Box 2.1

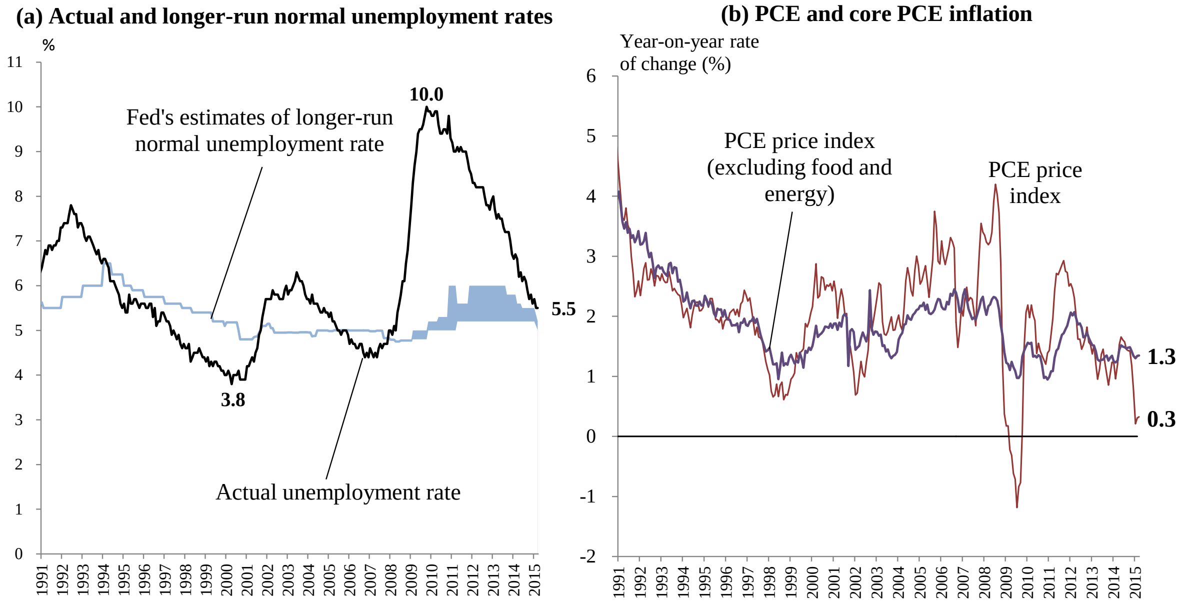
The US Federal Reserve's policy objectives and recent progress

The US Federal Reserve (Fed) is committed to the mandate of fostering maximum employment and price stability when setting monetary policy. As the pace of monetary policy normalisation in the US is widely perceived as a key source of uncertainty facing the global economy, this note reviews the recent performance as well as historical trends of the oft-cited major indicators related to the dual mandate.

Maximum employment is associated with a longer-run normal level of unemployment rate, also known as the non-accelerating inflation rate of unemployment (NAIRU). Such longer-run unemployment rate reflects the lowest level of unemployment to which the economy would converge, under appropriate monetary policy yielding stable prices. However, such a natural rate is hardly measurable directly and probably changes over time, subject to shifts in the composition of the labour force or other dynamics in the job market.

In the past, the Fed's estimates of the longer-run normal unemployment rates generally hovered between 5% and 6%. In March 2015, the estimates made by the Federal Open Market Committee (FOMC) members had a central tendency of 5.0-5.2%, down from 5.2-5.5% estimated in December 2014(1). The sustained job gains in recent years helped push the unemployment rate down successively from a peak of 10.0% in mid-2009 to 5.5% in March 2015. Based on such estimates of longer-run unemployment rates, the Fed seems to be close to fulfilling its maximum-employment objective ***(Chart 1a)***.

Chart 1 : Unemployment rate heading for longer-run level but inflation remained subdued



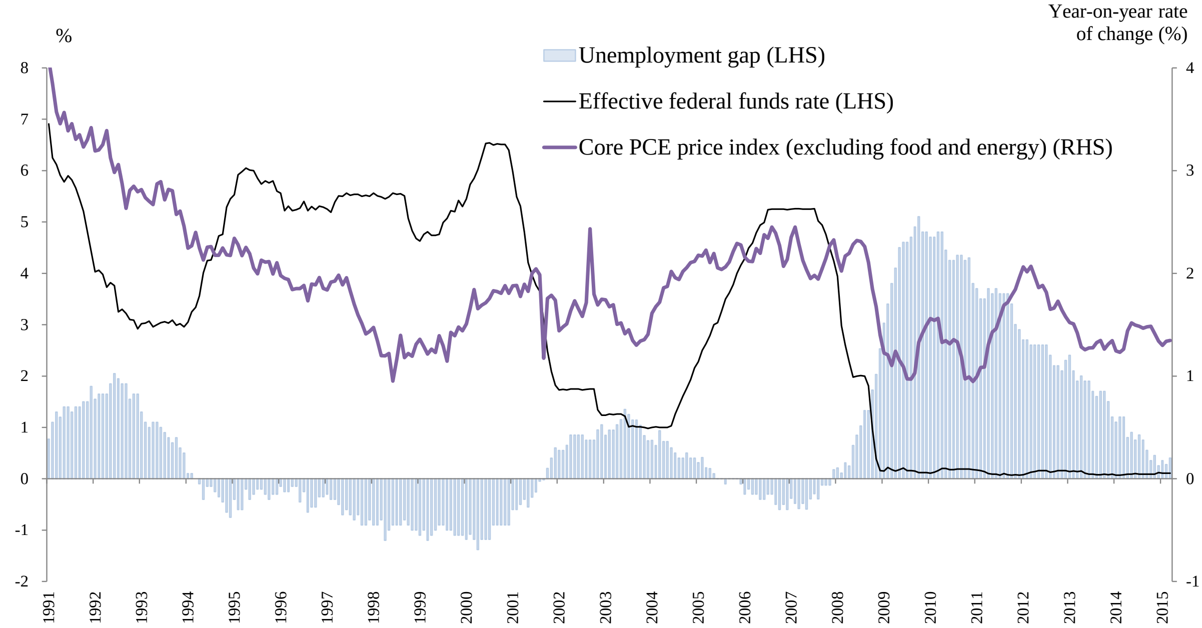
As to the inflation arm of the Fed's dual mandate, the steep fall in crude oil prices in the latter part of 2014 helped keep headline inflation at a very low level in recent months. The personal consumption expenditure (PCE) inflation, the preferred gauge by the Fed, held at a meagre year-on-year rate of 0.3% in March 2015. Excluding the volatile food and energy prices, the core PCE inflation was 1.3% ***(Chart 1b)***, still below the Fed's explicit target of 2%. In its recent policy statements, the Fed indicated that it would increase interest rates when it is "reasonably confident" that inflation would gradually move towards the target. This would be so if the labour market improves further and the transitory effects of lowered energy and other import prices dissipate.

(1) Since 2009, the FOMC published quarterly participants' longer-run forecasts of unemployment rate, real GDP growth and PCE inflation. The range of central tendency includes all projections but the three highest / lowest values. For data before 2009, Fed staff's estimates were used.

Box 2.1 (Cont'd)

Chart 2 juxtaposes the federal funds rates, core PCE inflation, and deviations of the actual unemployment rates from longer-run estimates (i.e. unemployment gap). Along with the sustained recovery from the recession of 2008-09, supported by a near-zero interest rate environment, the unemployment gap has almost been closed but inflation remained below-target in the recent periods. Such uneven progress complicated policymakers' judgment on the appropriate timing of removing policy accommodation. Whether the fall in unemployment rate would lead to higher inflation in the near term is still a question under discussion and debate. Indeed, in the mid-1990s, the actual unemployment rate stayed below the estimated longer-run normal unemployment rate for several years without any signs of accelerating inflation.

Chart 2 : Effective federal funds rate^, inflation, and unemployment gap since the 1990s



Note: (^) The effective federal funds rate is the weighted average of interest rates at which depository institutions trade federal funds (balances held at Fed Banks) with each other overnight. It is essentially market-determined but is influenced by the Fed through open market operations to reach the federal funds rate target.

Though the lesson from mid-1990s may suggest more room for a longer hold in raising interest rates, some research results attributed the observed dynamics between unemployment and inflation during the 1990s to such factors as greater trade openness, productivity growth and increased labour market efficiency. Thus the experience from that episode may not apply to the present day situation. To the Fed, proceeding the monetary policy normalisation too cautiously may lead to undesirable scenarios when rapid increases in interest rates were called for in face of a sharp upturn in inflationary pressures, which would agitate financial markets and dampen economic growth. Conversely, raising rates too hastily could dampen the hard-earned recovery. It may also lead to renewed rate cuts, thereby damaging the Fed's credibility.

Though at present market expectations are for an interest rate lift-off sometime this year, the Fed has reiterated that the path of monetary policy normalisation will be gradual and the assessment of progress towards its mandated objectives will remain data-dependent, based on various indicators on the job market and inflation pressures and expectations, as well as financial and international developments.

In sum, the onset and subsequent path of the US monetary policy normalisation, coupled with its divergence from the policy directions in other major economies, remains a key source of uncertainty facing the global economy, fuelling volatility in financial markets and capital fund flows. The recent moderation in economic indicators on various fronts in the US economy has also clouded the policy outlook further. We need to monitor these developments closely.