The Next Phase of Monetary Policy

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The views expressed by the author are her own and do not necessarily reflect those of the Federal Reserve System, its governors, officers or representatives.

Good afternoon. I appreciate the opportunity to be here at the Central Exchange. The Federal Reserve Bank of Kansas City has enjoyed a long and productive relationship with this organization, and I applaud the Central Exchange's important contributions to supporting women in our community as it celebrates its 35th anniversary this year.

As the national economy continues to expand, the Federal Reserve has turned its attention to the issues associated with normalizing monetary policy after years of unprecedented accommodation. Preparing for the next phase of monetary policy has involved consideration of the mechanics for raising rates, clear principles supporting the normalization process, and now, the discussion about the appropriate timing of the first rate increase. In my remarks today, I'll offer my views on the economy's progress and the appropriate stance of monetary policy. I will close by offering some observations about recent calls for further transparency and accountability for the Federal Reserve.

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The economic outlook

The U.S. economy is expanding at an above-trend growth rate, which I expect to continue through the end of the year. A strong dollar and certain aspects of the foreign outlook pose some risks, but the economy appears well positioned to withstand such headwinds.

The economic outlook is positive for both consumers and businesses. Consumer confidence strengthened markedly in the second half of last year as gasoline prices declined and the labor market improved, and we have seen an increased willingness to spend on discretionary goods and services, such as restaurants and recreational activities. Household balance sheets continue to strengthen, which should support consumer spending. Meanwhile, businesses are reporting that it's a good time to expand, with industrial capacity utilization hitting its pre-recession rate and spending on research and development accelerating.

Importantly, this improved outlook for consumers and businesses suggests that momentum in the labor market will likely continue going forward. The economy added more than 3 million jobs in 2014, the highest level since 1999, and the rapid pace of job creation has continued into the beginning of 2015.

Along with this strong employment growth, we've seen significant improvement in the unemployment rate, which has fallen from 6.7 percent in December 2013 to 5.7 percent in January of this year. The current level is less than one-half percentage point away from what many view as the long-run normal rate. With more than 5 million job openings currently posted, there are now fewer than two unemployed people per job opening, down from nearly seven per job opening during the depths of the financial crisis. Evidence from the last business cycle indicates that as this balance tilts toward a tighter labor market, wage pressures are likely to increase.

Already, the rates at which people voluntary leave their jobs are increasing as employers look to recruit workers from other firms and workers look to increase their wages. For example, research by my staff shows that in the second half of 2014, individuals who switched jobs saw their wages increase more than 5 percent compared to what they earned in the prior quarter—a notable rise compared to a few years earlier. As more workers quit their jobs and seek out higher-paying employment, wage pressures are likely to broaden and further increase.

Of course, while these positive indicators are encouraging, the labor market is not completely back to normal. For example, the share of "long-term" unemployed and the number number of individuals working part-time for economic reasons remains elevated. These aspects of our labor market are concerning. As the economy continues to expand and the labor market tightens further, job opportunities should become more available for those who have had difficulty securing full-time employment.

To evaluate the health of the labor market in a way that takes into account both strong employment growth and job-finding challenges for many others, my staff developed an index of labor market conditions that includes a range of variables—something like a stock market index for the labor market. This approach shows that momentum in the labor market is near its highest rate in two decades. If momentum continues at this pace, the labor market will return to its average level of activity later this year. This does not mean that all labor markets indicators will be back to pre-crisis levels or even their historical average, but on a broad basis, the labor market will be close to what can be considered normal.

Typically, a growing economy and tightening labor market would be accompanied by rising inflation. That has not been the case recently. In terms of consumer price inflation, the Fed's preferred measure is running at 0.25 percent year-over-year—down from the 1.5 percent pace at the middle of last year. The recent sharp declines in oil prices are positive for economic growth, but lower energy prices are dampening headline measures of inflation. However, the impact of these transitory factors should fade later this year, particularly as oil prices stabilize.

Looking beyond these temporary factors, other important components of inflation are moving higher. Rental prices for housing have been strong, for example, and are likely to continue rising. The strength in the labor market I just mentioned is also likely to lead to more rapid wage gains. So while inflation is somewhat below the Fed's 2 percent goal, I am not overly concerned with this shortfall. Instead, I see current and forecasted inflation as generally consistent with price stability.

Against a backdrop of the ongoing economic expansion, a strengthening labor market and low but firming inflation, it is reasonable to contemplate a shift in the stance of monetary policy. Moving to the next phase of policy entails judgment on both the timing of the first rate increase and then the pace of future increases—issues that the Federal Open Market Committee will deliberate carefully.

The liftoff decision

The labor market, as I've highlighted, has experienced substantial improvement over the past year. But in earlier stages of the recovery, much of the emphasis was on a weak labor market as the driver of accommodative policy. For example, we implemented a number of bond-buying programs, commonly referred to as "QE 1, 2, and 3," held the federal funds rate near zero since the end of 2008, and relied on various iterations of "forward guidance" to signal our intentions that short-term rates would remain accommodative. Until March of last year, forward guidance for keeping short-term rates near zero hinged on a 6.5 percent unemployment rate threshold. In addition, the last large-scale asset purchase program was tied to achieving substantial improvement in the outlook for the labor market. This past October, we took the first steps towards normalization by ending the bond-buying programs.

Now with the economy approaching full employment, attention has turned to moving inflation back towards the 2 percent goal. Rather than focusing solely on either employment or inflation, policy needs to take a balanced approach, as is clearly codified in the Fed's Statement on Longer-Run Goals and Monetary Policy Strategy. The balanced approach suggests that temporary deviations of unemployment and inflation from their longer-run values do not necessarily warrant an extreme policy setting. Instead, the stance of policy needs to take into account the magnitudes of any deviations, as well as how long any deviation is expected to last. Currently, unemployment is not far from its longer-run level, and the lower rate of headline inflation is expected to be temporary. And as I've mentioned, monetary policy should look through temporary factors, such as the oil price decline, as long as there is reasonable confidence that inflation will be moving towards 2 percent within the forecast horizon and that longer-term inflation expectations remain stable.

This balanced approach framework supports taking steps to remove the extraordinary amount of monetary accommodation currently in place. The next phase in this process is to move the federal funds rate off its near-zero setting. While the FOMC has made no decisions about the timing of this action, I continue to support liftoff towards the middle of this year due to improvement in the labor market, expectations of firmer inflation, and the balance of risks over the medium and longer run.

Liftoff in the middle of this year, in my view, would be fully consistent with the FOMC's Statement on Goals and Monetary Policy Strategy, which reminds the public that "monetary policy actions tend to influence economic activity and prices with a lag." This means some time will pass before we can see the effects of interest rate decisions, so monetary policy must be forward-looking and act before the economy reaches full employment and 2 percent inflation. Waiting until economic conditions are nearly back to normal before raising rates may put policy behind the curve and require rates to rise rapidly in the future.

Another factor supporting liftoff in the near future is that many of the benchmarks policymakers use to assess the appropriate level of short-term rates indicate rates should be above zero. These benchmarks signal liftoff even after accounting for some possible changes in the economy, such as a slower trend rate of growth stemming from demographic change and a more modest pace of productivity growth.

After liftoff

Although considerable attention is now centered on the timing of raising rates, this step is only one of many in the policy normalization process. Every interest rate decision depends on how the economy unfolds, so simply deciding to make the first interest rate move by no means puts interest rate decisions on autopilot. At the same time, policymakers can't perpetually wait for just "one more data point," so actions often must be taken in anticipation of how economic conditions are expected to develop.

The FOMC will need to be forward-looking in determining the pace of removing accommodation. Unique to the extraordinary amount of monetary stimulus that exists today, it is important to emphasize these steps are a "removal of accommodation" and not "tightening." I see raising the federal funds rate off zero in the middle of this year as a step to normalize financial conditions alongside a strengthening economy, rather than an attempt to slow an overheating economy. The alternative of moving rates off zero much later, but raising them at a faster pace, risks disrupting financial market and sharply slowing economic activity. For that reason, I see more balanced risks under an approach that raises rates sooner, such as in the middle of this year, but at a gradual pace.

Conclusion

As the Federal Reserve contemplates its path to normalizing monetary policy, it does so at a time of tremendous public scrutiny. There are calls for more transparency and accountability related to its monetary policy and its supervision and regulation of large financial institutions. As a result, changes to Fed structure and governance are being contemplated by Congress.

To be sure, accountability and the public's scrutiny of the Federal Reserve are to be expected and appropriate. It is well understood that securing the public's trust and confidence depends on the central bank's ability to meet its mandates from Congress. But contemplated changes should be focused in a way that does not compromise the Federal Reserve's key strengths, including an independent FOMC and a decentralized structure. Broad-based representation, public oversight and the ability of policymakers to bring independent views to the table have been enduring features of the system and have proven to be a source of strength for the nation's central bank. It would be a mistake to alter that balance without thoughtful and careful consideration.