A Momentous Monetary Policy Decision

The Federal Reserve has signaled that it will begin raising short-term interest rates at its December 15 meeting. The Federal Open Market Committee (FOMC) has maintained its federal funds rate target close to zero for seven years, and it has frequently described the removal of monetary policy accommodation as “normalization.” Consequently, many will infer from this decision that the FOMC judges the economy to be sufficiently close to “normal” to warrant the onset of tightening. Nonetheless, current economic conditions are not consistent with this policy action, and starting the tightening process now would pose substantial risks to the Federal Reserve’s statutory goals of maximum employment and price stability.

Maximum Employment. U.S. employment remains well below its potential, according to the most recent assessment of the Congressional Budget Office (CBO). This shortfall is equivalent to about 3½ million full-time jobs. Consequently, even if nonfarm payrolls continue growing at a pace of 200,000 jobs per month, the employment gap will not be closed until 2017. As shown in the left panel of the chart above, CBO’s estimate of the output gap now stands at about 3 percent—roughly the same as the troughs of the previous two recessions in the early 1990s and the early 2000s. Indeed, in each of those instances the FOMC did not begin to tighten the stance of policy until its real-time assessments of the output gap were close to 1 percent. In effect, the CBO’s analysis underscores that the economy is not yet close to normal and that the onset of tightening is not warranted at this juncture.

Price stability. The Fed's inflation target of 2 percent is gauged in terms of the price index for personal consumption expenditures (PCE). This measure has been running around 0.2 percent over the past year, and its subdued level owes only partly to a steep decline in crude oil prices. As the chart above shows, even the rate of core PCE inflation—which excludes food and energy prices—has been trending downward since 2011 and now stands at 1.3 percent. The magnitude of the inflation shortfall is evident from other indicators as well. For example, trimmed mean PCE inflation (an indicator constructed by the


1 https://www.cbo.gov/publication/50724
Federal Reserve Bank of Dallas) is running at 1.7 percent, about three-fourths of a percentage point lower than its average level before the recession. As for the outlook, the Fed has regularly projected that core inflation would soon turn upward and converge back to its target. But as the chart above shows, those forecasts have consistently proven overly optimistic. The continuing appreciation of the U.S. dollar and falling global commodity prices make it plausible that the shortfall in core inflation will widen further in coming quarters.

The Current Stance of Policy. Federal Reserve staff recently concluded that the neutral level of short-term real interest rates (that is, adjusted for inflation) is now close to zero, with no signs of any incipient reversion to its historical average.2 Their analysis implies that the “new normal” level of the federal funds rate is only 2 percent, and hence the current degree of monetary accommodation is actually quite modest. Indeed, combining this estimate of the neutral real rate with CBO’s output gap assessment and the current rate of core PCE inflation, the Taylor Rule prescribes a negative setting for the federal funds rate, while the “balanced approach” benchmark advocated by Yellen (2012) calls for an even more accommodative monetary policy stance.

The Balance of Risks. The FOMC has characterized the current trajectory for private domestic spending as “solid” and the risks to the economic outlook as “nearly balanced.” Recent economic readings, however, seem notably less sanguine. Consumer spending barely budged in September and October, while shipments of nondefense capital goods (excluding aircraft) have been essentially flat since August. Consequently, the prospect that the economy is on the verge of overheating seems rather far-fetched, especially compared with the likelihood of scenarios involving a significant slowdown or contraction. Moreover, economic activity and inflation only respond gradually to changes in the stance of monetary policy. Thus, if Fed officials proceed along their projected policy path over the next few quarters, the federal funds rate may well be close to 1½ percent before they recognize that the policy tightening was premature. And the adverse consequences of such a policy mistake would be amplified by the likely constraints on providing any further monetary or fiscal stimulus. All of these considerations indicate that instead of starting to remove monetary accommodation, the Federal Reserve should maintain its current policy stance until the employment shortfall has declined further and core inflation is moving definitively back towards its target.

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