

# **To Ease or Not to Ease? What Next for the Fed?**

***(With Reference to Bill Frenzel, Alan Greenspan, Masaaki Shirakawa, Sherman Maisel and Raghuram Rajan)***

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*Remarks before the Economic Club of Minnesota*



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*The views expressed are my own and do not necessarily reflect official positions of the Federal Reserve System.*

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Richard W. Fisher

Thank you, Congressman [Mark] Kennedy. You and Congressman [Tim] Penny are most kind to have invited me to speak here today. If I may, I would like to tip my hat to another former congressman who sits on your board, Bill Frenzel. Bill and my father-in-law served together for many years in Congress. Bill was a moderate; Jim [Collins] an ultra-conservative. And yet, back then, they worked closely together for the greater good and are exemplars for us all in these contentious political times. When I was deputy U.S. trade representative, I could always call on Bill to help guide me through the Ways and Means Committee, which he knew like the back of his hand. He used to say that “negotiating with Congress is a heck of a lot harder than negotiating with the Chinese.” He certainly got that right! Please give Bill my highest regards and thanks for being a good man.

My wife, Nancy, and I sent our children to a Concordia Language Village about a four-hour drive from here, a little south of Bemidji. I remember my daughter asking me: “Dad, I wonder why they call the lake near Walker ‘Leech Lake’?” My answer was: “You’ll find out soon enough.” And indeed she did.

I have been asked to speak about the course of the U.S. economy. I do so with considerable humility, bearing in mind a lesson from one of my undergraduate professors, 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. The iconic Bernard Baruch said it well: “If (economists) knew so much, they would have all the money and we would have none.”<sup>1</sup> 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 receding, the pace of the recovery is obviously 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 \$69 billion in the second quarter of 2010, a swing of \$231 billion that accounted for approximately 61 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 the 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.

Contemplating this scenario, the brow begins to furrow. The key pace of economic recovery is clearly insufficient to create the number of jobs the United States needs to bring down unemployment significantly in the foreseeable future. If we cannot generate enough new jobs to sufficiently absorb the labor force over the intermediate future, we cannot expect to grow final demand needed to achieve more rapid economic growth.

In the summation of the recent Federal Open Market Committee (FOMC) meeting, released after we concluded our deliberations, 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 *lête 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.”<sup>2</sup>

I am afraid that despite recent speculation in the press and among market pundits, we did little at that meeting 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.

Since the FOMC meeting, a handful of my colleagues have fanned further speculation about QE2 by signaling their personal positions on the matter quite openly in recent speeches and interviews in the major newspapers. Hence the headline in yesterday’s *Wall Street Journal*, “Central Banks Open Spigot,”<sup>3</sup> a declaration that surely gave the ghosts of central bankers past the shivers and sent a tingle down the spine of gold bugs from Bemidji to Beijing.

I very much share the concerns of my colleagues who fret that unemployment is not receding quickly enough. (I spent too much of my childhood with a father who, bless his soul, often struggled to find work.) Given that we at the Fed are mandated to maintain price stability *and* create the monetary conditions to encourage maximum employment growth—at a time when inflation is “somewhat below” what the Committee as a whole judges appropriate—I

instinctively understand the impulse to put the monetary pedal to the metal to try to move the needle on employment growth. And yet the efficacy of further accommodation at this point has yet to be established.

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 parked at 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; 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.<sup>4</sup> 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 might be more appropriate, perhaps, 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? Why is it that, as pointed out in Alan Greenspan's op-ed in this morning's *Financial Times*, the share of liquid cash flow allocated to long-term fixed asset investment has fallen to its lowest level in the 58 years for which data are available?<sup>5</sup> If current dramatically high levels of liquidity and low interest rates are not being harnessed to add to payrolls or expand capital expenditures, would driving interest rates further down and adding further liquidity to the system through Fed purchases of Treasury securities induce U.S. businesses and consumers to get on with spending it?

The intrepid theoretical 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, as suggested in the recent declarations of some of my colleagues.

There is some sound theory behind these arguments. Yet, 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, "Part of it is uncertainty: We just don't know what the new regulations [*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.

So, it is indeed true that some economic theories would lead one to believe we can 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.”<sup>6</sup> The reality of fiscal and regulatory policy inhibiting the transmission mechanism of monetary policy is most definitely present and is vexing to monetary policy makers. It is indisputably a significant factor holding back the economic recovery.

One of my most intellectually credentialed and also pragmatic colleagues, your very own president of the Minneapolis Fed, Narayana Kocherlakota, has noted that one of our deep-seated problems is structural unemployment. He believes 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.”<sup>7</sup> 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.

If you happened to read the obituary of former Fed Governor Sherman Maisel in today’s *New York Times*, you might have noted a relevant quote from his repertoire: “In my view, changes in monetary policy may be desirable, but they should be used only to a limited degree in attempts to control movements in demand arising from non-monetary sources.”<sup>8</sup> There are limits to what monetary policy can accomplish if fiscal policy blocks the road.

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 remove or reduce the tax and regulatory uncertainties that act as an impediment to businesses responding to an increase in final demand. I think most all would consider this to be a far more desirable outcome than being saddled with a bloated Fed balance sheet.

In my darkest moments I have begun to wonder if the monetary accommodation we have already engineered might even be working in the wrong places. Far too many of the large corporations I survey that are committing to fixed investment 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, however, 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 is eager to “open the spigots,” 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, 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.

Part of our cost/benefit analysis should include where the inertia of quantitative easing might take us. Let’s go back to that eye-popping headline in yesterday’s *Wall Street Journal*: “Central Banks Open Spigot.” The article led off with a discussion of the Bank of Japan’s announcement of a new bond-buying program. It prefaced this by noting that this round of the Bank of Japan’s

quantitative easing was done “anticipating that the U.S. Federal Reserve will resume large-scale purchases of U.S. Treasury bonds and [in light of] strong domestic political pressure to spur growth and restrain a rising yen.” Referring to the fact that the BOJ would be buying real-estate investment funds and exchange-traded funds, in addition to government bonds and corporate IOUs, it then quoted the governor of the bank, Masaaki Shirakawa—a thoughtful man and, incidentally, a member of the advisory board of the Dallas Fed’s Globalization and Monetary Policy Institute—as concluding: “If a central bank tries to seek greater impact from its monetary policy, there is no choice but to jump into such a world.” The article went on to say: “Central bankers elsewhere are strongly indicating that they are preparing to open credit spigots to reflate their economies at a time when fiscal policy is stalled or contracting.”

My reaction to reading that article was that it raises the specter of competitive quantitative easing. Such a race would be something of a one-off from competitive devaluation of currencies, a beggar-thy-neighbor phenomenon that always ends in tears. It implies that central banks should carry the load for stymied fiscal authorities—or worse, give in to them—rather than stick within their traditional monetary mandates and let legislative authorities deal with the fiscal mess they have created. It infers that lurking out in the future is a slippery slope of quantitative easing reaching beyond just buying government bonds (and in our case, mortgage-backed securities). It is one thing to stabilize the commercial paper market in a systematic way. Going beyond investment-grade paper, however, opens the door to pressure on a central bank to back financial instruments benefiting specific economic sectors. This inevitably leads to irritation or lobbying for similar treatment from economic sectors not blessed by similar monetary largess.

In his recent book titled *Fault Lines*, Raghuram Rajan reminds us that, “More always seems better to the impatient politician [policymaker]. But any instrument of government policy has its limitations, and what works in small doses can become a nightmare when scaled up, especially when scaled up quickly.... Furthermore, the private sector’s objectives are not the government’s objectives, and all too often, policies are set without taking this disparity into account. Serious unintended consequences can result.”<sup>9</sup>

While all of us are impatient with the unemployment situation, it is worthwhile bearing Rajan’s wry observations in mind. There is a great deal of legitimate debate still to take place within the FOMC on the subject of quantitative easing and the pros and cons and costs and benefits of further monetary accommodation. Whatever we might do, if anything, must be consistent with long-term price stability and not add to the nightmare of confusing signals already being sent to job creators.

What will we likely decide at the next FOMC meeting? I’ll answer that with the same answer I gave my daughter when she asked about Leech Lake: “You’ll find out soon enough.”

Thank you.

I would be happy to hear your questions and, in the tradition of central bankers, do my utmost to avoid answering them.

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

<sup>2</sup> See Federal Open Market Committee Press Release, Sept. 21, 2010, [www.federalreserve.gov/newsevents/press/monetary/20100921a.htm](http://www.federalreserve.gov/newsevents/press/monetary/20100921a.htm).

<sup>3</sup> “Central Banks Open Spigot,” by Megumi Fujikawa and David Wessel, *Wall Street Journal*, Oct. 6, 2010.

<sup>4</sup> 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](http://www.nfib.com/Portals/0/PDF/sbet/sbet201009.pdf).

<sup>5</sup> See “Fear Undermines America’s Economic Recovery,” by Alan Greenspan, *Financial Times*, Oct. 7, 2010, p. 11.

<sup>6</sup> See *This Simian World*, by Clarence Day, New York: Alfred Knopf, 1920, p. 67.

<sup>7</sup> See “Inside the FOMC,” speech by Narayana Kocherlakota, Marquette, Mich., Aug. 17, 2010, [www.minneapolisfed.org/news\\_events/pres/speech\\_display.cfm?id=4525](http://www.minneapolisfed.org/news_events/pres/speech_display.cfm?id=4525).

<sup>8</sup> See “Sherman J. Maisel, Former Fed Governor, Dies at 92,” by Sewell Chan, *New York Times*, Oct. 7, 2010.

<sup>9</sup> See *Fault Lines: How Hidden Fractures Still Threaten the World Economy*, by Raghuram Rajan, Princeton, N.J.: Princeton University Press, 2010, p. 43.