Thomas M Hoenig: The high cost of exceptionally low rates

Speech by Mr Thomas M Hoenig, President of the Federal Reserve Bank of Kansas City, at the Bartlesville Federal Reserve Forum, hosted by Bartlesville Chamber of Commerce, Bartlesville, Oklahoma, 3 June 2010.

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

I appreciate the opportunity to join you here today. Bartlesville plays an especially important role in the history of the Federal Reserve Bank of Kansas City. After Congress passed the Federal Reserve Act nearly a century ago, a special committee was appointed to determine where the nation's 12 regional Federal Reserve Banks would be located and what regions those banks would serve. When that committee met in Kansas City to discuss business relationships in the central United States, Frank Phillips was among those who attended and spoke in favor of locating our Bank in Kansas City and having it serve Oklahoma. The support from Mr. Phillips and others from Oklahoma was absolutely critical to the eventual decisions that established the Bank in Kansas City and included Oklahoma in the Tenth Federal Reserve District that we serve. A few years after our founding, we opened our Oklahoma City Branch. This morning, the community and business leaders who serve on the Branch's Board of Directors – including Bartlesville's own K. Vasudevan – met here in Bartlesville, which seems especially appropriate.

This is not the only connection between the Federal Reserve's founding and Oklahoma. The Senate sponsor of the Federal Reserve Act was one of Oklahoma's first senators, Robert Owen. Senator Owen, like Mr. Phillips, recognized the importance of having the central bank of the United States tied directly to America's Main Streets and not isolated in Washington or on Wall Street. That structure is at least as important today as it was a century ago. It is my hope that, after much debate, the regulatory reform legislation now under discussion in Washington will affirm in its final version the importance of these regional responsibilities.

It is our job as the regional headquarters of the nation's central bank to serve as the link between our communities and national policy deliberations. Although these policy issues are always important to our nation, today we find ourselves at a unique and difficult point. We are attempting to support an economic recovery, but in doing so, also avoid fostering the next crisis. It is this challenge that I would like to spend the next few minutes discussing and sharing with you my views.

Economic outlook

At this point, the U.S. economy appears on the path to recovery. Subject to the risks I will discuss a bit later, the general outlook is good. GDP grew at nearly a 4 percent pace in the second half of last year, after bottoming out last summer. I anticipate growth will be slower this year, coming in between 3 and 3½ percent.

What is perhaps most encouraging now is the changing composition of growth that we are seeing. Last fall, a good portion of the GDP growth could be traced to temporary factors related to fiscal stimulus and inventory adjustments by firms that had scaled back during the worst of the recession. At that time, there was considerable uncertainty about what might happen once these temporary factors subsided. However, more recent data suggest that the recovery is more broad-based and self-sustaining, and perhaps even stronger than anticipated.

Consumer spending, which makes up more than 70 percent of GDP, has been expanding at a solid pace. While consumers have been cautious about big-ticket purchases, we're starting

to see some signs that this is changing as consumer confidence improves. Manufacturing activity continues its sharp rebound, and nonmanufacturing activity has been expanding as well. With businesses seeing a recovery in demand, business purchases of equipment and software have been robust.

Jobs, of course, remain a critical issue. Improvements in labor markets boost household income prospects and enables Americans to take care of themselves and their families and to save for their future. So of course jobs are a crucial component in the transition to self-sustaining growth. We are now seeing clear signs that the process of job creation is taking hold. Payrolls have risen in each of the first four months of this year. In April, payrolls increased by a strong 290,000. The recent uptick in the unemployment rate from 9.7 to 9.9 percent actually reflects an improved outlook, as workers who dropped out of the job market are gaining confidence and beginning to reenter the workforce. Solid job gains in the months ahead will translate into a downward trajectory for the unemployment rate later this year and into next year.

Nevertheless, while the economy is improving, recovery in certain sectors will be prolonged. Notably, the construction industry has yet to convincingly turn the corner. The residential housing market received a boost from federal homebuyer tax credits last fall and again this spring, but given the overhang of unsold homes, building activity will remain subdued through most of this year or longer. Nonresidential construction will likely continue to contract this year, due to high vacancy rates in that sector. These are important negatives but by themselves should not derail the recovery.

Looking at the economy more broadly, inflation has drifted lower in recent months, which is typical following a recession. While energy prices have kept consumer price inflation around 2 percent, inflation in non-food and non-energy prices – which is core inflation – has been running at rates of around 1 percent. These inflation rates are likely to continue for the next year or so. However, as the economic recovery continues or picks up momentum, I expect inflation to drift higher.

As for risks to this outlook, there are several. The fluid situation in Greece and Europe reminds us to be wary. The European debt problems have increased uncertainty and a renewed aversion to risks, and are causing investors to flee riskier assets such as stocks and junk bonds for safer assets such as U.S. Treasury debt. These shifts will have a modest negative net effect on U.S. economic growth in the near term. As an aside, I would note this episode illustrates the longer run danger of running persistent budget deficits – a situation that we must soon address in the United States.

Monetary policy

It is within the context of this outlook and its longer run implications that the Federal Open Market Committee must balance its objectives of supporting short-run economic growth and long-run stable growth and low inflation. It also is within the context of this outlook and these objectives that policy must be normalized, as reflected in the level of real interest rates and the size and composition of the Federal Reserve's combined balance sheet.

Achieving such multiple objectives requires deft handling. But most certainly, the first step toward a more normal policy is to move policy rates off zero, back toward neutral.

In saying this, I have no illusions about the challenges of moving away from zero. But in my judgment, the process should begin sooner to avoid the danger of having to over compensate later, as so often happens in policy.

I would begin the normalization of policy by outlining for the public a two-step process:

First, the Federal Reserve would continue to unwind its extraordinary policy actions implemented as a response to the financial turmoil that began in the fall of 2008. The market's need for these facilities has eased and we have closed most of them, returning the

discount window to more normal operations. As part of this first step, the FOMC would also eliminate its commitment to maintaining "exceptionally low levels of the federal funds rate for an extended period."

Second, with these steps taken, with the improvements in market conditions and liquidity, and with an improving outlook, the FOMC would be prepared to raise the funds rate target to 1 percent by the end of summer. This would continue the current highly accommodative policy, but would move nominal rates away from zero and real rates to a less negative level.

We would then pause, maintaining the funds rate at 1 percent while we assess the economic outlook and emerging financial conditions. This would provide time to judge whether and to what degree further policy adjustments are warranted to assure long-run financial equilibrium and stability.

Based on the current outlook consensus, it seems reasonable that the economy would be well-positioned to accept this modest increase in the funds rate. As a reminder, the funds rate target remained between 1 and 2 percent even after the intensification of the crisis in the fall of 2008. It was reduced to its current target range of zero to ¼ percent in mid-December 2008. Relative to the depths of the crisis, conditions today are much improved from where we were 18 months ago. Financial stress is clearly reduced and a sustainable economic recovery appears under way. It is also important to emphasize that the 1 percent fed funds rate target, coupled with the Federal Reserve's large balance sheet, provides an extraordinarily accommodative monetary policy environment and one that would ensure the economy's continued progress in the recovery.

Setting out such a plan would be a more orderly move toward unwinding the earlier extraordinary actions and would serve to reduce the likelihood of a buildup of new financial imbalances.

Let me turn now to the subsequent steps that might be taken to more fully restore policy to a long-run equilibrium policy level. Given the relatively modest expected trajectory of growth and inflation, these added moves will involve some quarters to complete. But the direction should be firmly established now with the timing dependent on the performance of a combination of financial, inflation and growth variables. Experience tells me that a clear commitment now to such action would mitigate the likely need to later tighten beyond our estimate of neutral that so often comes with delay. More specifically, these next steps involve raising the funds rate from 1 to above 3 percent reasonably quickly as we gain confidence that GDP and employment are on a steady path toward potential. The final steps would take rates to between 3.5 and 4.5 percent as economic growth approaches long-run potential.

If we are to achieve a steady rate environment, it is also important that the Federal Reserve's balance sheet be restored to its pre-crisis size and composition. Obviously this requires the careful process of selling the Federal Reserve's $1.3 trillion portfolio of mortgage-backed securities. Various approaches to this can be identified but most agree that it should be done with the process or time horizon clearly set out for all to see. I also would suggest it begin at least when the fed funds rate rises above 1 percent or sooner if conditions provide the opportunity.

Monetary policy and unemployment

Finally, I want to spend a few minutes suggesting why it is important to move the federal funds rate off of zero even though the unemployment rate remains above 9 percent. It has been argued, with some supporting evidence, that the Federal Reserve's commitment to very low interest rates in 2003 and 2004 was too low for too long and contributed to the housing and credit boom and subsequent busts.

Between August 2002 and January 2005 – two-and-a-half years – the federal funds rate was below the rate of core inflation. Such low interest rates encourage borrowing and a buildup of

debt, sometimes in ways we do not fully appreciate until much later with the benefit of hindsight. In addition, low interest rates – especially with a commitment to keep them low – led banks and investors to feel "safe" in the search for yield, which involves investing in less-liquid and more risky assets. In addition, financial institutions often search for yield by increasing the amount of assets supported by each dollar of net worth – leverage. For example, leverage at securities broker dealers rose dramatically. After averaging just 13-1/4 between 1970 and 2000, leverage climbed to a high of 40 in the third quarter of 2007 – the start of the financial crisis.

It was after a period of too-low interest rates, too much credit, too much leverage that the collapse of the housing bubble, the rapid deleveraging and the ensuing financial crisis occurred. And it was after these events that unemployment rose to more than 10 percent and the United States lost 8.4 million jobs. In 2010, we have only gained back 573,000 jobs.

In another period, the mid-1970s and early 1980s, low interest rates also triggered an extreme swing in the economic cycle. The real fed funds rate was kept negative for a span of nearly three years, from November 1974 to September 1977. The low interest rate environment led initially to a drop in the unemployment rate. But rising inflation and asset bubbles eventually dictated a restrictive monetary policy implemented by Fed Chairman Paul Volcker and his FOMC colleagues. In the end, the nation paid a high price for the low rates of the 1970s, when unemployment reached 10.8 percent in the recession of the early 1980s.

In the drive to achieve price stability and stable growth, monetary policy is a powerful tool. Certainly lowering interest rates is the appropriate monetary policy response to the onset of an economic recession and rising unemployment. But it is also a blunt instrument that has a wide set of intended but also unintended consequences that can and have worsened economic outcomes including misallocation of precious resources, inflation and long-term unemployment. That is why we want to return to a sustainable long-term equilibrium policy rate, starting soon.

The economy is improving and policy should reflect that fact, carefully but confidently. Although we find ourselves in a unique environment, history offers us some important lessons. If we do not learn from past mistakes, we will find ourselves repeating them yet again.