

The Path to Normalization

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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.

I appreciate the opportunity to be here today with our Denver Branch Office Board of Directors. Breckenridge provides an appropriate backdrop to discuss the current stance of monetary policy as the Federal Reserve contemplates its eventual exit from unconventional and highly accommodative monetary policy. Like skiers, our ability to anticipate what is likely to be around the next turn will make the difference between a smooth run down the mountain or an unpleasant spill.

As the U.S. economy gradually returns to normal, monetary policy will need to do the same. My remarks today will focus on what it means to return to normal for economic conditions and for the stance of monetary policy. Of course, these are my own views and not those of the Federal Open Market Committee (FOMC) or the Federal Reserve System.

Normalizing economic conditions

More than five years after the crisis and despite consecutive years of economic growth since then, I still sense some hesitation in household and business confidence about the economy. Clearly, sentiment has become more positive and hopeful over the past few years but remains cautious. Perhaps the Great Moderation made us too confident, and so, on the other side of the Great Recession, we keep looking over our shoulder—not wanting to be fooled again.

Turning first to the outlook, I anticipate the economy will continue to grow and unemployment to fall in the coming year. Although growth this year will likely be similar to last, the factors driving it will be different and point to surer footing. For example, last year inventories provided a temporary boost to growth, whereas this year households and businesses are in a better position to spend and invest. As a result, demand for both products and services is likely to rise, supporting overall growth on a more-sustained basis.

Stronger growth, if it occurs, will certainly be welcome as the crisis and slow recovery over the past five years have posed many challenges to families, businesses and policymakers. Several issues still remain as the level of longer-term unemployment remains elevated, housing's share of overall economic activity remains low, and businesses still seem tentative in terms of capital spending.

Despite these issues, I think a return to more-normal economic conditions is on the horizon. At the same time, we must remember normal is a range, and the economy will look different this time around compared to other recoveries. Still, the unemployment rate is 6.3 percent, which is less than 1 percentage point away from what the FOMC views as the longer-run, or normal, rate. If the unemployment rate falls at about the same rate as over the past few years, the economy will reach this normal level by the end of next year.

And although inflation has been low for a few years, it is not hard today to see examples of rising prices. Food prices have risen sharply over the past few months. People who rent either a house or apartment are also seeing a steady rise in the rents they are paying. And having just moved through the graduation season, I would note that the rise in tuition costs continues to outpace the price of many other goods. Because of these factors, I expect inflation to move nearer to the FOMC's 2 percent goal.

Projections from the FOMC also indicate that a return to normal is within the forecast horizon. Based on the Federal Reserve's economic projections, the unemployment rate is expected to be at its longer-run level by the end of 2016. Inflation, as well, is expected to be near 2 percent at that time. While I think we could achieve these levels sooner than these projections suggest, it is noteworthy that these objectives are no longer beyond the forecast horizon.

Normalizing monetary policy

As the economy returns to normal, the Federal Reserve's posture of extraordinary accommodation will need to shift to more-neutral settings. The timing and pace will have a significant influence on whether the economy experiences a hard or soft landing. Moreover, this path to normal is not a familiar one. Efforts by the central bank over the past five years have been unprecedented, and its process of normalization is likely, in many respects, to lack familiar rhythms.

With the elevated size of the balance sheet, one issue is simply "how" interest rates will be increased when the time comes. Some aspects of this discussion relate to the mechanics of how the Fed actually changes interest rates, but other aspects relate to how large a footprint the Fed should make in the nonbank financial system as a result of its overnight reverse repos. The steps that the FOMC takes in preparation of the first rate hike also are in focus.

To be sure, the FOMC has done some planning along these lines. Going back to June 2011, the FOMC agreed on a number of key elements of a normalization, or exit, strategy. At the time, the plan was to first cease reinvesting some or all payments of principal on the securities we hold. This action would cause the balance sheet to begin shrinking without having to sell any bonds from our portfolio. The next step of the 2011 plan was for the FOMC to modify its forward guidance on the path of the federal funds rate—that is, the signals we provide about how long we anticipate short-term rates will stay near zero.

At that time, the plan called for taking steps to reduce the amount of reserves held in the banking system. Currently, banks hold about \$2.7 trillion in reserves, compared to only around \$10 billion prior to the crisis. The elevated level of reserves reflects the bond-buying programs, often referred to as "QE 1, 2 and 3." As a voting member in 2013, I did not support the last round

of bond-buying, partly because of the complications these actions have for normalizing monetary policy.

Following these steps, the 2011 plan then called for the FOMC to begin raising its target for the federal funds rate, provided economic conditions were approaching normal. From that point on, changing the funds rate target would be the primary means of adjusting the stance of policy, and other tools, such as the interest rate paid on reserves and the adjustments to the level of reserves in the banking system would be used to bring the funds rate toward its target.

The final aspect of the 2011 strategy was to return the balance sheet to a more-normal size and composition. Of course, getting back to an all-Treasury portfolio of normal size will take some time. In 2011, the size of the balance sheet was approximately \$2.5 trillion. Today, the Federal Reserve's balance sheet is approaching \$4.5 trillion, so some aspects of the 2011 plan will likely need to be revisited. In fact, the FOMC reviewed this plan last year and considered the 2011 principles broadly as still applicable. However, the FOMC has noted that when it becomes appropriate to normalize monetary policy, the details of the process would depend in part on economic and financial developments and that it would communicate its intentions as that time approaches.

A decision the FOMC will need to make in the relatively near future, however, is what to do with the balance sheet after the end of the "taper"—that is, after the current round of bond-buying comes to an end. I think allowing the balance sheet to decline due to "passive runoff," which stops reinvesting the maturing securities, prior to the first rate hike is appropriate. As the outlook improves, this modest step would begin the normalization process and is in line with the 2011 principles. Unless there is a major change in the outlook, I see abiding by principles that

the FOMC reaffirmed last year as important. Central banks should make efforts to follow through on their plans, otherwise they risk losing credibility.

Lingering headwinds and rates in 2016

Tightening monetary policy is difficult, and history offers examples when such steps came too late. Cutting rates is easy when economic activity is slowing and inflation falling, but raising rates can be more difficult as the economy strengthens. This is especially true if the signals of sustainable growth are not entirely clear cut. While some have argued the aggressive easing actions taken during the crisis required courage, both from a policy and political standpoint, I expect the normalization phase will require a great deal more. Accordingly, sending the appropriate signals and communicating is clearly important so that tightening policy is not a surprise.

One current issue is that even as the economy moves back toward more-normal conditions, the FOMC has signaled that monetary policy is still some time away from normalizing. For example, the FOMC's projections show the federal funds rate below its longer-run level at the end of 2016, even though economic conditions have normalized. As I noted earlier, I expect the economy could be there a bit sooner.

Of course, this recovery has been slower than normal. Lingering headwinds reflecting tight credit conditions, uncertain and restrictive fiscal policy, and uneven growth across the global economy have affected the pace of recovery.

For monetary policy, some are concerned that these headwinds could linger into 2016, justifying a low policy rate to offset their effects. I think it is hard to see such persistent headwinds still weighing on the economy two years from now, unless some new shock causes

economic activity to slow. Take, for example, fiscal policy, which has been tight during this economic recovery. In particular, last year's tax increases and the sequester cuts in government spending put a dent in economic growth in 2013. However, the effects of this fiscal restraint are fading this year, so fiscal policy is unlikely to be a persistent headwind going forward. Credit conditions also have been tight, although they have eased since the end of the recession. Consumer borrowing, for example, has recently stepped up. Growth in certain types of credit, such as in leveraged lending and subprime auto loans, is an area of concern.

As the headwinds weighing on the recovery thus far start to fade, policy may need to react sooner than what is suggested in the FOMC's projections. However, once policy normalization begins, a gradual rise in the federal funds rate toward its longer-run level will be important and promote financial stability. Steady moves are more predictable and reduce the chance of unexpected shifts in longer-term interest rates.

A gradual path for the federal funds rate is suggested by the FOMC's projections. However, in my view, it will likely be appropriate to raise the federal funds rate somewhat sooner and at a faster pace. My concern is that keeping rates very low into late 2016 will continue to incentivize financial markets and investors to reach for yield in an economy operating at full capacity, posing risks to achieving sustainable growth over the longer run.

Conclusion

As the economy continues to recover and moves toward sustainable growth, so monetary policy must step away from its extraordinary influence. A gradual withdrawal and clear communication are key to a smooth transition, allowing markets to resume a greater role in credit allocation and pricing of risk.

The challenge for monetary policy is to converge on this path in a timely fashion, facilitating a return to normal and achieving its long run objectives for the economy.