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U.S. Monetary Policy and International Implications

Remarks by

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at

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Thank you. It is a pleasure to be here. This morning I will first briefly review the U.S. and global economic outlook. I will then discuss the basic rationale underlying the Federal Reserve's recent policy decisions and place these actions in an international context.

U.S. and Global Outlook

The U.S. economy has faced significant headwinds, and, although the economy has been expanding since mid-2009, the pace of our recovery has been frustratingly slow. The headwinds include the effects of deleveraging by households, the still-weak U.S. housing market, tight credit conditions in some sectors, spillovers from the situation in Europe, fiscal contraction at all levels of government, and concerns about the medium-term U.S. fiscal outlook. In this environment, households and businesses have been quite cautious in increasing spending. Accordingly, the pace of economic growth has been insufficient to support significant improvement in the job market; indeed, the unemployment rate, at 7.8 percent, is well above what we judge to be its long-run normal level. With large and persistent margins of resource slack, U.S. inflation has generally been subdued despite periodic fluctuations in commodity prices. Consumer price inflation is running somewhat below the Federal Reserve's 2 percent longer-run objective, and survey- and market-based measures of longer-term inflation expectations have remained well anchored.

The global economic outlook also presents many challenges, as you know. Fiscal and financial strains have pushed Europe back into recession. Japan's economy is recovering from last year's tragic earthquake and tsunami, and it continues to struggle with deflation and persistent weak demand. And in the emerging market economies, the rapid snap-back from the global financial crisis has given way to slower growth in the face of weak export demand from the advanced economies. The soft tone of global activity is yet another headwind for the U.S. economy.

Looking ahead, economic projections of Federal Open Market Committee (FOMC) participants prepared for the Committee's September meeting called for the economic recovery to proceed at a moderate pace in coming quarters, with the unemployment rate declining only gradually. FOMC participants generally expected that inflation was likely to run at or below the Committee's inflation goal of 2 percent over the next few years. The Committee also judged that there were significant downside risks to this outlook, importantly including the potential for an intensification of strains in Europe and an associated slowing in global growth.

Federal Reserve's Recent Policy Actions

All of the Federal Reserve's monetary policy decisions are guided by our dual mandate to promote maximum employment and stable prices. With the disappointing progress in job markets and with inflation pressures remaining subdued, the FOMC has taken several important steps this year to provide additional policy accommodation. In January, the Committee noted that it anticipated that economic conditions were likely to warrant exceptionally low levels of the federal funds rate at least through late 2014--a year and a half later than in previous statements. In June, policymakers decided to continue through year-end the maturity extension program (MEP), under which the Federal Reserve purchases long-term Treasury securities and sells short-term ones to help depress long-term yields.

At its September meeting, with the data continuing to signal weak labor markets and no signs of significant inflation pressures, the FOMC decided to take several additional steps to provide policy accommodation. It extended the period over which it expects to maintain exceptionally low levels of the federal funds rate from late 2014 to mid-2015. Moreover, the Committee clarified that it expects to maintain a highly accommodative stance of monetary policy for a considerable period after the economic recovery strengthens. The FOMC coupled these changes in forward guidance with additional asset purchases, announcing that it will purchase agency mortgage-backed securities (MBS) at a pace of $40 billion per month, on top of the $45 billion in monthly purchases of long-term Treasury securities planned for the remainder of this year under the MEP. The FOMC also indicated that it would continue to purchase agency MBS, undertake additional asset purchases, and employ other tools as appropriate until the outlook for the labor market improves substantially in a context of price stability.

The open-ended nature of these new asset purchases, together with their explicit conditioning on improvements in labor market conditions, will provide the Committee with flexibility in responding to economic developments and instill greater public confidence that the Federal Reserve will take the actions necessary to foster a stronger economic recovery in a context of price stability. An easing in financial conditions and greater public confidence should help promote more rapid economic growth and faster job gains over coming quarters.

As I have said many times, however, monetary policy is not a panacea. Although we expect our policies to provide meaningful help to the economy, the most effective approach would combine a range of economic policies and tackle longer-term fiscal and structural issues as well as the near-term shortfall in aggregate demand. Moreover, we recognize that unconventional monetary policies come with possible risks and costs; accordingly, the Federal Reserve has generally employed a high hurdle for using these tools and carefully weighs the costs and benefits of any proposed policy action.

International Aspects of Federal Reserve Asset Purchases

Although the monetary accommodation we are providing is playing a critical role in supporting the U.S. economy, concerns have been raised about the spillover effects of our policies on our trading partners. In particular, some critics have argued that the Fed's asset purchases, and accommodative monetary policy more generally, encourage capital flows to emerging market economies. These capital flows are said to cause undesirable currency appreciation, too much liquidity leading to asset bubbles or inflation, or economic disruptions as capital inflows quickly give way to outflows.

I am sympathetic to the challenges faced by many economies in a world of volatile international capital flows. And, to be sure, highly accommodative monetary policies in the United States, as well as in other advanced economies, shift interest rate differentials in favor of emerging markets and thus probably contribute to private capital flows to these markets. I would argue, though, that it is not at all clear that accommodative policies in advanced economies impose net costs on emerging market economies, for several reasons.

First, the linkage between advanced-economy monetary policies and international capital flows is looser than is sometimes asserted. Even in normal times, differences in growth prospects among countries--and the resulting differences in expected returns--are the most important determinant of capital flows. The rebound in emerging market economies from the global financial crisis, even as the advanced economies remained weak, provided still greater encouragement to these flows. Another important determinant of capital flows is the appetite for risk by global investors. Over the past few years, swings in investor sentiment between "risk-on" and "risk-off," often in response to developments in Europe, have led to corresponding swings in capital flows. All told, recent research, including studies by the International Monetary Fund, does not support the view that advanced-economy monetary policies are the dominant factor behind emerging market capital flows.[1] Consistent with such findings, these flows have diminished in the past couple of years or so, even as monetary policies in advanced economies have continued to ease and longer-term interest rates in those economies have continued to decline.

Second, the effects of capital inflows, whatever their cause, on emerging market economies are not predetermined, but instead depend greatly on the choices made by policymakers in those economies. In some emerging markets, policymakers have chosen to systematically resist currency appreciation as a means of promoting exports and domestic growth. However, the perceived benefits of currency management inevitably come with costs, including reduced monetary independence and the consequent susceptibility to imported inflation. In other words, the perceived advantages of undervaluation and the problem of unwanted capital inflows must be understood as a package--you can't have one without the other.

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[1] See, for example, Atish R. Ghosh, Jun Kim, Mahvash S. Qureshi, and Juan Zalduendo (2012), "Surges," International Monetary Fund Working Paper WP/12/22 (Washington: IMF, January), www.imf.org/external/pubs/ft/wp/2012/wp1222.pdf; International Monetary Fund (2011), *Recent Experiences in Managing Capital Inflows--Cross-Cutting Themes and Possible Policy Framework* (Washington: IMF, February), www.imf.org/external/np/pp/eng/2011/021411a.pdf; and Kristin J. Forbes and Francis E. Warnock (forthcoming), "Capital Flow Waves: Surges, Stops, Flight, and Retrenchment," *Journal of International Economics*.

Of course, an alternative strategy--one consistent with classical principles of international adjustment--is to refrain from intervening in foreign exchange markets, thereby allowing the currency to rise and helping insulate the financial system from external pressures. Under a flexible exchange-rate regime, a fully independent monetary policy, together with fiscal policy as needed, would be available to help counteract any adverse effects of currency appreciation on growth. The resultant rebalancing from external to domestic demand would not only preserve near-term growth in the emerging market economies while supporting recovery in the advanced economies, it would redound to everyone's benefit in the long run by putting the global economy on a more stable and sustainable path.

Finally, any costs for emerging market economies of monetary easing in advanced economies should be set against the very real benefits of those policies. The slowing of growth in the emerging market economies this year in large part reflects their decelerating exports to the United States, Europe, and other advanced economies. Therefore, monetary easing that supports the recovery in the advanced economies should stimulate trade and boost growth in emerging market economies as well. In principle, depreciation of the dollar and other advanced-economy currencies could reduce (although not eliminate) the positive effect on trade and growth in emerging markets. However, since mid-2008, in fact, before the intensification of the financial crisis triggered wide swings in the dollar, the real multilateral value of the dollar has changed little, and it has fallen just a bit against the currencies of the emerging market economies.

Conclusion

To conclude, the Federal Reserve is providing additional monetary accommodation to achieve its dual mandate of maximum employment and price stability. This policy not only helps strengthen the U.S. economic recovery, but by boosting U.S. spending and growth, it has the effect of helping support the global economy as well. Assessments of the international impact of U.S. monetary policies should give appropriate weight to their beneficial effects on global growth and stability.