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Conceptual Pitfalls and Monetary Policy Errors

The Federal Reserve is on the verge of triggering the process of monetary policy tightening. In particular, a number of Fed officials have indicated that the Federal Open Market Committee (FOMC) is likely to start raising its federal funds rate target within the next few months—and perhaps as soon as its upcoming meeting next week. Unfortunately, the rationale for that policy judgment rests on faulty analytical assumptions about the labor market, inflation dynamics, the stance of monetary policy, and the balance of risks to the economic outlook. Consequently, initiating monetary tightening at this juncture would be a serious policy error.

The Magnitude of the Employment Gap. An accurate assessment of labor market slack is essential for both aspects of the Fed's dual mandate of fostering maximum employment and price stability. According to the minutes of the last FOMC meeting in late July, many members concluded that the current incidence of slack was modest and likely to be *"largely eliminated in the near term."* More recently, Fed officials have described the economy as *"close to full employment."* Such assessments rest on several problematic assumptions:

-- Some labor market indicators, such as initial jobless claims, have reverted to pre-recession levels, but those indicators largely reflect labor market functioning and the volatility of shocks and do *not* provide clear signals regarding the magnitude of labor market slack. By analogy, the various gauges for a car engine may give normal readings, but that provides practically no information about how much power may be needed for the car to climb up a very steep hill.

-- The conventional unemployment rate (U3) is now close to assessments of its longer-run normal level, but other dimensions of labor market slack remain elevated. In particular, U3 does not reflect the incidence of *hidden unemployment*, namely, about 2½ million Americans who are not actively searching for work but are likely to rejoin the labor force as the economy strengthens. Moreover, U3 does not incorporate the extent of *underemployment* (individuals working part-time who are unable to find a full-time job), which remains significantly higher than its pre-recession level. Thus, the "true" unemployment rate—including hidden unemployment and underemployment—currently stands at around 7¼ percent, and the total magnitude of the U.S. employment gap is equivalent to around 3½ million full-time jobs.

-- Nonfarm payrolls have been expanding at a solid pace, but that pace will need to be maintained for about two more years in order to close the employment gap. In particular, recent analysis indicates that the potential labor force is expanding by about 50,000 individuals per month due to demographic factors. Thus, if nonfarm payrolls continue rising steadily by about 200,000 jobs per month (the average pace over the past six months), then the employment gap will diminish next year and be eliminated in mid-2017. By contrast, a tightening of monetary conditions would cause the economic recovery to decelerate and the pace of payroll growth might well drop below 100,000 jobs per month, in which case the employment gap would barely shrink at all.

The Contours of the Inflation Outlook. The FOMC has established an inflation goal of 2 percent, as measured by the personal consumption expenditures (PCE) price index. Its recent communications have stated that the tightening process will commence once the FOMC is *"reasonably confident"* that inflation will move back to the 2 percent objective over the medium term. It seems unwise for such a crucial policy decision to place so much weight on the FOMC's inflation outlook and little or no weight on the observed path of wages and prices.

-- FOMC participants' inflation forecasts over the past few years have proven to be persistently overoptimistic (see figure 1). For example, in early 2013, when core PCE inflation was running at about 1½ percent, FOMC participants generally anticipated that it would rise to nearly 2 percent over the course of 2014 and 2015, whereas in fact it has declined to around 1.2 percent. Indeed, its underlying trend has been drifting steadily downward since the onset of the last recession.

-- Despite some recent suggestions to the contrary, there is a strong empirical linkage between the growth of nominal wages and the level of the employment gap. Moreover, as shown in my recent joint work with Danny Blanchflower, the wage curve exhibits some flattening at high levels of labor market slack, which explains why nominal wage growth has remained subdued over the past few years even as the employment gap has declined from its post-recession peak (see figure 2). This empirical pattern also implies that the pace of nominal wage growth is likely to pick up somewhat over coming quarters as the employment gap declines further.

Gauging the Stance of Monetary Policy. Fed officials have recently characterized the current stance of monetary policy as *"extremely accommodative."* Such characterizations may be helpful in motivating the onset of *"policy normalization"* but seem inconsistent with professional forecasters' assessments of the equilibrium real interest rate and with the implications of simple benchmark rules.

-- The distance between the current federal funds rate and its longer-run normal level depends crucially on the magnitude of the *equilibrium real interest rate*. Most FOMC participants have projected the longer-run normal rate to be about 3¾ percent, consistent with an equilibrium real rate only slightly lower than its historical average of about 2 percent. By contrast, over the past few years professional forecasters have made substantial downward revisions to their assessments of the "new normal" level of interest rates. For example, surveys conducted by the Philadelphia Fed indicate that professional forecasters expect short-term nominal interest rates to be around 2¾ percent in 2018 and to remain at that level on average over the next ten years, corresponding to an equilibrium real interest rate of only ¾ percent. Such revisions presumably reflect the downgrading of the outlook for potential output growth as well as prospects for headwinds to aggregate demand persisting well into the future. If professional forecasters' assessments are roughly correct, then the current funds rate is by no means extremely accommodative.

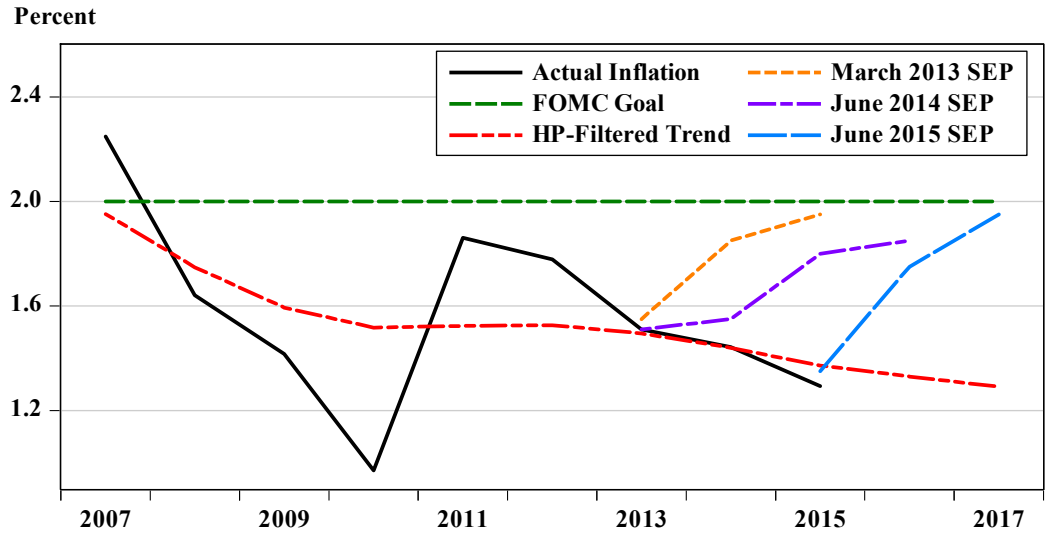
-- In June 2012, then-Vice Chair Yellen noted that *"simple rules provide a useful starting point for determining appropriate policy"* while emphasizing that such rules cannot be followed mechanically. That speech considered the Taylor (1993) rule along with an alternative rule analyzed by Taylor (1999) that Yellen described as *"more consistent with the FOMC's commitment to follow a balanced approach."* Thus, it is instructive to evaluate each of these simple rules using the current core PCE inflation rate (1.2 percent), the CBO's current assessment of the output gap (3.1 percent), and professional forecasters'

consensus estimate of the equilibrium real interest rate ($r^* = 0.75$). Using these values, the Taylor (1993) rule prescribes a funds rate of 0.1 percent, exactly in line with the FOMC's current target range of 0 to ¼ percent, and the Taylor (1999) rule prescribes a funds rate well below zero (-1.4 percent). Neither of these two benchmarks calls for a tighter stance of policy. Indeed, the "balanced approach" rule preferred by Yellen (2012) indicates that macroeconomic conditions will not warrant the initiation of monetary policy tightening until sometime next year.

Assessing the Balance of Risks. Over the past eighteen months, FOMC statements have regularly characterized the balance of risks to the economic outlook as *"nearly balanced."* Of course, that assessment has recently come into question due to a bout of financial market volatility in conjunction with shifting prospects for major foreign economies (most notably China). Regardless of how financial markets may evolve in the near term, however, it seems clear that the balance of risks remains far from symmetric. If the U.S. economy were to encounter a severe adverse shock within the next few years (whether economic, financial, or geopolitical in nature), would the FOMC have sufficient capacity to mitigate the negative consequences for economic activity and stem a downward drift of inflation? For example, if safe-haven flows caused a steep drop in Treasury yields along with a sharp widening of risk spreads, would a new round of QE still be feasible or effective? Alternatively, would the Federal Reserve implement measures to push short-term nominal rates below zero, as some other central banks have done recently? In the absence of satisfactory answers to such questions, it is essential for the FOMC to maintain a highly accommodative stance of monetary policy as long as needed to ensure that labor market slack is fully eliminated and that inflation moves back upward to its 2 percent goal. Such a strategy will help strengthen the resilience of the U.S. economy in facing any adverse shocks that may lie ahead.

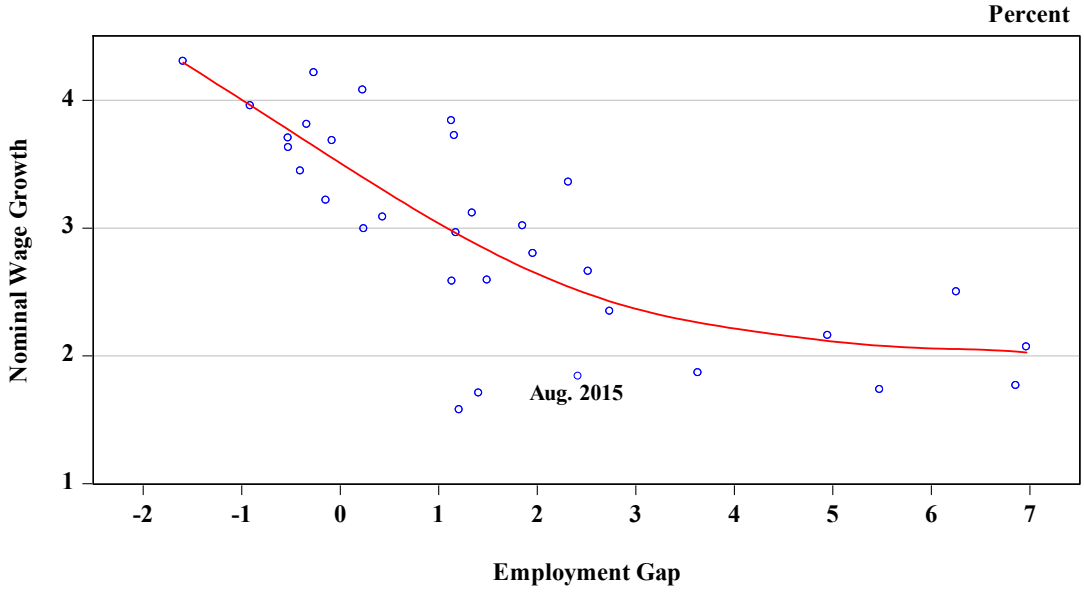
Concluding Remarks. The FOMC's near-term strategy has become so opaque that even the most seasoned analysts can only guess what policy decisions may be forthcoming at its upcoming meetings. Moreover, the FOMC has provided no information at all (apart from the phrase *"likely to be gradual"*) about how its policy stance will be adjusted over time in response to evolving macroeconomic conditions. Unfortunately, such opacity is likely to exacerbate economic and financial uncertainty and hinder the effectiveness of monetary policy in fostering the goals of maximum employment and price stability. Therefore, it is imperative for the FOMC to formulate a systematic monetary policy strategy and to explain that strategy clearly in its public communications.

Figure 1: The Recent Evolution of Core PCE Inflation



Note: In this figure, the core PCE inflation rate is given by the four-quarter average change in the PCE price index excluding food and energy, and the FOMC's outlook is given by the midpoint of the central tendency of core PCE inflation projections, as published in the FOMC Summary of Economic Projections (SEP) at each specified date.

Figure 2: The Wage Curve



Note: In this figure, each dot denotes the pace of nominal wage growth (as measured by the 12-month change in the average hourly earnings of production and non-supervisory workers) and the average level of the employment gap (including hidden unemployment and underemployment) for each calendar year from 1985 to 2014 and for Aug. 2015 (the latest BLS employment report).