Thomas M Hoenig: Monetary policy cannot solve every problem – concerns with zero rates

Statement by Mr Thomas M Hoenig, President and Chief Executive Officer of the Federal Reserve Bank of Kansas City, before the House Subcommittee on Domestic Monetary Policy and Technology, United States House of Representatives, Washington DC, 26 July 2011.

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Chairman Paul, Ranking Member Clay and members of the subcommittee, thank you for the opportunity to discuss my views on the economy from the perspective of president of the Federal Reserve Bank of Kansas City and as a 20-year member of the Federal Reserve System's Federal Open Market Committee (FOMC).

The Fed's mandate reads: "The Board of Governors of the Federal Reserve System and the Federal Open Market Committee shall maintain long-run growth of the monetary and credit aggregates commensurate with the economy's long-run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates."

The role of a central bank is to provide liquidity in a crisis and to create and foster an environment that supports long-run economic health. For that reason, as the financial crisis took hold in 2008, I supported the FOMC's cuts to the federal funds rate that pushed the target range to 0 percent to 0.25 percent, as well as the other emergency liquidity actions taken to staunch the crisis. However, though I would support a generally accommodative monetary policy today, I have raised questions regarding the advisability of keeping the emergency monetary policy in place for 32 months with the promise of keeping it there for an extended period.

I have several concerns with zero rates. First, a guarantee of zero rates affects the allocation of resources. It is generally accepted that no good, service or transaction trades efficiently at the price of zero. Credit is no exception. Rather, a zero-rate policy increases the risk of misallocating real resources, creating a new set of imbalances or possibly a new set of bubbles.

For example, in the Tenth Federal Reserve District, fertile farmland was selling for $6,000 an acre two years ago. That land today is selling for as much as $12,000 an acre, reflecting high commodity prices but also the fact that farmland loans increasingly carry an interest rate of far less than the 7.5 percent historic average for such loans. And with such low rates of return on financial assets, investors are quickly bidding up the price of farmland in search of a marginally better return.

I was in the banking supervision area during the banking crisis of the 1980s, when the collapse of a speculative bubble dramatically and negatively affected the agriculture, real estate and energy industries, almost simultaneously. Because of this bubble, in the Federal Reserve Bank of Kansas City's District alone, I was involved in the closing of nearly 350 regional and community banks. Farms were lost, communities were devastated, and thousands of jobs were lost in the energy and real estate sectors. I am confident that the highly accommodative monetary policy of the decade of the 1970s contributed to this crisis.

Another important effect of zero rates is that it redistributes wealth in this country from the saver to debtor by pushing interest rates on deposits and other types of assets below what they would otherwise be. This requires savers and those on fixed incomes to subsidize borrowers. This may be necessary during a crisis in order to avoid even more dire outcomes, but the longer it continues, the more dramatic the redistribution of wealth.

In addition, historically low rates affect the incentives of how the largest banks allocate assets. They can borrow for essentially a quarter-point and lend it back to the federal government by purchasing bonds and notes that pay about 3 percent. It provides them a means to generate earnings and restore capital, but it also reflects a subsidy to their operations. It is not the Federal Reserve's job to pave the yield curve with guaranteed returns for any sector of the economy, and we should not be guaranteeing a return for Wall Street or any special interest groups.

Finally, my view is that unemployment is high today, in part, because interest rates were held to an artificially low level during the period of the early 2000s. In 2003, unemployment at 6.5 percent was thought to be too high. The federal funds rate was continuously lowered to a level of 1 percent in an effort to avoid deflation and to lower unemployment. The policy worked in the short term.

The full effect, however, was that the U.S. experienced a credit boom with consumers increasing their debt from 80 percent of disposable income to 125 percent. Banks increased their leverage ratios – assets to equity capital – from 15-to-1 to 30-to-1. This very active credit environment persisted over time and contributed to the bubble in the housing market. In just five years, the housing bubble collapsed and asset values have fallen dramatically. The debt levels, however, remain, impeding our ability to recover from this recession. I would argue that the result of our short-run focus in 2003 was to contribute to 10 percent unemployment five years later.

That said, I am not advocating for tight monetary policy. I'm advocating that the FOMC carefully move to a non-zero rate. This will allow the market to begin to read credit conditions and allocate resources according to their best use rather than in response to artificial incentives.

More than a year ago, I advocated removing the "extended period" language to prepare the markets for a move to 1 percent by the fall of 2010. Then, depending on how the economy performed, I would move rates back toward more historic levels. I want to see people back to work, but I want them back to work with some assurance of stability.

I want to see our economy grow in a manner that encourages stable economic growth, stable prices and long-run full employment. If zero interest rates could accomplish this goal, then I would support interest rates at zero. In my written testimony, I have included three speeches that describe in more detail my position on monetary policy.

Monetary policy cannot solve every problem. I believe we put the economy at greater risk by attempting to do so.

Thank you, Mr. Chairman. I look forward to your questions.