

Hard Choices

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These are trying times for the U.S. economy. The unemployment rate is almost 10 percent, our financial system remains under stress, community bank failures have become weekly news and the central bank is printing money to such an extent that zero interest rates bring little return to those who choose to save.

Not in decades has the Federal Reserve seen such challenges in how it conducts monetary policy. With this in mind, this morning I will give you my sense of the issues we face and the hard choices that must be made. I'll begin by focusing on financial reform legislation, including my observations about where we are with too-big-to-fail. Then I'll turn to the economy and monetary policy.

Regulatory Choices

On March 6, 2009, I gave a speech in Omaha called "Too Big Has Failed." I shared my thoughts about the financial crisis and my concern for the long-run effects of bailing out investors of the largest financial institutions. That speech hit a nerve by stating what many considered a simple truth, which is that taxpayers should not subsidize our largest financial firms. With our very important Federal Reserve Branch office in Omaha, I have been in Nebraska many times since then, but this is my first trip back after the passage of financial reform legislation, so it seems an appropriate time to review some of the implications of enacting the 2,300-page law.

Overall, important steps were taken in an effort to strengthen and enhance the regulatory framework and accountability of financial institutions. However, the success of this legislation entirely depends on how well regulatory authorities implement the new requirements.

There is, for example, a provision called the Volcker Rule, which will limit a large firm's ability to set up speculative activities. So-called "proprietary" trading and the sponsorship of hedge funds that engage in higher-risk activities must be done outside of commercial banks and bank holding companies, away from direct access to insured funds and the Federal Reserve's discount window. This is an important provision. However, there are exceptions to the rule and, again, whether it works as intended will depend on how strongly the rules are written, and how well they are interpreted and enforced.

The legislation also sets up a new consumer bureau to address the gaps in unregulated and under-regulated financial firms, including mortgage finance companies, payday lenders and credit card issuers. Its success will depend on whether it can appropriately identify those institutions exploiting those gaps and bring them into accepted standards of behavior. If the new bureau merely directs its resources to the already heavily regulated community banks, its beneficial effects will be minor. A targeted implementation program is critical if the consumer is to experience the hoped-for benefits.

The legislation primarily hoped to address the public's concerns about too-big-to-fail institutions—that is, those that are so large and interconnected that they will be bailed out by taxpayers no matter what risks and bad decisions they make because they are too “systemically important” to be allowed to fail. Whether or not too-big-to-fail is addressed by this legislation depends on the leadership at the regulatory agencies when the next crisis occurs. The law now requires that the FDIC take into receivership an institution that is designated as “in default or danger of default” for which the regular bankruptcy process would have systemic consequences. The process for taking this action is complex, requiring multiple regulatory parties to agree, the Treasury Secretary making the final determination with the President's concurrence, and a court ruling that the action isn't arbitrary and capricious. This will be an incredible challenge for the regulatory agencies. Recent experience tells us that time is of the essence in a national liquidity crisis. It will be extremely difficult in practice to designate the largest institutions as insolvent, take them over and liquidate. The simple truth is “too-big-to-fail” will not go away easily.

Our largest institutions, even after their poor performance during this last crisis, remain financially and politically powerful institutions. It gives me pause, for example, that after the recent devastating experience of the global banking crisis, regulatory authorities are already backing off initial attempts to strengthen international capital requirements for these largest banks and financial firms. The Basel Committee just announced an agreement to establish for our largest global banks a Tier 1 capital-to-asset ratio of 3 percent. This is a 33-to-1 leverage ratio. Bear Stearns entered this crisis and failed with a 34-to-1 leverage ratio. It leaves a small cushion for error and is a level of risk that I judge unacceptable.

As I consider the outlook for financial regulation, I am hopeful but realistic regarding whether next time things will be different. Regulatory agencies have been given a mandate and authority to strengthen oversight of the largest firms. Success will depend on whether we choose to make hard calls and to use the new authority with integrity, fairness and resolve.

Monetary Choices

I want to spend my remaining time on monetary policy. I acknowledge that there are different perspectives on the array of economic data we receive and analyze, and therefore there are legitimate, differing views about what is best for the economy. The Federal Reserve has a dual mandate to pursue stable prices and stable long-term growth. The entire FOMC is committed to pursuing those goals, but there are differing views on the causes and fixes to our current situation.

I have been at the Fed through past swings in the business cycle. There is today a familiar theme as I listen to the media, various economists and “market experts.” They say we are entering the era of a “new normal” in which we have to accept high unemployment and low income growth and that interest rates will remain at zero indefinitely. They warn that deflation is a serious risk and that the U.S. could become another Japan, which must be avoided at all costs. Before this week’s FOMC meeting, *The Wall Street Journal* wrote that the Fed would add more stimulus into the economy—including the purchase of long-term treasuries. It turns out that reporter was remarkably prescient.

I share these concerns about our economy. Economic conditions are far from satisfactory, unemployment is simply too high, and we want a stronger recovery. But as much as I want short-term improvement, I am mindful of possible longer-term consequences of zero interest rates and further easing actions. Rather than improve economic outcomes, I worry that the FOMC is inadvertently adding to “uncertainty” by taking such actions. Remember, high interest rates did not cause the financial crisis or the recession. Let me summarize four key points that I judge relevant in choosing among monetary policy options.

Trend data show modest recovery

The recovery is proceeding as many economists earlier this year outlined that it would. It is a modest recovery, with mixed results. Yet, GDP is likely to expand at somewhere around a 3 percent rate through the remainder of the year. Month-to-month data will be mixed, as is typical during recovery. For example, industrial production was down 0.3 percent for April, up 1.3 percent for May, and up 0.1 percent for June. New orders for non-defense capital goods

excluding aircraft were down 2.8 percent in April, up 4.7 percent in May, and up 0.6 percent in June. Durable goods orders were up by 2.9 percent in April, down 0.7 percent in May and down 1.2 percent in June. Corporate profits are being reported as consistently strong, month after month. What these data points tell me is that volatile monthly data should not drive policy actions.

While monthly data may be mixed, the trend data are consistently positive. Private job growth has been less than hoped for but positive nonetheless. Private payrolls increased 630,000 since January 1. In the first half of the year, private labor income increased in all components: hours worked, employment and wages. Hours worked have risen more rapidly than employment, which is typical for the early stages of an economic recovery. In fact, we are experiencing a better pace of recovery this time than at this point in our previous two economic recoveries.

In addition, since the second quarter of 2009, personal income growth has increased 2.8 percent, consumption is up 1.6 percent, investment in equipment and software is up 15 percent, and housing is up 5.3 percent. Year-over-year, industrial production is up 8.2 percent, high tech is up 20 percent and manufacturing is up 8.3 percent. Corporate profits are up 57 percent since the fourth quarter of 2008. While we are not where we want to be, the economy is recovering and, barring specific shocks and bad policy, it should continue to grow over the next several quarters.

Corrections take time

We are recovering from a horrific set of shocks, and it will take time to “right the ship.” Moreover, the financial and economic shocks we have experienced did not “just happen.” The financial collapse followed years of too-low interest rates, too-high leverage, and too-lax financial supervision as prescribed by deregulation from both Democratic and Republican administrations. In judging how we approach this recovery, it seems to me that we need to be careful not to repeat those policy patterns that followed the recessions of 1990-91 and 2001. If we again leave rates too low, too long out of our uneasiness over the strength of the recovery and our intense desire to avoid recession at all costs, we are risking a repeat of past errors and the consequences they bring.

Here are some important figures regarding just how out of balance our economy became and what might have contributed to these imbalances between the early '90s and today:

- The real fed funds rate averaged 1.6 percent between 1991 and 1995, 0.37 percent between 2001 and 2005 and -1.0 percent from 2008 to the present, hardly a tight policy environment.
- Gross federal debt increased from 60 percent to 75 percent of nominal GDP
- Consumer debt increased from 63 percent to 94 percent of nominal GDP
- Nonfinancial debt increased from 189 percent of nominal GDP at the start of the decade to 234 percent by December 2008.
- Between 1993 and 2007, the average leverage of the 20-largest financial institutions in the U.S. (total assets-to-tangible equity capital) increased from 18-to-1, to over 25-to-1, reaching as high as 31-to-1.
- The U.S. increased its debt to the rest of the world dramatically from 4.87 percent to 24.32 percent of nominal GDP.

Obviously, the effect of these trends on our economy has been significant and we must accept that they will not be corrected quickly.

It is not time for tight policy

In my view, maintaining an accommodative monetary policy is necessary at this time, but a clear policy path toward a less highly accommodative policy will encourage a more sustained recovery. Under such a policy, financial deleveraging will evolve slowly and many of the remaining economic imbalances will rebalance. Under such a policy, the economy will expand at a sustainable moderate pace with similar moderate job growth, but job growth that will be stable and resilient. There may be ways to accelerate GDP growth, but in my view, highly expansionary monetary policy is not a good option.

To be clear, I am not advocating a tight monetary policy. I am advocating a policy that remains accommodative but slowly firms as the economy itself expands and moves toward more balance. I advocate dropping the “extended period” language from the FOMC’s statement and removing its guarantee of low rates. This tells the market that it must again accept risks and lend if it wishes to earn a return. The FOMC would announce that its policy rate will move to 1

percent by a certain date, subject to current conditions. At 1 percent, the FOMC would pause to give the economy time to adjust and to gain confidence that the recovery remains on a reasonable growth path. At the appropriate time, rates would be moved further up toward 2 percent, after which the nominal fed funds rate will depend on how well the economy is doing.

If such a path were chosen, then how might GDP and important components perform? Let me start with consumption, which for decades amounted to about 63 percent of GDP. During the boom it rose to 70 percent. It seems reasonable that the consumer will most likely return toward more historical levels relative to GDP and then grow in line with income. If so, the consumer will contribute to growth but is unlikely to intensify its contribution to previously unsustainable levels.

To view the role of the consumer from another perspective, I would note that personal savings declined from nearly 10 percent of disposable income in 1985 to less than 2 percent in 2007. It is now closer to 6 percent, better in many ways, but still below historical norms. Assuming it stabilizes and personal incomes grows as it has so far this recovery, you get a clearer sense of how consumption will contribute to the economy's expansion but also why it is unlikely to play a dominant role as it did in this past decade.

While businesses need to rebalance as well, they are essential to the strength of the recovery. Fortunately, they are in the early stages of doing just that. Profits are improving and corporate balance sheets for the nonfinancial sector are strengthening and are increasingly able to support investment growth as confidence in the economy rebuilds. Also, although credit supply and demand may be an issue impeding the recovery to some extent, a shortage of monetary stimulus is not the issue. There is enormous liquidity in the market, and it can be accessed as conditions improve.

Finally, the federal government needs to rebalance its balance sheet as well. Federal and state budget pressures are enormous, and uncertain tax programs surely are a risk to the recovery. This adds harmful uncertainty upon both businesses and consumers. However, while these burdens are a drag on our outlook, they are not new to the U.S. and, by themselves, should not bring our economy down unless they go unaddressed.

I believe the economy has the wherewithal to recover. However, if, in an attempt to add further fuel to the recovery, a zero interest rate is continued, it is as likely to be a negative as a positive in that it brings its own unintended consequences and uncertainty. A zero policy rate

during a crisis is understandable, but a zero rate after a year of recovery gives legitimacy to questions about the sustainability of the recovery and adds to uncertainty.

Market motives

We were reminded of the critical nature of our financial markets when they locked up during the crisis. We need markets to function smoothly. However, market participants should not direct policy. When mixed data are reported as systematically negative results, and the more positive, long-term growth trends fail to be adequately acknowledged, it is an invitation to hasty actions. Of course the market wants zero rates to continue indefinitely: They are earning a guaranteed return on free money from the Fed by lending it back to the government through securities purchases.

The current recovery in its first year saw GDP grow an average of 3.2 percent. The GDP growth rate for the 1991 recovery was 2.61 percent; and for the 2001 recovery, it was 1.92 percent. We would all like to see a stronger recovery, but slow growth is not a decline in growth and we should not react hastily.

The summer of 2010 has seemed strikingly familiar to me. I recently went back and looked at news reports for the spring and summer of 2003, just prior to when the FOMC lowered the fed funds rate to 1 percent, where it remained until 2004. I'll provide just two examples. In June 2003, one prominent economist noted in *USA Today*: "The Federal Reserve Board recently warned that America faces a risk of [deflation]. Japan has been suffering from it for more than a decade. Europe may be heading toward it. The entire world economy could succumb to it. ...This could be the first round in a deflationary cycle. The Commerce Department reports orders to U.S. factories slipped 2.9% in April from March, the largest decline in 17 months. ...With fewer jobs and stagnant wages, Americans won't be able to buy enough to keep the economy going."

Also in June 2003, a *Boston Globe* columnist noted: "On the surface, one can make the case that the Fed doesn't have to do anything at all. Interest rates are incredibly low....Still, the Fed will not sit on its hands. Chairman Alan Greenspan and his deputies have done everything but advertise the coming rate cut on the Goodyear blimp. Their motivation is to avoid deflation.

...Another rate cut, even a cut of one-half point, doesn't guarantee that there won't be an economic collapse. But it makes that collapse less likely—hence the notion of rate cut as

insurance policy. As insurance, a rate cut is pretty cheap. Lower rates aren't going to trigger a burst of inflation, and if they give the economy an extra boost, well, who is going to complain about that?"

In the third quarter of 2003, immediately following these and many similar articles, GDP expanded at what turned out to be nearly a 7 percent annual rate, yet rates were left at 1 percent for several months. With the low rates very low for a considerable period, credit began to expand significantly and set the stage for one of the worst economic crisis since the great depression. In my view, it was a very expensive insurance premium. Unemployment today is 9.5 percent. I fully acknowledge that I was on the FOMC at that time. That's why I believe that zero rates during a period of modest growth are a dangerous gamble.

The Great Depression of the 1930s was a traumatic event. We need to be aware of its lessons. We need to avoid its mistakes. For example, the Fed should never again double reserve requirements overnight. However, I urge us not to forget other more-recent lessons from the great inflation and the financial crisis of 2008: Real interest rates that are negative 40 percent of the time create severe consequences.

One final note about deflation: The consumer price index was a mere 18 in 1945 but was 172 at the start of this century. Today, despite our most recent crisis, the CPI is over 219. Not once during more than half a century has the index systematically declined. I find no evidence that deflation is the most serious threat to the recovery today.

Conclusion

I agree that the Federal Reserve needs to keep its policy rate accommodative. For a while longer, it should remain even below the long-run equilibrium rate. However, the economy is improving and is growing at a rate faster than the last two recoveries. Importantly, the recent financial crisis and recession was not caused by high interest rates but by low rates that contributed to excessive debt and leverage among consumers, businesses and government. We need to get off of the emergency rate of zero, move rates up slowly and deliberately. This will align more closely with the economy's slow, deliberate recovery so that policy does not lag the recovery.

Monetary policy is a useful tool, but it cannot solve every problem faced by the United States today. In trying to use policy as a cure-all, we will repeat the cycle of severe recession

and unemployment in a few short years by keeping rates too low for too long. I wish free money was really free and that there was a painless way to move from severe recession and high leverage to robust and sustainable economic growth, but there is no short cut.