

Dean Croushore Blog about Monetary Policy

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Now Is the Time to Start the Normalization Process

The FOMC will meet on September 16 and 17, and will consider whether or not to raise its target interest rate for the first time since 2006. There is much concern in financial markets about this meeting and many people apparently care about the outcome. Speculation in the press suggests that the recent whipsawing of financial markets, combined with weaker-than-expected growth in China, might lead the Fed to postpone raising its target interest rate.

The internal debate at the FOMC meeting is likely to be intense. On the one side, many FOMC participants have been arguing for quite some time that the Fed needs to move interest rates away from zero because the extraordinary policy accommodation that has been in place since 2008 must come to an end. The normalization of policy must occur and those in favor of raising the target interest rate at the meeting will argue that the Fed needs to begin this long process right now. On the other side, FOMC participants who oppose raising the target interest rate will point to inflation being well below its 2% target and continued long-term unemployment and underemployment as reasons for the Fed to maintain accommodative policy with interest rates near zero.

Although there is much focus on this upcoming meeting in September, this particular decision will not turn out to be as important as the Fed's future decisions. At some point, interest rates must increase. What should really concern participants in financial markets is not whether the Fed begins to raise its target interest at this meeting or the one in October or the one in December, but rather how fast and how high interest rates rise over the next year or two. And no one, not even Fed Chair Janet Yellen, can tell anyone what the future path of interest rates will be. It all depends on the data, in terms of both economic strength (focus on GDP growth and employment growth) and inflation.

The main reason that the Fed has delayed raising its target interest rate for so long is that some of the key data have been coming in weaker than expected. GDP growth has continued to be mediocre, at best, while inflation is much lower than the Fed's 2% target. While the low level of inflation can be blamed in part on the decline in energy prices that has occurred in the past year, even when we exclude the volatile food and energy components of inflation it is still well below 2%. But labor markets are performing much better than expected, with the unemployment rate having fallen to 5.3%.

The key to understanding why many FOMC participants want to start to raise interest rates now comes from the lag between policy action and its impact. Monetary policy works with a long lag, which means that actions today have their largest impact on the economy in 6 to 9 months and have the greatest impact in inflation in 18 months. That means that the Fed is not looking primarily at what the economy looked like last month but rather what it will look like in the coming 2 years. And, given the strength in labor markets, many FOMC participants are fairly certain that faster GDP growth will follow. As GDP growth increases and the unemployment rate gets closer to a level consistent with what economists call the "natural rate of unemployment," inflation is likely to rise. What is frightening to many macroeconomists is that inflation has, in the past, begun to rise very rapidly when monetary policy has been accommodative and the economy has been growing strongly, as happened in the late 1960s and throughout much of the 1970s. What's more, the Fed's policy is much more accommodative now than it

was in the 1960s and 1970s. So, the Fed needs to be preemptive with policy and start to raise interest rates long before inflation begins to accelerate. If the Fed waits until inflation is above 2%, it will be much too late. Delayed action could lead to an inflation rate of 5% or even higher.

In sum, the Fed should ignore short-run distractions like the slowdown in China and volatile stock markets and raise its target interest rate at this meeting. But what will be more interesting than this meeting's outcome will be to see how high and how fast interest rates rise over the next 2 years. If the data remain weak, short-term interest rates may only rise a few percentage points. But if the economy begins to grow faster, inflation may rise above the Fed's 2% target, and then who knows how high the Fed will have to raise its target interest rate. The Fed would find it better to start on that process now, rather than later.