
A Cautious Approach to Monetary Policy Normalization

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The views expressed today are my own and not necessarily
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Introduction

Good morning. Thank you.

My comments today will be about the U.S. economy and current monetary policy challenges, with some specific thoughts on the housing market. But before I begin, I should note that my commentary reflects my own views and does not necessarily represent those of my colleagues on the Federal Open Market Committee (FOMC) or within the Federal Reserve System.

I really value the opportunity to speak to groups such as yours. Obviously, it provides me with a forum to communicate my views about monetary policy. I believe that clear communication is essential for the accountability, credibility and effectiveness of our policy decisions. But the occasion offers an additional opportunity. Your experiences and perspectives help me formulate my own thoughts about the economy and monetary policy. Therefore, I look forward with great interest to your questions and observations at the end of my remarks.

As a little background, at the end of each meeting the FOMC issues a statement that provides some context for its monetary policy decisions. In addition to providing commentary on developments since the last meeting, the statement offers guidance on how the Committee expects monetary policy to evolve. For example, in the most recent statement released just a few weeks ago, the Committee said that “in determining whether it will be appropriate to raise the target range at its next meeting, the Committee will assess progress — both realized and expected — toward its objectives of maximum employment and 2 percent inflation.”¹

Goals of Monetary Policy — Are We There Yet?

These objectives refer to the dual mandate Congress gave to us. More specifically, the Federal Reserve is charged with fostering financial conditions that achieve 1) stable prices and 2) maximum sustainable employment.

For the first goal, the inflation rate over the longer run is primarily determined by monetary policy. So the FOMC has the ability to specify a longer-run goal for inflation. Since January 2012, the Committee has set an explicit 2 percent inflation target as measured by the annual change in the Price Index for Personal Consumption Expenditures (PCE).²

For the second goal, quantifying the maximum sustainable level of employment is a much more complex undertaking. Many nonmonetary factors affect the structure and

¹ Federal Open Market Committee (2015a).

² This was first acknowledged in Federal Open Market Committee (2012). It remains in the most recent statement of our longer-run goals; see Federal Open Market Committee (2015c).

dynamics of the labor market. These factors can vary over time and are hard to measure. Consequently, the Committee does not set a fixed goal for employment, but instead considers a wide range of indicators to gauge maximum employment.

Nonetheless, FOMC participants provide their individual views of the longer-run normal level of unemployment that are consistent with the employment mandate. The median estimate among FOMC participants is currently 4.9 percent.³ My own assessment is in line with this projection.

Given these operational objectives, how close are we to achieving the goals of our dual mandate? There is no doubt that labor markets have improved significantly over the past seven years. Job growth has been quite solid for some time now. That includes last month's number, which was quite good. And today, at 5 percent, the unemployment rate is one half its peak in 2009. This is just a tenth of a percentage point above the median long-run projection. However, a number of other labor market indicators lead me to believe that there still remains some additional resource slack beyond what is indicated by the unemployment rate alone: Notably, 1) a large number of people who are employed part time would prefer a full-time job; 2) the labor force participation rate is quite low, even after accounting for demographic and other long-running trends; and 3) wage growth has been quite subdued.⁴ In sum, I don't think we're quite there yet, but we have made good progress toward meeting our employment mandate.

Housing, however, is one area where the recovery probably still has a good way to go. As I'm sure I don't need to remind this group, the housing market was hit particularly hard by the Great Recession. From their peak in early 2006 to their trough in 2011, house prices fell about 30 percent on average across the nation⁵. A home is the most important asset for many households, and as real estate values plummeted, so did household wealth. Over 5.5 million Americans lost their homes, many others ended up with underwater mortgages⁶. As a result, consumers found themselves in the difficult position of having to reduce other spending to build back lost wealth, with the obvious negative repercussions for the rest of the economy. While this wealth effect certainly wasn't the only factor contributing to the Great Recession, it certainly was an important one.

To support activity during and since the recession, the Fed has reduced the federal funds rate, our traditional policy instrument, as low as effectively possible. And we sought to provide additional accommodation through nontraditional means, such as our

³ Four times a year the FOMC releases its Summary of Economic Projections (SEP), which give participants' forecasts of key economic variables over the next three years and for the longer run. See Federal Open Market Committee (2015b) for the most recent projections.

⁴ See Evans (2014a, 2014b, 2014c, 2015a, 2015b, 2015c).

⁵ For instance, the CoreLogic National House Price Index declined 32 percent over this period and the S&P/Case Shiller National Home Price Index was down over 27 percent.

⁶ Based on staff calculations from data at <http://www.hopenow.com/industry-data/HopeNow.FullReport.Updated.pdf>.

large-scale asset purchase programs.⁷ But even as overall economic growth has recovered, progress in the housing market has been slow and uneven. Some areas of the country have seen real estate values rebound to levels exceeding previous highs. But improvement in other regions has been slower. For example, house values in the East North Central District — which includes Illinois, Indiana, Michigan, Ohio and Wisconsin — are currently still 3.5 percent below their previous high.⁸

Part of the impediment to the housing recovery has been the retrenchment of financial institutions from mortgage and construction lending during and after the crisis. For instance, according to the Federal Reserve's *Senior Loan Officer Opinion Survey on Bank Lending Practices*, banks tightened standards for mortgage loans to prime borrowers and maintained the tighter standards throughout the 2006 to 2012 period. For borrowers with less pristine credit histories, banks have started to ease standards somewhat only this year⁹. As a result, today — over six years into the recovery — mortgages are difficult to obtain or refinance for those without the best credit histories. Therefore, not everyone who would like to has been able to take advantage of those historically low interest rates.

Of course, housing demand is not just driven by financing opportunities. At its base, the demand for housing is determined by the number of households. And the rate of household formation has been truly low. To form a new household, people must have a sense of confidence that their employment is secure and their income is likely to grow. The Great Recession and subsequent weak recovery certainly weighed heavily on this confidence. Consider young adults between the ages of 20 and 24 years old — ages when many normally take the first steps toward forming their own households. In 2007, almost 75 percent of these 20 to 24 year olds were either working or actively searching for jobs. Today that number is around 70 percent.¹⁰ You can't expect those who have dropped out of the labor force to go live on their own or start a family.

That said, housing market conditions are improving. Although construction of single-family homes remains well below pre-recession levels, it has improved some. Moreover, the more affordable multifamily home sector has shown considerable growth. Further improvements in the labor market should make more and more people confident of their ability to form a new household and own a home. And there are signs of some freeing up of unusually tight credit in mortgage markets. So I anticipate that economic conditions will support continued gradual improvements in the housing market.

⁷ The Fed embarked on multiple rounds of asset purchases (or quantitative easing) — and used forward guidance — to reduce longer-term interest rates. For details, see Board of Governors of the Federal Reserve System (2015a, 2015b).

⁸ This is based on the Federal Housing Finance Agency's Purchase-Only house price data. For the nation as a whole, the index is 0.9 percent below its peak

⁹ For detailed results of the Senior Loan Officer Opinion Survey, see <http://www.federalreserve.gov/boarddocs/SnLoanSurvey/>.

¹⁰ Based on data reported by the Bureau of Labor Statistics' Current Population Survey. For additional information, see <http://data.bls.gov>.

What can I say about the outlook more generally? In the FOMC's latest forecast, my colleagues on the Committee projected that real gross domestic product (GDP) growth would run in the 2-1/4 to 2-1/2 percent range over the next year and a half or so. My personal view is closer to the upper end of that range. Most of us — myself included — also expect the unemployment rate to edge down further and even fall slightly below its long-run sustainable level by the end of next year.¹¹ I also anticipate the elements of extra labor-market slack that I just mentioned to dissipate over that time. So I see we are close to reaching our employment mandate.

However, I am far less confident about reaching our inflation goal within a reasonable time frame. Inflation has been too low for too long. Core PCE inflation — which strips out the volatile energy and food components and is a good indicator of underlying inflation trends — has averaged just 1.4 percent over the past seven years. Core PCE inflation over the past 12 months was just 1.3 percent. And inflation according to the total PCE Price Index — which does include food and energy prices — was just 0.2 percent over the past year.

Most FOMC participants expect inflation to rise steadily from these low levels, coming in just a shade under the Committee's 2 percent target by the end of 2017.¹² My own forecast is less sanguine. I expect core PCE inflation to undershoot 2 percent by a greater margin over the next two years than do my colleagues. I expect core PCE inflation to be just below 2 percent at the end of 2018.

A Risk-management Approach to Monetary Policy

So why do I lack confidence in our ability to achieve our 2 percent inflation target over the medium term? One reason is that there exist a number of important downside risks to the inflation outlook. Now I recognize that “medium term” is somewhat vague. To a central banker it can mean two to three years or three to four years. It is more a term of art than science.

So what are these inflation risks? With prospects of slower growth in China and other emerging market economies, low energy and import prices could exert downward pressure on inflation longer than most anticipate. That's a risk. In addition, while many survey-based measures of long-term inflation expectations have been relatively stable in recent years, we shouldn't take them as confirmation that our 2 percent target is assured. In fact, some survey measures of inflation expectations have ticked down in the past year and a half. Furthermore, measures of inflation compensation derived from financial markets have moved quite low in recent months. These could reflect either lower expectations of inflation or a heightened concern over the nature of the economic conditions that will be associated with low inflation. Adding to my unease is anecdotal

¹¹ According to the median forecast of latest SEP, the unemployment rate is projected to edge down further next year to 4.8 percent and to remain at that level through the end of 2018. The median forecast for real gross domestic product (GDP) growth is 2.1 percent for 2015. It rises to 2.3 percent in 2016 before gradually edging down to 2 percent (the longer-run estimate of real GDP growth) in 2018 (Federal Open Market Committee, 2015b).

¹² In the latest SEP, the median forecast for both core and total PCE inflation is 1.7 percent in 2016, 1.9 percent in 2017, and 2.0 percent in 2018 (Federal Open Market Committee, 2015b).

evidence: I talk to a wide range of business contacts, and virtually none of them are mentioning rising inflationary or cost pressures. No one is planning for higher inflation. My contacts just don't expect it.

How does this asymmetric assessment of risks to achieving the dual mandate goals influence my view of the most appropriate path for monetary policy over the next three years? It leads me to conclude that 1) a later liftoff and 2) a more gradual normalization of our monetary policy setting will best position the economy for the potential challenges ahead.

More specifically, before raising rates, I would like to have more confidence than I do today that inflation is indeed beginning to head higher. Given the current low level of core inflation, some evidence of true upward momentum in actual inflation is critical to this assessment. I believe that it could be well into next year before the headwinds from lower energy prices and the stronger dollar dissipate enough so that we begin to see some sustained upward movement in core inflation. After liftoff, I think it would be appropriate to raise the target interest rate very gradually. This would give us sufficient time to assess how the economy is adjusting to higher rates and the progress we are making toward our policy goals.

Overall, my view of appropriate policy is somewhat more accommodative than those held by the majority of my colleagues. In addition to economic and inflation forecasts, FOMC participants also submit individual assessments of the appropriate monetary policy supporting their forecasts. These policy judgments are summarized in the Federal Open Market Committee's well-known "dot plot."

Appropriate Pace of Policy Firming

Federal Funds Rate at Year-End
(percent)



Source: Interest rate projections are from the September 17, 2015 FOMC Summary of Economic Projections. Market expectations are from OIS futures as of November 6, 2015.

This is the chart that shows FOMC participants' views of the appropriate target federal funds rate by the end of each year for 2015 through 2018 and also over the longer run. Each participant's fed funds rate forecast is shown as a distinct dot at each of these time horizons. Let us focus for a moment on the median policy projection, highlighted with a red dot, for the end of 2015: Most of my colleagues think that it will be appropriate to raise the target federal funds rate sometime this year. Over the next three years, these projections envision a slow increase in the rate, to about 3-1/2 percent by the end of 2018.¹³ On average, this path is consistent with the target federal funds rate increasing by 25 basis points at every other FOMC meeting over the next three years. This is certainly a gradual path by historical standards. It is even slower than the so-called measured pace of increases over the 2004–06 tightening cycle, which was 25 basis points per meeting. In my view, though, an even more patient approach is warranted. Let me explain my thinking.

Historically, central bankers have established their credibility by defending their inflation target from above — to fight off undesirably high inflation. Today, policy needs to defend our inflation target from below. This is necessary to validate our claim that we aim to achieve our 2 percent inflation target in a symmetric fashion. Failure to do so may weaken the credibility of this claim. The public could begin to mistakenly believe that 2 percent inflation is a ceiling — and not a symmetric target. As a result, expectations for average inflation could fall, lessening the upward pull on actual inflation and making it even more difficult for us to achieve our 2 percent target.

Another factor underlying my thinking about policy is a consideration of policy mistakes we could make. One possibility is that we begin to raise rates only to learn that we have misjudged the strength of the economy or the upward tilt in inflation. In order to put the economy back on track, we would have to cut interest rates back to zero and possibly even resort to unconventional policy tools, such as more large-scale asset purchases. I think our multiple rounds of asset purchases were effective, but they clearly are a second-best alternative to traditional policy. This scenario is not merely hypothetical. Just consider the recent challenges experienced in Europe and Japan. Policymakers tried to raise rates that were near or at their lower bounds; but faced with faltering demand, they were forced to reverse course and deploy nontraditional tools more aggressively than before. And we all know the subsequent difficulties Europe and Japan have had in rekindling growth and inflation. So I see substantial costs to premature policy normalization.

An alternative potential policy mistake would be that sometime during the gradual policy normalization process, inflation begins to rise too quickly. Well, we have the experience and the appropriate tools to deal with such an outcome. Given how slowly underlying inflation would likely move up from the current low levels, we probably could keep inflation in check with only moderate increases in interest rates relative to current

¹³ Specifically, the median projected path for the target federal funds rate is 0.4 percent at the end of 2015; 1.4 percent at the end of 2016; 2.6 percent at the end of 2017; and 3.4 percent at the end of 2018. The median projection for the longer-run level of the federal funds rate is 3.5 percent (Federal Open Market Committee, 2015b).

forecasts. And given how gradual the projected rate increases are to start with, the concerns being voiced about the risks of rapid increases in policy rates if inflation were to pick up seem overblown to me. For example, we could raise the funds rate 100 basis points more than envisioned by the median participant's projection in a year simply by increasing rates 25 basis points at every meeting instead of at every other meeting — that's hardly a steep path of rate increases.

All told, I think the best policy is to take a very gradual approach to normalization. The outlook for economic growth and the health of the labor market continues to be good. But the outlook for inflation remains too low. A gradual path of normalization would balance both the various risks to my projections for the economy's most likely path and the costs that would be involved in mitigating those risks.

Now I would like to emphasize that while I favor a somewhat later liftoff than many of my colleagues, the precise timing for the first increase in the federal funds rate is less important to me than the path the funds rate will follow over the entire policy normalization process. After all, today's medium- and longer-term interest rates depend on market expectations of the entire path for future rates, not just the first move. In turn, these medium- and longer-term rates are key to the borrowing and spending decisions of households and businesses.

Accordingly, when thinking about the initial stages of normalization, I find it useful to focus on where I think the federal funds rate ought to be at the end of next year. And right now, given my economic outlook and assessment of risks, regardless of the exact date for liftoff, I think it could well be appropriate for the funds rate to still be under 1 percent at the end of 2016.

There is an important caveat, though, to my comment downplaying the importance of the exact date of liftoff. It is critically important to me that when we first raise rates the FOMC also strongly and effectively communicates its plan for a gradual path for future rate increases. If we do not, then market participants might construe an early liftoff as a signal that the Committee is less inclined to provide the degree of accommodation that I think is appropriate for the timely achievement of our dual mandate objectives. I would view this as an important policy error.

Effective Communication Is a Critical Policy Tool

I cannot stress enough how critical it is for monetary policymakers to effectively communicate how they aim to achieve their long-run goals and strategies. They must clearly describe how their views on the appropriate path for monetary policy will help generate outcomes for employment and inflation that are consistent with achieving the mandated goals within a reasonable time frame. Moreover, they must demonstrate they have appropriately considered the risks to their outlooks on the economy. I hope I have done that for you today by laying out my forecast for the economy and what I consider to be the appropriate path for policy.

We also need to be clear about how monetary policymakers will react to new data as the economy evolves. We talk a lot about data dependence, but what does that really mean? To me, it involves the following: 1) evaluating how the new information alters the outlook and the assessment of risks around that outlook and 2) adjusting my expected path for policy in a way that keeps us on course to achieve our dual mandate objectives in a timely manner. So, if in the coming months inflation rises more quickly than I currently anticipate and appears to be headed to undesirably high levels, then I would argue to tighten financial conditions sooner and more aggressively than I presently do. If instead inflation headwinds persist, I would advocate a more gradual approach to normalization than I currently envision. In either case, my policy forecasts would change and I would explain how and why they did.

Such communication helps clarify our reaction to new information — the so-called Fed reaction function you hear financial market analysts talk about. This in turn makes it easier for households and businesses to plan for the future. Such transparency is a key feature of goal-oriented, accountable monetary policy — the kind of policy that the Federal Reserve is committed to providing today and in the future.

Thank you.

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