A Long, Long Way to Go

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Any opinions expressed here are my own and do not necessarily reflect those of others on the Federal Open Market Committee.

Introduction

A much anticipated FOMC meeting

- The FOMC met amid heavy speculation this past Wednesday and Thursday.
- The Committee decided not to begin policy normalization at this time.
- Committee participants continue to expect normalization to commence shortly.
- Once normalization begins, policy will remain extremely accommodative through the medium term.

Reaction to the decision

- The market reaction to the decision seems to be that it created rather than reduced global macroeconomic uncertainty.
- The Financial Times headline this morning was, "Yellen Gives Investors a World of Worry."
- I argued against the decision at the FOMC meeting and I will lay out some of my views here.

Normalization is consistent with continued accommodation

Pressure on the decision to normalize

- The commentary around the decision to begin normalization has unfortunately taken on a binary tone over the summer.
- It is as if the Fed, upon making a single 25 basis point move, will suddenly be adopting a restrictive monetary policy.
- But this is far from the truth.
- Indeed the Committee has already committed to an exceptionally accommodative monetary policy over the next three years.

Press conference quote

- Chair Yellen at Thursday's press conference:
  - "The stance of monetary policy will likely remain highly accommodative for quite some time after the initial increase in the federal funds rate in order to support continued progress toward our objectives of maximum employment and 2 percent inflation."
- This has been the standard view of the Committee for many years.

Normalization is consistent with accommodation

- Analysts opposed to beginning normalization now tend to cite certain relatively minor but still-fragile aspects of the U.S. macroeconomic outlook.
  - These include inflation below target, a few aspects of labor market performance, and international concerns as the Committee statement mentioned this week.
- But the idea of normalization is entirely consistent with desires to address these concerns through continued policy accommodation.

It's all good

- In short, even during normalization the Fed's highly accommodative policy will be putting upward pressure on inflation, encouraging continued improvement in labor markets, and providing the best contribution to global growth that we can provide.
- I will now turn to the very strong case for normalization.

The strong case for normalization

The case for normalization

- The case for normalization is simple: The Committee's goals have essentially been met, but the Committee's policy settings remain stuck in emergency mode.

Committee goals essentially met

- The Committee wants unemployment at its long-run level and inflation of 2 percent.
- The Committee is about as close to meeting these objectives as it has ever been in the past 50 years.

Policy remains a long way from normal

- The Committee's policy settings are at emergency levels.
- The Fed's balance sheet has ballooned to about $4.5 trillion.
  - The 2006 balance sheet was about $800 billion.
- The policy rate remains at about 13 basis points, where it has been for nearly seven years.
  - The Committee thinks the long-run level of the policy rate should be about 350 basis points.

No satisfactory answer

- Why do the Committee's policy settings remain so far from normal when the objectives have essentially been met?

- The Committee has not, in my view, provided a satisfactory answer to this question.

Prudent monetary policy

- A prudent monetary policy based on traditional central banking principles would begin normalizing the Committee's policy settings gradually, since the goals of policy have essentially been met.

Still extremely accommodative

- For those who still think more accommodation is needed—do not worry!
- Policy will remain exceptionally accommodative through the medium term no matter how the Committee proceeds.
- This means there will continue to be upward pressure on inflation and downward pressure on unemployment.

The argument in pictures

- This talk tells this story with pictures.

Committee objectives essentially met

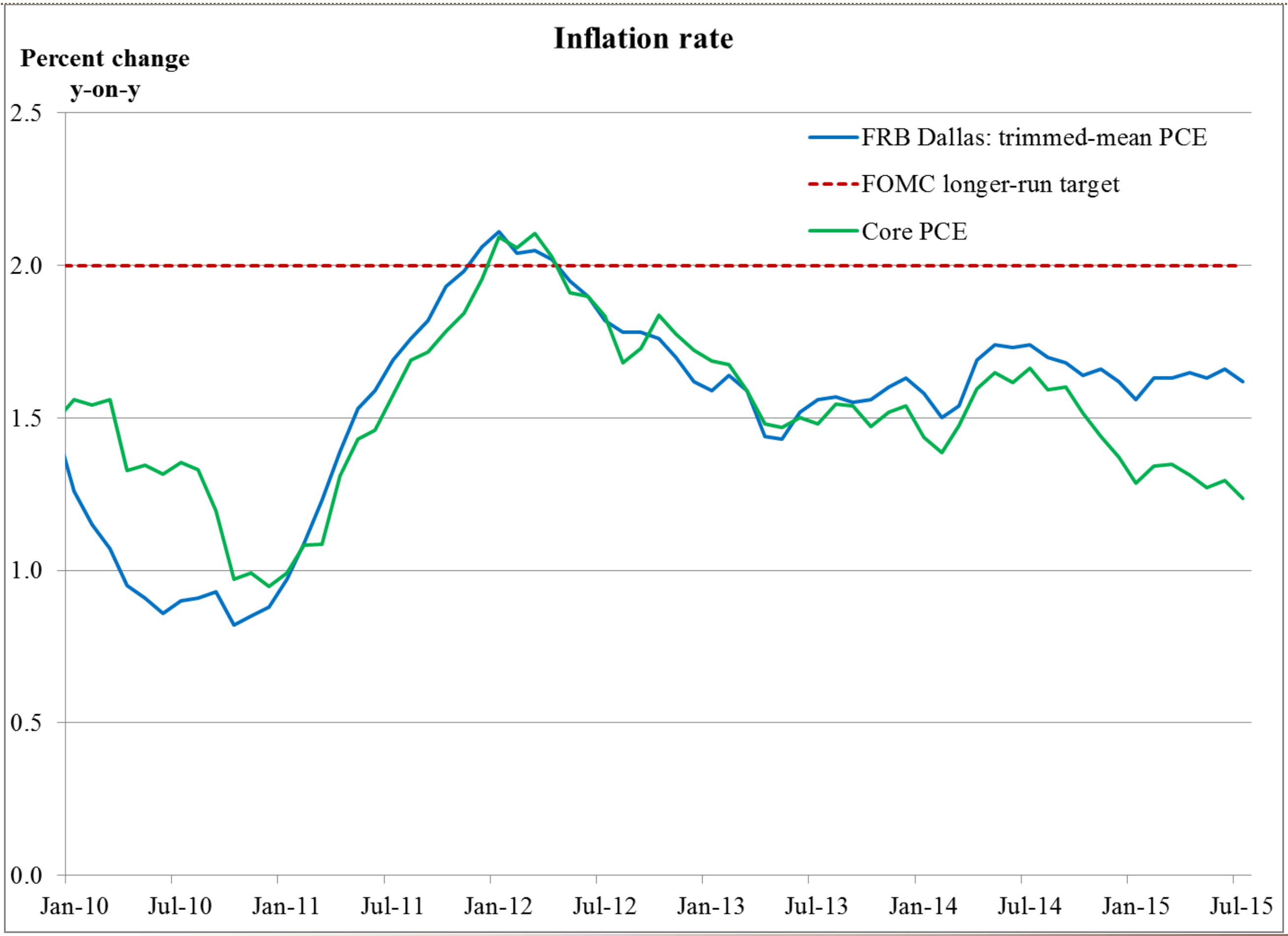
Committee objectives essentially met

- Again, the Committee wants unemployment at its long-run level and inflation of 2 percent.
- The Committee is about as close to meeting these objectives as it has ever been in the past 50 years.

Unemployment relative to Fed objective

Source: Bureau of Labor Statistics and Federal Reserve Board. Last observation: August 2015.

Inflation relative to Fed objective



Source: FRB Dallas. Last observation: July 2015.

How far is the Fed from its goals?

- The distance of the economy from the FOMC's goals can be measured with a simple objective function:

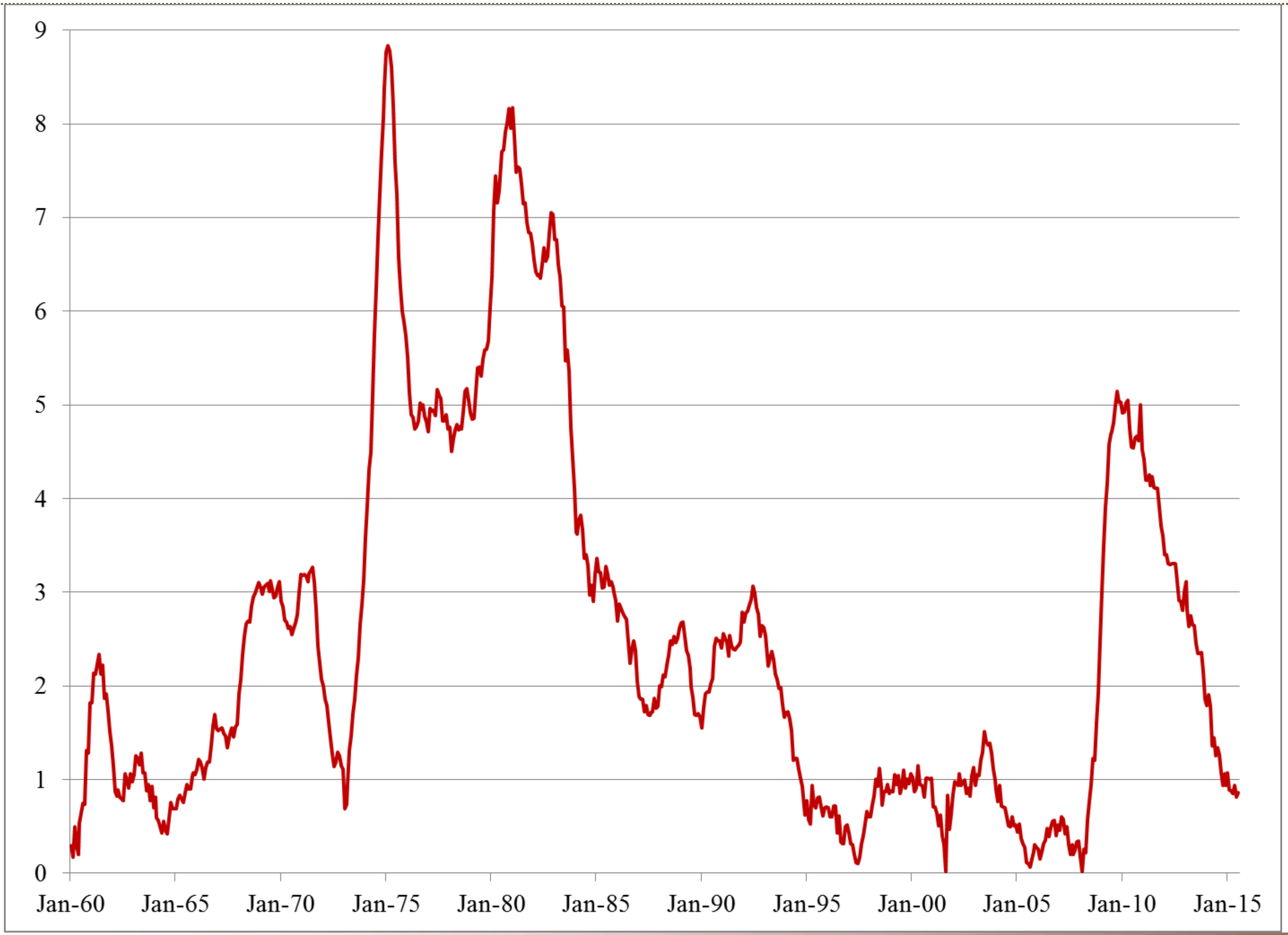
$$\text{Distance from goals} = (\pi - \pi^*)^2 + (u - u^*)^2.$$

  - π is inflation and π^* is the target rate of inflation, in percentage points.
  - u is the unemployment rate and u^* is the long-run average rate of unemployment.
- This version puts equal weight on inflation and unemployment and is sometimes used to evaluate various policy options.

Using the objective function

- Set $\pi^* = 2\%$, the FOMC's inflation target.
- For π I will use the year-over-year core PCE inflation rate.
- Set $u^* = 4.9\%$, the median longer-run value of the September FOMC Summary of Economic Projections.
- Take the square root of the objective function values for better scaling.
- Lower values are better.
- How far away is the FOMC from its goals?

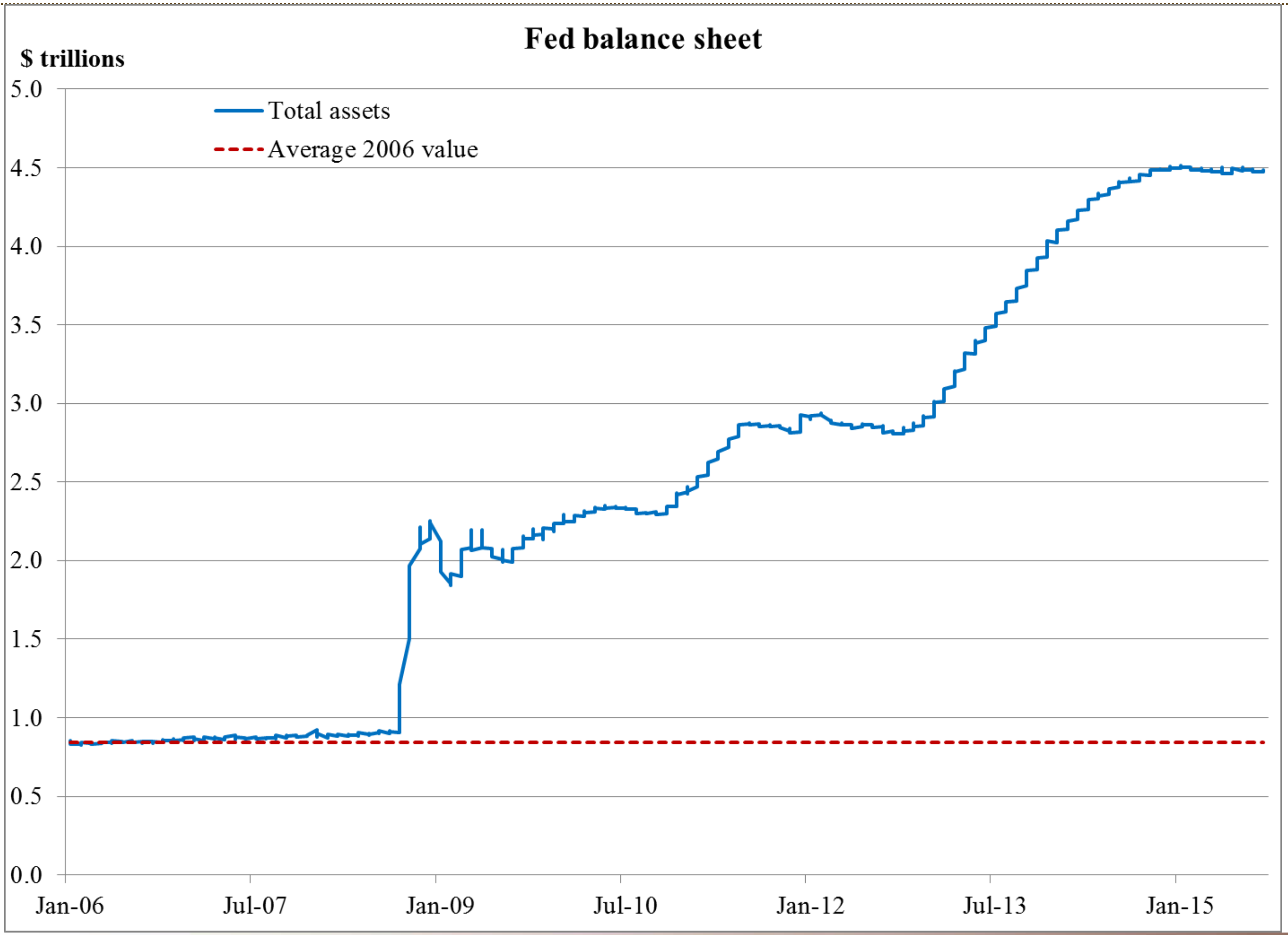
Square root of objective function value since 1960



Source: Bureau of Economic Analysis, Bureau of Labor Statistics and author's calculations. Last observation: July 2015.

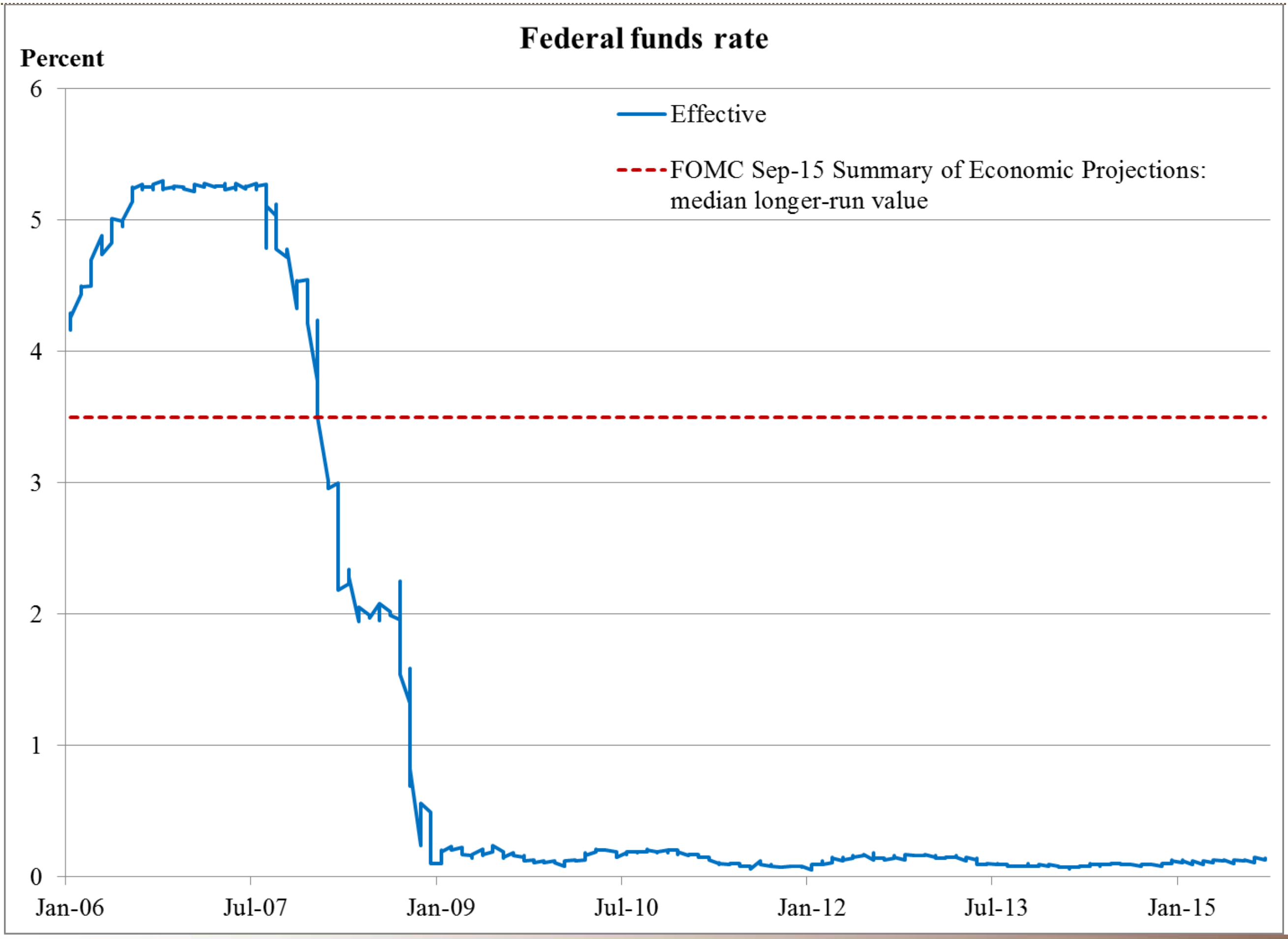
Policy settings far from normal

Fed balance sheet



Source: Federal Reserve Board. Last observation: week of September 16, 2015.

Fed policy rate



Source: Federal Reserve Board. Last observation: week of September 9, 2015.

A long, long way to go

- With the balance sheet exceptionally large and the policy rate exceptionally low, there is little chance monetary policy will be restrictive any time soon.
- The Committee currently expects the policy rate to approach a long-run normal level several years from now.
- To actually implement what would traditionally be viewed as a restrictive monetary policy—one that would put downward pressure on inflation—the policy rate would have to exceed the long-run normal level.
- That is not happening for many years.

Prudent monetary policy

Prudent monetary policy

- A prudent monetary policy based on traditional central banking principles would begin to return policy settings to normal levels over the medium term.
- Advantages:
  - Policy settings return to historical norms.
  - Policy accommodation still provided during the transition.

Conclusions

Conclusions

- A large majority of the FOMC projects that policy normalization will commence this year.
- The case for policy normalization is quite strong, since Committee objectives have essentially been met.
- Monetary policy will remain exceptionally accommodative, putting upward pressure on inflation and downward pressure on unemployment, even as policy settings are gradually normalized.

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