

The Federal Reserve and the Path of Monetary Policy

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The views expressed by the author are her own and do not necessarily reflect those of the Federal Reserve System, its governors, officers or representatives.

It is always a pleasure to be in Omaha, home to one of the three Branch offices of the Federal Reserve Bank of Kansas City. This morning, I had the opportunity to meet with our Omaha Branch board of directors and listen to their thoughts on the local and national economy. This board is a diverse group of experienced business and community leaders who represent a wide range of industries in Nebraska, including agriculture, banking, manufacturing, insurance and the nonprofit sector. This kind of information-gathering is a process repeated around the country involving nearly 270 individual directors in 36 Federal Reserve locations.

While today's headlines are filled with speculation about future leadership changes for the Fed and talk of tapering, I would note that day-in and day-out, thousands of dedicated Federal Reserve employees are working to serve the public's interest in monetary policy, financial services, bank supervision, community affairs and other areas. They provide broad-based support to the financial system that underpins the economy of this region and 11 others across the country. It's a responsibility that has its roots in an era of frequent banking panics and financial instability.

I highlight this expansive network of "on-the-ground" connections ahead of my remarks about the U.S. economy and monetary policy because, over the course of the next 12 months, my colleagues and I will be talking about historical perspectives on the Federal Reserve as we commemorate the centennial of the signing of the Federal Reserve Act on December 23, 1913. My remarks today will cover briefly the importance of these populist roots and their relevance to monetary policy deliberations nearly 100 years later, especially as it relates to my responsibility to bring forward independent views of the U.S. economy.

Populist roots

At the end of the 19th century, it was clear that the nation's monetary system was not working to the economy's benefit, and it was especially ill-suited for farmers, laborers, merchants and wholesalers.

The nation's unstable financial system led to tremendous uncertainty about the value of money. This uncertainty was fueled by the constant threat of a possible financial crisis, which would hit the nation's banks every few years as part of a vicious cycle. In a time when there was no deposit insurance, we can appreciate why these crises were known as "panics," as depositors raced to their local banks hoping they would not be greeted by a closed teller window at the end of the line.

Right here in Nebraska, where agriculture played such a key role in the economy, as it does today, an attorney by the name of William Jennings Bryan gave a voice to farmers' concerns about the financial system and the problems surrounding the seasonal availability of credit. As a three-time presidential candidate, Bryan helped shape the national conversation about the financial problems experienced by those in the middle of the country. Bryan was a vocal critic of banks and the gold standard, and his famous "Cross of Gold" speech, given at the Democratic National Convention in 1896, cemented his historic reputation as a persuasive speaker and leader on these issues.

However, while Bryan and others who shared his concerns had ideas about how to reform the nation's monetary system and pushed for what they called an "elastic currency," no significant reform was attempted until after the Panic of 1907.

Much of what has been written about the 1907 panic centers on the activities of speculators in New York City who attempted to corner the copper market with disastrous results.

From there, the story shifts to the role of New York financier J.P. Morgan in organizing a private-sector rescue of the nation's financial system.

Perhaps less well-known is the impact the panic had on the rest of the country, including the Midwest and Nebraska. As banks in New York seized up, the flow of money to the rest of the country stopped. Within weeks, there was no currency available for businesses to pay workers, for merchants to pay their vendors or for borrowers to pay their debts.

Due to the shortage of currency in this part of the country, streetcar workers in the city of Omaha during the fall of 1907 were paid with the nickels customers used to pay their fares. In smaller Nebraska cities, such as Hastings, informal coalitions of banks quickly organized and issued cashier's checks that circulated as cash throughout their community until the panic eased and U.S. currency began to flow again. In many places, businesses were forced to close and employees were laid off because there was simply no way to pay wages.

It was clear that this growing nation needed a central bank. By 1912, some lawmakers presented a plan that would place responsibility for the nation's credit and money supply into a single, centralized board consisting of 46 directors who overwhelmingly represented the banking industry. Populists including Bryan, who by this time was serving as secretary of state under President Woodrow Wilson, criticized this approach as giving too much power to financial interests.

Oklahoma Senator Robert Owen, a banker during the Panic of 1893, generally agreed with Bryan's concerns but recognized the need for a more balanced and representative approach to central banking. For more than a decade, Owen had proposed his own banking reform measures, and as chairman of the new Senate Banking Committee in 1913, he was in a position

to introduce a bill that included both a central government board and a regional reserve system to represent differing regional economies and banking needs.

President Wilson and members of Congress debated these issues for months. By late 1913, lawmakers finally arrived at the compromise that created the Federal Reserve System and its structure of a central Board of Governors in Washington and 12 regional Reserve Banks located across the country.

The Federal Reserve reflects the tradition of checks and balances that characterize other important institutions in the United States. The Federal Reserve's designers recognized that the central bank would need a wide range of perspectives when deliberating policy that affects the availability of credit and money in the broader U.S. economy. The regional Reserve Banks provide a clear line of sight into how national policy affects Main Street.

While I consider the Federal Reserve's structure to be a success in terms of the founders' intent, I often read that "too many voices" and the "complex structure" of the Federal Reserve System are confusing to the public. To the contrary, it is important that this representative structure not be disregarded or diminished. This structure and its governance provides for a diversity of views that are transparent to the public and are reflected in its deliberations about the U.S. economy and its decisions on monetary policy—a subject to which I will now turn.

The labor market and monetary policy

The U.S. economy continues to heal as it recovers from the depths of the financial crisis. Without question, this recovery has been unusually slow and uneven. And a return to full employment has been elusive, despite massive doses of stimulus, which have included five years of near-zero, short-term interest rates, an unprecedented expansion of the Federal Reserve's

balance sheet by more than \$2.5 trillion, and for the past year, \$85 billion per month in purchases of U.S. Treasury and mortgage-backed securities.

The FOMC has emphasized in its policy statements that labor market conditions have been a key factor motivating its decision to pursue highly accommodative and unconventional monetary policy. Almost one year ago, the FOMC launched a program of open-ended, large-scale asset purchases, known as QE3, with the intention of speeding up the recovery and bringing the unemployment rate down faster. The Committee promised to continue these monthly asset purchases “until the outlook for the labor market improved substantially in a context of price stability.”

Over the past 12 months, the unemployment rate has dropped a bit more than one-half of a percentage point and the economy has added more than 2 million jobs. At this pace of improvement, the labor market is creating enough jobs to continue bringing down the unemployment rate. Consumer attitudes toward the labor market are also changing for the better. For example, according to the Conference Board, more consumers are likely to describe jobs as “plentiful” compared to “hard to get” than at any point in almost five years.

Acknowledging this improvement, however, does not ignore the reality that a number of factors are negatively affecting the pace of labor market improvement. Although businesses now appear more likely to retain their workers than in the recent past, they still appear quite cautious in terms of adding to their payrolls. In this respect, the data show the hiring rate has remained relatively flat, although the number of new job openings continues to rise.

One factor weighing on the pace of new hiring is the difficulty businesses are having in finding qualified workers. In the most recent National Federation of Independent Business survey, 40 percent of small businesses reported they are finding few or no qualified applicants

for open positions, and firms have been cautious about adding new workers due, in part, to risks and uncertainty facing the U.S. and global economy. This suggests to me the labor market is facing challenges that monetary policy cannot directly address.

In terms of my own outlook for the nation's economy, I expect growth this year of around 2 percent. The economy's potential for higher growth depends on a more predictable and stable economic backdrop, both in terms of fiscal policy and foreign growth.

Inflation has also received some recent attention—not for being too high, but for potentially being too low. I find little cause for alarm in this regard. Although official measures of inflation are currently below the Fed's longer-term goal of 2 percent, the inflation rate is likely poised to move closer to the target based on gasoline and food prices, which have moved higher over the past few months. In addition, longer-term inflation expectations remain anchored at levels consistent with the Federal Reserve's objective.

Moving back to normal

Markets are now beginning to adjust to the reality that the current level of central bank accommodation cannot last indefinitely. In fact, longer-term interest rates have risen based on Chairman Bernanke's statements that it "would be appropriate to moderate the monthly pace of purchases later this year." Given the decline in the unemployment rate and noted risks to financial stability posed by the asset purchases, I have advocated for such reductions this year as a voting member of the FOMC.

I have been more skeptical than the majority of the Committee that the benefits of continued easing through unconventional policy actions justify the risks, particularly when the economy is growing and financial markets are not under acute stress. While continued

accommodative settings for monetary policy are warranted as the recovery proceeds, I continue to support slowing the pace of purchases as the appropriate next step for monetary policy. For example, an appropriate next step toward normalizing monetary policy could be to reduce the pace of purchases from \$85 billion to something around \$70 billion per month, then have purchases going forward split evenly between Treasury and agency-MBS securities.

Communicating the future path for asset purchases will also be important. As long as labor markets continue to heal and inflation remains stable near its target, I would like to see the pace of purchases gradually decline and brought to a close in the first half of next year.

As we have seen, financial markets are prone to volatility when monetary policy begins to shift course, so reducing the pace of purchases gradually is appropriate. The shift is needed, however, to begin moving toward a more normal interest rate environment. To the extent that longer-term interest rates move higher as the pace of purchases slows, the economy is positioned to benefit from modestly higher longer-term interest rates. For example, bank net interest margins can improve over time without having to resort to increasing the amount of risk they take onto their balance sheet, thereby supporting financial stability. In addition, retirees and savers who rely on fixed-income investments can, over time, begin to realize improved returns.

Of course, markets and the public want to know more than just the “next step” for asset purchases. They are also interested, for example, in how long short-term interest rates are likely to remain at the current very low level. In this respect, the FOMC has relied on forward guidance in the form of “thresholds.” Specifically, the FOMC has indicated that short-term rates are likely to remain near zero “at least as long as the unemployment rate remains above 6-1/2 percent” and “inflation between one and two years ahead is projected to be no more than a half percentage

point above the Committee's 2 percent longer-run goal.” Inflation expectations also must remain stable.

While this kind of guidance communicates important information, it is only part of the story. Markets and the public also want to know how quickly interest rates are likely to rise after the initial rate increase. In this respect, there may be scope to enhance FOMC communications. For example, the most recent Summary of Economic Projections indicates the range of the appropriate federal funds rate at the end of 2015 ranges from near zero to 3 percent. With such a broad range, markets and the public are likely having a difficult time understanding exactly how fast the FOMC is likely to raise interest rates after the first rate hike.

One way to clarify a path for future interest rate moves would be to include more information about future short-term interest rates in the FOMC statement. For example, the statement could include the median projected interest rate from the FOMC projections for the end of 2015; this is currently 1 percent. Providing this information in the statement could help to clarify the collective view of the Committee about the path of interest rates after liftoff.

Projections can and should change as the economic outlook shifts. But the challenges of exiting from such an extended period of near-zero interest rates are likely to require some form of guidance and could serve as a potentially important enhancement in our ongoing communication efforts.

Conclusion

The U.S. economic recovery continues, and determining the future path of monetary policy will be challenging as the FOMC deliberates its next steps in light of its unconventional

policy stance. In less than two weeks, the Committee will meet to discuss the economy's performance and progress, and to determine an appropriate policy prescription.

A decision to reduce the Federal Reserve's monthly asset purchases would be appropriate at that meeting, as would clearer guidance about the path forward. It is time to begin a gradual—and predictable—normalization of policy.

The transition is likely to result in episodes of volatility as the markets adjust to the changing policy stance. However, postponing the move to reduce asset purchases won't ease the inevitable adjustment. Taking action now, with a firm plan and clear commitment, will begin the long process of putting monetary policy to more-normal settings and achieving our objectives for sustainable growth.