Federal Reserve Bank of Cleveland

Economic Conditions and Monetary Policy

by Sandra Pianalto

As I am sure you are all very well aware, the Federal Reserve's policymaking body, the Federal Open Market Committee, or FOMC, will meet again at the end of June to consider the course of U.S. monetary policy.

Over the next couple of weeks, everyone involved with the FOMC will study a vast amount of data and many economic forecasts. During those same two weeks, we will also see a lot of speculation in the media and elsewhere about what the FOMC will do when it meets on June 28 and 29. Current economic conditions figure prominently into FOMC discussions and the making of monetary policy, and I would like to talk about how I am thinking about current economic conditions and monetary policy and explore how our economy's performance is influencing the Federal Reserve's monetary policy decisions.

Please note that the opinions I express here today are mine alone. I do not presume to speak for any of my colleagues in the Federal Reserve System.

How Monetary Policy Decisions Are Made at the Federal Reserve

Let me begin with a few words about how we operate at the Federal Reserve.When news reports talk about "the Fed," they are really talking about a combination of two entities: the seven-member Board of Governors based in Washington, D.C., and led by Chairman Ben Bernanke and the 12 Federal Reserve Banks around the country.

I lead the Federal Reserve Bank of Cleveland—the Fourth District in the 12-district system. The Fourth District includes all of Ohio, western Pennsylvania, eastern Kentucky, and the panhandle of West Virginia.

Like the 11 other Reserve Banks, the Federal Reserve Bank of Cleveland conducts research on economic conditions, supervises banks, provides financial services to banks and the U.S. Treasury; and serves as a resource for community economic development. And, yes, we also participate in conducting monetary policy—an area that has been dominating the headlines recently.

Monetary policy is conducted by the FOMC, which brings together the seven governors and 12 Reserve Bank presidents. We meet eight times a year in Washington, D.C.

Let me give you a quick run-through of a typical meeting. One of the first things we consider is projections for domestic and international economic conditions. These projections are developed by the economists at the Board of Governors and are contained in a document known as the Green Book. The projections are reviewed with the Committee, and we use this time on the agenda to raise questions about the projections and discuss issues associated with them.

Next, we discuss what we have been hearing from business leaders in our respective districts about international, national, and regional business conditions. In FOMC meetings, we have what we call a "go 'round." We literally go around the conference table, with each of the 19 members offering his or her viewpoint on economic conditions and the economic outlook.

In order to set monetary policy appropriately, policymakers need to assess current economic conditions, understand how the economy got where it is, and have a good idea of where it is heading. Because economic conditions are always in flux, good communications are important to successful policymaking. Communications can help the public appreciate policymakers' objectives, understand their thinking about the prospects for meeting those objectives, and consider how new information might affect policy choices. This *Commentary* was adapted from a speech given to the Broadcast Cable Financial Management Association on June 12, 2006, in Orlando, Florida.

After each member has spoken, it is time to consider policy options, which are outlined for the Committee members in advance in a document called the Blue Book. Then it is time for a second "go 'round," with members stating their views on which policy option should be adopted. If it is obvious that members generally agree, this "go 'round" can be fairly brief. Otherwise, a more in-depth discussion takes place.

When we feel that we have enough information to make a decision on monetary policy, we proceed with a vote. Then we publish a public statement about our decision, summarizing what we did and why. Three weeks later, we publish the minutes of our meeting.

ISSN 0428-1276

Today, market watchers are focused on what we will decide to do later this month with our main policy instrument—the target for the federal funds rate. The federal funds rate is the rate at which banks lend each other money overnight. Movements in this rate have a powerful, if indirect, effect on the interest rates that have an impact on you and other consumers—on loans for cars, home mortgages, and business finance.

The FOMC has a dual mandate: first, to maintain price stability over the long term, and, second, to promote maximum sustainable economic growth. Ultimately, we want the public to be confident that inflation will remain low and stable over time, and that the economy will continue to expand.

How Economic Performance Influences Monetary Policy

Now let me explain how we go about deciding where to set the target for the federal funds rate. Our national economy today is in reasonably good condition. But in order to set policy appropriately, we have to analyze not just where we are now, but also how we got here and where it looks like we're heading.

So, how did the current business cycle unfold, and how did the FOMC respond? The economic downturn that began in 2001 called for a significantly lower federal funds rate. In light of weakening economic growth, falling market interest rates, and a general increase in perceived risks in the global economic outlook, the FOMC reduced the federal funds rate from $6^{1}/_{2}$ percent to $1^{1}/_{4}$ percent by late 2002—a level that had not been seen since 1961.

In early 2003, in addition to maintaining an accommodative monetary policy to support the economic expansion, the FOMC also became concerned with the possible emergence of an unwelcome disinflation. In response, in June 2003, we lowered the federal funds rate one more time, to the historically low level of 1 percent.

Starting in mid-2004, as the threat of unwelcome disinflation passed and economic conditions began to normalize, it made sense to begin the process of removing our policy accommodation. We accomplished that by raising our target for the federal funds rate.

We did not know, at the time, how high we would have to raise the federal funds rate target. But we knew that the direction had to be considerably northwards. Step by step, in a series of 16 quarter-point adjustments, the FOMC has raised the federal funds rate to where it is today—5 percent.

Looking at the nation's current economic situation, do the data suggest that we have adjusted the federal funds rate appropriately? How are we doing in achieving our objectives of sustainable economic growth and price stability?

Let's start by looking at economic growth. After a weak fourth quarter in 2005, mainly due to significant energy-price shocks and devastating hurricanes, the economy bounced back quite strongly in the first quarter of this year. Looking ahead, most forecasters are expecting economic growth to be about 3 percent for the second half of this year and for 2007. These growth rates, while consistent with a healthy economy, are lower than what we experienced for most of 2004 and 2005.

The sectors of the economy that will support our economic growth this year are expected to be somewhat different from those that prevailed in the past few years. The housing market, after several years of strong expansion, is already showing signs of cooling off this year. Consumer sentiment has been deteriorating, according to the latest surveys, and recent data show signs that consumer spending is softening after its strong first-quarter performance.

Consumers have sustained their spending during the past several years, partly by cashing out some of their home-equity dollars. This extra source of financing is likely to slow down in a softening housing market. Fortunately, though, I expect to see enough employment and income growth coming out of the labor market to keep consumer spending advancing at a moderate rate.

On the business side, I look for capital spending to continue to expand at a decent pace again this year. Stronger economic growth abroad will also boost American exports. These two sectors—business spending and exports—are likely to mitigate the effects of a slowdown in the consumer and housing sectors.

In summary, as the year progresses, I anticipate that the pace of economic expansion will slow from its rapid rate of growth in the first quarter. Nevertheless, I believe that we are on track to achieve our objective of sustainable economic growth.

What about our objective of price stability? Inflation rates can be affected by all kinds of unusual events in the short term, especially large swings in energy prices. Of course, all of us are painfully aware of the huge increases we have seen in energy prices. We feel it every time we fill up our gas tanks. Americans are complaining that the energy-price increases have hit them hard—and they're right. The price of a barrel of oil has gone from about $20 in 2002 to roughly $70 today.

Price pressures are also being felt across an array of other commodities, goods, and services. As a result, the core rate of inflation has also been edging up lately. The Consumer Price Index has increased by 3.5 percent during the past year. The so-called core rate—that is, the CPI excluding food and energy—hasn't risen as much: It rose slightly more than 2 percent during the past year. But the core CPI has increased at an annualized rate of more than 3 percent during the past three months. This inflation picture, if sustained, exceeds my comfort level.

Fortunately, the public is, for the most part, looking at this disappointing inflation news as a transitory development. Measures of long-term inflation expectations have been mixed lately, but, on the whole, I regard them as remaining contained. The FOMC's challenge is to make sure that they stay contained.

The recent news on inflation troubles me, but the news has not come as a complete surprise. Last year I began to anticipate that we might confront some disappointing inflation data in the first half of this year, although I was not expecting quite as much inflation as we have seen. Still, I have been expecting price pressures to diminish.

This juncture in the policymaking process is the most difficult. There is, after all, a time lag between monetary-policy actions and their ultimate effect on inflation. That is, even though the recently reported inflation numbers have been edging upward, I think that the cur-

rent 5 percent level of the federal funds rate is near a point that is consistent with a gradual improvement in the inflation outlook.

Of course, my current inflation outlook depends on the rest of the economy developing along the lines of my broader forecast. Specifically, I expect a flattening-out of energy prices, a cooling housing market, continued strong productivity growth, and a moderation in the overall pace of economic activity.

Communications in Monetary Policy

By now, it should be clear that setting monetary policy consists of several forward-looking elements—forecasts, inflation expectations, and the lagged effects of current and recent policy actions, to name just a few. Communication also plays an important role in the entire enterprise of policymaking, especially in light of these forward-looking factors.

Our communication not only informs the public of our interest rate actions, but also provides a context for understanding why the actions were taken, and, more broadly, helps the public to form expectations about future economic and inflation conditions. For the FOMC to anchor the public's inflation expectations—which I have argued is essential to meeting our objectives of sustainable economic growth and price stability—our policy decisions and communications must give the public confidence that we will produce low inflation over the long run.

The FOMC does not have long experience with frequent and detailed monetary policy communications. The Committee only began its current practice of immediately announcing its policy decisions in 1994. In a previous speech, I characterized the period since then as one in which the FOMC started learning how to talk.

To me, that process is in some sense like a person learning how to walk through a dark room without knowing where the furniture is. You move very slowly, feeling your way. Sometimes you discover you're a bit off course. You may stumble, but you learn to adapt and move toward your destination. From my perspective, changes in the Committee's communications process since 1994 reflect an institution that is becoming more comfortable with greater transparency.

Let me give you an example of how our more recent communications have evolved. Recall the episode that I mentioned earlier in my remarks, about our concern over unwelcome disinflation in 2003 and early 2004. To address that particular problem, the Committee explained that it expected to maintain its low federal funds rate for a considerable period. This language guided market participants to expect no policy changes for a while.

As the threat of unwelcome disinflation passed, the language was gradually modified, eventually being replaced by language suggesting that the accommodative policy could be removed at a measured pace. This phrase signaled that the funds rate would rise, but that it would rise slowly and predictably.

That language was altered once again last December. Rather than repeating that accommodation could be removed at a measured pace, the Committee said that some further measured firming might be required. This change indicated, for the first time, that the Committee was focused on the risks of higher inflation. In January, the word "measured" was eliminated, signaling that the timing and magnitude of future actions would be less certain.

As our experience demonstrates, communicating to markets is complicated because incoming data can affect not only how we evaluate current economic conditions, but also our view of where the economy is heading. Also, FOMC members may not all interpret the data in the same way at the same time. Although differences of opinion lead to better policy decisions over time, they add to the challenge we face as a Committee in communicating with the public.

So what are financial markets expecting? Well, as you may know, there is a market that deals with federal funds futures, and at the moment, market participants place much higher odds on another 25-basis-point rate hike than on a pause at the FOMC's meeting later this month.

However, before the next FOMC meeting, more information on both prices and real economic activity will be available. Even if those numbers fail to change my outlook for inflation and economic growth, they may push my assessment of risks in one direction or another. New data, including statements from FOMC members, could also shift the odds that market participants place on the FOMC's upcoming decisions, in much the same way as they have during the past few weeks.

It is important to emphasize that a good communication policy does not mean that the public will always be able to anticipate what the FOMC will do next. Sometimes the economic situation is simply too fluid to admit such certainty.

What good communications can do is help people appreciate the Committee's objectives, understand how policymakers are thinking about the prospects for meeting those objectives, and consider how new information might affect policy choices.

Federal Reserve Bank of Cleveland
Research Department
P.O. Box 6387
Cleveland, OH 44101

Return Service Requested:
Please send corrected mailing label to the above address.

Material may be reprinted if the source is credited. Please send copies of reprinted material to the editor.

PRSRT STD
U.S. Postage Paid
Cleveland, OH
Permit No. 385

Sandra Pianalto is the president and chief executive officer of the Federal Reserve Bank of Cleveland.

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.

Economic Commentary *is published by the Research Department of the Federal Reserve Bank of Cleveland. To receive copies or to be placed on the mailing list, e-mail your request to* 4d.subscriptions@clev.frb.org *or fax it to* 216-579-3050. Economic Commentary *is also available at the Cleveland Fed's site on the World Wide Web:* www.clevelandfed.org/research.

We invite comments, questions, and suggestions. E-mail us at editor@clev.frb.org.