# Comments to the Harvard Club of New York City on Monetary Policy
## (With Reference to Tommy Tune, Nicole Parent, the FOMC, Velcro, Drunken Sailors and Congress)

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*Remarks before the Harvard Club of New York City*

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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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Thank you, Nicole [Parent]. And thanks to the Harvard Club of New York for including me in your speaker series. It is quite something to see one's picture on the cover of the Harvard Club of New York *Bulletin* wedged between that of Tommy Tune and Nina Khrushcheva, Nikita Khrushchev's great-granddaughter.

My wife Nancy and I celebrated our 39th anniversary on Sept. 8. Knowing that she has seen and loved everything our fellow Texan Tommy Tune has ever done on the musical stage, and having grown up with the image of Nikita Khrushchev as First Secretary of the Communist Party of the Soviet Union banging his shoe on the podium of the United Nations and saying, "We will bury you!" I thought I would impress her that evening by showing her the *Bulletin*. "In your wildest dreams," I asked her, "did you ever think that the skinny, long-haired boy you married 39 years ago would be headlining a speaker series alongside Tommy Tune and Nikita Khrushchev's great-granddaughter?" Her answer was classic: "Richard, we have been married for four decades. I hate to disappoint you sweetheart, but you don't appear in my wildest dreams."

**A Word About Nicole Parent**
I am here to speak to you about monetary policy. But before I start, I am going to take advantage of your undivided attention to announce to all assembled here tonight that the former president of this club and my fellow Harvard Overseer, Nicole Parent, is engaged to be married. Nicole, may your marriage last at least 39 years and may you be blessed with the wildest of dreams and the best of life.

**A Different Perspective**
In addition to the Algonquin, there are two iconic buildings on this side of West 44th Street. One is the New York Yacht Club; the other is the Harvard Club. I mention this because the close proximity of these two buildings suggests something of a biographical metaphor. I spent four years at a Naval Academy prep school before becoming a midshipman in 1967 at Annapolis, where I majored in engineering and learned the craft of seamanship and naval warfare. Then, in 1969, Harvard kindly recruited me in as a transfer student. Two years later, I graduated with a degree in economics.

In thinking through many of the policy issues that confront me as a member of the Federal Open Market Committee (FOMC), I tend to combine both backgrounds, as well as an orientation framed by having an MBA and spending a significant portion of my career as a banker and market operator. My perspective is thus framed from the viewpoint of an engineer, an MBA and a former market operator—not as a PhD economist. For most economic theoreticians, hundreds of billions, or even trillions, of dollars are inputs into a dynamic stochastic general equilibrium model and other econometric equations. To a banker, businessperson or market operator, these are real dollars that have to be thought of within the framework of a transmission mechanism that needs to get the money from its origin at the Fed into the real economy with maximum efficacy. My focus tends toward the practicable—how to harness theory to devise a workable solution to

the problems that confront a central banker. There are many superb PhD theorists among the 19 members of the FOMC and support staff. There are only a handful of us—four, to be exact—who have worked as bankers or in the financial markets.

Tonight, I am going to provide my take on the FOMC's most recent decision to embark on a new round of quantitative easing focused on mortgage-backed securities (MBS). Given my background, and the fact that the Navy is once again welcome back in Harvard Yard, I'll ask your forbearance if I use some seafaring references.[1]

As the book kindly cited by Nicole says, I am given to providing the "straight skinny."[2] I am a Texan. I speak bluntly and directly. I am not given to circumlocution, and I checked diplomacy at the door when I gave up my post as an ambassador and trade negotiator. Please don't take offense and please bear in mind that my comments this evening are mine alone; I do not claim to speak for anybody else in the Federal Reserve System.

I shall start my remarks with what I argued at last week's FOMC meeting, then finish with some comments on the outcome of that meeting and what needs to be done next.

**The Recent FOMC Meeting**

It will come as no surprise to those who know me that I did not argue in favor of additional monetary accommodation during our meetings last week. I have repeatedly made it clear, in internal FOMC deliberations and in public speeches, that I believe that with each program we undertake to venture further in that direction, we are sailing deeper into uncharted waters. We are blessed at the Fed with sophisticated econometric models and superb analysts. We can easily conjure up plausible theories as to what we will do when it comes to our next tack or eventually reversing course. The truth, however, is that nobody on the committee, nor on our staffs at the Board of Governors and the 12 Banks, really knows what is holding back the economy. Nobody really knows what will work to get the economy back on course. And nobody—in fact, no central bank anywhere on the planet—has the experience of successfully navigating a return home from the place in which we now find ourselves. No central bank—not, at least, the Federal Reserve—has ever been on this cruise before.

This much we do know: Our engine room is already flush with $1.6 trillion in excess private bank reserves owned by the banking sector and held by the 12 Federal Reserve Banks. Trillions more are sitting on the sidelines in corporate coffers. On top of all that, a significant amount of underemployed cash—or fuel for investment—is burning a hole in the pockets of money market funds and other nondepository financial operators. This begs the question: Why would the Fed provision to shovel billions in additional liquidity into the economy's boiler when so much is presently lying fallow?

Great battles at sea are fought with modern analytical tools and the most sophisticated IT and advanced weaponry available. Fleet commanders, like central bankers, use every bit of the intelligence, technology and theory at their command. But ultimately, just as with great engagements at sea, the decisive factor is judgment. In forming their judgments, fleet commanders rely upon briefings from their senior officer corps on the elements, on the conditions at hand and on their tactical and strategic recommendations before deciding on the proper course of action.

As you all know, the Federal Reserve's mission is mandated by the Congress. It calls for us to steer a monetary course according to a dual mandate—we are charged with maintaining price stability while conducting policy so as to best assist in achieving full employment. Most all of the FOMC members—the senior officer corps of the Federal Reserve fleet—have surveyed the horizon from their different watch stations and agree that inflation is not an *immediately* foreseeable threat. Over the past week, however, there has been a noticeable increase in the longer-term inflation expectations inferred from bond yields. These inferences can be volatile and are not always reliable, but a sustained increase would suggest incipient doubts about our commitment to the Bernanke Doctrine of sailing on a course consistent with 2 percent long-term inflation. I believe that even the slightest deviation from this course could induce some debilitating mal de mer in the markets.

**Charting a Course to Full Employment with Businesses at 'Sixes and Sevens**'

In the current tumultuous economic sea, facing strong headwinds common in the aftermath of financial crises and balance-sheet recessions, our desired port is increased employment. Certain theories and various hypothetical studies and models tell us that flooding the markets with copious amounts of cheap, plentiful liquidity will lift final demand, both through the "wealth effect" channel and by directly stimulating businesses to expand and hire. And yet from the perspective of my watch station—as I have reported time and again—the very people we wish to stoke consumption and final demand by creating jobs and expanding business fixed investment are not responding to our policy initiatives as well as theory might suggest.

Surveys of small and medium-size businesses, the wellsprings of job creation, are telling us that nine out of 10 of those businesses are either not interested in borrowing or have no problem accessing cheap financing if they want it. The National Federation of Independent Business (NFIB), for example, makes clear that monetary policy is not on its members' radar screen of concerns, except that it raises fear among some of future inflationary consequences; the principal concern of the randomly sampled small businesses surveyed by the NFIB is with regulatory and fiscal uncertainty.[3] This is not terribly difficult to understand: If you are a small business, especially, and not only if you operate as an S corporation or as a limited liability company, you are stymied by not knowing what your tax rate will be in future years, or how you should cost out the social overhead of your employees or how you should budget for the proliferation of regulations flowing from Washington.

With regard to business fixed investment and job-creating capital expenditures (capex), the math is pretty straightforward: Big businesses dominate that theater. Most all of these businesses have abundant cash reserves or access to money, many at negative real interest rates. I have repeatedly reported to the committee that the CEOs I personally survey will simply not be motivated by further interest rate cuts to invest domestically—beyond their maintenance needs—in job-creating capex. In preparing for this last FOMC meeting, I specifically asked my corporate interlocutors the following question: "If your costs of borrowing were to decrease by 25 or more basis points, would this induce you to spend more on job-creating expansion?" The answer from nine out of 10 was "No."

The responses of those I surveyed are best summarized by the comments of one of the most highly respected CEOs in the country: "We are in 'stall mode,' stuck like Velcro, until the fog of uncertainty surrounding fiscal policy and the debacle in Europe lifts. In the meantime, anything further monetary accommodation induces in the form of cheaper capital will go to buying back

our stock." This is not an insignificant sounding, coming as it did from the CEO of a company that has the capacity to spend upward of $15 billion on capex.

To be sure, buying in stock will have a positive wealth effect on that company's shareholders, but putting the equivalent amount of money to work in spending on plant and equipment would put more people back to work more quickly.

Another CEO of a large corporation provided me with an additional source of uncertainty. In this CEO's words, China "may be transitioning toward becoming the caboose of the global economy rather than its engine." This may be a tad bit hyperbolic, but it indicates there is growing uncertainty about the great emerging economy that was once considered an eternal fountain of future demand.

With the disaster that our nation's fiscal policy has become and with uncertainty prevailing over the economic condition of both Europe and China and the prospects for final demand growth here at home, it is no small wonder that businesses are at sixes and sevens in committing to expansion of the kind we need to propel job creation.

**The Duke University Survey**

My assessment of the efficacy of further monetary accommodation in encouraging job-creating investment among operating businesses was recently confirmed by a more rigorous analysis in the Global Business Outlook Survey of chief financial officers by the Fuqua School of Business at Duke University—the Harvard of the South—in September.[4]

Of the 887 CFOs surveyed, only 129, or 14.5 percent, listed "credit markets/interest rates" among the top three concerns facing their corporations. In contrast, 43 percent listed consumer demand and 41 percent cited federal government policies. Ranking third on their list was price pressures from competitors (thus affirming most hawks' sense that inflationary pressure is *presently* sedentary); fourth was global financial instability. The analysts at Duke summarized their findings as follows: "CFOs believe that a monetary action would not be particularly effective. Ninety-one percent of firms say that they would not change their investment plans even if interest rates dropped by 1 percent, and 84 percent say that they would not change investment plans if interest rates dropped by 2 percent."

**Citing the Evidence of the Unsophisticated and the Sophisticates Alike**

Citing these observations, I suggested last week that the committee might consider the efficacy of further monetary accommodation. When I raised this point inside the Fed and in public speeches, some suggested that perhaps my corporate contacts were "not sophisticated" in the workings of monetary policy and could not see the whole picture from their vantage point. True. But final demand does not spring from thin air. "Sophisticated" or not, these business operators are the target of our policy initiatives: You cannot have consumption and growth in final demand without income growth; you cannot grow income without job creation; you cannot create jobs unless those who have the capacity to hire people—private sector employers—go out and hire.

In the period between the August FOMC meeting and the meeting last week, some very prominent academic and policy sophisticates also questioned the efficacy of large-scale asset purchases. Among them were Michael Woodford of Columbia University—a former colleague of Ben Bernanke's when they were at Princeton—and Bill White of the Organization for

Economic Cooperation and Development and formerly of the Bank for International Settlements, and others.

Like me, Professor Woodford argues that the economy would not benefit from additional liquidity. Like me, he argues that large-scale asset purchases and maturity-extension programs like Operation Twist are unlikely to appreciably stimulate private borrowing activity through portfolio-balance or term-premium effects.[5] And as for Bill White—a globally respected economist who stood up to convention and predicted in 2003 that policies being pursued at the time would engender the financial crisis of 2008–09—here is what he wrote in a particularly thought-provoking paper a week before the Fed's annual symposium last month at Jackson Hole, Wyo.:[6]

"In this paper, an attempt is made to evaluate the desirability of ultra easy monetary policy by weighing up the balance of the desirable short run effects and the undesirable longer run effects—the unintended consequences … It is suggested that there are grounds to believe that monetary stimulus operating through traditional ('flow') channels might now be less effective in stimulating aggregate demand than is commonly asserted … It is further contended that cumulative ('stock') effects provide negative feedback mechanisms that also weaken growth over time … In the face of such 'stock' effects, stimulative policies that have worked in the past eventually lose their effectiveness.

"It is also argued … that, over time, easy monetary policies threaten the health of financial institutions and the functioning of financial markets, which are increasingly intertwined. This provides another negative feedback loop to threaten growth. Further, such policies threaten the 'independence' of central banks, and can encourage imprudent behavior on the part of governments. In effect, easy monetary policies can lead to moral hazard on a grand scale. Further, once on such a path, 'exit' becomes extremely difficult. Finally, easy monetary policy also has distributional effects, favoring debtors over creditors and the senior management of banks in particular. None of these 'unintended consequences' could be remotely described as desirable."

I do not necessarily agree with all of either Woodford's or White's arguments, but in light of my soundings of unsophisticates and sophisticates alike, I felt an urge at the meeting last week to tie the chairman to the mast, Odyssean-style, and to stuff wax in the ears of my fellow committee members, in order to resist the Siren call of further large-scale asset purchases.

But I have no such powers. I am only one officer in the loyal crew that sails under the command of Admiral Bernanke. My reports were given a fair hearing. But neither they, nor the arguments of others who questioned the need to provide further accommodation, carried the day, and a decision was made.

Having weighed the various tactical and strategic arguments of his officer corps, our helmsman decided to call down to the engine room and request that more coal be shoveled into the economy's boilers. It was decided that further accommodation would be required in the form of mortgage-backed securities purchases of $40 billion per month and that Operation Twist and the reinvestment of principal payments from our current holdings of agency debt and MBS would be maintained: A total of $85 billion a month in additional accommodation would be added to the system at least through the end of the year. For added measure, the committee announced that if

the outlook for employment does not improve "substantially," it "will continue its purchases of agency mortgage-backed securities, undertake additional asset purchases, and employ its other policy tools as appropriate until such improvement is achieved." As it always does, the FOMC noted that it will "take appropriate account of the likely efficacy and costs of such purchases."[7]

**A Fair Assessment and a Prayer**

Even though I am skeptical about the efficacy of large-scale asset purchases, I understand the logic of concentrating on MBS. The program could help offset some of the drag from higher government-sponsored entities' fees that have been recently levied, will likely lower the spreads between MBS and Treasuries and should put further juice behind the housing market—one of three durable-goods sectors that is assisting the recovery and yet is operating well below long-run potential (the other two sectors are aircraft and automobiles). The general effects of inducing more refinancing may aid housing and households in other ways. Lower mortgage rates could help improve the discretionary spending power of some homeowners. Underwater homeowners might have added incentive to continue meeting mortgage payments, spurring demand and preventing underwater mortgages from sinking the emerging housing recovery. Of course, much depends on the transmission mechanism for mortgages, as my colleague Bill Dudley spoke about yesterday.

Despite my doubts about its efficacy, I pray this latest initiative will work. Since the announcement, interest rates on 30-year mortgage commitments have fallen about one-quarter percentage point—about what I had expected—so, so far, so good.

**Our Dysfunctional Congress and Drunken Sailors**

I would point out to those who reacted with some invective to the committee's decision, especially those from political corners, that it was the Congress that gave the Fed its dual mandate. That very same Congress is doing nothing to motivate business to expand and put people back to work. Our operating charter calls for us to conduct policy aimed at achieving full employment in addition to preserving price stability. A future Congress might restrict us to a single mandate—like other central banks in the world operate under—focused solely on price stability. But unless or until that is done, we have to deliver on what the American people, as conveyed by their elected representatives, expect of us.

One of the most important lessons learned during the economic recovery is that there is a limit to what monetary policy alone can achieve. The responsibility for stimulating economic growth must be shared with fiscal policy. Ironically, and sadly, Congress is doing nothing to incent job creators to use the copious liquidity the Federal Reserve has provided. Indeed, it is doing everything to *discourage* job creation. Small wonder that the respondents to my own inquires and the NFIB and Duke University surveys are in "stall" or "Velcro" mode.

The FOMC is doing everything it can to encourage the U.S. economy to steam forward. When we meet, we consider views that range from the most cautious perspectives on policy, such as my own, to the more accommodative recommendations of the well-known "doves" on the committee. We debate our different perspectives in the best tradition of civil discourse. Then, having vetted all points of view, we make a decision and act. If only the fiscal authorities could do the same! Instead, they fight, bicker and do nothing but sail about aimlessly, debauching the nation's income statement and balance sheet with spending programs they never figure out how to finance.

I am tempted to draw upon the hackneyed comparison that likens our dissolute Congress to drunken sailors. But patriots among you might take umbrage, noting that a comparison with Congress in this case might be deemed an insult to drunken sailors.

**The Plea of the Navy Hymn and '*Illegitimum Non Carborundum*'**

If you want to save our nation from financial disaster, may I suggest that rather than blame the Fed for being hyperactive, you devote your energy to getting our nation's fiscal authorities to do their job.

Since 1879, every chapel service at the Naval Academy concludes with a hymn that contains the following plea: "O hear us when we cry for Thee, for those in peril on the sea." We cry for a nation that is in peril on the blustery seas of the economy. Our people are drowning in unemployment; our government is drowning in debt. You—the citizens and voters sitting in this room and elsewhere—are ultimately in command of the fleet that sails under the flag of the United States Congress. Demand that it performs its duty.

Just recently, in a hearing before the Senate, your senator and my Harvard classmate, Chuck Schumer, told Chairman Bernanke, "You are the only game in town." I thought the chairman showed admirable restraint in his response. I would have immediately answered, "No, senator, you and your colleagues are the only game in town. For you and your colleagues, Democrat and Republican alike, have encumbered our nation with debt, sold our children down the river and sorely failed our nation. Sober up. Get your act together. *Illegitimum non carborundum*; get on with it. Sacrifice your political ambition for the good of our country—for the good of our children and grandchildren. For unless you do so, all the monetary policy accommodation the Federal Reserve can muster will be for naught."

But, then again, I am not Ben Bernanke. And I imagine that after listening to me this evening, you might be grateful I am not.

Now, in the great tradition of central banking, I will do my utmost to provide you with the "straight skinny" and avoid answering any questions you might have.

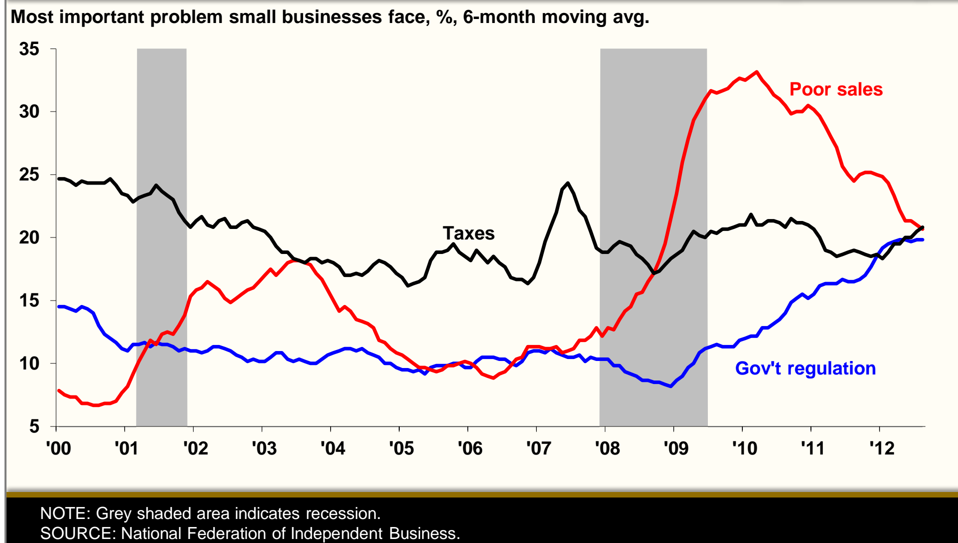
Thank you.

**Notes**

[1] On March 4, 2011, President Drew Faust announced that the Navy Reserve Officers' Training Corps would return to Harvard University after a 40-year absence. For more, see "ROTC Returns to Harvard," by Jennifer Levitz, *Wall Street Journal*, Sept. 11, 2012.

[2] See *Texas Got It Right!* by Sam and Andrew Wyly, New York: Melcher Media, October 2012.

[3] See Small Business Economic Trends survey, National Federation of Independent Business, September 2012, www.nfib.com/research-foundation/surveys/small-business-economic-trends.




[4] See Duke University/CFO Magazine Global Business Outlook Survey, Duke University's Fuqua School of Business, www.cfosurvey.org.
[5] See "Methods of Policy Accommodation at the Interest-Rate Lower Bound," by Michael Woodford, Columbia University, August 2012.
[6] See "Ultra Easy Monetary Policy and the Law of Unintended Consequences," by William R. White, Federal Reserve Bank of Dallas Globalization and Monetary Policy Institute Working Paper no. 126, www.dallasfed.org/assets/documents/institute/wpapers/2012/0126.pdf.
[7] See the Federal Open Market Committee statement, Sept. 13, 2012, www.federalreserve.gov/newsevents/press/monetary/20120913a.htm.