Rangers, Yankees and Federal Open Market Committee: One Game at a Time

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Thank you, Steve (Gallagher). I am incredibly touched that you and the New York Association for Business Economics are holding this lunchtime rally for the Texas Rangers baseball franchise.

I have been asked to talk about the economy. I realize that many of you are here looking for clues as to what will emerge from the next meeting of the Federal Open Market Committee (FOMC). You might get a sense of what shapes one FOMC participant's perspectives and inputs this afternoon. But let me say right up front that as in the American League championship playoffs, the outcome of the next FOMC is yet to be determined.

Just as bookies in Vegas adjust their lines for the playoffs, the oddsmakers on the Street are constantly reassessing their positions regarding monetary policy. They change with new developments in the economy (the Fed's Beige Book, for example, will be released tomorrow); with every public pronouncement of individual FOMC members; with insights proffered by the daily wire services and editorials in the Sunday editions of the nation's finest newspapers (and good regional ones like your *New York Times*); and with the insights of consultants and analysts, some of whom even claim, spuriously, to have access to the internal deliberations of Federal Reserve policymakers. But until the committee meets, nothing is decided.

You should bear this in mind given the recent speculation about the prospect for further quantitative easing or the shape and nature of forward policy guidance: No decisions have been made on these fronts and will not be made until the committee concludes its deliberations at its next meeting on Nov. 3.

Well, there is your "take home" from lunch! But given that we have some time left, if you will indulge me, I would like to give you one man's view on the outlook for the U.S. economy. I do so with considerable humility being in a room full of major league economists. And because the professional economists among you know as well as I do that John Kenneth Galbraith was not all that far off when he divulged that "economic forecasting was invented to make astrology look respectable."

So what do I divine from contemplating the celestial bodies of the economy? And how might this shape my approach to monetary policy?

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 net exports and government purchases. Only consumption and nonresidential fixed investment are likely to make positive contributions to the expansion. In these sectors, there is no reason to believe that growth will be notably strong, though the latest retail numbers surprised to the upside despite the warm weather, which typically retards fall sales. Residential investment, meanwhile, was an outright drag on growth last quarter, reflecting the hangover from expiring tax incentives; now, the foreclosure debacle has added a serious wrinkle to the potential for a clearing of that crucial market. On net, then, I see only modest third-quarter growth at a level slightly above 2 percent, with a gradual rate of acceleration to what would best be described as moderate growth after that.

Contemplating this scenario, the brow begins to furrow. We are barely cruising above what we at the Dallas Fed call “stall speed.” Annual real gross domestic product (GDP) growth below 2 percent has predicated every recession since 1970. If we continue to barely clear the 2 percent hurdle, the pace of economic recovery will be 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 the final demand needed to achieve more rapid economic growth.

In the summation of the recent 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 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 is “prepared to provide additional accommodation if needed to support the economic recovery and to return inflation, over time, to levels consistent with its mandate.”[1] Chairman (Ben) Bernanke, who I might add is the only person empowered to speak on behalf of the entire committee, repeated this verbatim in the penultimate sentence of his speech last Friday in Boston: “In particular,” he said, “the FOMC is prepared to provide additional accommodation if needed to support the economic recovery and to return inflation over time to levels consistent with our mandate.” And he concluded by saying: “Of course, in considering possible further actions, the FOMC will take account of the potential costs and risks of nonconventional policies, and, as always, the committee’s actions are contingent on incoming information about the economic outlook and financial conditions.”[2] In short, the Chairman said nothing in Boston that hadn't already been said in the FOMC's most recent pronouncement or in his earlier speech in Jackson Hole, Wyoming.

Let me give you my two cents on some of the potential costs and risks that the Chairman has been referencing in his recent speeches.

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. The problem is that, presently, the efficacy of further accommodation using nonconventional policies is not all that 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 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 3 percent of small businesses surveyed by the National Federation of Independent Business reported financing as their top business problem in October.[3] 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-size 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 the Oct. 7 edition of the *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?[4] 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 more 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.

There is some valid theory behind this approach. 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 the productivity of the current workforce. Without exception, all the business leaders I interview cite nonmonetary issues—fiscal policy and regulatory constraints or, worse, uncertainty going forward—and better opportunities for earning a return on investment elsewhere as factors inhibiting their willingness to commit to expansion in the U.S. As the CEO of one medium-size 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 those at small businesses, remain fixated on driving productivity and lowering costs, budgeting to "get fewer 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, and/or induce greater final demand if people and businesses with money in their pockets believe the central bank will tolerate inflation somewhat "above" levels consistent with our mandate. Yet, to paraphrase the early 20th century progressive Clarence Day—the once-ubiquitous contributor to my favorite magazine, *The New Yorker*—"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 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, the president of the Minneapolis Fed, Narayana Kocherlakota, has noted that a deep-seated problem is structural unemployment. He believes that we do not have a workforce adequate to meet 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 were true, then the matching of job skills to needs is doubly complicated if businesses feel handicapped by the current tax and regulatory regime or see other countries as better places to expand in a globalized, cyber-ized economy that encourages investment to gravitate to optimal locations for enhancing return on investment.

While its sports coverage is second to none, my favorite part of the *New York Times* is the obituary section. I read it daily not only because it is superbly written, but because it offers nuggets of wisdom learned by others who have gone before us. If you had read the obit of former Fed Governor Sherman Maisel two weeks ago, you might have noticed 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."[7] There are limits to what monetary policy can accomplish if fiscal policy blocks the road.

Of course, if fiscal and regulatory authorities are able to dispel the angst that businesses are reporting and put together a credible plan for deficit reduction that does not choke off growth, 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. This would render moot the argument for QE2, or a second round of quantitative easing**.** The key is to remove or reduce the tax and regulatory uncertainties that act as an impediment to businesses as they respond to increases 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. The Treasury International Capital, or TIC, data released yesterday morning show that foreign interest in buying Treasuries remains robust. Yet, 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 they unfold 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) Spigot," as proclaimed on the front page of the Oct. 6 *Wall Street Journal,*[8] might this not add to the uncertainty already created by the fiscal incontinence of Congress and the regulatory and rulemaking excesses about which businesses now complain?

In performing a cost/benefit analysis of a possible QE2, we will need to bear in mind that one cost already 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 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 also 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 hard to build a case that the main recipient of further credit extensions, namely the U.S. Treasury, and 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 the *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."[9]

While all of us are impatient with the unemployment situation, it is worth 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 of course be consistent with long-term price stability. But we also must avoid the unintended consequence of adding to the nightmare of confusing signals that job creators are already receiving from other government authorities.

So, what will we likely decide at the next FOMC meeting? As with the American League championship, you'll find out when it's over and only then.

Before concluding, I want to return to the TIC data I mentioned earlier. Yesterday, I asked a trader of sovereign debt how he interpreted the recent numbers. His answer: "We are still the best-looking horse in the glue factory." It was a witty reply. But it was disturbing. This is

America. Whether we are Ranger or Yankee fans, Texans or New Yorkers, we have been blessed to live in the most prosperous nation on earth. We cannot now accept simply being the "least worst" among major economies. We must be better than the rest.

This cannot be accomplished by the FOMC alone. Whatever we do with monetary policy will be of limited utility, if not counterproductive, unless it is complemented by sensible fiscal policy that restores confidence and puts the American people back to work. We are not glue-factory horses. We are thoroughbreds. It's time to put us back on track.

Thank you.

Notes

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

[2] See "Monetary Policy Objectives and Tools in a Low-Inflation Environment," speech by Ben S. Bernanke, Boston, Mass., Oct. 15, 2010, www.federalreserve.gov/newsevents/speech/bernanke20101015a.htm.

[3] See "NFIB Small Business Economic Trends," by William C. Dunkelberg and Holly Wade, National Federation of Independent Business, October 2010, www.nfib.com/Portals/0/PDF/sbet/sbet201010.pdf.

[4] See "Fear Undermines America's Economic Recovery," by Alan Greenspan, *Financial Times*, Oct. 7, 2010, p. 11.

[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.

[7] See "Sherman J. Maisel, Former Fed Governor, Dies at 92," by Sewell Chan, *New York Times*, Oct. 7, 2010.

[8] "Central Banks Open Spigot," by Megumi Fujikawa and David Wessel, *Wall Street Journal*, Oct. 6, 2010.

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