Observations on the U.S. Economy: Need the Fed Do More?

(With Reference to Elvis Costello, Clarence Day, Narayana Kocherlakota and Bernard Baruch)

Remarks before the Vancouver Board of Trade

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On September 11, 2001, I was on a flight returning from the celebration of the opening of the Jewish Museum in Berlin two days earlier. We were approaching New York City as the World Trade Center was attacked and were rerouted to Toronto. As one of the first planes to land in Canada, we were held on the tarmac for some time, having only been told we had been prevented from landing in New York because of "severe headwinds." After deplaning and going through an extensive screening process, we were finally briefed on what little was known at the time of the horrors of that day. We finally exited the airport to find hundreds of cars of private citizens who had spontaneously massed and come to the airport to take any and all of their American brethren into their homes and care for us while we waited anxiously to learn more of what had happened and why.

That afternoon, I somehow managed to get through by phone to my wife, Nancy. She was hiding in the basement of a home in Washington, D.C., with our two youngest children. With the passage of time, it is easy to forget how chaotic and frightful that day was. Nancy was in Georgetown, a stone's throw from the Pentagon. It was unclear if all of Washington was under attack; rumors abounded that the Capitol and the White House were targeted. I wanted to make sure my wife and children were safe. She reported they were and then asked if I was. I remember saying, "I am safe in the hands of our Canadian brothers and sisters." This is the first time I have had a formal chance to say it, so I am taking the liberty of doing so: Thank you for the compassion and unconditional friendship you and your countrymen showed the United States on that infamous day. For the rest of my life, Canada will hold a special place in my heart.

I am delighted to be in this magnificent, thriving city of Vancouver. My son Miles―the one who was huddled in the basement with his mom and little sister on September 11―is filming his first lead role in a movie here as we speak. It is a Warner Brothers film titled *Final Destination 5,* due for release next summer. So, of course, I am hoping Vancouver will be the launching point for my being able to retire in comfort. And this is the home of two of my favorite musicians, Diana Krall and her husband, the eclectically talented Elvis Costello, who works closely with and is highly regarded by the Dallas Symphony Orchestra. I am especially honored to speak to the Vancouver Board of Trade and to have been introduced by Jason [McLean]. This body has long been a forceful advocate for private enterprise and for limited and effective government involvement in economic activity. The ethic here is very compatible with the successful economic practices of my home state of Texas.

I have been asked to speak about the course of the U.S. economy. Before doing so, let me provide some disclaimers.

First, as is the practice of all senior Federal Reserve officials, I speak only for myself as but one of 18 who presently participate in Federal Open Market Committee (FOMC) deliberations. I do not speak for the others on the FOMC, and they do not speak for me.

Second, I do so bearing in mind a lesson from a Canadian turned Harvard professor, John Kenneth Galbraith, who taught me and his other students that "economic forecasting was invented to make astrology look respectable."

It is rare that economists' precise forecasts ever prove accurate. As the iconic Bernard Baruch said so well: "If [economists] knew so much, they would have all the money and we would have none."[1] Even with the advantages we at the Federal Reserve have, with our access to data and battalions of brilliant economists on our staffs that model and analyze it, we are not prescient. Making monetary policy as a central banker comes down to judgment, which must constantly be recalibrated and refined as we contemplate and make decisions. Today, I can only offer my best personal judgment as to where the U.S. economy is headed.

An analysis of the current predicament in the United States leads one to conclude that while the risks of a double-dip recession are small, the pace of the recovery is subpar. Late last year and in early 2010, we had a burst of growth led primarily by inventory adjustment. Real inventory accumulation rose from a minus $162 billion in the second quarter of 2009 to a plus $63 billion in the second quarter of 2010, a swing of $225 billion that accounted for approximately 60 percent of the 3 percent real GDP growth that we saw over that four-quarter period. With inventories now better aligned with sales, it is doubtful this variable will provide much economic propulsion in the coming quarters.

Turning to final demand, the weak pace of recovery in U.S. export markets and political and budget realities mean that little near-term growth impetus can be expected from either net exports or government purchases. Only consumption and nonresidential fixed investment are likely to make positive contributions to expansion. Yet, in these sectors, there is no reason to believe that growth will be notably strong. Residential investment, meanwhile, was an outright drag on growth last quarter, reflecting the hangover from expiring tax incentives. It has since shown signs of bottoming out but can hardly be expected to become a robust factor for the foreseeable future. On net, then, I see only modest third-quarter growth, with an acceleration to moderate growth after that.

The key point is that the pace of the economic recovery is insufficient to create the number of jobs the United States needs to bring down unemployment.

If we cannot generate enough new jobs to absorb the labor force, we cannot expect to grow final demand needed to achieve more rapid economic growth. In the summation of the deliberations of the FOMC last week, it was crisply noted that "employers remain reluctant to add to payrolls." At the same time, the Committee reported it saw no prospect on the foreseeable horizon for inflation—the bête noire of all central bankers—to raise its ugly head; neither was the bête rouge of deflation highlighted. Instead, in more convoluted syntax, the majority view of the Committee was summarized as follows: "Measures of underlying inflation are currently at levels *somewhat below* those the Committee judges most consistent, over the longer run, with its mandate to promote maximum employment and price stability." The statement concluded by saying that the FOMC was "prepared to provide additional accommodation *if* needed to support the economic recovery and to return inflation, over time, to levels consistent with its mandate."[2]

I am afraid that despite recent speculation in the press and among market pundits, we did little to settle the debate as to whether the Committee might actually engage in further monetary accommodation, or what has become known in the parlance of Wall Street as “QE2,” a second round of quantitative easing. It would be marked by an expansion of our balance sheet beyond its current footings of $2.3 trillion through the purchase of additional Treasuries or other securities. To be sure, some in the marketplace—including those with the most to gain financially—read the tea leaves of the statement as indicating a bias toward further asset purchases, executed either in small increments or in a “shock-and-awe” format entailing large buy-ins, leaving open only the question of when. At least one renowned investor noted in a widely reported CNBC interview that the FOMC’s release meant “we (the Fed) want economic growth, and we don’t care if there’s inflation.” He asked pointedly: “Have they ever said that before?”[3] For many, the FOMC’s pronouncement was interpreted as confirming the promise of a “Fed put,” implying that the greater the economy’s weakness, the more easy money the Fed will provide.

And yet the efficacy of further accommodation at this point is not crystal clear. When the Federal Reserve buys Treasuries to drive down yields, it adds money to the financial system. In sharp contrast to the depths of the Panic of 2008, when liquidity had evaporated and we stepped into the breach to revive it, today there is abundant liquidity in our economy. The excess reserves of private banks sitting on the balance sheets of the 12 Federal Reserve Banks exceed $1 trillion. Nonfinancial corporations have an aggregate liquid asset ratio running at a seven-year high; cash flow from current production is running above total investment expenditure; and cash as a percentage of market cap is extraordinarily high. Credit availability remains a challenge for small businesses, but only 4 percent of small businesses surveyed by the National Federation of Independent Business reported financing as their top business problem.[4] And reports of lagging receivables or the stretching out of payment terms that were so prominent only one year ago in the corporate supply chain have become as scarce as hens’ teeth.

However one may view the prominence of credit constraints for small businesses, it is unclear whether broad monetary actions will alleviate them; it may be more appropriate for the Treasury to undertake a targeted fiscal initiative to improve credit availability to small businesses. For mid- and large-sized nonfinancial firms, capital is fairly abundant in America, and it is unclear how much they would benefit from lowering Treasury interest rates.

The vexing question is: Why isn’t this liquidity being utilized to hire new workers and reduce unemployment? If current dramatically high levels of liquidity and low interest rates are not being harnessed to add to payrolls, would driving interest rates further down and adding further liquidity to the system through Fed purchases of Treasury securities induce businesses and consumers to get on with spending it?

The intrepid economist would argue in the affirmative, the logic being that there is a tipping point at which the market becomes convinced that money held in reserve earning negligible returns is at risk of being debased through some inflation and, thus, should be spent rather than hoarded. Hence, the appeal of the Fed’s showing a little leg of inflationary permissiveness.

I am personally wary of this argument, despite its theoretical logic. My soundings among those who actually do the work of creating sustainable jobs and making productive capital investments—private businesses big and small—indicate that few are willing to commit to expanding U.S. payrolls or to undertaking significant commitments to expand capital expenditures in the U.S. other than in areas that enhance productivity of the current workforce. Without exception, all the business leaders I interview cite nonmonetary factors—fiscal policy and regulatory constraints or, worse, uncertainty going forward—and better opportunities for earning a return on investment elsewhere as inhibiting their willingness to commit to expansion in the U.S. As the CEO of one medium-sized business put it to me shortly before the last FOMC meeting, "Part of it is uncertainty: We just don't know what the new reg[ulation]s [*sic*] like health care are going to cost and what the new rules will be. Part of it is certainty: We know that taxes are eventually going to have to increase to get us out of the fiscal hole Republicans and Democrats alike have dug for us, and we know that regulatory intervention will be getting more intense." Small wonder that most business leaders I survey, including small businesses, remain fixated on driving productivity and lowering costs, budgeting to "get less people to wear more hats." Tax and regulatory uncertainty—combined with a now well-inculcated culture of driving all resources, including labor, to their most productive use at least cost—does not bode well for a rapid diminution of unemployment and the concomitant expansion of demand.

The Fed operates under a dual mandate that charges us with both keeping prices stable *and* maintaining maximum sustainable employment. Some economic theories would lead one to believe we could shake job creation from the trees if we were to further expand our balance sheet. Yet, to paraphrase the early 20th century progressive, Clarence Day—the once ubiquitous contributor to my favorite magazine, *The New Yorker*, and author of one of my all-time favorite films, *Life with Father*—"Too many [theorists] begin with a dislike of reality."[5] The reality of fiscal and regulatory policy inhibiting the transmission mechanism of monetary policy is vexing to monetary theorists. And yet it seems to me to be a significant factor holding back economic recovery.

One of my brightest and most intellectually credentialed colleagues, Narayana Kocherlakota, president of the Minneapolis Fed, has noted that one of our deep-seated problems is structural unemployment—that we do not have a workforce adequate to the needs of the high-value-added businesses that define the U.S. "Firms have jobs but can't find appropriate workers," he says. And he concludes, "It is hard to see how the Fed can do much to cure this problem."[6] I would add that if this is true, then the matching of job skills to needs is doubly complicated if businesses feel handicapped by the current tax and regulatory regime or find other countries better placed to expand in a globalized, cyber-ized economy that encourages investment to gravitate to optimal locations for enhancing return on investment.

In my darkest moments, in fact, I wonder if the monetary accommodation we have engineered might not be working in the wrong places. Far too many of the large corporations I survey report that the most effective way to deploy cheap money raised in the current bond markets or in the form of loans from banks, beyond buying in stock or expanding dividends, is to invest it abroad where taxes are lower and governments are more eager to please. This would not be of concern if foreign direct investment in the U.S. were offsetting this impulse. This year, net direct investment in the U.S. has been running at a pace that would exceed minus $200 billion, meaning outflows of foreign direct investment are exceeding inflows by a healthy margin. We will have to watch the data as it unfolds to see if this is momentary fillip or evidence of a broader trend. But I wonder: If others cotton to the view that "(the Fed) doesn't care about inflation," or begin to question whether we at the FOMC can slice the apple so precisely as to maintain inflation at a rate between what is now "somewhat below" that which is "most consistent with [our] mandate"—say 1 percent—and a level that is more consistent with the mandate—say 2 percent—might this not add to the uncertainty already created by the fiscal incontinence of Congress and the regulatory and rule-making “excesses” about which businesses now complain?

In his much-noted speech at Jackson Hole in August, Federal Reserve Chairman Ben Bernanke spoke of the need to evaluate the costs as well as the benefits of further monetary accommodation.

In performing a cost/benefit analysis of a possible QE2, we will need to bear in mind that one cost that has already been incurred in the process of running an easy money policy has been to drive down the returns earned by savers, especially those who do not have the means or sophistication or the demographic profile to place their money at risk further out in the yield curve or who are wary of the inherent risk of stocks. A great many baby boomers or older cohorts who played by the rules, saved their money and have migrated over time, as prudent investment counselors advise, to short- to intermediate-dated, fixed-income instruments, are earning extremely low nominal and real returns on their savings. Further reductions in rates earned on savings will hardly endear the Fed to this portion of the population. Moreover, driving down bond yields might force increased pension contributions from corporations and state and local governments, decreasing the deployment of monies toward job maintenance in the public sector. Debasing those savings with even a little more inflation than what is above minimal levels acceptable to the FOMC is unlikely to endear the Fed to these citizens. And if—and here I especially stress the word *if* because the evidence is thus far only anecdotal and has yet to be confirmed by longer-term data—*if* it were to prove out that the reduction of long-term rates engendered by Fed policy had been used to unwittingly underwrite investment and job creation abroad, particularly in countries where exchange-rate adjustment is inhibited, then the potential political costs relative to the benefit of further accommodation will have increased.

Another issue to be considered before embarking on a program to purchase additional long-term assets is whether such programs violate the basic tenets of the bedrock Bagehot principle, named for the 19th century British leader who “wrote the playbook” for central banking. Walter Bagehot advocated that when responding to a financial crisis, a central bank should lend freely at a penalty rate to anybody and everybody on good collateral. This was the principle we followed in addressing the Panic of 2008, and it was the right thing to do. While none of us are satisfied with the current pace of economic expansion and job creation, presently it is not clear that conditions warrant further crisis-like deployment of the Fed’s arsenal. Besides, it would be difficult to build a case that the main recipient of further credit extensions, namely the U.S. Treasury, or borrowers whose rates are based on historically low spreads over Treasuries, have difficulty accessing the capital markets.

So I confess that, at least in *my* mind, it is not clear that the benefits of further quantitative easing outweigh the costs, especially if the economic scenario I outlined at the beginning of these comments obtains.

What I envision from the current vantage point is an anemic recovery, but not one that slips into reverse gear. Thus, barring an unforeseen shock, I have concerns about the efficacy of further expanding the Fed’s balance sheet until our political authorities better align fiscal and regulatory initiatives with the needs of job creators. Otherwise, further quantitative easing 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 businesses are reporting, further accommodation might not even be needed. If job-creating businesses are more certain about future policy and are satisfactorily incentivized, they are more likely to take advantage of low interest rates, release the liquidity they are hoarding and invest it robustly in hiring and training a workforce that will propel the American economy to new levels of prosperity, rendering moot the argument for QE2. The key is to first remove or reduce the tax and regulatory uncertainties that act as an impediment to businesses responding to an increase in final demand. I consider this to be a far more desirable outcome than being saddled with a bloated Fed balance sheet.

That is the view from the Dallas Fed.

Thank you, Peter [Brown], for inviting me to be one of the Board of Trade's "Distinguished Speakers." I should tell you that last night I turned to my wife and asked, "In your wildest dreams did you ever envision my being a Distinguished Speaker for a forum as prestigious as the Vancouver Board of Trade, following in the footsteps of Prime Minister Goh, Prince Philip, President Zedillo and President Clinton?" This was her reply: "I hate to let you down, Richard, but after 37 years of marriage, you rarely appear in my wildest dreams."

Thank you all.

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[1] See *Bernard M. Baruch: The Adventures of a Wall Street Legend*, by James Grant, New York: John Wiley and Sons, 1997, p. 310.

[2] See Federal Open Market Committee Press Release, Sept. 21, 2010, www.federalreserve.gov/newsevents/press/monetary/20100921a.htm.

[3] See "Hedge Fund Titan David Tepper," interview, CNBC, Sept. 24, 2010, www.cnbc.com/id/15840232?play=1&video=1598887347.

[4] See "NFIB Small Business Economic Trends," by William C. Dunkelberg and Holly Wade, National Federation of Independent Business, September 2010, www.nfib.com/Portals/0/PDF/sbet/sbet201009.pdf.

[5] See *This Simian World*, by Clarence Day, New York: Alfred Knopf, 1920, p. 67.

[6] See "Inside the FOMC," speech by Narayana Kocherlakota, Marquette, Mich., Aug. 17, 2010, www.minneapolisfed.org/news_events/pres/speech_display.cfm?id=4525.