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Accommodative Monetary Policy: Savior or Saboteur?

Good morning—I'm very pleased that the Utah and Montana Bankers Association decided to hold their meeting in Sun Valley. I represent the nine western states of the 12th Federal Reserve District, including Idaho. One nice thing about my District is that people always want to come visit.

Obviously, when you invite a Fed president to speak, you're expecting to hear about the economy and monetary policy. I won't disappoint in that respect—after the past several years, it's nice to finally be upbeat about where things are and where we're headed. But it's also an opportunity to talk about some of the policy decisions the Fed has made, what the future holds, and to address some of the apprehensions some people have about the Fed's actions. So I'd also like to speak to a few of the concerns and criticisms I hear most frequently. Now is a perfect time to pause for the usual disclaimer that the views I express today are wholly my own and do not necessarily reflect those of others in the Federal Reserve System.

Economic outlook

First, the economic outlook. In a nutshell, the U.S. economy is looking a lot better these days. There have been some glitches; most notably, gross domestic product (GDP) shrank in the first quarter. However, the evidence points to transitory factors being the main culprit there, such as the terrible weather that afflicted large portions of the country. With that behind us, I expect a rebound to moderate growth in the second quarter and for the rest of this year. Looking past the first-quarter drop, I expect real GDP growth to run above 3 percent for the remainder of the year. That's in no way blisteringly fast, but it is enough to keep the labor market moving in the right direction.

Indeed, despite the bad news on GDP in the first quarter, the employment data have been outright encouraging. Nationally, we've added an average of about 200,000 jobs per month, pushing the total number of jobs back above its pre-recession peak.

This is an important milestone, and I'm optimistic about the outlook—but I should stress that the labor force has grown quite a bit since the recession started; we would need to surpass pre-recession numbers to get back to a normal labor market. A labor market working at full speed has reached what economists refer to as the "natural rate" of unemployment—that's the lowest rate we can reasonably expect in a well-functioning, healthy economy. Obviously, that number will never be zero—in a dynamic, ever-changing economy like ours, people will get laid off and quit jobs, and new people will enter the workforce. I put the natural rate at around 5¼ percent. So with the current unemployment rate at 6.3 percent, there's still a way to go before we're at full employment.

That's for the whole U.S. economy, however. Things are a lot better in Utah and Montana—both have unemployment rates well below the national average and closer to historical norms.

A key contributor to the improving economy is strengthening balance sheets, both for households and the banking sector. As house prices have climbed over the past few years, the number of borrowers underwater has come way down. Combined with the increase in jobs, that means fewer mortgages are going into foreclosure.

Banking conditions more generally continue to improve.[1] Banks in our District are better capitalized and more liquid, earnings have risen, and loans are growing. I know that there are concerns about narrow interest rate margins and the impact of the eventual rise in interest rates, particularly among community bankers. There's no doubt that narrow interest margins have held down banks' earnings, but as banking conditions and the overall economy continue to strengthen, I see earnings recovering as well.[2] Now, some banks, looking to increase income, have added to their holdings of longer-term assets. This increases their interest-rate risk, which remains a focus area for our bank supervisors.

Although the economy in general is on a good trajectory, we've seen some loss of momentum in the housing market's recovery. House prices have rebounded nicely from post-crash lows, but the gains posted in home sales and construction have not been as strong as hoped.

[1] Federal Reserve Bank of San Francisco, Banking Supervision and Regulation (2014).
[2] Genay and Podjasek (2014).

Higher mortgage rates explain a large part of the slowdown.[3] That isn't likely to reverse, but there are other factors that lead me to be optimistic about housing going forward. The recession forced a lot of adults to move back home, and as the recovery continues, they'll move out and buy houses or move into apartments. Homes are also still relatively affordable, incomes are rising, and despite last year's jump in mortgage rates, they're still low by pre-recession standards.

Let me wrap this all into a forecast for the next few years. I see real GDP growth averaging a bit above 3 percent in 2015 and 2016, which should be enough to generate relatively strong job growth. I expect the unemployment rate to gradually decline, hitting about 6 percent at the end of this year, falling below 5 ½ percent by the end of next year, and reaching my estimate of the natural rate by the first half of 2016.

I'll also say a few words about inflation. Those of us born before the 1970s reflexively worry about high inflation, but the problem for the past few years has actually been inflation that's persistently low. The inflation rate the Fed follows most closely—the personal consumption expenditures price index—has been running at about 1¾ percent over the past year. This is below the Federal Open Market Committee's preferred 2 percent longer-run goal. This isn't all that surprising in light of the fact that the economy is still running below capacity and

[3] Krainer (2014).

wage growth has remained modest. As the economy moves closer to full employment, I expect inflation to edge up gradually towards 2 percent.

Addressing some common concerns

I said I'd like to address some of the issues I hear, most of which have to do with concerns about, and criticisms of, the Fed's actions over the past six years or so.

As a brief refresher, the Fed's monetary policy stance has been very accommodative since the economy fell into recession in the wake of the global financial crisis. We lowered the federal funds rate to near zero back in December 2008, we've been pretty explicit about where we think those rates are headed, and we've engaged in several large-scale asset-purchase programs, commonly known as quantitative easing, or QE.[4]

We often say, when describing these measures, that extraordinary economic times call for extraordinary economic measures. And that's true. But I don't want to give the impression that "extraordinary" means "radical" or "unprecedented." Some of the unease around the Fed's policies probably stems from that misunderstanding. But these policies weren't dreamed up on the fly.[5] They're different, and they're unconventional, but they're not outside the natural realm of central bank theory or practice.

In normal times, the Fed buys and sells securities in order to keep the federal funds rate at its target level. This, in turn, affects other interest rates—such as those on car loans, mortgages,

[4] Williams (2012).
[5] Bernanke and Reinhart (2004) and Bernanke, Reinhart, and Sack (2004).

and bonds—which affects other financial conditions and, ultimately, the spending decisions of households and businesses. With short-term interest rates close to zero, however, the Fed shifted the emphasis to buying longer-term assets, in order to bring down longer-term interest rates. So what we have is still essentially standard monetary policy, adjusted to reflect the reality that short-term interest rates are near zero.

Enough is enough?

Although there's general consensus that the measures we took in the immediate wake of the crisis were necessary, critics of the Fed's policies believe that we've been too accommodative since then, and that after 2010, we should've stepped back and let the economy move on its own. I often hear that the economy's recovering, so why is the Fed still intervening? Or, in other words: "enough is enough."

Ending accommodative policy prematurely would have been a major mistake. In 2010, the economy wasn't yet back on track—in fact, it had barely begun to recover. When we initiated the second round of asset purchases, or QE2, in November 2010, the unemployment rate was around 9½ percent—only slightly down from its peak of 10 percent.

The latest round of asset purchases—or QE3—was announced in September 2012, when the economy was better, but still well short of healthy. At around 8 percent, the unemployment rate had improved, but was still very high by historical standards, and inflation was running below the preferred 2 percent longer-term goal. In both situations, the very real danger of the recovery stalling and the economy slipping into a state of prolonged stagnation called for additional monetary stimulus.

When you break a leg, you don't just snap the pieces back into place; you leave the cast on until the bone heals. Otherwise, you risk doing even greater damage. And in this case, the economy wasn't ready to walk on its own. Not doing anything, or not doing enough, would just have led to more pain and the need to take even stronger measures down the road.

I was recently in Japan, which offers a real-life example. They shied away from sufficiently aggressive policy and the Japanese economy remained mired in deflationary stagnation for 20 years. Only now are they starting to put more forceful policies into place, and, happily, they're working—but those policies are much more forceful than they would've been had they been instituted 15 or 20 years ago. In keeping with the patient analogy, you can keep the cast on for a few weeks and let it heal, or you can go without and require extensive surgery later. So if we take the longer view, the Fed's actions are in line with people who prefer a light policy touch: we're essentially doing less now to avoid having to do more later.

It was Milton Friedman—one of the greatest economists of the past century and a leading expert on the Great Depression—who taught us that when inflation is too low, monetary policy needs to do more than just lower short-term interest rates near zero. In particular, he said it can buy longer-term bonds to add additional monetary stimulus.[6] That's what we've done and it's

[6] Friedman (2000).

worked. We've avoided deflation and helped the economy start moving back towards normal.[7] The journey's not complete, but we're much further down the road than we would have been had we executed an early exit from accommodative policy.

Is accommodative policy an "enabler"?

The second concern I hear is that the Fed's policies are papering over holes in the economy, falsely propping up failing businesses, and, for lack of a better term, enabling congressional and White House inaction. The argument is that, by keeping the economy on an even keel, we're allowing businesses that would otherwise fail to limp along and Washington to put off making difficult decisions.

There is a ring of truth to the idea that low interest rates might be acting as life support for companies that are destined to fail. The flip side of that coin, however, is that low rates gave good companies the ability to get back on their feet before they went bankrupt. It's important to provide an economic environment that allows fundamentally sound firms to thrive. That may provide a temporary crutch to some companies that will eventually go bankrupt, but over the longer term, the right companies will survive. Nothing in life is perfect, and in terms of a trade-off, I'm happy with a few bad companies staying in the game for a while if it means a lot of good ones have a chance to survive, too.

[7] Chung et al. (2012).

Regarding political inaction on federal policy, I will say that from an economic perspective, there is reason to worry about the lack of action in Washington. When brinkmanship comes to a head, it creates uncertainty that has real, quantifiable effects. If you look at measures of uncertainty, you'll see a spike during the debt ceiling standoff in 2011, the fiscal cliff of 2012, and the government shutdown last year. Estimates put the toll of policy uncertainty as adding around 1¼ percentage points to the unemployment rate, which translates into roughly 2 million lost jobs.[8]

So it's important that federal fiscal policy gets done. But I don't believe that the Fed is, in the parlance of pop-psychology, an "enabler" of what most characterize as Washington's intransigence on fiscal policy. This position argues that the Fed is somehow *too* reliable; that because we have the tools to manage a crisis, other institutions will avoid their own areas of responsibility because they can rely on us to pull an economic rabbit out of our hat. If there's no urgency, they can avoid action on politically volatile legislation, and the can gets kicked further and further down the road.

Let me be clear that us doing our jobs doesn't absolve anyone of the responsibility to do theirs. Decisions about taxes, spending, and entitlement programs will always collectively be a political third rail, and monetary policy—be it accommodative or fully normalized—won't change that. The idea that the Fed's "propping up" of the economy is letting Congress avoid

[8] Leduc and Liu (2013).

decision-making doesn't hold; that implies that the only prompt to action would be an economy in freefall, something no one wants. Congress has many reasons to act on fiscal policy—not least of which being a growing population and shifting demographics that will see the largest generation in our history moving into old age—and nothing we do to interest rates will alter that reality.

The "enabling" argument is largely driven by an underlying concern that the Fed has somehow lost its independence, or that it's becoming too active a player in the economy. But nothing could be further from the truth. We hold our independence as sacrosanct, because it's necessary for us to make the best policy decisions we can. If we step out of our assigned role, we could endanger that independence, and that would fundamentally alter our ability to do our jobs.

Can the Fed manage monetary policy with such a large balance sheet?

The third concern I hear, and it's one of the most frequently voiced, is that the size of the Fed's balance sheet poses inflationary and other risks as we seek to normalize the stance of monetary policy. I'm very cognizant of this issue, as is everyone at the Fed, and it's one we take seriously.

There's no question that our asset-purchase programs have massively expanded the size of the Fed's balance sheet. On the eve of the financial crisis, we owned roughly $850 billion in assets. Today, that number stands at close to $4.5 trillion, with about $2.7 trillion in bank reserves on the liability side. Eventually, after we bring rates back up and normalize monetary policy, we'll have to unwind much of that balance-sheet growth.

We've spent the past several years testing out various tools that will help us raise and normalize interest rates. Importantly, we can now pay interest on reserves held at the Fed and we have other tools to reduce reserves even with a large balance sheet. This means that the usual process of the money multiplier—whereby ample bank reserves can fuel rapid growth in the money supply—is short-circuited. These tools mean we can control short-term interest rates as needed to stem any inflationary pressures down the road.

We're also going to be very clear in our communications when we eventually bring rates back to normal. Making that communication work won't necessarily be easy, as the taper tantrum reminded us last year. But we've put a lot of thought and effort into ensuring that, once it's appropriate to normalize the stance of monetary policy, we can raise interest rates as needed, communicate our intentions to the markets, manage the balance sheet over time, and bring us back to full employment without undue inflationary pressures. So I understand the concerns, but we are aware of them, we're planning for them, and we've got the tools to manage them.

Has the Fed run out of tools?

The fourth fear people express is that the Fed has run out of firepower. This is one I really want to be clear on, because the biggest mistake a central bank can make is to throw up its hands and say it can't get the job done. The economists Christina and David Romer wrote a must-read paper showing that this kind of policy apostasy has historically been catastrophic—from the Great Depression to the inflation of the 1970s, any time a central bank decided its policies couldn't hold up in a fight led to disaster.[9] The most obvious example they cited was during the Great Depression, when Fed policymakers lost confidence that aggressive monetary policy would work. Some thought that monetary policy was already so accommodative that it couldn't do any more than it already had. Others thought the source of the crisis was the irresponsibility and excess leading up to the stock market crash, which they didn't think monetary policy could address. Either way, their inaction contributed to the depth and length of the Great Depression.[10]

Likewise, the Romers noted that the Fed failed to intervene sufficiently to combat inflation during much of the 1970s—again, in part because policymakers didn't think that monetary policy could address spiraling inflation. Because they didn't act, inflation took years and a deep recession to get under control.[11]

I see the historical precedent as strong support for the Fed's actions over the past seven years, and as a cautionary tale for the future. Adam Smith wrote that all money is a matter of belief, and in this case, the same goes for policy. It's crucial to understand both the power and

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[9] Romer and Romer (2013).
[10] Friedman and Schwartz (1963).
[11] Romer and Romer (2013).

limits of the tools at your disposal. Not believing in their strength is effectively relinquishing responsibility; and once you relinquish responsibility, you've failed in your mandate.

Implications for current monetary policy

I am aware that not everyone is a fan of the Fed or of accommodative policy. I'm not deaf to criticism, and reasonable people disagree on policy all the time. But the bottom line is, it has worked. And the asterisk is that it's not permanent. We won't raise interest rates for some time, which is the real marker of tightening policy. However, we've already considerably reduced the pace of our asset purchases, which will likely end this year. We're moving towards normalization, and as the economy continues to improve, we'll take off the cast; when it's able to move on its own, we'll take away the walking stick. The events of the past several years demanded strong policy action, and we were right to take it. But it doesn't reflect a fundamental shift in our goals or strategy.

Conclusion

It's been a long road back from recession. The recovery has been slower than I would have liked, and there are a thousand different views on the Fed's decision making. But the path was eased by strong monetary policy, and it helped us to get where we are today—on the road back to full employment and price stability.

Thank you.

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