

What About Zero?

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Santa Fe, N.M.
April 7, 2010

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.