Another approach might be an inflation target that is achieved on average over a fixed period of time or over the business cycle. In theory, a price-

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[5]Other government policies that focus on productivity growth and labor force participation might contribute to faster trend growth and a higher natural rate of interest, thereby providing additional monetary policy space. Moreover, the prospect of a future return to the zero lower bound suggests that, along with monetary policy, fiscal policies need to be on the menu of possible counter-cyclical options.

[6] Former Federal Reserve Chair Janet Yellen discussed possible monetary policy responses to a future recession, including the use of an aggressive policy rule for setting the funds rate in advance of hitting the zero lower bound (ZLB), and asset purchases and forward guidance at the ZLB in "The Federal Reserve's Monetary Policy Toolkit: Past, Present and Future," *Designing Resilient Monetary Policy Frameworks for the Future*, Federal Reserve Bank of Kansas City Economic Policy Symposium, August 2016. https://www.kansascityfed.org/~/media/files/publicat/sympos/2016/2016yellen.pdf?la=en. At the same symposium, Marvin Goodfriend discussed the use of negative nominal interest rates in "The Case for Unencumbering Interest Rate Policy at the Zero Bound." https://www.kansascityfed.org/~/media/files/publicat/sympos/2016/2016goodfriend.pdf?la=en.

level target that is fully credible could potentially smooth fluctuations in output and employment, especially at the zero lower bound.

While not pre-judging the potential efficacy of such strategies, I see both fundamental and practical issues to grapple with in moving to such regimes. What works in elegant economic models can have limitations and unintended consequences when put into practice. Fundamentally, an effective price-level target could substantially reduce uncertainty about the price level many years into the future and thereby help households and businesses make long-term plans and commitments. It also could increase the variability of, and uncertainty about, inflation over the medium term. This is because a price-level target would require policymakers to engineer an increase in inflation in response to the price level falling below its target path and engineer a decrease in inflation in response to the price level rising above the target path. These benefits and costs would need to be carefully weighed.

On a more practical level, there are a number of issues to be considered. First, in a price-level targeting regime, choosing the base period can make a big difference. For example, getting back to a 2 percent price-level path that was based in a year just prior to the Great Recession would require a much longer period of above 2-percent inflation than if the base year were set more recently. This is simply because the cumulative undershoot of the 2-percent price path would be so much greater under the earlier base period.

Second, given the difficulty over the last decade in getting inflation up to 2 percent on a sustained basis, it is not clear to me that adopting a price-level target would be any more effective than our current inflation target. And deliberately pushing inflation above 2 percent at a time when the unemployment rate is well below its presumed longer-run level could be costly. It would likely require a further overheating of the labor market with related misallocation of resources, along with increased uncertainty about the future inflation rate and price level.

Third, a price-level targeting strategy is time inconsistent unless policymakers can credibly commit to following it. If the goal is to have inflation of 2 percent on average, a period of below 2 percent inflation would require an equal period of inflation above 2 percent. But once inflation has moved up to 2 percent, policymakers might be tempted to renege on their prior commitment and not allow inflation to go higher. This would undermine the future credibility of the price-level targeting strategy. To the extent the public understood this time inconsistency problem, price-level targeting would not be credible to begin with, absent a commitment device. With regular turnover among members of the FOMC, it would be difficult for one Committee to commit a future Committee to a particular course of action.

Fourth, the timeframe for achieving an average inflation target would be difficult to determine and communicate. "Over the business cycle" is a vague timeframe since business cycles vary in length and recessions are notoriously difficult to predict. Given that U.S. inflation has been below target for seven years, would we need or want seven-plus years of inflation above 2 percent? At what point should bygones be bygones?

Finally, the Federal Reserve's most recent Monetary Policy Report to Congress contained a section on policy rules and systematic monetary policy. It provided an example of a price-level targeting rule that included the gap between the level of prices today and the level of prices that would be observed if inflation had been a constant at 2 percent from a specified starting year (1998). The prescription from that rule would have been to set the target funds rate at less than 1 percent at the end of last year. Of course, it is impossible to judge the counterfactual implications of maintaining the funds rate target at or below 1 percent throughout the recovery. I think it is fair to assume, however, that the potential to generate real and financial imbalances might be substantial, ultimately imposing an even higher cost to the economy than where we are today.

Conclusions

The economy's fundamentals are sound. Downside risks are notable however as my outlook calls for growth to slow to trend, with moderating job gains and low inflation. In these circumstances, monetary policy can take a wait-and-see approach.

Over the longer-run, with an evolving economy, prudent policymaking would suggest taking a look at our current policy strategies to see if they can be improved or refined, especially in light of the possibility of a future return to the zero lower bound. In doing so, we must be aware that what works in theory may have limitations and unintended consequences when adopted in practice. The Federal Reserve will explore these issues as part of its review of its monetary policy strategy, tools and communications practices this year.