THE FEDERAL RESERVE'S MANDATE: LONG RUN

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Introduction and Framework

Thank you, and it is a pleasure to welcome you to Denver. This is the largest metropolitan area in the Tenth Federal Reserve District and home to one of three branches of the Federal Reserve Bank of Kansas City. The Denver branch serves Colorado, Wyoming and New Mexico—three of the seven states of our region.

I appreciate this opportunity to engage and interact with business economists from around the country regarding the policy choices now confronting the nation, especially those confronting the Federal Reserve.

In setting out my views, I'll first spend a minute describing the economy's performance and then turn to the matter of quantitative easing versus my preferred path of gradual steps to a renormalization of monetary policy.

Short-Term Outlook

Currently, a major and necessary rebalancing is taking place within our economy. This includes the deleveraging of consumers, businesses and financial institutions, and it's during a time that state and local governments are struggling with budgets and mounting debt loads. In this context, a modest recovery with positive overall data trends should be seen as highly encouraging.

Following a bounce back from restocking earlier this year, the economy has slowed but it has not faltered. GDP growth has averaged about a 2½ percent annual pace since the first of the year. Industrial production is showing growth of almost 6 percent, and high-tech more than double that. The consumer continues to buy goods, with personal income growing at more than a 3 percent rate, personal consumption expenditures at about 3 percent, and retail sales at more than 4 percent. And the U.S. economy has added more than 850,000 net new private sector jobs since the first of the year. While modest, these are positive trends for the U.S. economy.

The issue is, of course, that while private jobs are being added within the economy, it is not enough to bring unemployment down to where we all would like to see it. Unemployment remains stubbornly high at 9.6 percent. With such numbers, there is, understandably, a desire and considerable pressure for the Federal Reserve to "do something, anything" to get the economy back to full employment. And for many, including many economists, this means having the Federal Reserve maintain its zero interest rate policy or further still, engage in a second round of quantitative easing – now called QE2. Some are even suggesting these actions are necessary for the Federal Reserve to comply with its statutory mandate.

Interpreting the Policy Mandate

The FOMC's policy mandate is defined in the Federal Reserve Act, which requires that: "The Board of Governors of the Federal Reserve System and the Federal Open Market Committee shall maintain long-run growth of the monetary and credit aggregates commensurate with the economy's long-run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates."

There is, within the Act, a clear recognition that our policy goals are long-run in nature. In this way, the Act recognizes that monetary policy works with long and variable lags. Thus, the FOMC should focus on fostering maximum employment and stable prices in the timeframe that monetary policy can legitimately affect – the future. The FOMC must be mindful of this fact and be cautious in pursuing elusive short-term goals that have unintended and sometimes disruptive effects.

In recent weeks, some have argued that with inflation low and the jobless rate high, the Federal Reserve should provide additional accommodation. Such an action – the purchase of assets by the central bank as a policy easing tool – would mark a second round of quantitative easing. While there are several ways to accomplish this, many suggest that the most likely method would be for the Federal Reserve to purchase additional long-term securities, including U.S. Treasuries.

Proponents of QE2 argue that it would provide a near-term boost to the economy by lowering long-term interest rates while raising inflation. These benefits would arise from the purchase of U.S. Treasury securities, which would lead to lower U.S. Treasury and corporate rates. These lower interest rates would then stimulate consumer and business demand in several ways, including encouraging mortgage refinancing that could lead to increased consumer spending, boosting exports through a likely lower exchange rate, and fostering higher equity prices, thereby creating additional wealth. Such a move is said to be consistent with the FOMC's September 21, 2010 announcement, which stated that it 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."

Such easing, it is hoped, would bring inflation back up to something closer to 2 percent, a rate that many judge to be consistent with the Federal Reserve's mandate. In addition, higher inflation would increase demand as consumers move purchases forward to avoid paying higher prices in the future.

So, with these purported benefits, why would anyone disagree?

New Risks and QE2

I believe there are legitimate reasons to be cautious when considering this approach. A meaningful evaluation of QE2 must consider not simply whether benefits actually exist but, if they do, how large they are and whether they are larger than possible costs.

Based on recent research and the earlier program of purchasing long-term securities—known as LSAP—I think the benefits are likely to be smaller than the costs.

Some estimates suggest that purchasing $500 billion of long-term securities might reduce interest rates by as little as 10 to 25 basis points. The LSAP program was effective, in part, because we were in a crisis. Financial markets were not functioning properly, or at all, during the depths of the financial crisis. In such a situation, it is reasonable that central bank purchases would be useful and effective. However, currently the markets are far calmer than in the fall of 2008. The financial crisis has passed and financial markets are operating more normally. One could argue, in fact, that with markets mostly restored to pre-crisis functioning, the effect of asset purchases could be even smaller than the 10 to 25 basis point estimate.

I would also suggest that even if we achieved slightly lower interest rates, the effect on economic activity is likely to be small. Interest rates have systematically been brought down to unprecedented low levels and kept there for an extended period. The economy's response has been positive but modest.

In fact, right now the economy and banking system are awash in liquidity with trillions of dollars lying idle or searching for places to be deployed or, perhaps more recently, going into inflation hedges. Dumping another trillion dollars into the system now will most likely mean they will follow the same path into excess reserves, or government securities, or "safe" asset purchases. The effect on equity prices is likely to be minor as well. There simply is no strong evidence the additional liquidity would be particularly effective in spurring new investment, accelerating consumption, or cushioning or accelerating the deleveraging that is hopefully winding down.

If the purported benefits are small, what are the possible costs?

First, without clear terms and goals, quantitative easing becomes an open-ended commitment that leads to maintaining the funds rate too low and the Federal Reserve's balance sheet too large. The result is a further misallocation of resources, more imbalances and more volatility.

There is no working framework that defines how a quantitative easing program would be managed. How long would the program continue, and what would be the ultimate size? Would purchases of long-term assets continue until the unemployment rate is 9 percent or 8 percent or even less? Would purchases continue until inflation rises to 2 percent or 3 percent or more? Would the program aim to reduce the 10-year Treasury rate to 2¼ percent or 2 percent or even less? Without answers to these and other questions, QE2 becomes an open-ended policy that introduces additional uncertainty into markets with few offsetting benefits.

As central bank assets expand under quantitative easing, what will be the exit strategy? In the midst of a financial crisis, we may not have the luxury of thinking about the exit strategy. In current circumstances, however, we must define an exit strategy if the objective is to raise inflation but contain interest rate expectations. If history is any indication, without an exit strategy the natural tendency will be to maintain an accommodative policy for too long.

While I agree that the tools are available to reduce excess reserves when that becomes appropriate, I do not believe that the Federal Reserve, or anyone else, has the foresight to do it at the right time or right speed. It may work in theory. In practice, however, the Federal Reserve doesn't have a good track record of withdrawing policy accommodation in a timely manner.

Second, we risk undermining Federal Reserve independence. QE2 actions approach fiscal policy actions. Purchasing private assets or long-term Treasury securities shifts risk from investors to the Federal Reserve and, ultimately, to U.S. taxpayers. It also encourages greater attempts to influence what assets the Federal Reserve purchases. When the Federal Reserve buys long-term securities – such as the $1.2 trillion in mortgage backed securities it purchased during the financial crisis – it favors some segments of the market over others. And when the Federal Reserve is a ready buyer of government debt, it becomes a convenient source of cash for fiscal programs. During a crisis this may be justified, but as a policy instrument during normal times it is very dangerous precedent.

Third, rather than inflation rising to 2 or 3 percent, and demand rising in a systematic fashion, we have no idea at what level inflation might settle. It could remain where it is or inflation expectations could become unanchored and perhaps increase to 4 or 5 percent. Not knowing what the outcome might be makes quantitative easing a very risky strategy. It amounts to attempting to fine-tune inflation expectations—a variable we cannot precisely or accurately measure—over the next decade.

And why might inflation expectations become unanchored?

The budget deficit for 2011 is expected to be about $1 trillion. Even if the Federal Reserve were to purchase only $500 billion—and this amount in itself is a source of considerable uncertainty—that would appear to monetize one-half of the 2011 budget deficit. In addition, the size of the Federal Reserve's balance sheet—now and over the next decade—will influence inflation expectations. Expanding the balance sheet by another $500 billion to $1 trillion over the next year, and perhaps keeping the balance sheet at $3 trillion for the next several years, or increasing it even further, risks undermining the public's confidence in the Fed's commitment to long run price stability, a key element of its mandate.

While QE2 might work in clean theoretical models, I am less confident it will work in the real world. Again, I will note that the FOMC has never shown itself very good at fine-tuning exercises or in setting and managing inflation and inflation expectations to achieve the desired results.

Given the likely size of actions and the time horizon over which QE2 would be in place, inflation expectations might very well increase beyond targeted levels, soon followed by a rise in long-term Treasury rates, thereby negating one of the textbook benefits of the policy.

Non-Zero Rates as an Option

At this point, with a modest recovery underway and inflation low and stable, I believe the economy would be better served by beginning to normalize monetary policy. If long run stability is the goal, then re-normalizing policy is an important step toward realizing that goal. How might we achieve this goal?

First, rather than expand the Federal Reserve's balance sheet by purchasing additional U.S. Treasury securities, the Fed should consider discontinuing the policy of reinvesting principal payments from agency debt and mortgage-backed securities into Treasury securities. Given where we are, we would need to make such a change slowly but systematically. Allowing maturing mortgage backed securities to roll off, the Federal Reserve's balance sheet would shrink gradually, with relatively small consequences for financial markets.

Second, we should take the first early steps to normalize interest rate policy. This is not a call for high rates but a call for non-zero rates. In 2003 the FOMC delayed our efforts to raise rates. In that period we reduced the federal funds rate to 1 percent and committed to keeping it there for a considerable period. This policy fostered conditions that let to rapid credit growth, financial imbalances and the eventual financial collapse from which we are still recovering. Had we been more forceful in our action to renormalize policy then, it's likely we might have suffered far less in 2008 through 2010.

Also, any effort to renormalize policy would include signaling a clear intention to remove the commitment to maintain the federal funds rate at 0 to ¼ percent "for an extended period." As the public adjusts to this, we should then turn to determining the pace at which we return the funds rate to 1 percent. Once there, we should pause, assess and determine what additional adjustment might be warranted. A 1 percent federal funds rate is extremely accommodative, but from that point we could better judge the workings of the interbank and lending markets and determine the order of policy actions that would support sustained long-term growth.

Other Concerns Regarding Zero Rates

These are difficult times, no doubt, and it is tempting to think that zero interest rates can spark a quick recovery. However, we should not ignore the possible unintended consequences of such actions. Zero rates distort market functioning, including the interbank money and credit markets; zero rates lead to a search for yield and, ultimately, the mispricing of risk; zero rates subsidize borrowers at the expense of savers.

Finally, it is important to note, that business contacts continue to tell me that interest rates are not the pressing issue. Rather, they are concerned with uncertainties around our tax structure; they are desperate to see this matter settled. They need time to work through the recent healthcare changes; and they are quite uncertain about how our unsustainable fiscal policy will be addressed. They are insistent that as these matters are addressed, they will once again invest and hire. QE2 cannot offset the fundamental factors that continue to impede our progress.

Conclusion

We are recovering from a set of shocks, and it will take time. These shocks did not develop overnight, but came after years of interest rates that were too low, leverage that was too high, and financial supervision that was too lax. If we have learned anything from this crisis, as well as past crises, it is that we must be careful not to repeat the policy patterns we have used in previous recoveries, such as 1990-91 and 2001. If we again leave rates too low for too long out of fear that the recovery is not strong enough, we are almost assured of suffering these same consequences yet again. I am fully committed to the Federal Reserve's dual mandate to maintain long-run growth so as to promote effectively the goals of maximum employment, stable prices and moderate long-term interest rates.