Monetary Policy Tactics and Strategy
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Thank you for that kind introduction, Don. It is a pleasure to be with this esteemed group today. This morning, I'd like to talk about monetary policy, but before I do, I need to note that, as always, the views I express are my own, and do not necessarily coincide with the views of my colleagues within the Federal Reserve. I'd like to talk about monetary policy from two different perspectives: tactics and strategy. These obviously are two pertinent aspects of any sustained planning or decision-making endeavor, whether it involves public policy or the private goals of businesses or households. By tactics, I mean the decisions we make and the actions we take on a day-to-day, month-to-month, or, in the case of the Federal Open Market Committee, twice-a-quarter basis. Our most visible tactical decision is our choice of the federal funds rate. You have probably noticed that I have disagreed with many of my colleagues on this tactical choice at recent meetings, and I will say a few words later on about why.

Tactics are in a sense reactive – for us, the choice of appropriate policy actions as economic conditions unfold. Strategy, on the other hand, is the more forward-looking part of a decision-making problem: The process by which you establish specific goals and objectives, and think through the types of actions – that is, tactical choices – that are likely to be required to move you toward your goal. A strategy doesn't pin down all of your actions in advance. Rather, a strategy guides your thinking about how to make tactical choices in response to incoming information in a way that is consistent with achievement of your long-run goals.

Tactics

In the first part of my remarks this morning, I would like to review the tactical situation facing U.S. monetary policymakers. To set the stage, let me start with the broader context. The U.S. economy currently is in a period of transition. In the three years leading up to the second quarter, real gross domestic product – our broadest measure of total economic activity – grew at a 3.75 percent annual rate. That's a very healthy growth rate to sustain over a number of years, and it significantly cut into the underutilization of labor resources that emerged during the recession earlier in this decade. Over 5 million new jobs were created over this period and the unemployment rate fell by a full 1.5 percentage points. Labor market conditions are fairly firm now, and the economy is transitioning to a period of growth at a rate consistent with job creation roughly matching the growth in the number of workers over time. Although there is some uncertainty about exactly how fast that is, it is probably somewhere around 3 percent per year, and it would probably involve creating roughly 100,000 jobs per month.

It would not be unusual for the transition to trend growth to be a little bumpy, however. That occurred back in 1995, for example. Growth in the first half of that year dipped below 1 percent at an annual rate before returning to a healthy pace that was sustained for the next five years. And this time around there is an obvious reason to expect growth to drop below average for a time, namely, the end of the housing boom. I'll offer a couple of observations about the boom itself before I talk about its aftermath.

First, the recent housing boom was very large by historical standards; a couple of numbers will help illustrate. In 2005 almost 2 million new homes were built in the U.S., which is about 50 percent more than the average number built each year in the 1990s. And last year the average price of a home sold in the U.S. rose 13 percent; versus an average increase of less than 3 percent per year back in the 1990s.

Second, it's important to remember that the recent housing market boom was driven by fundamental factors that were – and still are – quite favorable. Population continues to expand; for example, last year the number of households increased by one percent nationwide. Income is growing – so far this year, inflation-adjusted disposable income per person has increased at a 2.3 percent annual rate. Household net worth is 53 trillion dollars, which represents over five-and-a-half years of disposable personal income. The tax treatment of housing remains highly favorable. And finally, mortgage interest rates were extremely low for many years, and even now are quite reasonable by historical standards.

This multi-year surge in housing investment was bound to come to an end, as the demand for upgrades and first homes became satiated. In addition, the rise in mortgage interest rates since 2004 has helped dampen demand. In fact, it seems likely that much of the increase in interest rates was anticipated, and thus probably gave an extra boost to demand in 2005 as consumers took advantage of what they saw then as the waning days of lower mortgage rates. A return to more normal housing market conditions is well under way. New home sales are down about 20 percent from last year's peak, and housing starts have fallen by a similar magnitude. The rate of price appreciation has fallen substantially as well, to the point that average prices were lower in September than they were a year earlier, although data on average sale prices are distorted by changes in the composition of sales.

Some further retrenchment seems likely in the months ahead, as housing market activity returns to a more sustainable level in which volume, inventories and time-on-market are closer to historical averages. This adjustment naturally involves a fair amount of uncertainty for market participants. Both buyers and sellers are probably more unsure than usual right now about where prices need to settle in order to clear markets. In the meantime, they are collectively engaged in a time-consuming process of discovering the prices at which expectations and plans of buyers and sellers are mutually consistent. But while there is substantial uncertainty about where the bottoming out will occur, I don't think a catastrophic collapse in housing activity is likely, since the fundamental determinants of housing demand that I listed earlier remain favorable – prospects for population and real income growth look good, net worth remains high, and after-tax mortgage interest rates are still historically low. In fact, tentative signs are emerging that housing markets may be stabilizing, although because housing data are notoriously choppy, one should treat month-to-month numbers with more than the usual amount of care right now.

Outside of housing, the rest of the economy is in reasonably good health. Business capital spending, for example, has been quite a bright spot in recent years. Since early 2003, business fixed investment has grown at over a 6.5 percent annual rate, and since the beginning of this year has grown at an 8.8 percent rate. This more than offset the 10 percent contraction in residential investment over the same time period. The fundamental underpinnings of near-term investment demand are encouraging as well. Profitability is high, capacity utilization has been steadily rising, and many firms see strong demand for their products. So I expect capital spending to continue to be a source of strength over the next several quarters.

Many economic analysts are concerned about the potential fallout of a weakening housing market on consumer spending. Could falling housing prices cause consumers to rein in spending? It's important to begin with fundamentals. While fluctuations in household wealth are capable of affecting spending at the margin, consumers' spending behavior is predominantly determined by their current and future income prospects. And those prospects are looking pretty good right now. With the unemployment rate at 4.6 percent**,** the labor market is looking fairly tight. Despite large increases in gasoline prices earlier this year, inflation-adjusted incomes have been rising, as I noted earlier. And now that we've seen some relief at the gas pump, it would not be surprising to see a modest pickup in real income growth in the next couple of months. The deceleration and fall in housing prices certainly has cut into household net worth to some extent, and consumer spending did decelerate at the beginning of this year. But so far, such wealth effects have been relatively limited – consumer spending rose a healthy 3.1 percent in the third quarter.

Taking all these considerations into account, I would look for consumer spending to continue to expand at a reasonably good pace even if housing prices come in weaker than expected.

The labor market is another widely-cited arena for potentially adverse spillover effects from the housing market. We have seen employment in the residential construction sector fall this year as residential building activity has declined. Fortunately, however, nonresidential construction is on an upswing – over the four quarters ending in September, investment in nonresidential structures rose over 13 percent in real terms. This has allowed many home construction workers to simply change construction jobs rather than become unemployed. Indeed, although in September residential construction employment had fallen by 54,000 since peaking in February, nonresidential construction employment was up by 95,000.

So the outlook for overall spending looks reasonably good: consumer spending is on track, and business investment is robust. The downturn in housing activity has and will subtract from headline GDP growth, but it is not likely to cancel out these sources of strength.

In contrast, the outlook for inflation is discomforting. Over the last two years, there have been several episodes in which energy prices have surged and pushed up the overall inflation rate. More troubling is the fact that we have seen significant increases in "core inflation" – the measure of inflation that strips out food and energy prices. According to our preferred index, the price index for personal consumption expenditures, core inflation ran close to 3 percent this past spring.

While core PCE inflation has settled down to around 2.25 percent, that is a rate that would be unacceptable on a sustained basis. Here is where tactics have to be driven by strategy. The Federal Reserve's strategic goal, as a central bank, is price stability. We are the only institution that can achieve this, and attaining and maintaining price stability is the best contribution we can make to maximizing economic growth.

I and several other members of the FOMC have expressed the view that our price stability objective is equivalent to a core PCE inflation rate in a band between 1 and 2 percent, that is, a band centered around 1.5 percent. You might think that price stability should mean inflation equal to zero, that is, prices not changing over time, on average, but there are known upward biases in our available price indexes, and targeting a band above zero is a way of taking those biases into account.

Core inflation has been above this 1 to 2 percent band for over two years now, since April 2004, and is running at 2.5 percent so far this year. The longer inflation remains elevated, the more difficult it will be to bring it back down. As people observe actual core inflation between 2.25 and 2.5 percent, and as they observe the FOMC's tactical reactions to those numbers, they form expectations regarding future inflation and those expectations become the basis for price setting in product and labor markets. (By the way, it was for his contributions to economic research on exactly this phenomenon that Professor Edmund Phelps was awarded the Nobel Prize in economics several weeks ago. Some of his cited work emphasized the extent to which the public's expectations will shift over time as they observe policymakers actual tactical choices.) The strategic issue here is that if the Fed allows inflation to remain above target for too long, inflation expectations could become tightly centered around the higher rate.

This danger is what prompted me to vote at recent FOMC meetings for tactics aimed at bringing inflation down more rapidly, and in a way that convinces the public of our strategic intent to keep inflation low and stable. Against this risk, one must weigh the risk that a further increase in the federal funds rate might exacerbate the housing-related slowdown. My assessment at recent meetings has been that the economy is resilient enough right now to withstand further policy tightening.

Strategy

There is another way for the public to learn about our intent, however, beyond simply observing our tactical choices. We can try to communicate more directly with the public about our monetary policy strategy. Households, businesses and financial market participants form their expectations about future inflation from several sources: past inflation experience, their understanding of the economic outlook, their observation of the Fed's monetary policy actions, and their beliefs about the Fed's inflation strategy. A key component of monetary policy strategy is our long-term goal for inflation – what the Fed would like to see as an average rate of inflation over long periods of time. While it is difficult to perfectly control inflation quarter to quarter, the Fed can pin down long-run average inflation very well.

Inflation targeting has been adopted by many other central banks: the European Central Bank and the central banks of the United Kingdom, Sweden and New Zealand, for example. There are many aspects of inflation targeting as it has been implemented abroad – inflation reports, consultations with Finance Ministers, supporting legislation, and so on. But the core feature of inflation targeting everywhere is communicating an explicit numerical inflation objective. So I think it makes sense to talk about inflation targets in the context of the broader subject of "communications" – how we as a central bank communicate about monetary policy.

I'd like to start by suggesting that we should not think of "conducting monetary policy" and "communicating about monetary policy" as two different things. It is certainly tempting to think of setting a target for a short-term interest rate and issuing policy statements as two separate acts that raise two separate sets of considerations. But modern monetary economics and common sense both tell us that the two are inseparable. People will always try to figure out what the central bank is going to do with its policy instrument in the future, no matter how much or how little the central bank actually says about these things. If the central bank says nothing, it still implicitly communicates via its actions, because people will always try to infer the central bank's future conduct from their current and past actions. In fact, modern monetary economics teaches that there is a very real sense in which "monetary policy is all about communication."

The logic behind this statement is not complex or arcane. First, money is intrinsically useless; it has value only for what it can purchase in the future. People accept money in exchange for valuable resources only because they expect others to accept it in exchange in the future. Therefore, the current value of money depends on the value people expect money to have in the future. So expected future inflation can give rise to inflation pressures today.

A corollary to this principle is that controlling current inflation requires controlling people's expectations for future inflation. This is the sense in which monetary policy is all about communications, because anything we do to shape people's perceptions and expectations amounts to communications, whether we're communicating by words or by deeds. The central implication here is the importance of managing and stabilizing the public's inflation expectations.

The history of the 1970s provides a vivid illustration. The Federal Reserve allowed inflation to rise during economic expansions and following oil price shocks. Expectations regarding future inflation subsequently rose as well, as the public observed our tolerance for rising inflation. This provided a further impetus to inflation, as those expectations influenced wage bargains, and price-setting by firms. A large part of the battle to reduce inflation in the 1980s and '90s was a battle to dampen the "inflation psychology" that had taken hold, that is, a battle to convince the public that we would achieve and maintain price stability. Over the course of those decades, we and other central bankers around the world learned another important lesson relating to communications: Namely, that words and subsequent deeds must ultimately be consistent.

The economic term for this principle is "time consistency," which simply means that your tactical choices have to be consistent with people's expectations of those choices over time. (By the way, the 2004 Nobel Prize in economics honored Professors Finn Kydland and Ed Prescott for their pioneering work applying exactly this principle to, among other things, monetary policy.) The more common term for this principle is "credibility," and a popular slang expression is "walking the talk." The 1970s again provide a vivid illustration: All throughout the 1970s, the Fed said it was against inflation, but our actions spoke differently and people came to believe our actions rather than our words. In the early 1980s, the battle to reduce inflation required costly policy actions to convince people of our intentions. It took time and effort to establish our credibility.

What does this mean for inflation targeting? If we adopt an inflation target, we will have to be sure that we back up our commitment with appropriate monetary policy actions. Otherwise, our target would just be viewed as "cheap talk." One way to appreciate the potential value of an explicit inflation target is to consider how it might have helped us cope with inflation dynamics over the last few years. On several occasions, usually in response to energy price shocks, questions have arisen about where inflation was headed, that is, about what inflation rate we were willing to tolerate. After Hurricane Katrina, for example, when retail gasoline prices rose above $3 a gallon, there was widespread speculation that the Fed would pause in order to protect growth rather than protect price stability. Measures of inflation expectations rose noticeably as a result. That speculation was off-base, though. Forceful public statements by Committee members tamped down those expectations, but core inflation did bump up for a time as firms were able to pass on energy price increases to buyers who may have been anticipating a broader upswing in inflation.

A similar episode occurred this past spring in response to another round of energy price increases. Inflation expectations rose, and were subsequently tamped down by Committee member communications, but not before another bulge in core inflation emerged, a bulge that has now only partly subsided. I take both these episodes as mini-inflation-scares. In both cases, and others as well in recent years, I believe some financial market volatility can fairly be attributed to public uncertainty about our intentions for inflation.

If we had had a credible inflation target in place, I believe that market reactions most likely would have been different. People would have known that we intended to return core inflation to our target. Maintaining the credibility of a target, however, would impose constraints on our tactical choices. If core inflation drifts substantially above target, I believe that the Committee would feel compelled to explain how long it was likely to take for inflation to return to target and to comment on the policy actions that would likely be required to get there. Moreover, if we see evidence that markets do not view our target as credible, we may feel compelled to take further policy actions to enhance our credibility.

There are differences of opinion among economists about short-run inflation dynamics, and about how fast the central bank should seek to return inflation to target. But there is virtual unanimity that the central bank can bring about any average inflation it likes over the horizon of a decade or more. Moreover, it is important to recognize that this is not the case with regard to real economic quantities such as output growth or the unemployment rate. The central bank can influence the path of output and employment over short horizons, but in the long-run, real economic variables are determined by the fundamental forces of productivity growth, population growth, labor force participation decisions, savings behavior, and the like. There is virtual unanimity that these are ultimately beyond the control of the central bank, and so to set an explicit objective for growth or employment would be a mistake.

I have talked about monetary policy tactics and strategy, and have touched on the interplay between the two. Tactical policy decisions should be guided by strategic objectives; this is an obvious and widely applicable principle. But in the case of monetary policy, the public's expectations regarding future tactical decisions play a crucial role in determining current outcomes, because inflation expectations play such a crucial role in determining current inflation. Without having credibly and explicitly communicated our strategic goals, tactical decision-making is more challenging than it needs to be. Policymakers are in that case forced to resort to policy actions – that is, funds rate changes – to influence the public's expectations. Accordingly, one factor contributing to my voting decisions at the last few FOMC meetings was a sense that inflation expectations were somewhat higher than would be consistent with my definition of price stability. As communications tools go, however, funds rate changes are relatively blunt. I believe, therefore, and I hope to have convinced you, that an explicit numerical objective for inflation would improve the effectiveness of both the strategy and tactics of monetary policy.