

Statement of
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Chairman Paul, Ranking Member Clay and members of the subcommittee, thank you for the opportunity to discuss my views on the economy from the perspective of president of the Federal Reserve Bank of Kansas City and as a 20-year member of the Federal Reserve System's Federal Open Market Committee (FOMC).

The Fed's mandate reads: "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."

The role of a central bank is to provide liquidity in a crisis and to create and foster an environment that supports long-run economic health. For that reason, as the financial crisis took hold in 2008, I supported the FOMC's cuts to the federal funds rate that pushed the target range to 0 percent to 0.25 percent, as well as the other emergency liquidity actions taken to staunch the crisis. However, though I would support a generally accommodative monetary policy today, I have raised questions regarding the advisability of keeping the emergency monetary policy in place for 32 months with the promise of keeping it there for an extended period.

I have several concerns with zero rates. First, a guarantee of zero rates affects the allocation of resources. It is generally accepted that no good, service or transaction trades efficiently at the price of zero. Credit is no exception. Rather, a zero-rate policy increases the risk of misallocating real resources, creating a new set of imbalances or possibly a new set of bubbles.

For example, in the Tenth Federal Reserve District, fertile farmland was selling for \$6,000 an acre two years ago. That land today is selling for as much as \$12,000 an acre,

reflecting high commodity prices but also the fact that farmland loans increasingly carry an interest rate of far less than the 7.5 percent historic average for such loans. And with such low rates of return on financial assets, investors are quickly bidding up the price of farmland in search of a marginally better return.

I was in the banking supervision area during the banking crisis of the 1980s, when the collapse of a speculative bubble dramatically and negatively affected the agriculture, real estate and energy industries, almost simultaneously. Because of this bubble, in the Federal Reserve Bank of Kansas City's District alone, I was involved in the closing of nearly 350 regional and community banks. Farms were lost, communities were devastated, and thousands of jobs were lost in the energy and real estate sectors. I am confident that the highly accommodative monetary policy of the decade of the 1970s contributed to this crisis.

Another important effect of zero rates is that it redistributes wealth in this country from the saver to debtor by pushing interest rates on deposits and other types of assets below what they would otherwise be. This requires savers and those on fixed incomes to subsidize borrowers. This may be necessary during a crisis in order to avoid even more dire outcomes, but the longer it continues, the more dramatic the redistribution of wealth.

In addition, historically low rates affect the incentives of how the largest banks allocate assets. They can borrow for essentially a quarter-point and lend it back to the federal government by purchasing bonds and notes that pay about 3 percent. It provides them a means to generate earnings and restore capital, but it also reflects a subsidy to their operations. It is not the Federal Reserve's job to pave the yield curve with guaranteed returns for any sector of the economy, and we should not be guaranteeing a return for Wall Street or any special interest groups.

Finally, my view is that unemployment is high today, in part, because interest rates were held to an artificially low level during the period of the early 2000s. In 2003, unemployment at 6.5 percent was thought to be too high. The federal funds rate was continuously lowered to a level of 1 percent in an effort to avoid deflation and to lower unemployment. The policy worked in the short term.

The full effect, however, was that the U.S. experienced a credit boom with consumers increasing their debt from 80 percent of disposable income to 125 percent. Banks increased their leverage ratios—assets to equity capital—from 15-to-1 to 30-to-1. This very active credit environment persisted over time and contributed to the bubble in the housing market. In just five years, the housing bubble collapsed and asset values have fallen dramatically. The debt levels, however, remain, impeding our ability to recover from this recession. I would argue that the result of our short-run focus in 2003 was to contribute to 10 percent unemployment five years later.

That said, I am not advocating for tight monetary policy. I'm advocating that the FOMC carefully move to a non-zero rate. This will allow the market to begin to read credit conditions and allocate resources according to their best use rather than in response to artificial incentives.

More than a year ago, I advocated removing the “extended period” language to prepare the markets for a move to 1 percent by the fall of 2010. Then, depending on how the economy performed, I would move rates back toward more historic levels.

I want to see people back to work, but I want them back to work with some assurance of stability. I want to see our economy grow in a manner that encourages stable economic growth, stable prices and long-run full employment. If zero interest rates could accomplish this goal,

then I would support interest rates at zero. In my written testimony, I have included three speeches that describe in more detail my position on monetary policy.

Monetary policy cannot solve every problem. I believe we put the economy at greater risk by attempting to do so.

Thank you, Mr. Chairman. I look forward to your questions.

Rebalancing Toward Sustainable Growth

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The Rotary Club of Des Moines and the Greater Des Moines Partnership
Des Moines, Iowa
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The views expressed by the author are his own and do not necessarily reflect those of the Federal Reserve System, its governors, officers or representatives.

Introduction

The U.S. economic recovery is under way, but it remains more uncertain and volatile than anyone would like. Some believe that the Federal Reserve can speed up the recovery by keeping the federal funds rate near zero, where it has been for nearly two-and-a-half years, and by promising to keep it there for an extended period. If I judged—or if evidence suggested—that a zero rate would solve our country’s unemployment problem or speed up the recovery without causing other adverse consequences, I would support it. However, monetary policy is not a tool that can solve every problem.

In today's remarks, I will outline my current views on the economy, and suggest what alternative options and policies our leaders might consider as we search for ways to build a stronger, more resilient economy.

U.S. economic conditions

First, it is a testament to the U.S. economic system that even as this nation carries a heavy public and private debt burden, the economy is completing its second year in recovery. The level of activity, as measured by GDP, has now surpassed its pre-recession peak after growing at a nearly 3-percent pace last year. However, I am concerned that in working to offset the effects of this devastating crisis and to restore the economy to health, an extended zero-interest-rate policy is producing new sources of fragility that we need to be aware of and allow for in our future policy choices.

Governments, businesses and consumers have made financial choices and allocated resources with an understanding that a zero-interest-rate policy will remain in place indefinitely.

The longer we leave interest rates at zero, the more asset values will be defined by these low rates and the greater the negative impact will be once the inevitable move up in rates begins.

Complicating the fragility around monetary policy, fiscal policy as a pro-growth policy instrument also appears to be approaching its limit. The government's stimulus efforts to support the economy, along with lower tax revenues, have resulted in historically large fiscal deficits and a very large debt level. Without a dramatic change, the deficit and the debt will only become more daunting with the rising cost of entitlement programs and likely higher interest rates.

For well over a decade, the U.S. consumer has been a principal source of world demand and economic growth. As a result, the United States has incurred consistently large trade deficits, contributing to imbalances in the global economy. As we have painfully learned from the housing bust, growth built on imbalances is ultimately unsustainable.

Circumstances require, therefore, that we transition from an economy that relies too heavily on consumption and government spending for growth toward more sustainable sources of demand and economic prosperity. How we undertake this transition will define our economy and country's economic future.

To start, over the next several years, we must change our national savings, consumption and investment habits. Such shifts, though fundamental to long-term economic health, are admittedly difficult to accomplish. They require changes in behavior and expectations. They involve dramatic shifts in resource use, which are not painless as workers are temporarily displaced and industries are disrupted. The pain is immediate, and the payoff comes slowly. However, the gains also can be significant, as more sustainable long-run economic growth is well worth the effort and sacrifice.

In a recent visit to Singapore, I witnessed that nation's commitment to job creation. For example, during the recent crisis and recession, Singapore developed a program to retrain unemployed workers to ensure they would have the skills needed when its manufacturing sector recovered. As is well understood, workforce training matters. I spoke with individuals who described the drive to bring new factories on-line, with the goal of bringing a factory on-line with minimal delays and, by their description, without compromising safety.

Lessons from Germany

Other countries have made similar changes out of necessity or during a time of economic distress such as we are experiencing today. Countries have made deliberate choices and not relied on chance to change economic incentives and behavior that served to improve economic performance. I'm not advocating that we pick winners and losers—in fact, that is my biggest argument against too-big-to-fail financial institutions. Rather, I have observed a number of countries that are building and expanding their manufacturing bases—such as Korea, Singapore and China—that have been able to experience strong GDP growth over long periods of time.

Germany offers another example of a country having made significant changes to accomplish real employment goals. In the mid-1990s, Germany's trade deficit was similar to that of the United States. Since then, Germany has moved away from trade deficits to surging surpluses, while the United States has continued to run large trade deficits. Complementing this shift, German levels of employment have made great strides, and its unemployment rate has touched its lowest point in nearly 20 years.

I am not suggesting that the United States attempt to be Germany or Singapore, two countries that differ from us in many ways. I am also not advocating that we suddenly strive to achieve a large U.S. trade surplus. This might only create other global imbalances and

distortions. However, adjustments in our economy are necessary, and other countries have shown it can be done.

Perhaps the most immediate, and obvious, observation is the simplest: We must change our national savings rate. To rebalance the U.S. trade position from deficit to balance requires that the sum of private and public savings match domestic investment. In other words, a country must not produce less than it consumes if it wishes to balance its trade position with the rest of the world.

During the 2000s, Germany's personal savings rate increased and is currently about double the U.S. rate. German households paid down debt and avoided heavily relying on debt, in contrast to the United States and so many other countries' households.

The personal savings rate in the United States has modestly increased since the start of the recession, which is an important positive trend. Unfortunately, this improvement has been more than offset by the dramatic deterioration in public saving reflected in the nation's fiscal deficits. Though a significant amount of the recent deterioration in public finances is related to the U.S. financial crisis, the fact remains that our national savings crisis has been under way for nearly three decades. Since the early 1980s, our nation has consistently chosen to spend rather than save, as witnessed by the long-term decline in our private savings rate and our tendency toward fiscal deficits. Most importantly, when we look across the more developed countries, we see that those with higher national savings rates tend to have smaller trade deficits and higher domestic production per person.

Germany has also benefitted from managing unit labor costs in a manner that keeps its labor force globally competitive. Over the last decade, the German economy experienced relatively modest wage increases and important productivity gains. Both of these factors

contributed to keeping unit labor costs in check. However, another important component of its success came in the form of labor policy reforms.

In the early 2000s, Germany, with labor and management input, passed a series of labor market enhancements called the “Hartz laws.” These laws modified some of the more generous employee benefits and reduced restrictions on temporary workers and the ability to lay off workers. Germany’s reforms also sought to incentivize unemployed workers to transition to employment by making changes to job training programs for the unemployed and creating targeted subsidies to support some manufacturing job creation.

Finally, Germany developed export markets by focusing on meeting the needs of parts of the world experiencing the fastest growth and demonstrating strong demand for capital goods that German manufacturers produce: emerging economies in Asia, Europe and Latin America.

The United States is well-positioned to match this kind of performance, if it chooses to do so. For example, since 2000, the share of our exports going to the BRIC countries—Brazil, Russia, India and China—has more than doubled. If we choose to increase our savings rate, if government, labor and management see the mutual advantage of investing in and building a competitive manufacturing environment, then job growth will follow.

As the U.S. economy shifts gears to shrink its trade imbalances, many parts of the country will have a role to play. I fully expect Iowa to be an integral participant in this shift. Iowa already possesses a strong manufacturing base that is a key driver of the state economy. By some estimates, about half of the manufacturing firms in the state are small- and medium-sized enterprises, which provide some parallels with Germany’s renowned export powerhouses, known as the *Mittelstand*.

Real solutions versus economic shortcuts

Rebalancing our economy and improving our trade position is a necessary development, but unfortunately, it will take time. And as our immediate desire is to rush to improve our economy, I warn against the all-too-common impulse to take shortcuts and suffer their unintended consequences. Here in Iowa, for example, one area where I suspect this tradeoff might be playing out is in the recent rapid run-up in agricultural land prices.

Agricultural exports have played a significant role in the rapid rise of land prices. Since 2000, agricultural exports from Iowa have increased by a factor of six. A portion of this growth reflects surging commodity prices due to factors on the supply side—such as extreme weather in parts of the world—and on the demand side, including the well-documented, rapidly growing food demands of emerging economies.

In addition to anticipated strong future demand for agricultural commodities, there is another factor affecting these prices: exceptionally low interest rates. As a bank regulator in the 1980s, responsible for financial institutions in Nebraska, Kansas, Oklahoma, Missouri, Wyoming, Colorado and New Mexico, I witnessed the devastating effects of easy credit and leverage in agriculture, real estate and energy. We closed or assisted nearly 350 banks in our region alone.

With interest rates near zero and with additional massive liquidity poured into our economy, all interest rates are affected. Therefore, asset values of every kind are also being affected, including land values in Iowa. Loans for land are available at rates well below historical levels—in some instances, 400 basis points below historical averages. The effect on land assets, like any asset, is to artificially boost its value. And there is ample experience that tells us that if rates were to rise quickly, this would affect world demand for commodities and raise the cost of

capital on land almost instantly. When—not if—the adjustment occurs, we will see a dramatic drop in values. In the meantime, if operators and speculators have incurred large amounts of debt, then a new crisis will emerge.

Finally, we know that a crisis can affect more than one segment of the economy. It nearly always affects the broad economy and employment. Shortcuts don't work. We need to focus on the real economy. We need to focus on real reform.

Conclusion

My point today is simply that as powerful as monetary policy is, it sometimes is not enough. It cannot ensure an economy that balances its savings and investing needs. It by itself cannot correct our current account deficit or enhance savings and investment. These will require important changes in our real economy. Providing the right environment in which government can play its role in supporting business and the consumer to save, invest, manufacture and service national and global needs in the end will create real income and wealth.

We need to focus on long-term, stable monetary policy and fiscal policy goals that support these broader goals. Having seen the effects of financial crisis after financial crisis as short-term policies beget short-term policies, we should know that an ever-present short-run focus, even if well intentioned, is the road to ruin.

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 led 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.

What About Zero?

Thomas M. Hoenig
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Santa Fe, N.M.
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Introduction

Good afternoon. I'm pleased to be in New Mexico today, and I extend my congratulations and best wishes to the city of Santa Fe on its 400th anniversary.

Last week, *The Wall Street Journal's* front page featured an article with a headline focused on the "epic comeback" of the corporate bond market. The article chronicled how a record \$31.5 billion in new high-yield, high-risk "junk" bonds came on the market last month and how investments in bond mutual funds last year were the highest on record. Thanks to the combination of near-zero short-term interest rates and the Federal Reserve's large-scale purchases of mortgage-backed securities, investors are flush with cash. And, as is sometimes the case, cash earning so little is an enticement to take on additional risk in hopes of higher returns.

The bond market is not the only place where we are seeing the impact of cash-rich investors. Our contacts within the Tenth Federal Reserve District have shared anecdotal information suggesting that operators and investors in the Midwest are buying farmland and bidding up the price. We've seen this in the agricultural regions of our District in the past, notably in the run-up to the banking crisis of the 1980s.

Events such as these, along with new economic research now coming to light, are beginning to document a story about long-run risks that are created when money and credit are easy for too long, when interest rates are near zero, and when financial imbalances risk macroeconomic and financial instability.

As we all know, the last couple of years have been an extraordinary period in our nation's economic history. In response to the crisis, the Federal Reserve took unprecedented steps to drive down long-term interest rates and provide direct support to a fragile housing market. This was in addition to the steps taken by the administration and the Treasury. We will long study these events. Although we may disagree on the specifics of the actions taken during that period, most agree that without strong intervention, the outcome would have been dire.

But as the economy turns the corner and we move beyond the crisis, what about the challenges we now face, and what about policy actions over the next several quarters? The economy appears to be on the road to recovery, and we find ourselves having to face important questions of how the Federal Reserve will unwind the policy response to the crisis. In particular, what are the hazards of holding the federal funds rate target close to zero? The risks of raising rates too soon are clear and compelling. My comments, however, concern the risks of raising rates too late. Such risks also can be significant but all too often seem more distant and less compelling, and therefore hold great long-term danger for us all.

The economic outlook

As a preface to a discussion on the issues, I first should outline my expectation for the U.S. economy. Policy choices can be realistically considered only after first defining how we judge current conditions and our outlook for the future.

From my vantage point, the outlook is generally good. A number of indicators suggest the economy has begun to recover and is expanding at a steady pace since hitting bottom last summer. GDP grew nearly 4 percent in the second half of last year, and growth of almost 3 percent is expected in the first quarter of this year. The pace of growth should modestly pick up over time, and looking ahead, I expect GDP growth of about 3 percent for 2010.

While labor markets remain weak, they seem to have stabilized. The pace of job losses gradually slowed over the course of 2009 and early 2010. In the first three months of the year, unemployment has remained essentially unchanged at 9.7 percent. Importantly though, Friday's report from the Labor Department showed the largest increase in non-farm payrolls in three years with more than 160,000 jobs added. Further, forward-looking indicators such as temporary help services, which has grown rapidly since the middle of last year, suggest broader job growth will continue. This is good news because such progress is essential for sustained growth. And like most, I am following it

carefully. Unfortunately, it tends to lag the recovery and makes the implementation of policy always difficult to manage during the early stages of a recovery.

Consumer spending has been growing at a solid pace, and most forecasters put first quarter consumption growth at more than 3 percent. These are critical improvements because consumer spending, which has accounted for about 70 percent of GDP, will be a critical force strengthening the recovery. The manufacturing sector has followed the consumer and also has been expanding at a strong pace. Production has increased at an annual rate of about 8 percent since hitting bottom last summer. In turn, business spending on equipment and software appears to be picking up.

These are encouraging signs that the forces necessary for a sustained recovery seem to be moving into place and that this is not just a temporary boost from the fiscal stimulus package and sharp slowing in the pace of inventory liquidation.

Residential and non-residential construction continues to struggle, although to varying degrees. Residential construction spending has fallen sharply in the last few months after a strong uptick in the second half of last year, thanks in large part to the homebuyer tax credit. Looking ahead, spending should pick up considerably in response to the extended tax credit and then rise at a more moderate pace after the credit expires.

The picture is considerably bleaker for the non-residential sector. Private spending fell at an annualized rate of more than 25 percent in the last three months and is likely to fall further for most or all of this year. There has been an increase in vacancy rates for office, retail, and industrial space. Meanwhile, non-residential property values are down. The soft market is due in part to problems with financing. With many banks facing the prospect of considerable losses in commercial real estate, lending remains weak.

Looking at the economy more broadly, inflation has drifted lower in recent months and is following the pattern common during and after a recession. While energy prices have kept consumer price inflation at around 2 percent, inflation in non-food and non-energy price – core inflation – stands

at about 1 percent. In the absence of any current cost pressures from tight labor markets or other input prices, inflation will likely remain low for the next year or two.

Risks of a commitment to near-zero rates

With the economy gradually recovering from a severe recession, monetary policy is by any measure highly accommodative. The key challenge for the Federal Reserve's Federal Open Market Committee, is the question, "For how much longer should it remain so?"

The FOMC statement, issued after several meetings including the most recent, has said that "conditions will likely warrant keeping the fed funds rate, which is our key monetary policy tool, at exceptionally low levels for 'an extended period.'" The statement elaborates that this view is based on "economic conditions, including low rates of resource utilization, subdued inflation trends, and stable inflation expectations."

By itself, the current state of the economy warrants an accommodative monetary policy. However, as the economy continues to improve, risks emerge around the act of holding rates low for an extended period.

I have dissented at the last two FOMC meetings specifically because I believe the "extended period" language is no longer warranted and I am concerned about the buildup of financial imbalances creating long-run risks.

There is no question that low interest rates stimulate the interest-sensitive sectors of the economy and can, if held there too long, distort the allocation of resources in the economy. Artificially low interest rates tend to promote consumer spending over saving and, over time, systematically affect investment decisions and the relative cost and allocation of capital within the economy.

Today, as we look back over the past decade, there is a case to be made that too many resources were channeled into financial market activities and into real estate construction, both residential and non-residential. Some researchers have argued that keeping interest rates very low in

2002-2004 contributed to the housing boom and bust. Exceptionally low rates, while perhaps not the single cause, played an important role in creating the conditions leading to our recent crisis.

We now find ourselves with a Federal Reserve System balance sheet that is more than twice its size of two years ago. The federal funds rate is near zero and the expectation, as signaled by the FOMC, is that rates will remain so for an extended period. And the market appears to interpret the extended period as at least six months. Such actions, moreover, have the effect of encouraging investors to place bets that rely on the continuance of exceptionally easy monetary policy. I have no doubt that many on Wall Street are looking at this as a rare opportunity.

These actions are not taken to enrich one group over another. They are taken with the well intended purpose of assuring a strong economic recovery and to create an environment of sustained job growth and strong business investment. I take no exception to this goal. However, the unintended negative consequences of such actions are real and severe if the monetary authority goes too long in creating such conditions.

Low rates, over time, systematically contribute to the buildup of financial imbalances by leading banks and investors to search for yield. *The Wall Street Journal* article tells a story about the market coming back that also makes my point. The search for yield involves investing in less-liquid assets and using short-term sources of funds to invest in long-term assets, which are necessarily riskier. Together, these forces lead banks and investors to take on additional risk, increase leverage, and in time bring in growing imbalances, perhaps a bubble and a financial collapse.

I make no pretense that I, or anyone, can reliably identify and “prick” an economic bubble in a timely fashion. However, I am confident that holding rates down at artificially low levels over extended periods encourages bubbles, because it encourages debt over equity and consumption over savings. While we may not know where the bubble will emerge, these conditions left unchanged will invite a credit boom and, inevitably, a bust.

What next?

So, what options are available to policymakers?

I appreciate the inclination for staying the course that financial markets have come to expect: keeping the federal funds rate target near zero and maintaining a commitment to very low rates for an extended period of time. That view is motivated by concerns over an unemployment rate of nearly 10 percent and persuaded by the fact that core inflation remains below 2 percent.

Continuing with current policy may also reflect confidence that the longer-term risks of financial imbalances are quite small and could be mitigated as they emerge. The Federal Reserve could correct imbalances through interest rate action or regulatory changes as the imbalances become apparent later.

However, in times of uncertainty policymakers tend to reassure themselves that an accommodative course of action can be reversed always in a timely fashion. Inevitably, though, the policy bias is to delay, to let accommodative conditions stand, and to reverse only when the economy is beyond recovery and into an expansion. The outcome too often is greater inflation, significant credit and market imbalances, and an eventual financial crisis.

An alternative policy option is to be more proactive, but cautious. This would require initiating a reversal of policy earlier in the recovery while the data are still mixed but generally positive. Small reversals in rates would leave policy highly accommodative and supportive of our economy's recovery but would put more weight on mitigating the risk of longer-run financial imbalances. It would end the borrowing subsidy more quickly and would moderate credit conditions in a more timely fashion. It would reduce the likelihood that inflationary pressures might build, or that financial imbalances might emerge. And over time it would contribute to greater macroeconomic stability.

Under this policy course, the FOMC would initiate sometime soon the process of raising the federal funds rate target toward 1 percent. I would view a move to 1 percent as simply a continuation of our strategy to remove measures that were originally implemented in response to the intensification

of the financial crisis that erupted in the fall of 2008. In addition, a federal funds rate of 1 percent would still represent highly accommodative policy. From this point, further adjustments of the federal funds rate would depend on how economic and financial conditions develop.

Conclusion

As we look forward from here, I expect that all options will be considered and discussed fully as we navigate the course of monetary policy. As we consider our choices, I want to end my remarks by emphasizing that I am confident all of us want the best outcomes for the U.S. economy. The Federal Reserve understands its mission of stable prices and long-term, stable growth. Perhaps because I have been part of the history of the central bank for these past three decades, I am as concerned about the introduction of instability into the economy as I am about managing it when it occurs. I am convinced that the time is right to put the market on notice that it must again manage its risk, be accountable for its actions, and cease its reliance on assurances that the Federal Reserve, not they, will manage the risks they must deal with in a market economy.