Monetary Policy in Challenging Times

Introduction
Communication is so important, especially in challenging times like these. And I am a strong proponent of communication - both listening to and sharing information. Communication is a critical part of my role as a member of the Federal Open Market Committee, or FOMC. Considering the extraordinary economic conditions of the past few years, I believe it is imperative that I not only listen to business and community leaders in my district and around the nation, but also that I actively share my views on the Federal Reserve's objectives and monetary policy actions. The conditions we have navigated in recent years have been unlike any we have faced in our lifetimes. Many of the actions the Federal Reserve has taken have been without precedent. I'll speak more on those in a few minutes.

I'm going to talk about three topics this afternoon. I'll begin with some background on the Federal Reserve and monetary policy. Next, I will briefly recap the major actions we've taken in response to the financial crisis. And I will wrap up with my economic outlook and my thoughts on monetary policy.

As always, the views I express are mine alone and do not necessarily reflect those of my colleagues in the Federal Reserve System.

The Federal Reserve and the FOMC
Let me start with a few comments about the Federal Reserve, which incidentally will commemorate its 100th anniversary in 2013. The Federal Reserve has many responsibilities, including supervising banks, providing payment services to banks, and providing banking services to the U.S. Treasury. But today, I will focus on our role in setting monetary policy for the nation. Through our monetary policy actions, the Federal Reserve influences the level of interest rates, which in turn affects the cost and availability of credit. As I will discuss later, we have worked very hard over the past few years to keep the cost of credit at very low levels to help the American economy recover and to encourage growth without spurring higher inflation.

Specific decisions and actions are taken by the Federal Reserve's policy-making committee -- the FOMC -- which includes the seven governors who are appointed by the President of the United States and confirmed by the Senate. In addition, the 12 Federal Reserve Bank presidents representing districts around the country, of which I am one, participate in the meetings. Five of the presidents cast votes, along with the governors, at any given meeting. The committee is currently chaired by Ben Bernanke. The FOMC meets eight times a year in Washington, DC, to review financial and economic conditions.
economic conditions and determine the appropriate monetary policy. We will meet again in about two weeks, on July 31 and August 1.

At each FOMC meeting, Chairman Bernanke, members of the Board of Governors, and the Federal Reserve Bank presidents convene around a large oval table, along with staff members who will be presenting at the meeting. The meetings begin with reports from staff on developments in financial markets and the outlook for both the domestic and international economies. Following the staff reports, each FOMC participant has the opportunity to present his or her economic outlook and information on the conditions in his or her region. Chairman Bernanke concludes the economic go-round with a summary of the participants’ views on the outlook and his own views. After this, the discussion of monetary policy begins, first with staff presenting alternatives for monetary policy, followed by each participant presenting his or her policy views. The meeting ends with a vote on the policy decision. I believe this process provides for diversity of input, encourages interaction, and leads to policy decisions that reflect the collective judgment of the Committee members.

The Fed’s Dual Mandate and Policy Formation by the FOMC

With that general background, let me now turn to how we actually arrive at monetary policy decisions at the end of the meeting. To guide us, Congress passed laws requiring the Federal Reserve to promote stable prices and maximum employment over time. We refer to these two objectives as our “dual mandate.” Put another way, we undertake monetary policy actions that promote stable prices and maximum employment.

It takes time for our monetary policy actions to affect the economy, so our policy decisions have to be forward-looking. And that is exactly why participants around the FOMC table bring their economic projections to the discussions. Of course, those projections are informed by what’s going on today in the domestic and international economies.

As I mentioned earlier, the Federal Reserve can influence the cost and availability of credit to keep the economy on a path that is consistent with our goals of stable prices and maximum employment. When we influence interest rates upward or downward, we tighten or ease monetary conditions. The FOMC typically conducts monetary policy by targeting the federal funds rate, which is the interest rate that banks pay one another for borrowing money overnight. Changes in the federal funds rate then filter through financial markets, affecting other interest rates and asset prices. When the Federal Reserve pursues an accommodative monetary policy, interest rates tend to decline, economic activity strengthens, and inflation tends to rise.

The remarkably unusual economic environment we are in today calls for a highly accommodative monetary policy, but it requires us to conduct monetary policy somewhat differently. So let’s turn now to the steps we have taken in response to the financial crisis.

Major Policy Actions Since the Crisis

Economic historians have criticized the Federal Reserve for not acting decisively and aggressively to reduce the severity of the Great Depression back in the 1930s. We learned from that experience, and I believe that, particularly in recent years, we have responded creatively and proactively to the extraordinary market conditions that began in 2008. Indeed, this time, the Federal Reserve has taken
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unprecedented steps to avoid another Great Depression, and we have continued to aggressively pursue policy actions designed to promote economic growth while maintaining stable prices.

The FOMC began to ease monetary conditions in September of 2007 by lowering the federal funds rate. By the end of 2008, we reduced the federal funds rate to nearly zero, and it has remained there ever since. Once the federal funds rate fell that low and could fall no lower, we resorted to nontraditional techniques to ease monetary conditions further. You might think of this as taking the back roads when the interstate is shut down: It may not be as efficient, but the new route can still get you to your destination. In our case, the new techniques included purchasing very large quantities of federally guaranteed mortgage securities and U.S. Treasury debt. The primary goal of these large-scale asset purchases is to directly push down longer-term interest rates -- thereby supporting the economic recovery.

The initial large-scale asset purchase program, which is commonly called “quantitative easing,” or “QE,” was announced in the midst of the financial crisis in 2008, and was part of a broader effort to stabilize financial markets and ease credit conditions. The program was expanded in March of 2009 to push down longer-term interest rates, especially in the mortgage market. The FOMC felt compelled to initiate a second “quantitative easing” program in November of 2010, when the outlook for growth declined sharply and deflationary pressures emerged. As a result of these programs, our balance sheet has expanded from about $900 billion before the financial crisis to nearly $3 trillion today. In addition, on two occasions, we adjusted the composition of our balance sheet by selling short-term Treasury securities and purchasing an equivalent amount of longer-term Treasury securities. We have also stepped up communications to the public about the future path of interest rates. Currently, the FOMC expects that economic conditions are likely to warrant exceptionally low levels for the federal funds rate at least through 2014. I believe that our highly accommodative monetary policy has, in fact, produced lower long-term interest rates, which in turn have induced more business investment and consumer spending, while supporting price stability.

Current Economic Outlook and Monetary Policy

Against that backdrop, let’s shift now to the present. I will finish today with my current economic outlook and views on monetary policy. Because of the very deep recession caused by the financial crisis, our recovery has been frustratingly slow. The economy is still struggling to gain traction, and remains in the grip of headwinds holding back stronger progress. A stronger expansion is going to require significant support from consumer spending and business investment, but both consumers and business executives are cautious. Many households remain focused on paying down their debt and are reluctant to make major purchases beyond the bare essentials. Moreover, household spending has been limited by very slow income growth during the past few years.

In the business sector, many companies have been able to record very solid profits, but they have done so by closely controlling costs and limiting their investments and hiring. Businesses, like households, are leery of expanding their debt to finance new projects. They have built large cash holdings as a precaution in uncertain times.

Uncertainty seems to be the watchword of the day, specifically uncertainty about Europe and uncertainty about U.S. fiscal policy.
Europe is a large export market for the United States, and its economic challenges present uncertainty for U.S. exporters - and consequently a risk to U.S. growth prospects. Many countries in Europe are unfortunately experiencing a recession right now, which is reducing the demand for U.S. exports into those countries. The European governments have taken significant steps on political and economic reforms, but more work remains to be done, and financial conditions in Europe remain fragile and volatile.

Then, we need to consider the short-term issues with U.S. fiscal policy. Major tax changes and spending cuts are scheduled to take effect next January. And, at nearly the same time, we are going to once again reach the federal debt ceiling, which could cause volatility in financial markets. There are reasons to think that these potential fiscal challenges are already taking their toll on our economy. Some business leaders I hear from have reported that they are preparing for lost revenue from their government contracts, and are taking proactive steps today to reduce their spending and hiring.

These are just a few of the factors I take into account in developing my economic outlook. When all is said and done, I am expecting growth to come in for 2012 just around 2 percent, and I would add that reaching this level of moderate growth is going to require some acceleration in growth in the second half of this year. With this GDP growth forecast, my outlook includes a very slow improvement in the jobless rate. Although I expect the pace of GDP growth to pick up gradually through 2014, I anticipate that unemployment will likely remain above 7 percent at the end of that year. That still would leave some distance from the 6 percent unemployment rate that I judge to be consistent with maximum employment for the U.S. economy these days.

So what about my outlook for inflation? For several years running, our highly accommodative monetary policy has prompted some observers to worry that a major inflation problem is just around the corner. That has not been the case over the past three years, as PCE (personal consumption expenditures) inflation has averaged just 1.7 percent. This is a bit below, but still close to, the 2 percent rate that the FOMC has designated as our inflation objective over the longer run. Given my outlook for slow economic growth and slow wage growth, I anticipate that core inflation will remain near 2 percent over the next few years.

My outlook is based on the highly accommodative monetary policy currently in place. Indeed, today's highly accommodative policy is necessary for the economy to make further progress on output and employment, and is consistent with the Committee's longer-run inflation objective.

Monetary policy should do what it can to support the recovery; however, there are limits to what monetary policy can accomplish. Monetary policy cannot directly control the unemployment rate; it can only foster conditions in financial markets that are conducive to growth and a lower unemployment rate. At times, significant obstacles can get in the way. U.S. monetary policy cannot solve Europe's fiscal and banking problems, nor can it put U.S. fiscal policy on a sustainable trajectory. As such, monetary policy cannot solve all of the economy's problems, especially in today's highly uncertain environment.

Nonetheless, if recent weak economic data persist and cause my outlook for economic growth and inflation to become weaker than I currently anticipate, additional policy actions could be warranted. As I mentioned earlier, in 2010, when I supported our second large-scale asset purchase program, there had been a sharp deterioration in the economic outlook and growing concerns about deflationary
pressures. The economic outlook is the primary input into our policy decisions, of course - but then, monetary policy options are also evaluated according to their costs and benefits. However, assessing these benefits and costs has been, and remains, challenging in today's unusual economic and policy environment.

Let me be more specific about the benefits and costs. By benefits, I mean the ability of our policy actions to move the economy closer to our goals of stable prices and maximum employment. By costs, I mean the potentially adverse effects that our policy actions might impose on financial markets and the economy.

I'll start with the benefits, using the example of our large-scale asset purchases. Large-scale asset purchases act to lower long-term interest rates, thereby promoting more private-sector borrowing to finance business investment and consumer spending. Corporate borrowing rates have fallen significantly during the past few years. Research studies strongly support the conclusion that our large-scale asset purchase programs have contributed to the decline in interest rates. Lower interest rates have helped business to restructure their balance sheets and free up cash for new investments. It took awhile after the recession ended, but business borrowing has begun to increase again. Households have restructured their balance sheets, too. Note that $4.1 trillion of home mortgages have been refinanced in the past four years. Such refinancing activity provides consumers more money to spend on other products and to pay down other debts.

Our large-scale asset purchases also have the benefit of pushing back against deflationary pressures that can emerge during periods of exceptional economic weakness. In doing so, quantitative easing programs can help keep inflation from falling persistently below our inflation objective.

So, there is no question in my mind that large-scale asset purchases can provide the benefits that are commonly attributed to them. But our experience with these programs is limited, justifying more analysis. For example, as the structure of interest rates has moved lower over time, it is possible that future large-scale asset purchase programs will yield somewhat smaller interest rate declines than past programs. A related issue to evaluate is whether further reductions in longer-term interest rates would stimulate economic activity to the same degree as they have in the past. One example of why interest rate changes might not follow history comes from bankers, who report that credit standards are still tight -- suggesting that further reductions in interest rates may not translate into as much borrowing and spending as would be the case in more normal times. These issues are well-known and receive regular attention in Committee discussions.

We are using large-scale asset purchases as a policy tool in an unusual financial and economic environment - one in which future benefits may be more muted. Nonetheless, if warranted, further asset purchases would have benefits.

Let me now turn to some of the potential costs. It is conceivable that, at some point, policies designed to promote further declines in rates could interfere with financial stability. Some financial institutions find themselves being challenged by the low-interest-rate environment and might take actions to remain profitable that could affect financial system risk. These are some of the financial stability issues we are monitoring and that have to be taken into account as we consider our policy options.

It is also conceivable that, at some point, the Federal Reserve's presence in certain securities markets would become so large that it
would distort market functioning. It would be helpful to have a better understanding of how large the Federal Reserve’s participation would have to be to cause a meaningful deterioration in securities market functioning, and of the potential costs of such deterioration for the economy as a whole. For me, these are important issues since the effectiveness of the quantitative easing approach requires that the asset purchases be of a “large scale”; the initial large-scale asset purchase program totaled $1.7 trillion and the second one amounted to $600 billion.

The bottom line is this: The FOMC’s large-scale asset purchase programs have been an important economic stabilizer and are supporting the expansion. But these programs may entail costs, and that is why the FOMC constantly reviews the costs and benefits of our policy actions.

Closing
In closing, I’d like to thank you once again for providing me with the opportunity to give you some background on the Federal Reserve, to explain how the FOMC operates, and to share my views on the economic outlook and monetary policy.

To recap, I expect the U.S. economy to continue to expand, supported by a highly accommodative monetary policy. My outlook calls for the pace of growth to pick up over the course of this year and into 2013 as the headwinds holding back the recovery gradually abate. I also expect inflation to remain close to 2 percent. If the expansion were to continue to lose momentum, and inflation threatened to run persistently below 2 percent, additional policy action could be warranted.

My outlook is subject to considerable uncertainty, since any number of better or worse scenarios could actually materialize. There is no substitute for constantly assessing incoming information, updating forecasts, and evaluating the costs and benefits of our policy options. As I have tried to describe today, that’s the principal role of the FOMC.