William C Dudley: Reflections on the economic outlook and the implications for monetary policy

Remarks by Mr William C Dudley, President and Chief Executive Officer of the Federal Reserve Bank of New York, at Fordham Wall Street Council, Fordham University Graduate School of Business, New York City, 23 September 2013.

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Thank you, Dean Gautschi, for that kind introduction. It is a pleasure to be here today at Fordham University and I thank the Fordham Wall Street Council for hosting me. This morning my remarks will focus on the U.S. economic outlook.

I am also going to discuss a new tool that the New York Fed will begin to test – an overnight, fixed-rate full allotment reverse repo facility. I want to dispel any misconceptions about why we are doing this testing. The introduction of this facility is not a precursor to a change in the stance of monetary policy. Instead, the goal of this new facility is to improve our control over overnight interest rates to aid us in the implementation of monetary policy.

As always, what I have to say today reflects my own views and opinions and not necessarily those of the Federal Open Market Committee (FOMC) or the Federal Reserve System.

Let me start by summarizing my main points regarding the economic outlook. In my view, the economy is slowly healing. But, while significant progress has been made since the end of the recession, there remain a number of headwinds that have offset the improvement in the underlying fundamentals. As a result, we have yet to see any meaningful pickup in the economy's forward momentum.

The most notable recent headwind, of course, has been the large amount of fiscal drag this year from the payroll and income tax increases and the budget sequester. Also noteworthy is the tightening of financial market conditions that has occurred since May. As we move into 2014, the fiscal headwinds should abate somewhat. As that occurs, the improving underlying fundamentals of the economy should begin to dominate, pushing up the overall growth rate.

But this is just a forecast, it has not been realized yet. That is one reason why I supported the FOMC's decision last week to maintain the current pace of our Treasury and mortgage-backed security purchases. In my view, the economy still needs the support of a very accommodative monetary policy. Adjustments to that policy need to be anchored in an assessment of how the economy is actually performing, how financial conditions are evolving, and how this affects the longer-term outlook and the risks around it. Our decisions on how to adjust our policy tools – for example, the pace of asset purchases and forward guidance with respect to the level of short-term rates – must be rooted in the ongoing flow of information that informs our judgments about the prospects for a sustainable recovery. Decisions on the pace of asset purchase and forward guidance must be based on what is most appropriate to achieve our dual mandate objectives of maximum sustainable employment in a context of price stability.

Economic outlook

Let's dig a bit deeper into the tug-of-war between improving fundamentals and the drag exerted by fiscal policy and tighter financial conditions.

Starting with the improving underlying fundamentals, one important aspect is the household sector and its balance sheet. In a number of dimensions, households have made significant progress in repairing their finances. Prior to the recession, households took on an excessive amount of debt – much in the form of residential mortgages. The process of deleveraging and reducing this debt overhang is now well advanced. For example, household debt relative to disposable income has declined substantially since it peaked in the third quarter of 2007, bringing it back to levels last seen in early 2003. Delinquency rates on mortgages, auto loans and credit cards continue to decline. In addition, household wealth relative to disposable income has recovered from the steep decline following the crisis and is now near its 20-year average. Reflecting this improvement, credit standards are beginning to ease, which should support consumer spending on durable goods.

Another sector in which the fundamentals have improved is the housing sector. Most importantly, the excess supply of housing created during the boom appears to have been largely worked off. As a result, house prices are now rising in most areas of the country and homebuilding activity has strengthened. Moreover, there is further scope for gains in homebuilding. After all, the current annualized rate of housing starts – around 900,000 – is considerably below the rate consistent with the country's underlying demographic trends and the expected long-run rate of household formation. By these metrics, housing starts should ultimately climb back to about a 1.5 million annualized rate.

The underlying fundamentals supporting business investment are also good. Profit margins have been high and cash flows strong for some time. Credit availability has been gradually improving. For example, the Federal Reserve's Senior Loan Officer Opinion Survey indicates that banks are continuing to gradually ease their lending standards for commercial and industrial loans.

However, against these improving economic fundamentals, we have two important offsets. The first offset is the unusually high degree of fiscal drag, which the Congressional Budget Office (CBO) estimates at about 1¾ percent of potential GDP in 2013.[1] The two most important components of this restraint are the end of the payroll tax holiday and the increase in income tax rates this past January, and, more recently, the government spending cuts resulting from budget sequestration.

Another new source of drag for the economy is the sharp rise in long-term interest rates, especially residential mortgage rates – that has occurred since May. So far we don't have much hard data on how this is affecting the housing sector. But data through mid-September generally indicate that the rise in rates has cut into the upward momentum of the housing sector.

Currently, improving economic fundamentals versus fiscal drag and somewhat tighter financial conditions are pulling the economy in opposite directions, roughly cancelling each other. The economy continues to grow and payrolls are rising, but there is little evidence of a pickup in the economy's forward momentum. For example, real GDP growth is still stuck close to the 2.2 percent average annualized growth rate that has prevailed since the beginning of the expansion.

But, as the degree of fiscal drag and other headwinds lessen, the tug-of-war should begin to shift in favor of higher growth. Absent additional fiscal restraint, a further tightening of financial conditions, or some adverse external shock, I expect the economy to grow a bit faster in 2014.

So, how compelling is this narrative? In big picture terms, it certainly seems quite reasonable to me. However, no forecast is inevitable and there are some reasons to remain wary. In particular, although the fiscal drag will likely lessen in 2014, I expect it will still be significant, and the outcome of the current federal budget and debt ceiling debates may affect this assessment. Moreover, when one drills down and looks at the recent performance and outlook for the economy's major sectors, additional caution seems warranted.

Turning first to the outlook for fiscal policy, there are two points worth making. First, the CBO projects that significant fiscal drag will persist into 2014. Second, the fact that the degree of

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1 This number refers to the change in the high-employment budget deficit for fiscal year 2013 as estimated by the CBO in March.

restraint lessens next fiscal year could understate the actual impact on the economy because the full impact of some of this year's cuts may not yet have been fully felt. For example, consider university research spending that depends, in part, on federal grants. As the grant budget falls under sequestration, this will eventually squeeze university budgets over time and likely lead to additional belt-tightening.

Next, let's take a deeper look at how the major sectors of the private economy that might play a role in the strengthening story are doing currently: consumption, housing, business investment and trade. When we're done, I think you'll agree that there still are some reasons for caution.

Turning first to consumer spending, such spending has remained fairly subdued outside of interest rate-sensitive consumer durables. In July, for example, real personal consumption expenditures were flat, and it is unlikely that third quarter consumption growth will be much above a 2 percent annual rate.

Moreover, the drivers of consumer spending do not look particularly supportive. In particular, real disposable income growth has grown at less than a 1 percent annual pace since March. Furthermore, the recent data do not yet clearly indicate a firming in the income growth rate, or the two important components of labor income growth – hours and compensation.

The conundrum for consumers is a simple one: if consumer spending growth is to exceed 2 percent annualized on a sustained basis at a time when real disposable income growth is below 2 percent then this would require the household saving rate to decline persistently. But there is little reason to expect such a decline given that the current saving rate is at a level consistent with current level of household wealth relative to income.

We have a chicken-egg problem. If the saving rate remains stable, then stronger consumption growth will require a pickup in income growth. But for income to rise, demand must increase. This suggests that there may need to be an impetus to growth from other sectors of the economy to generate a boost in consumer spending growth.

One possible source is the housing sector. As noted earlier, housing starts are still quite low relative to what the country's demographics should support in the long run. But there are two difficulties here. First, the strength of the housing recovery may be blunted by the recent rise in mortgage rates. For example, before last week's partial reversal, the 30-year fixed mortgage rate had risen by about 120 basis points since May to more than 4½ percent. For a household considering buying a house and financing the purchase with a $100,000 30-year fixed-rate mortgage, this rise in mortgage rates would increase their annual payments by more than $800. The increase in financing costs and the rise in home prices has made housing considerably less affordable than it was earlier in the year. This is illustrated by the National Association of Realtors' affordability index which has declined by 25 percent over the six months ending in July.

Second, housing activity has already been contributing significantly to growth. For example, over the past two years, real residential investment swung from a drag of 1.1 percentage points of GDP to a contribution of 0.4 percentage points. Together, this suggests that the impetus to growth from housing may moderate rather than strengthen.

Perhaps, the economy can get a boost from business fixed investment. After all, most of the evidence points towards further improvement. First, as I noted earlier, profit margins and cash flows are high, and credit availability is improving. Thus, those businesses with successful track records should be able to readily finance new investments. Second, business fixed investment is not very high as a share of GDP and overall industrial capacity has been expanding only slowly. This suggests that this sector is not over extended. Third, the drop in U.S. energy costs relative to the rest of the world should spur more investment in the U.S. in energy intensive activities such as petrochemicals manufacturing.

However, there are also some negatives here as well. In particular, despite the positive factors I have cited, the growth in manufacturing output has been only moderate, with the overall manufacturing capacity utilization rate still below its pre-recession level. Thus, outside of the energy intensive sectors, there still appears to be little near-term motivation for firms to invest in order to increase their productive capacity. Businesses seem to be waiting for stronger demand before they significantly increase their investment outlays. Thus, we have a second chicken-egg problem.

On the trade side, the news is mixed. Although Japanese and European economic activity has picked up recently, the sustainability remains in question. Even as Europe emerges from its recession, growth is likely to be anemic at best over the next year, constrained by continued fiscal consolidation and tight credit conditions as their banks continue to deleverage. In Japan, the consumption tax is scheduled to increase significantly next year, which is likely to constrain domestic demand.

Moreover, the recent improvement in Europe and Japan has been offset by slowing in some emerging market economies. In fact, some emerging market economies are under pressure because they are running large current account and trade deficits. Any forced correction among these countries on trade is likely to be a drag on global growth and on U.S. exports over the near term. On balance, my outlook is that growth in the rest of the world will be roughly the same in 2014 as it is this year, so that the contribution of trade to growth will likely remain quite small.

Putting all these factors together, I still conclude that there is a basis for a pickup in growth as fiscal restraint lessens, but the impulse is not likely to be a particularly powerful one without some unanticipated impetus to growth that solves the chicken-egg problems, especially in the near term.

On the inflation side of the ledger, inflation remains below the Federal Reserve's 2 percent longer-run objective for the personal consumption expenditure (PCE) deflator. The year-over-year change in the total PCE deflator was 1.4 percent in July. This has created some concern that inflation is "too low," raising real interest rates and making monetary policy less accommodative. I acknowledge this concern, but I believe it will abate as inflation moves gradually back up towards a 2 percent annualized rate over the next few years.

A number of considerations inform my view. First, a decomposition of core inflation reveals that the most recent slowing in inflation has been largely confined to core goods, whereas the rate of increase of core services has been relatively steady. Such was not the case in 2010 – the previous instance of a significant slowing of inflation. This suggests that the fall in inflation partly reflects idiosyncratic factors that are not likely to be sustained.

Second, the recent data suggest that the downtrend in the inflation rate may be coming to an end. For example, the core personal consumption expenditures deflator rose at a higher rate over the past three months than during any other 3-month period since mid-2012.

Third, measures of longer-term inflation expectations, whether discerned from financial asset prices or from surveys of households or professional forecasters, remain well anchored at levels consistent with our 2 percent objective. This is important because inflation expectations are a major determinant of the inflation process. As long as inflation expectations stay well-anchored, it will be hard for inflation to fall further.

Putting these factors together along with my forecast of a gradual pickup in real economic activity, my outlook is for inflation to drift back toward our 2 percent objective over the medium term. However, much like the case of the real growth outlook, there is significant uncertainty around this forecast.

Monetary policy

So what does this all imply for monetary policy? As you are aware, at last week's FOMC meeting we made no changes to our monetary policy. In particular, the Committee decided to continue to purchase long-term Treasury securities and agency mortgage-backed securities at a monthly pace of $45 billion and $40 billion, respectively. The FOMC statement reaffirmed the Committee's intention "to continue its purchases of Treasury and agency mortgage-backed securities, and employ its other policy tools as appropriate, until the outlook for the labor market has improved substantially in a context of price stability."[2]

We also reaffirmed our forward guidance with respect to the federal funds rate. The statement notes that the Committee, "currently anticipates that this exceptionally low range for the federal funds rate will be appropriate at least as long as the unemployment rate remains above 6-1/2 percent, 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, and longer-term inflation expectations continue to be well anchored."[3]

Several questions have emerged following the meeting. Most noteworthy was – given that market expectations were skewed towards anticipating the beginning of a taper at this meeting – why the Committee did not begin to reduce the pace of asset purchases. Although I can't speak for the Committee, I can provide some reasons for my own decision.

To begin to taper, I have two tests that must be passed: (1) evidence that the labor market has shown improvement, and (2) information about the economy's forward momentum that makes me confident that labor market improvement will continue in the future. So far, I think we have made progress with respect to these metrics, but have not yet achieved success.

With respect to the first metric, we have seen labor market improvement since the program began last September. Over this time period, the unemployment rate has declined to 7.3 percent from 8.1 percent.[4] However, at the same time, this decline in the unemployment rate overstates the degree of improvement. Other metrics of labor market conditions, such as the hiring, job-openings, job-finding rate, quits rate and the vacancy-to-unemployment ratio, collectively indicate a much more modest improvement in labor market conditions compared to that suggested by the decline in the unemployment rate. In particular, it is still hard for those who are unemployed to find jobs. Currently, there are three unemployed workers per job opening, as opposed to an average of two during the period from 2003 to 2007.

With respect to the second metric – confidence that the economic recovery is strong enough to generate sustained labor market improvement – I don't think we have yet passed that test. The economy has not picked up forward momentum and a 2 percent growth rate – even if sustained – might not be sufficient to generate further improvement in labor market conditions. Moreover, fiscal uncertainties loom very large right now as Congress considers the issues of funding the government and raising the debt limit ceiling. Assuming no change in my assessment of the efficacy and costs associated with the purchase program, I'd like to see economic news that makes me more confident that we will see continued improvement in the labor market. Then I would feel comfortable that the time had come to cut the pace of asset purchases.

A few other points with respect to monetary policy are worth emphasizing following last week's FOMC meeting. First, as I have noted in earlier remarks, a decision to reduce the rate of asset purchases is not a tightening of monetary policy. If we are purchasing additional securities we are simply adding accommodation at a slower pace.

Second, any decision to cut the pace of asset purchases should not be taken as signaling an early exit from this period of unusually low short-term rates. We have established a threshold of 6.5 percent for the unemployment rate as long as we do not expect inflation to exceed

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2 Federal Open Market Committee statement, September 18, 2013.

3 Federal Open Market Committee statement, September 18, 2013.

4 The 8.1 percent unemployment rate refers to the August 2012 unemployment rate that was the latest information available to the Committee at its September 2012 meeting.

2½ percent at a one-to-two year horizon and inflation expectations remain well-anchored. It is likely to take a considerable amount of time to reach the 6.5 percent unemployment rate threshold. Moreover, because the 6.5 percent unemployment rate is a threshold, and not a trigger, depending on the economic circumstances, we might wait a long time after we breach the threshold before we begin to raise our federal funds rate target.

The point I wish to emphasize is that any decisions on the pace of asset purchases (the rate at which we are adding accommodation) versus liftoff in terms of the federal funds rate (a tightening of monetary policy) should be viewed as largely independent of one another. One does not foreshadow the other – certainly not in any mechanical way or with a definitive timeframe. As Chairman Bernanke noted in last week's press conference, our actions are data dependent and how the data will evolve is uncertain.

In addition, it is worth explaining why we anticipate the federal funds rate is still likely to be quite low relative to what Committee participants consider normal over the longer run, even as the Committee gets close to its employment and inflation objectives. For example, in the September Summary of Economic Projections, the median projection for the federal funds rate in the fourth quarter of 2016 is 2 percent, far below the median long-run federal funds rate projection of 4 percent, at the same time that the unemployment rate and inflation are close to the Committee's long-run objectives.

How does one explain this? As noted by Chairman Bernanke in last week's press conference, the still low federal funds rate projections for 2016 reflect the fact that economic headwinds – such as tight credit standards and ongoing fiscal consolidation – are likely to take a long time to fully abate. As a result, monetary policy will have to keep short-term interest rates very low for a sustained period in order for the Committee to achieve its objectives.

My view is that the neutral federal funds rate consistent with trend growth is currently very low. That's one reason why the economy is not growing very fast despite the current accommodative stance of monetary policy. Although the neutral rate should gradually normalize over the long-run as economic fundamentals continue to improve and headwinds abate, this process will likely take many years. In the meantime, the federal funds rate level consistent with the Committee's objectives of maximum sustainable employment in the context of price stability will likely be well below the long-run level.

Fixed-rate, full allotment overnight reverse repo facility

Before I conclude, I want to discuss a new tool that the Open Market Trading Desk (the Desk) at the New York Fed will be testing and developing in coming months. The new tool is a fixed-rate, full-allotment overnight reverse repo facility that would be available to a broad range of counterparties – not just open to the primary dealers through which we have historically conducted our open market operations.[5] By being available to a much broader array of counterparties, this should allow the Fed to tighten its control over money market rates.

I'll first explain in plain English what this facility is. Then I'll explain why we are testing it and what having such a facility in place might accomplish.

A fixed-rate, full allotment overnight reverse repo facility is a facility in which the Federal Reserve posts a fixed interest rate and accepts cash from counterparties, which include banks, dealers, money market funds, and some government sponsored enterprises (GSEs),

[5] The Desk has been conducting operational readiness exercises for the use of reverse repurchase agreements since late 2009. At the most recent FOMC meeting last week, the FOMC authorized the Desk to begin another testing program which begins today. See the Desk's September 20 announcement of the next round of testing.

on an overnight basis in return for a security. If implemented, the facility would be "full allotment" – that means the facility would have no cap on the amount of funds accepted from any of its counterparties at the posted overnight interest rate.[6] The repo facility is "reverse" because the direction in which the funds and securities move – participants are lending funds to the Fed rather than vice versa. Users of the facility are making the economic equivalent of an overnight collateralized loan of cash to the Federal Reserve. The amount of funds invested in the facility is likely to be sensitive to the posted interest rate. The higher the interest rate relative to comparable money market rates, the greater the participation is likely to be and vice versa.

There are several reasons motivating our interest in developing such a facility. First, such a facility should enable the Federal Reserve to improve its control over the level of money market rates. By offering a new, essentially risk-free investment, one would expect that anyone with access to such a facility would generally be unwilling to lend instead to someone else at a rate below that posted for the facility. This should help to establish a floor on the level of overnight rates. Right now, most short-term rates trade between 0 and 25 basis points, but occasionally T-bill and repo rates go negative, for example at quarter-end or when financial stresses increase the demand for very safe assets. The full allotment element of the reverse repo facility would increase the availability of a risk-free asset, satisfying the demand when the appetite for safe assets increases. This should help tighten the relationship between these and other money market rates. These reverse repos would be available to an expanded set of counterparties that includes many of the money market lenders who are ineligible to earn the interest on excess reserves (IOER), such as GSEs and a number of money market funds. Depending on the facility rate, these lenders who cannot earn the IOER rate might get a better rate by investing in the overnight RRPs compared to lending to banks or to broker dealers. This competitive effect could, in and of itself, put a stronger floor on money market rates.

Second, this new facility is also likely to reduce the volatility of short-term interest rates. If a lender that cannot earn the IOER rate has an unexpectedly large amount of funds to invest, this lender currently may have to accept an unusually low interest rate. But with the overnight reverse repo facility in place, this lender could lend as much funds as desired to the facility at a fixed rate and this should reduce the downward pressure on money market rates. By tightening control and reducing the volatility of short-term rates, such a facility should reassure investors that the Federal Reserve has sufficient tools to manage monetary policy effectively even with a very large balance sheet.

I have told you what this facility is for. Now let me emphasize what the testing and development of this facility does not foreshadow. The testing and the development of the facility is not being undertaken to facilitate or expedite exit from our large balance sheet and should not be considered to be an element of the exit process. The purpose of the facility is to establish a floor on money market rates and to improve the implementation of monetary policy even when the balance sheet is large. Even if our balance sheet increases significantly further and stays very large for many years, it will be useful to have this facility available to improve monetary policy control.

In coming months we will test the facility with two goals in mind. First, we want to be assured that there are no glitches operationally with somewhat higher transaction volumes than in previous tests, that we can accept cash from a larger array of counterparties, post collateral in the tri-party repo system and reverse the transactions each day smoothly. Second, while the limited size of the operations during this exercise will prevent the operations from having a significant impact on market rates, we will observe how the facility impacts individual

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6 During the testing phase, a ceiling will be placed on the maximum amount that can be invested per counterparty.

investor demand relative to other market rates. Additionally, we can see how sensitive that demand is to changes in market conditions such as quarter-end that increase the demand for safe assets. These observations will give us some insight into how the facility could affect the entire constellation of money market rates. Only by testing and learning will we be able to assess how best to use the facility.

In conclusion, let me turn back to the economic outlook and the role of monetary policy. I do believe that we are making progress towards our objectives of maximum sustainable employment in the context of price stability. The economic fundamentals are improving and I expect that the healing process will continue in the coming months and years. At the same time, it is important to recognize that the financial crisis generated significant headwinds that are only slowly abating. We must push against these headwinds forcefully to best achieve our objectives.

Thank you for your kind attention. I would be happy to take a few questions.