

Federal Reserve Bank of Cleveland

A Perspective on Monetary Policy

by Sandra Pianalto

Since I became president of the Federal Reserve Bank of Cleveland two years ago, I have made a point of getting out to various communities within our region on a regular basis to talk with business people—to hear what’s on their minds and where they think the regional economy is heading. It is important to bring that regional input with me in my role as national monetary policymaker.

I have just completed my second year on the Federal Open Market Committee, or FOMC, which is the Federal Reserve’s monetary policymaking group. We meet eight times a year in Washington, D.C. The voting members of the FOMC include the seven members of the Board of Governors of the Federal Reserve System, the president of the Federal Reserve Bank of New York, and four of the other eleven Reserve Bank presidents. All of the presidents participate in the policy discussions, but my voting responsibility on the FOMC alternates each year with the president of the Federal Reserve Bank of Chicago. In 2004, I had a vote, and this year Michael Moskow, the Chicago president, votes on FOMC policy actions.

And that brings me to what I would like to cover in my remarks to you today—a brief perspective on monetary policy. First, I will describe the FOMC’s goals in setting monetary policy. Next, I will talk about why we are moving the federal funds rate up from exceptionally low levels. Finally, I will explain why, as we adjust to a more normal economic environment, we need to pay close attention to the risks for higher inflation.

The views that I express today are mine alone. I do not presume to speak for any of my FOMC colleagues.

■ Monetary Policy Goals

Let me begin by telling you that conducting monetary policy is more complex than it might appear at first glance. Economic conditions can be unpredictable, so we need to find out which policy choices have the best chance of moving us toward our goals, given the changing environment around us.

Through the Federal Reserve Act, Congress has instructed the Federal Reserve to conduct monetary policy in support of the nation’s economic goals. Specifically, Congress requires the FOMC “to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates.” In our press releases, we refer to these requirements in shorthand as “price stability and sustainable growth.”

You will notice that there are no precise numerical definitions here. Even so, if we want to be successful in realizing these goals, we have to make them more concrete for operational purposes.

For the price stability goal, the FOMC tends to focus on the growth rate of the core Personal Consumption Expenditure price index, or PCE price index. The core PCE price index is a measure of average consumer prices, excluding the food and energy components, which tend to fluctuate quite a lot. It appears that the core PCE price index will come in at about 1½ percent for 2004, and most forecasters suggest that pace will continue in 2005. Inflation around 1½ percent, if sustained, appears close

This Commentary contains an insider’s view of the decisionmaking process followed by the monetary policymakers of the FOMC. In particular, Sandra Pianalto, president and CEO of the Federal Reserve Bank of Cleveland and a member of the FOMC, describes her take on the objectives, principles, and economic events that have played a role in the Committee’s decisions since last June, when it made the first of a series of interest rate increases. These remarks were originally made to the Association for Corporate Growth in Pittsburgh, Pennsylvania, on January 18, 2005.

to what several countries have chosen as their working definition of price stability.

For the sustainable growth goal, the approach is not quite as precise. The general idea is that monetary policy should do what it can to support the expansion of gross domestic product, or GDP, near its “potential.” The tricky part is that the economy’s potential growth rate can change over time. Some changes are temporary—such as when we have oil price shocks. But some changes are more permanent—for instance, when there are major upward shifts in productivity. These changes can make it difficult to measure potential GDP.

Although we have more than one goal, I believe that in the long run, maintaining price stability is the unique contribution that the Federal Reserve can make to

promoting maximum employment and moderate long-term interest rates. In many, if not most cases, this is true in the short run as well. The bottom line is that you cannot have maximum employment and moderate long-term interest rates without price stability.

■ Moving from Unusual Levels of Policy Accommodation

Now that I've discussed our goals, let me turn to the primary policy tool we use—the federal funds rate. When you boil down monetary policy, you find out that the Federal Reserve supplies the banking system with a highly liquid form of money, which banks hold as balances on deposit with us. Banks can buy and sell these funds in the money market, but since we control the supply, we essentially set the price. That price is the federal funds rate, the interest rate that banks pay for overnight funds.

By targeting a specific federal funds rate, the FOMC influences the level of other interest rates and the quantity of bank lending. Changes in the federal funds rate trigger a chain of events that affect other short-term interest rates, foreign exchange rates, long-term interest rates, and the amount of money and credit. Ultimately, interest rate changes affect a range of economic variables, including employment, output, and prices of goods and services.

Since last June, the FOMC has increased its target federal funds rate from an extremely low level of 1 percent to its current level of 2.25 percent. We have increased that rate by 25 basis points at each of our last five meetings, and the federal funds futures market shows a 95 percent probability that the FOMC will increase the federal funds rate target by another 25 basis points at our next meeting on February 2.

I'd like to give you a bit of history of how we got to the low level of 1 percent, and explain why the federal funds rate is trending up.

We had a brief and mild recession in 2001, followed by a slow and prolonged recovery period. By early 2003, the economy was being confronted by an unusual combination of forces: The nation was launching the war in Iraq, energy markets were volatile, and business confidence was low. At the same time, productivity growth stayed strong, adding to forces that were keeping infla-

tion at low levels. It almost seemed like a perfect storm of uncertainty in how economic conditions would unfold.

Soon, though, we had enough information to conclude that we faced a remote but unacceptable risk—the risk of “an unwelcome fall in inflation.” With interest rates already low and the economy struggling to regain its momentum, it seemed possible that short-term interest rates could fall to zero and that we could experience an outright *deflation*. This possibility was unprecedented in our recent experience. Economists may disagree about the potential effects of deflation on spending, production, and investment, but we know that actual deflations are rare and we think they are best avoided.

By June of 2003, the FOMC had cut the federal funds rate target to 1 percent—the lowest level it had reached since the late 1950s. We wanted to head off further disinflation. I think that by focusing on our price stability goal—in this case not letting the price level actually decline—our actions also promoted sustained economic growth.

We did not have the data to confirm it at the time, but it turns out that the economy had already begun to improve. It strengthened more in the second half of 2003. Employment growth remained sluggish, but investment spending jumped. In turn, market interest rates rose sharply, and did not retreat for the balance of the year.

The Committee still took a cautionary stance. Although we judged the probability of an unwelcome disinflation as fairly small by the end of 2003, we decided to keep the funds rate target low—or, as we stated in our press release, keep monetary policy accommodative—to support the ongoing economic expansion. Strong productivity growth provided some extra confidence that inflation would remain benign.

By the first half of 2004, the expansion seemed to be on firmer ground. Growth was solid, investment was largely holding up, and at long last employment growth appeared to be on the rebound. At the same time, we had to begin to consider the possibility that inflationary pressures could rise if monetary policy did not respond appropriately. After all, the deflation concern had now passed and our policy was still highly accom-

modative. So last June, we began moving the federal funds rate up.

It all boils down to changing economic circumstances. In 2003, the FOMC faced an unusual situation that caused us to adopt a highly accommodative policy—meaning that we wanted to provide plenty of liquidity at a low price. Since the middle of last year, we have been removing that accommodation gradually, causing an increase in short-term interest rates. How far will we go? That all depends on how the economy evolves.

■ Moving to a More Normal Environment

As the new year begins, I expect to find the economy growing on a more sustained path. The FOMC is adjusting to this more normal environment. I believe we are moving toward a more “neutral” monetary policy, one that is neither accommodative nor restrictive.

My way of thinking about neutral does not imply a particular numerical resting place for our policy target. I want to emphasize that our knowledge of the economy is not precise enough to encourage me to latch onto a specific number for the federal funds rate. If the economy strengthens further this year—and I hope it will—market interest rates are likely to rise as business and consumer confidence takes hold, and spending will increase along with growing production and employment. Under these circumstances, maintaining the same policy stance will probably mean that the federal funds rate will have to rise, too. In other words, interest rates can go up without changing the stance of monetary policy.

Of course, there are differences of opinion on how much rates will need to rise at any given time. Over time, central bankers have learned some important lessons—namely, that there is a lot of inertia in the inflation process, and that we cannot underestimate the possibility of inflation creeping in. And once an inflationary psychology takes hold, it can be difficult and costly to reverse.

I recognize that on the surface, some of the recent price statistics might seem to present little cause for alarm. For example, even though the overall PCE price index increased by 2.6 percent during the past 12 months, the core PCE price index increased by only 1.5 percent. As

I mentioned earlier, this is roughly consistent with a working definition of price stability. We also see few signs that labor costs are increasing significantly faster than productivity, a development that often can signal a step-up in inflationary pressures.

But in my opinion, the momentum in the inflationary process has clearly shifted away from disinflation. And, unfortunately, it is not always possible to distinguish short-term movements in the price indexes from the emergence of an inflationary trend until after the fact.

We know that as the expansion lengthens, and rates of resource utilization tighten, the demand for credit tends to increase, which pushes real interest rates up. This is just a normal cyclical phenomenon. In these circumstances, monetary policymakers have to anticipate the potential for inflation to creep up over time if the policy rate does not move up as well—in other words, if policy unintentionally becomes accommodative.

The minutes from our December FOMC meeting reflect this thinking. Even though we have been moving rates higher at a measured pace during the past six months, we still see signs that the current level of the real federal funds rate target remains below the level that is most likely needed to keep inflation stable and economic output at its potential.

Business cycle developments are not the only factors that can affect real interest rates. Looking ahead, I see the potential for additional pressures on market interest rates coming from two other sources. One variable is our federal budget deficit. It is too simplistic to claim that fiscal deficits necessarily lead to higher interest rates. The economic impact of any given deficit almost certainly depends on the spending and tax policies that give rise to the budget shortfall—the fine print beneath the red ink, as it were. But it would not be shocking to find that there might be some interest-rate pressure from this source, at least in the short run.

The foreign sector provides another potential source of real interest rate pressure. Capital flows from abroad have helped to hold market interest rates in check. Imports have been meeting domestic demand that would otherwise have to be satisfied out of U.S. production. If foreign sources for financing our consumption and investment shrink, then it would be logical to see greater upward pressures on interest rates in the financial markets, as long as overall economic growth remains solid.

Regardless of the source, upward pressure on real interest rates will change the stance of monetary policy unless our nominal monetary policy targets are adjusted higher as well. Recognizing how difficult it is to know when policy is truly neutral, I think it is prudent to move the federal funds rate up to a position that gives me more confidence that monetary policy is no longer accommodative. I would prefer this strategy to finding out the hard way—for example, through a deterioration in inflation expectations or in the inflation picture itself—that we had maintained an overly accommodative stance for too long.

■ Conclusion

I have explained why the federal funds rate is trending up and how the FOMC has kept its focus on our fundamental policy goals. Economic trends are notoriously difficult to predict, and there are always surprises. I know that during my two years as a member of the FOMC, I have seen more than a few twists and turns in the path. But in every sense, the Federal Reserve begins with the end in mind—to maintain price stability and promote sustainable economic growth.

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The views expressed here are those of the author and not necessarily those of the Federal Reserve Bank of Cleveland, the Board of Governors of the Federal Reserve System, or its staff.

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