U.S. Monetary Policy: Risks of Delayed Action

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Thank you. I am pleased to be here today in Denver, which along with Omaha and Oklahoma City, is one of the three Branch locations that serve the Federal Reserve Bank of Kansas City's large and diverse district. Our Denver Branch office acts as the Federal Reserve's connection to this part of the country, and our staff here is closely involved in work that supports the Federal Reserve's functions.

Our cash processing and distribution operations in Denver provide currency and coin to financial institutions in Colorado, Wyoming and northern New Mexico, as well as parts of western Kansas and western Nebraska. Our bank supervision staff in Denver is dedicated to examining many state member banks, as well as thrift and bank holding companies to ensure they are operating in a safe and sound manner. In addition, we have an active regional and community presence, with staff responsible for public outreach and promoting fair and impartial access to credit across the region.

This week, our economists have toured the state of Colorado, with stops in Grand Junction, Durango and Pueblo. At each location, our staff has shared an economic update, but we have also listened to the concerns and questions of local businesses and community leaders. I know that one of the foremost concerns on the minds of people in Colorado is the recent flooding that has significantly affected individuals and businesses here. Our supervisory staff is working closely with financial institutions during the aftermath to ensure they have available resources to meet the needs of their customers and local communities. In addition, our Community Affairs staff is working with other agencies to coordinate relief efforts as appropriate. Events such as this highlight the important connection the Federal Reserve has to Colorado and in other places across our region.

Another direct channel to Main Street that we have is through the Denver Branch's board of directors. These seven individuals represent a wide range of industries, including technology, real estate, healthcare and banking, as well the non-profit sector working to meet the needs of local communities in this region. This board provides important information on local economic conditions and other concerns that I can then take with me to the deliberations I participate in at Washington, D.C., as a member of the Federal Open Market Committee. We greatly appreciate their insight and the service they provide to the Federal Reserve and our Denver Branch.

This evening, I will offer my views on the economy and monetary policy and explain why I disagreed with the FOMC's latest decision. These comments are my own and do not reflect the views of others on the FOMC.

Cumulative progress in the labor market

My overall assessment of the national economy is generally positive as the economy continues to slowly recover. I expect that we will see moderate GDP growth in the second half of this year of about 2 percent. As private demand grows and fiscal drag wanes, growth should pick up over the next year.

My outlook is supported by looking at several key sectors of the economy. Housing activity has moderated, but the recovery in this sector remains on track. Auto sales are close to pre-recession levels, and measures of the manufacturing and service sectors by the Institute for Supply Management point to solid gains in August.

Although aspects of the last employment report were softer than expected, labor market conditions continue to improve. More relevant than the most recent monthly employment snapshot is the change in broader labor market conditions over the last 12 months. The unemployment rate in August was 7.3 percent, compared to 8.1 percent a year earlier. This decline far exceeds what most forecasters expected a year ago. In terms of the overall level of employment, more than 2 million additional workers are employed today compared to a year ago.

With the unemployment rate elevated, continued progress will be needed. And in this regard, I have been encouraged by the sustained momentum of improvement that has occurred over the past year based on a comprehensive index of labor market activity developed by staff at the Kansas City Fed.

Importantly, the labor market and the broader economy have continued to improve in the face of fiscal tightening. I interpret this resilience as a signal that the economy's underlying fundamentals have improved substantially. For instance, stock markets have remained higher in the face of rising interest rates since May. Household balance sheets have been repaired over the last few years as outstanding mortgage debt has steadily declined and home prices have risen.

The official measures of inflation remain below the Fed's longer-term goal of 2 percent, but appear to have bottomed out. I expect inflation will begin to move closer to the target in the second half of this year and into next year as labor market conditions continue to improve and private demand strengthens. Longer-term inflation expectations also remain anchored at levels consistent with the Federal Reserve's objective.

The September No-Taper Decision

For five years, the Federal Reserve has been providing significant amounts of stimulus in the form of near-zero, short-term interest rates and through a number of programs that have increased the central bank's balance sheet by trillions of dollars.

In its most recent program known as QE3, which began a year ago, the Federal Reserve has been purchasing $85 billion in Treasury debt and mortgage-backed securities each month.

However, amid the signs of an improving economy that I have just described, the Federal Reserve took a costly step over the past several months to prepare markets for an eventual reduction to the pace of these purchases. Despite some episodes of elevated volatility, markets in the weeks leading into the last FOMC meeting were prepared for a modest reduction in the pace of purchases to be announced at last week's meeting. For example, the Blue Chip survey prior to the last FOMC meeting showed more than two-thirds of its respondents expected a reduction in the pace of asset purchases.

Communications from the FOMC, reflected in its July meeting minutes, had reinforced the market's expectations of an adjustment. The minutes from the July FOMC meeting stated that, "A number of participants mentioned that, by the end of the intermeeting period, market expectations of the future course of monetary policy, both with regard to asset purchases and with regard to the path of the federal funds rate, appeared well aligned with their own expectations." In other words, over the course of May through July, the market expectations on the timing of tapering had apparently fallen in line with those of the Committee.

However, the FOMC last week decided to maintain the pace of asset purchases. Fed communications that had supported the market's expectations of a modest taper, likely starting in September—and then the decision to make no adjustments in the pace of its bond buying—surprised many and disappointed some, including me. With this decision, a majority of the voting members of the FOMC determined that the Fed should continue aggressively easing monetary policy with $85 billion a month in asset purchases until there is more evidence that the economy's progress will be sustained.

To be clear, the FOMC had not committed to take action at the September meeting, despite the market's expectation. Of course, as Chairman Bernanke noted at last week's press conference, the FOMC should not let market expectations dictate policy. Rather, the Committee has to do what's best for the economy. I certainly agree with that principle. But in thinking about what is best for the economy, individual judgments on the Committee can vary, including what constitutes substantial improvement in the outlook for the labor market, which is the condition the Committee has laid out for ending the open-ended asset purchase program.

As I have noted, labor market conditions have improved and I view the outlook to have improved substantially. For example, the Blue Chip survey reported that the average monthly gain in employment last January for 2013 was expected to be 158,000. The latest survey indicates the average expected employment gain next year has increased to 192,000. Other timely labor market indicators, such as the employment component of the ISM manufacturing and non-manufacturing surveys, are also considerably higher than in May and June, when the initial signals were sent that tapering asset purchases would likely occur in the "next few meetings."

Risks of Delayed Action

I view the data has being sufficiently positive to continue with the plan the Chairman presented in June, which called for the pace of purchases to moderate this year and gradually decline for several months until they come to an end around mid-2014. Consistent with this roadmap, our previous guidance and market expectations, my preferred course of action would have been to begin tapering asset purchases at last week's meeting.

Even as I advocate for initiating a reduction in the pace of asset purchases, I share the desire to see further progress with this recovery, to be assured no setbacks lie ahead that would derail the recovery, and to achieve a sustained recovery and growth. But waiting for even more evidence in the face of continuing economic growth unnecessarily discounts the very real progress made over the past few years and also discounts the potential costs of a policy tool with which we have limited experience.

Delaying action not only allows potential costs to grow, it also has the potential to threaten the credibility and the predictability of future monetary policy actions. Policy moves that surprise the market often result in additional volatility. And by deciding that it needs to await further data, the Committee is suggesting its desire to be “data dependent” involves putting more emphasis on the most recent data points, which can be volatile and subject to revision, rather than on its own medium-term view of the economy. Another risk is that markets might misconstrue the postponement of action as reflecting a Committee assessment that the broader economic outlook is substantially weaker, when that is not the case.

Beyond the communication challenges associated with asset purchases, explaining the Committee’s interest rate policy and how long rates will remain near zero will be a crucial next step. To further mitigate risks when the time comes to start raising interest rates, it may be important to signal that increases in the federal funds rate, after liftoff, are likely to be gradual in order to gauge the economy’s response.

Finally, the Committee must think carefully about how recent and near-term actions might impact its forward guidance on short-term interest rates. The Committee has signaled rates are likely to remain near zero at least until the unemployment rate reaches 6.5 percent, but possibly longer, provided inflation forecasts remain below 2.5 percent. Failing to adjust purchases at the last meeting, however, could risk the credibility and strength of these thresholds.

My argument to reduce asset purchases and to begin the process of policy normalization is not an argument to tighten policy. Even with the initial reduction in bond purchases, the

Federal Reserve will continue to add to its balance sheet billions of dollars in accommodation while continuing to keep short-term interest rates near zero for still some time. This extended period of extraordinary accommodation creates incentives to reach for yield and conditions for risks to build and imbalances to grow—notwithstanding the shift in rates this summer that may have slowed the momentum in some asset markets. Recognizing that there has been clear, ongoing improvement in the labor market and other parts of the economy is not to suggest the end of accommodative policy, but instead acknowledges that it is time to move away from using policy tools that were appropriate during the financial crisis and begin the long process of adjusting policy to more normal conditions.

Conclusion

The Federal Reserve has responded aggressively in the face of a severe recession and financial crisis to provide liquidity and ease financial conditions. These actions have supported the economy's recovery. It is now time to acknowledge the progress and turn to a focus on the long-term prospects of the economy.

An initial reduction in the pace of its sizeable asset purchases would be appropriate given the ongoing improvement in economic conditions. By gradually reducing the amount of the Fed's monthly purchases, the central bank would be providing time for markets to adjust as smoothly as possible and to resume their critical role in pricing risk and allocating credit in our economy.