Monetary Policy and Shifting Economic Risks

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Introduction

The past three year period has been a great challenge to policymakers worldwide, including central bankers. Unprecedented steps have been taken to restore stability to the world economy and, just as importantly, to assure a sustained recovery. I certainly support these goals. While I argued for handling the largest financial institutions differently than was done, I supported the Federal Reserve's massive liquidity injections designed to staunch the financial crisis. After all, central banks exist in part for just that purpose. However, when the crisis is past, it is incumbent upon central banks to return to another of their responsibilities: creating conditions for a sustained economic recovery that requires looking beyond short-term goals to long-term consequences.

For more than a year, I have advocated, not for a tight U.S. monetary policy, but for one that would begin unwinding those policies put in place during the crisis. In January 2010, as the recovery entered its third quarter, I expressed the view that the Federal Open Market Committee should modify its rate guarantee to the market. That is, while agreeing that policy should remain accommodative, I voted against promising "exceptionally low rates for an extended period." As the recovery continued into the spring, I judged that the Federal Reserve should gradually shrink its enlarged balance sheet with minimal market disruption by disposing of mortgage-backed securities that were trading in the market at a premium. Thus, I voted against replacing maturing MBSs with similar or other securities. Finally, in the fall, I questioned the long-term benefits of further easing monetary policy during a recovery – and I voted against QE2.

Today, my view has not changed. The FOMC should gradually allow its $3 trillion balance sheet to shrink toward its pre-crisis level of $1 trillion. It should move the U.S. federal funds rate off of zero and toward 1 percent within a fairly short period of time. Then, after evaluating the effects of those actions, it should be prepared to move the funds rate further toward a level that could be reasonably judged as closer to normal and sustainable.

I recognize that these actions are not simple to implement. They would impact different economic sectors differently and to varying degrees. They involve tradeoffs in their effects and uncertainty about the short-term reactions of financial markets and the real economy. However, they are not unreasonable or radical or inconsistent with our experience in dealing with past crises. They are focused on the longer run – reflecting a sharp awareness that policy geared too long toward extensive accommodation undermines market discipline and encourages speculative activities. Put another way, these actions reflect the view that the longer exceptionally accommodative monetary policies remain in place, the greater the danger that resources will be misallocated within and across world economies.

Given the wide differences in views around these issues, I want to take time this evening to share my perspective on U.S. monetary policy choices and their effects on economic and financial outcomes.

Recovery is Under Way

The financial crisis is over, and the U.S. economy is recovering. GDP growth in the United States averaged 3.0 percent from the third quarter of 2009 through the fourth quarter of 2010. And it is worth noting that for the same period, the International Monetary Fund estimates that global GDP growth averaged 4.9 percent. Also, the United States added 1.5 million jobs into the private sector over the one-year period ending in February of this year. Other parts of the world, especially Asia, have experienced particularly strong growth. While parts of Europe and the U.K. have grown less robustly, the fact remains that the U.S. and much of the world is experiencing sustained economic growth.

With the United States and many world economies experiencing such growth and with the U.S. financial crisis over, I would expect to see a change in policy in which stimulus put in place at the height of the crisis would be throttled back. However, this change in policy is on hold in the United States. The reason for the delay is the existence of significant productive capacity that remains unused in many of the developed nations. While the U.S. economy has clearly strengthened, it has not yet returned to pre-crisis output and employment levels. Its unemployment rate, for example, remains near 9 percent. In the U.K., unemployment remains near 8 percent. Thus for many the issue of policy turns on one's confidence in the long run economic trends and the degree of monetary accommodation needed to ensure that those trends continue.

Shifting Economic Risks

The monetary policy being implemented currently within the United States and much of the world is more accommodative now than at the height of the crisis. Policy interest rates remain zero, and the Federal Reserve's balance sheet continues to expand even as the economy improves. With these actions, the FOMC's objectives have shifted from that of containing a global crisis to that of more quickly accelerating economic growth. Its components focus on raising inflation expectations, increasing asset values and pushing up growth in aggregate demand, and, as stated in its September 2010 press release, employment. While I agree these are worthy goals, I am concerned that maintaining a crisis-oriented policy as the tool to achieve them significantly changes the economic risks. Past success in pursuing this form of policy is mixed at best.

Central Banks and the Long Run

A Swiss central banker once advised me that the duty of a central banker is to take care of the long run so the short run can take care of itself. In the United States, this simple expression has been codified in its laws. The Federal Reserve Act requires that, "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."

These mandates recognize that the factors of production come together in a systematic fashion across economies, sectors within economies and resource availability to create growth. The process is not simple nor does it occur quickly – which is the purpose of putting policy in the context of the long run. It is within this context that policy should acknowledge the improving economic trends and begin to withdraw some degree of accommodation. If this is not done, then the risk of introducing new imbalances and long-term inflationary pressures into an already fragile recovery increase significantly.

Short-Run Actions Have Consequences

In the spring of 2003 there was worldwide concern that the U.S. economy was falling into a "Japanese-like" malaise; the recovery was stalling, deflation was likely to occur and unemployment was too high. This was the prevailing view despite the fact that the U.S. economy was growing at a 3.2 percent annual rate and the global economy's average growth was nearly 3.6 percent. In addition, the fed funds policy rate was 1 ¼ percent. Although most knew that such a low rate would support an expanding economy, in June 2003 it was lowered further to 1 percent and was left at that rate for nearly a year, as insurance.

Following this action, the United States and the world began an extended credit expansion and housing boom. From July 2003 to July 2006, the monetary base in the United States increased at an average annual rate of 4.9 percent, credit increased at an annual rate of 9 percent, and housing prices increased at an annual rate of about 14 percent. The long-term consequences of that policy are now well known. The United States and the world have just suffered one of the worst recessions in decades.

The crisis has sometimes been described as a "perfect storm" of unfortunate events that somehow came together and systematically undermined the financial system. Such events included, for example, weak supervision and a misguided national housing policy. While these factors certainly contributed to the severity of the crisis, monetary policy cannot escape its role as a primary contributing factor.

In reviewing data from this and earlier economic crises, the fact is that extended periods of accommodative policies are almost inevitably followed by some combination of ballooning asset prices and increasing inflation. I recently compared the movement of real policy interest rates and inflation for four countries: the United States, the U.K., Germany and Korea from 1960 to the present (Chart 1). The relationship between negative rates and high inflation is unmistakable. Also, the relationship between negative rates and housing price busts in advanced economies since 1970 is instructive. In this instance, nearly 50 percent of the housing price busts were preceded by negative real policy rates in the years before the busts (Chart 2). If a housing bust is thought of as a tail-risk event, these percentages are too high. Thus, it is also worth noting that as of this month, the U.S. real federal funds rate has been negative for 11 quarters.

These relationships, of course, must be tested more vigorously before final conclusions are drawn; but the data are strongly suggestive and the findings consistent with those of scholars such as Allan Meltzer. Extended periods of accommodative policy, pursued to enhance short-term economic growth, are often highly disruptive in their economic effects. After the easing actions of 2003, unemployment declined from 6.3 percent in June 2003 to 5 percent two years later and to 4.6 percent the following year. However, by late 2009, following the worst of the credit crisis, the unemployment rate was more than 10 percent.

The Future

As in 2003, concerns were voiced this past year that the U.S. economy was facing the prospect of deflation, slow growth and high unemployment. This was the case despite the many actions world economies had taken to remedy the crisis and stimulate growth. For me, it was difficult to conclude that more monetary expansion would assure a sustained recovery, and while there may be events that may slow economic growth, those events are related to other real factors.

As the United States continues to ease policy into its recovery, once again there are signs that the world is building new economic imbalances and inflationary impulses. I would suggest also that the longer policy remains as it is, the greater the likelihood these pressures will build and ultimately undermine world growth. In the United States, for example, with very low interest rates, we are beginning to see some assets accelerating in price. Agricultural land prices, for example, are increasing at double-digit rates. High-yield securities in financial markets are demanding price premiums beyond what some would judge reasonable relative to risk. Why? To quote a market participant, “What are my choices?”

The world for some time now has been experiencing rapidly rising commodity prices. While some of the increase may reflect global supply and demand conditions, at least some of the increase is driven by highly accommodative monetary policies in the United States and other economies. And, more recently, in the United States there is evidence of accelerating increases in core prices. Over the past four months, core PCE inflation in the United States has increased from a modest rate of 0.7 percent to a rate of 1.5 percent. I understand the U.K. also is experiencing rising prices. While no one can say with certainty whether this will continue, evidence is mounting that it might.

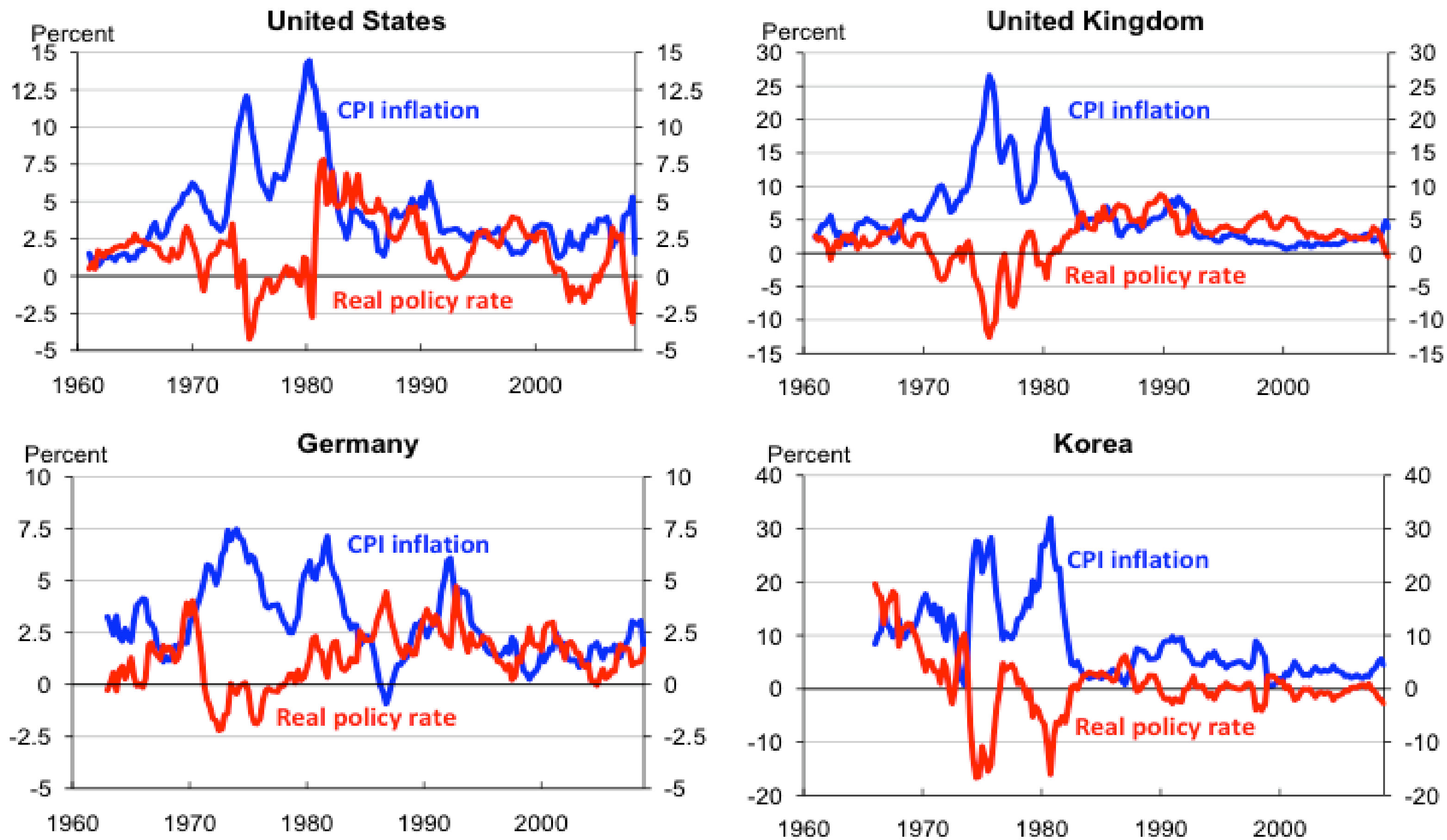
I conclude my remarks this evening with the following observation. I tracked the average growth of money and the price levels in the United States from the 19th century to the present (Chart 3). It should surprise no one that there is a striking parallel between the long-run growth of money and the growth in the price-level index. From the end of World War II alone, the price index has increased by a factor of ten. With such a track record, it is hard to accept that deflation should be the world’s dominant concern.

Conclusion

Central bankers must look to the long run. If current policy remains in place, we almost certainly will stimulate the growth of asset values and inflation. This may temporarily increase GDP and employment, but in the long run, we risk instability, damaging inflation and lost jobs, which is a dear price for middle and lower income citizens to pay.

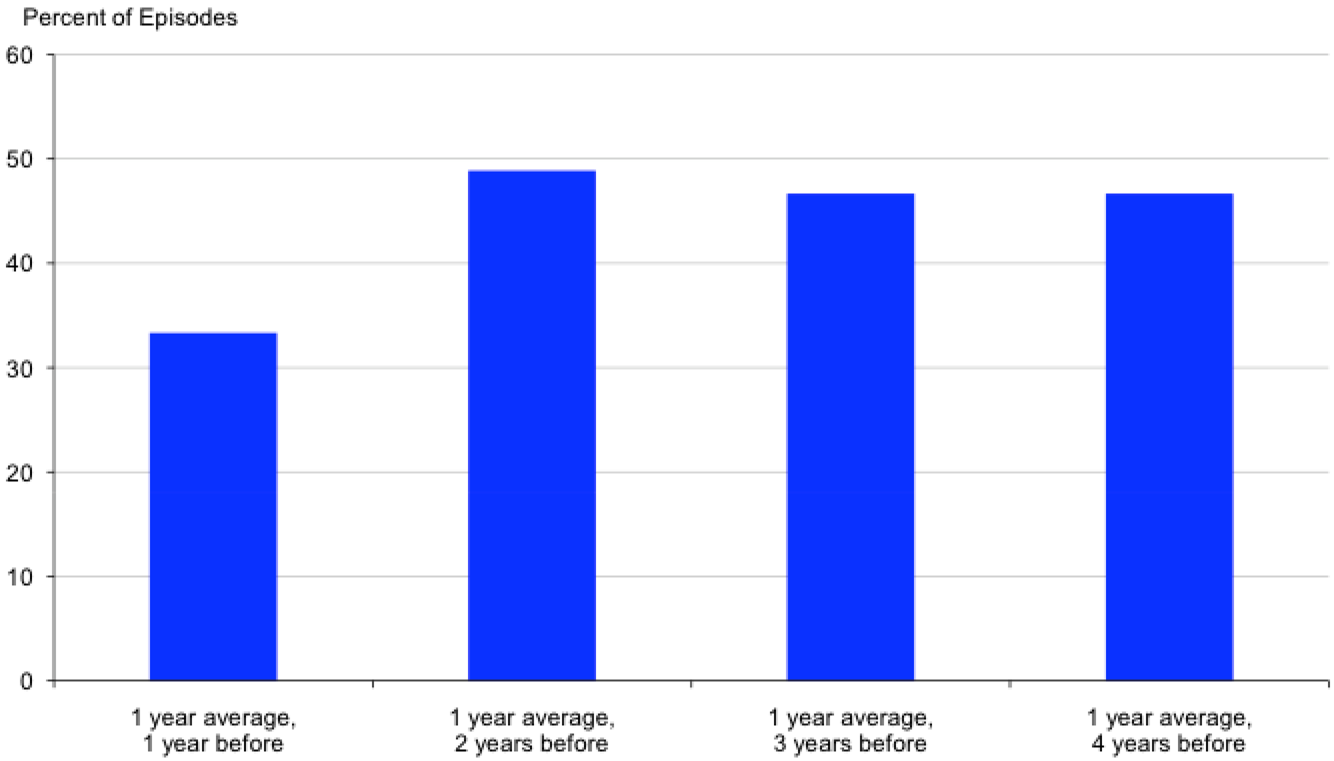
However, the long run is not yet here. We have opportunities to assure greater long-term stability. Moving policy from highly accommodative to merely accommodative would be a step in the right direction. In this way, we can achieve a better long-run outcome than if we delay normalization.

Inflation and Real Policy Rate



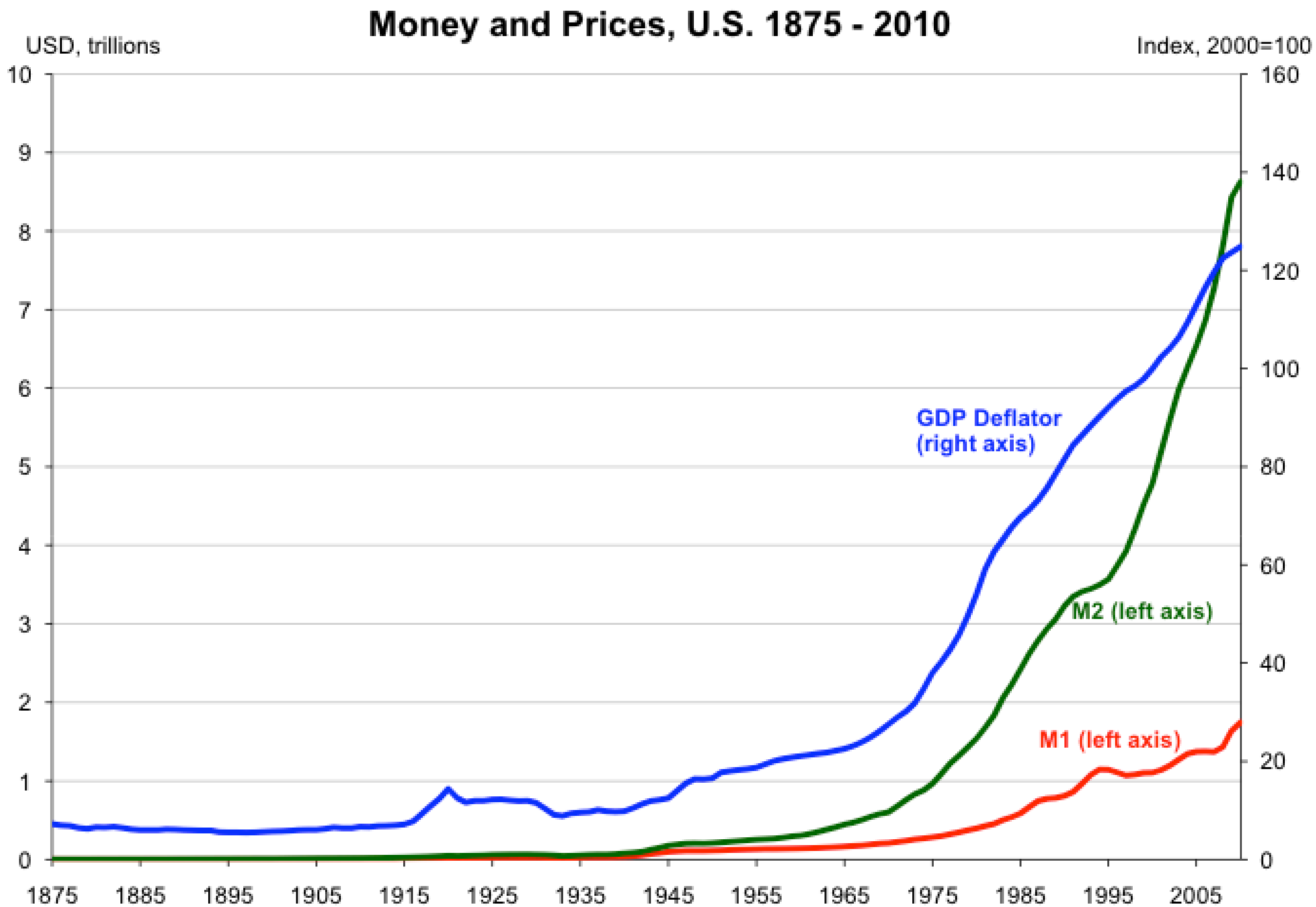
Note: The real policy rate equals the nominal policy rate minus CPI inflation (measured from a year ago).
Source data: IMF, World Economic Outlook, Chapter 3, October 2009, and <CEIC>.

Negative Real Policy Rate before Housing Price Busts



Note: A house price bust is generally defined as a period in which the real price of housing falls 5 percent or more in the year following a local peak in the real house price. In 5 cases (out of 45), the first year decline was less than 5 percent. For each house bust in year/quarter t, the average real policy rate in year t-1 (1 year average, 1 year before), year t-2 (1 year average, 2 years before), year t-3 (1 year average, 3 years before), and year t-4 (1 year average, 4 years before) was calculated. The chart shows the fraction of house price busts for which the real policy rate was negative in years t-1, t-2, t-3, and t-4.

Source data: IMF, World Economic Outlook, Chapter 3, October 2009, and staff calculations



Source: Macroeconomics, 11th Edition, Appendix A, Robert J. Gordon