Monetary Policy Going Forward
(Citing Bagehot, Bernanke and Babe Laufenberg)

Remarks before the Greater Houston Partnership

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Thank you, Jodie (Jiles). When I close my eyes and listen to you and that rich, resonant voice, I hear the cadence and passion of a great preacher. When I open my eyes, I see Jodie Jiles the accountant. Jodie, you may be the only "compassionate accountant" on the planet! I thank you for being a man of exacting precision while still possessing a great big heart. I thank you for serving the Houston Branch of the Dallas Fed with constant dedication in reminding us that we serve all the people of Texas and America, regardless of their economic status. And I thank you for that kind introduction.

I recently saw a sign in a shop window in West Texas that said "Lord, please give me just one chance … to prove that money can't buy happiness." Well, we all know that money can't buy happiness, but it sure helps. (I think it was W. Somerset Maugham who said, "Money is like a sixth sense without which you cannot make a complete use of the other five.") Today, I would like to talk about money from the perspective of monetary policy. What is the Federal Reserve's responsibility and what can the Fed do at this critical juncture to brighten the economic picture and bring about a happier circumstance?

Everything I say today reflects my own views. I never attempt to speak for others at the Fed; I always speak of my own volition. Given that I rotate into a formal voting member's slot on the Federal Open Market Committee (FOMC) next year, I thought it might be of interest if I outlined how I see things moving forward.

Financial Stability

For starters, I think it important to dispel the concept that the Fed has only a "dual" mandate.

To be sure, we are responsible under the Federal Reserve Act for creating the monetary conditions that foster full employment *and* price stability; I will turn to that critical dual mission in a minute. But we also have the responsibility to preserve financial stability. Delivering on our obligation to ensure financial stability is an important prerequisite for executing our duties under the Act. Thus, while it is not formally stated as such, ensuring financial stability is an assumed mandate of the Fed. Understanding that this, too, is the purpose of a central bank will help you understand why we acted as we did to address the Financial Panic of 2008 and what we might or might not do as we seek now to harness monetary policy to restore economic growth.

I think most everyone is aware of the actions the Fed has undertaken since the trip-wire event of Lehman's failure. I do want to remind you, however, that what we faced then was a full-blown liquidity crisis. No financial counterparty was willing to trust, or lend to, another. The interbank lending, commercial paper and asset-backed securities markets ceased to function; money market funds "broke the buck;" the stock and bond markets were in a tailspin; the mortgage markets were in total disarray. In response, the Fed did what central bankers have done since the iconic

Walter Bagehot wrote the rule book for responding to financial panics of the 19th century. We jumped into the breach as the lender of last resort.[1]

This was nervous-making for many. It required that we create and deploy programs totaling trillions of dollars to restore stability to the key markets, providing liquidity to banks and businesses. As it turned out, these emergency interventions by the Fed were effective. And, most important, once they had done their job, we wound them down and closed them up. Let me repeat that: All the emergency liquidity facilities that the Federal Reserve instituted were closed down and did not cost the taxpayers of this great country a single dime. Indeed, last year, as we finished up this work, the Federal Reserve paid $47.4 billion in profits to the Treasury. Imagine that! A government agency that (a) created programs that actually worked as promised, (b) made money for the taxpayers in the process and (c) undid the programs—all in the space of about 28 months—once they had done their job.

I mention this to illustrate a couple of points.

First, we take our job seriously. We are the central bank of the most powerful and important economy in the world. We bear significant responsibility as the lender of last resort. We have the power to create money. This is an awesome power. We are not afraid to use it. It requires that we discharge our duties deliberately. If we fail to act when action is required, we might be the agent of economic destruction. And if we overreact, we can be equally destructive. Which means we must at all times carefully weigh the costs, as well as the benefits, of any and all actions we take. And as the efficacy of our actions depends upon confidence in our integrity, we must always bear in mind that our word is our bond. We cannot risk either overpromising or undercommitting to executing the duties than have been assigned to us.

Second, I mention this responsibility by way of pointing out that the situation we face now is far different from that which we faced in 2008. Then, banks were at risk of not having access to capital; now they have over $1 trillion in excess reserves on deposit at the 12 Federal Reserve banks. Then, nonfinancial businesses feared the capital markets would be closed to them; now, the bond markets for publicly traded companies are significantly improved and quite robust (IBM recently issued three-year paper with a 1 percent coupon and, just last week, Norfolk Southern Corp. issued a 100-year bond with a 6 percent coupon); presently, significant amounts of working capital are lying fallow on the balance sheets of the larger firms. Then, the S&P 500 index was cascading to close at 676 on March 9 of 2009; yesterday, despite recent retracement, it closed 55 percent higher at 1,049. Then, small businesses faced being cut off from banks and other forms of non-publicly issued sources of capital; this July, of small businesses seeking credit, the National Federation of Independent Business reported that only 9 percent did not have their credit needs met and only 4 percent mentioned the availability of credit as a significant issue.[2]

I think one could reasonably state that when fear reached a feverish pitch and was crippling the most basic financial markets, the Fed acted appropriately and effectively to restore them.

That said, we are not in the financial pink. Consumers are still under financial duress, and while our most recent survey of senior loan officers indicates banks are beginning to ease credit standards, they are not necessarily expanding credit. The bottom line is that what is restraining the economy is not a shortage of current liquidity; rather, it is uncertainty, high household debt burdens and a lack of confidence in future income growth.

Incomes plunged in 2008 and into early 2009. Since then, growth has resumed. But the gap between where we are now and where we would have been had we cruised along at the long-term rate of nominal growth of 4 or 4.5 percent—consistent with 2.5 percent average real growth and 1.5 to 2 percent inflation—is large and is not narrowing. By our calculation at the Dallas Fed, nominal income is over 9 percent lower than where it would have been had we not been blown off course by the Panic of 2008. With incomes falling short, households have found themselves overburdened with debt. Compounding the problem, the Conference Board's consumer survey shows households expecting income increases over the next six months to be outnumbered by those expecting decreases. This pessimism about income prospects has continued, without interruption, since the collapse of Lehman Brothers. It is unprecedented in depth and duration in the 44 years the survey has been conducted.

As Jodie mentioned, I was a midshipman at the U.S. Naval Academy. One of the basic lessons learned in navigation courses at Annapolis is that if a storm has blown your ship off course, you don't simply resume your old compass heading. You make an adjustment to offset the effects of the blow and you beat a course accordingly. We need monetary and fiscal policies that bring economic growth back up to speed and, over the next few years, begin to close the income gap that opened up during the storms of 2008 and early 2009. Without such policies, progress in deleveraging the balance sheets of households and businesses will be painfully slow and our nation's recovery will be drawn out longer than necessary.

Price Stability

On the price front, I am known as an inflation hawk. I am comfortable with that description. As I have pointed out many times, ornithologists classify doves as being from the pigeon family. I do not wish to be anybody's pigeon, and nothing I just said about desiring faster income growth should lead you to think I have gone soft on inflation. Nor am I alone in my firm commitment to keeping inflation under control: You may have noted Chairman Ben Bernanke's unequivocal statement last week in Jackson Hole, Wyo., that he sees "no support" within the FOMC for increasing its medium-term inflation goals above levels consistent with price stability.[3] But it is clear that inflation is not the immediate problem facing the nation. As pointed out by the chairman, inflation has declined to a level that is at the low end of the 1.5 to 2 percent range that the participants in FOMC deliberations consider conducive for healthy economic growth over the long run.

The Dallas Fed, which as might be expected, being Texan, has a separate and distinct way of calculating inflation. We use a trimmed-mean analysis.[4] In studying the entrails of the price index for consumer expenditures (the PCE), at present we see neither an impulse toward inflation nor, despite much talk among economists and political pundits, toward deflation. Trimmed mean inflation rates recorded over the last three months have been slightly above the rates we saw in early spring, and the index's six- and 12-month inflation rates have been stable over the past three months. Within the core PCE index, rates of price change for two of the largest components—rent and owners' equivalent rent—have lately turned from falling to rising. That change of direction alone should, in the near term, provide some restraint against further disinflation in core PCE. In short, I concur with Chairman Bernanke's assessment that "the risk of either an undesirable rise in inflation or of a significant further disinflation seems low."[5]

Full Employment

With the efficacy of most financial markets reasonably restored and inflation subdued, the question then is how the Federal Reserve might best do its part to restore employment growth.

Here's the rub. Note that I say, "Do its part." The Fed is not the end-all for curing every economic pathology. To return to my naval analogy, we are not the only authority in the pilot house. We play a crucial role in conditioning the economy, but we do not play the only role. Fiscal and regulatory authorities share significant responsibility for incentivizing economic behavior through taxes, spending and rulemaking.

With this in mind, I have been outspoken about what I refer to as "random refereeing," by which I mean the tendency for lawmakers and rule makers to create programs that hinder, rather than advance, the incentive for the private sector to expand its payrolls. I spoke of this recently in San Antonio, noting that among the CEOs I regularly survey before every FOMC meeting—leaders of companies nationwide that vary in size from nine employees to over a million and represent a broad cross section of goods and service companies—the prevailing sentiment is that politicians and officials who craft and enforce taxes and rules have been doing so in a capricious manner that makes long-term planning, including expanding payrolls, difficult, if not impossible.[6]

Just last week, I sat in on a financial planning and budgeting discussion with middle managers of one of America's leading consumer goods producers. Asked directly how they determine the all-in cost of an employee, the CFO replied, "We can't. We can't because we don't know what will happen on the tax front or with social overhead." So their current plan is to withhold payroll expansion in the United States while investing their growing cash reserves in driving productivity enhancement from their current crop of over 200,000 employees, of which about 70,000 are located in the United States. Meanwhile, they are searching to expand their operations in other countries that "offer better incentives, stability and a more entrepreneurial environment." The sentiment expressed by this CFO is not atypical. A careful reader of the minutes of the last FOMC meeting will note that several participants in the committee's deliberations "reported that business contacts again indicated that uncertainty about future taxes, regulations, and health-care costs made them reluctant to expand their workforces. Instead, businesses had continued to meet growth in demand for their products largely through productivity gains and by increasing existing employees' hours." This does not bode well for job creation here at home.[7]

The retarding effect of heightened uncertainty over the fiscal and regulatory direction of the country makes it difficult to kick-start the transmission mechanism of the economy. One might reasonably posit that the gas tank of those who have the capacity to hire—the private-sector businesses of America—is reasonably full. And one might conclude that the Fed, having cut the cost of interbank overnight lending to near zero and used quantitative easing to coax the entire yield curve downward, has driven the cost of gas to virtually nil for both the government and those businesses that are creditworthy.

The issue now is how that fuel might be released so as to propel the engine of job creation and drive a happier pace of economic growth.

This does not mean that the actions of the Fed going forward are unimportant or that our job is ever done. At the last meeting of the FOMC, we collectively decided to reinvest the proceeds of payments from our portfolio of mortgage-backed securities into longer-term Treasury securities, thus keeping constant the size of our portfolio and avoiding a possible passive reduction in monetary accommodation. In part, this represents a recognition that the performance of the economy is sub-par and we wish to “do no harm” to the process of repair.

The former NFL quarterback and present sports anchor for the CBS affiliate in Dallas–Fort Worth, Babe Laufenberg, recently reminded me that in football, “momentum is not a light switch.” It cannot be turned on in an instant; it needs to build throughout the season. At a minimum, we need to let the slight momentum of the current economic recovery build and do nothing to disrupt it.

As for doing more than avoiding passive tightening in an attempt to goose up that momentum, much will depend on the cost–benefit trade-off of utilizing any of the additional tools in our kit. I think it is abundantly clear to the market that regardless of the language the FOMC employs to describe its deliberations and intentions, the consensus of the committee is to keep the price of money—the cost of the gas needed for our nation’s economic engine—low until the committee is confident that the gears of the economy have begun to mesh more robustly.

Which focuses attention on the size of our balance sheet and whether we will expand it. Personally, I would be reluctant to do so unless or until fiscal and regulatory initiatives are aligned with the needs of job creators. Otherwise, further accommodation might be pushing on a string. In the worst case, it could flood the engine of the economy with gas that might later ignite inflation. Of course, if the fiscal and regulatory authorities are able to dispel the angst that they are reportedly causing, further accommodation may not be needed because the liquidity that has been built up on corporate balance sheets and in the excess reserves of banks might then be released into the economy and spur job creation.

For me, the ball is in the fiscal court for now. Any further action by the Fed must be subject to the kind of rigorous cost–benefit analysis that Ben Bernanke cited in Jackson Hole. One of the variables that must be taken into account is whether fiscal and regulatory policies are conducive to growth.

Returning to the sign in that West Texas shop, I believe that monetary accommodation alone cannot buy happiness. I am as keen as anyone on providing the monetary means to make the engine of the American economy hum once again. We need to get back on the path of narrowing the gap between income growth and what the American people hoped and planned for when they charted the course of future income streams needed to meet their financial obligations, conduct their businesses and care for their families.

As with individuals, for the economy to be truly content, it must have confidence in itself and in the future. I believe the Fed should employ every tool it has available to make that possible. But it is important to recognize that we cannot do it alone. The best way to leverage the influence of monetary policy is to have fiscal and regulatory policy that complements, rather than counters, the impact we might have in helping the economy get back on the course of sustained, noninflationary growth.

Notes

[1] Richard W. Fisher, “Albert H. Gordon Lecture: Comments on the Current Financial Crisis” (Speech at Harvard University, Cambridge, Mass., Feb. 23, 2009), www.dallasfed.org/news/speeches/fisher/2009/fs090223.cfm.
[2] See “NFIB Small Business Economic Trends,” by William C. Dunkelberg and Holly Wade, National Federation of Independent Business, August 2010, www.nfib.com/Portals/0/PDF/sbet/SBET201008.pdf.
[3] Ben S. Bernanke, “The Economic Outlook and Monetary Policy” (Speech at the Federal Reserve Bank of Kansas City Economic Symposium, Jackson Hole, Wyo., Aug. 27, 2010), www.federalreserve.gov/newsevents/speech/bernanke20100827a.htm.
[4] See Trimmed Mean PCE Inflation Rate report, July 2010, www.dallasfed.org/data/pce/index.html, and “Behind the Numbers: PCE Inflation Update, July 2010,” by Jim Dolmas, http://dallasfed.org/data/pce/2010/pce1007.cfm.
[5] See note 3.
[6] See Richard W. Fisher, “Random Refereeing: How Uncertainty Hinders Economic Growth” (Speech before the San Antonio Chamber of Commerce, San Antonio, Texas, July 29, 2010), www.dallasfed.org/news/speeches/fisher/2010/fs100729.cfm.
[7] See Federal Open Market Committee meeting minutes, Aug. 10, 2010, www.federalreserve.gov/monetarypolicy/fomcminutes20100810.htm.