Susan S Bies: North American monetary policy - key developments in recent times

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It is a great pleasure for me to be here with you today. Certainly, the theme for today's session--"North American Monetary Policy"--ought to provoke some lively discussion. Let me start with the usual disclaimer--my remarks reflect my personal views and should not be taken as an official view of the Board of Governors or the Federal Reserve System. As you know, the FOMC last week chose to lower the target federal funds rate 50 basis points to a forty-year low of 1-1/4 percent and also indicated that it viewed the risks to the economy going forward as balanced. Of course, the macroeconomic developments over the last few years that have brought us to this point have been quite remarkable, and I'll offer some perspectives on some of those key developments in a moment. Over this same period, there have been some quite important developments in the art and science of central banking, and it seems useful to pause here at the outset to take stock of this evolution in central banking practice in the United States.

Though barely a single page in length, last week's FOMC announcement embodied all of the key structural elements of the current monetary policy framework in the United States. The text of the announcement provided a rationale for the decision in terms of the FOMC's twin objectives--long-run price stability and sustainable economic growth. The policy decision itself involved a specific setting for the key monetary policy instrument--the target federal funds rate. And the goals of central bank transparency and accountability were served by a discussion of the Committee's views about the important forces impinging on the economy at the present time and its sense of the balance of risks to the economy in the future. All three of these key elements of the monetary policy framework--the FOMC's objectives, primary policy instrument, and emphasis on transparency--have undergone significant change in recent years.

As indicated in the original version of the Federal Reserve Act in 1913, the Federal Reserve was founded "to furnish an elastic currency" and to promote "more effective supervision of banking." It wasn't until 1977 that the Congress amended the Federal Reserve Act to include very specific monetary policy objectives. Notably, the Congress established a so-called dual mandate for the Federal Reserve by directing it to foster conditions that would promote the goals of price stability and "maximum" employment. Over time, maximum employment is only possible when economic growth is sustainable--that is, when economic growth is sufficient to eventually eliminate any gap between level of aggregate demand and the economy's potential to produce. These dual objectives of price stability and sustainable output growth are the cornerstones of the U.S. monetary policy framework. The U.S. system of dual monetary policy objectives is sometimes regarded as quite distinct from the monetary policy frameworks adopted by many other countries in recent years that tend to emphasize price stability as the primary goal of monetary policy. My own view, though, is that the apparent differences between such frameworks and the U.S. system--while significant--may not be quite so large as commonly believed. For example, in addition to a price stability objective, many central bank charters include references to auxiliary objectives such as supporting the nation's general economic welfare or the stability of the financial system.

The instruments of monetary policy have changed in significant ways as well. In the United States and some other countries, money and credit aggregates have played an especially important role as monetary policy instruments at times in the past. However, the use of such variables as reliable guides for policy became increasingly problematic over recent years as increased competition and innovation in the financial sector tended to undermine the historical linkages between money and credit aggregates and key macroeconomic variables such as nominal GDP. Partly as a result, many central banks, including the Federal Reserve, came to view setting a particular level for a short-term interest rate, rather than controlling the growth of money and credit aggregates, as the primary modus operandi of monetary policy.

A final trend in central banking that was again implicit in last week's FOMC announcement is a movement toward greater transparency. Less than a decade ago, for example, the FOMC did not explicitly announce its policy decisions. Indeed, through much of the 1980s and early 1990s, the FOMC "signaled" its policy intentions to the market indirectly through a process involving technical distinctions among particular types of open market operations. In retrospect, while this procedure helped to support a cottage industry of Wall Street Fedwatchers, it increasingly came to be seen by the public and the Federal Reserve as unnecessary and even counterproductive. As a result, in 1994, the FOMC began explicitly announcing its policy decisions.

In a bid to further increase transparency, the FOMC introduced a balance of risks assessment in early 2000 as part of its policy decisions. The balance of risks assessment was designed as a vehicle to communicate the Committee's sense of the economic outlook over the "foreseeable future." The foreseeable future is one of those wonderful phrases we central bankers get to use. It is not intended to refer to a specific time horizon, and indeed, when the FOMC introduced the balance of risks statement, it suggested that the time horizon encompassed by the foreseeable future might well vary depending on the economic circumstances. However, in contrast to the previous "bias" statement, the concept of the foreseeable future in the balance of risks statement was intended to extend well beyond the upcoming intermeeting period. The balance of risks statement is released to the public at the conclusion of each FOMC meeting. By contrast, prior to 1999, the "bias" statement was only made known to the public after a six-week lag in the release of the minutes for each FOMC meeting. This past March, the FOMC took a further step toward increased transparency by including the roll call of the vote on the federal funds rate target, as well as an indication of the preferred policy choice of any dissenters. Indeed, press coverage following the September FOMC meeting noted the two dissents in favor of a policy easing reported in the announcement following that meeting.

So why have the Federal Reserve and many other central banks moved toward a policy framework involving greater transparency? The principle that central banks should be free of political interference in pursuing legally mandated objectives is now widely regarded as a key tenet supporting central bank credibility and effectiveness. However, democratic societies rightly should expect that central banks, as public institutions, should be publicly accountable for their actions, and greater transparency in central banking is an important factor in ensuring that this is the case. But central banks have found transparency useful for monetary policy purposes as well. By providing a clear rationale for their actions and an assessment of the economic outlook, central banks can reduce unnecessary uncertainties faced by market participants. Moreover, investors armed with a clearer understanding of the central bank's motives and views are better able to anticipate future monetary policy actions. This, in turn, helps to create a form of "automatic stabilizer" operating in financial markets; as the economy is buffeted by shocks, market participants anticipate how the central bank is likely to move short-term interest rates in the future, and these expectations are then immediately reflected in movements in long-term interest rates that help to counteract the effects of the shocks.

Well, I hope by now I've convinced you that the FOMC's announcements--though sometimes criticized as terse or inscrutable--are in fact the embodiment of nearly every major change in the U.S. monetary policy framework in the last twenty-five years. Not bad for a one-page document. Having talked at some length about the broad conceptual framework underlying last week's FOMC announcement, I'd like to now turn to what it actually said. A key passage of the announcement read as follows:

> The Committee continues to believe that an accommodative stance of monetary policy, coupled with still-robust underlying growth in productivity, is providing important ongoing support to economic activity. However, incoming economic data have tended to confirm that greater uncertainty, in part attributable to heightened geopolitical risks, is currently inhibiting spending, production, and employment.

Those two sentences succinctly summarize the important crosscurrents that the FOMC must take into account in the current environment. On the one hand, the current very low setting of the target funds rate is undoubtedly imparting considerable economic stimulus. Moreover, the U.S. economy has proven to be remarkably resilient in recent years, and underlying economic trends such as continued strong productivity growth bode well for economic prospects in the longer run. Indeed, the latest productivity data released just last week showed yet another very substantial increase in labor productivity in the third quarter. While some of the recent outsized increases in productivity may prove to be temporary, the recent data do suggest that underlying trend productivity growth remains quite buoyant, and that, in turn, should ultimately show through to stronger incomes for households and an improved profit outlook for businesses.

On the other hand, the U.S. economy has been beset by a string of adverse shocks in the last two years, and the FOMC last week expressed its concerns that the lingering effects of those shocks and the uncertainty about the economic outlook were factors hindering the economic recovery. As noted in the minutes of several past FOMC meetings, that uncertainty seems to be attributable to a confluence of several factors. The high-profile cases of corporate accounting scandals in the United States over recent months undoubtedly are an important part of the story. Certainly, the direct costs of these episodes in terms of losses sustained by investors and employees in the affected firms have been very substantial. But even more pernicious from a macroeconomic perspective has been the ensuing widespread loss of investor confidence in the integrity of firms' financial statements more broadly. Unfortunately, the spectacular misdeeds that have come to light have made it perfectly rational for investors to question the veracity of data and other information disclosed by all businesses. And that mistrust, in turn, has almost certainly contributed to the downdraft in many firms' equity prices and an increase in borrowing costs over recent months.

A related key source of uncertainty in the economic outlook is the prospect for a rebound in investment spending. To date, the Federal Reserve's easing actions have spurred the economy most visibly by increasing consumer demand for interest-sensitive items--particularly autos and new homes. Businesses, by contrast, have largely acted to shore up their frayed balance sheets by locking in longer-term funding at attractive rates and using the proceeds to pay down other forms of debt or to stockpile substantial holdings of liquid assets. To be sure, although it has yet to show any real signs of vigor, business fixed investment has at least seemed to stabilize. And business inventories currently seem lean in many industries, so there may be considerable scope for a pickup in inventory investment as the economy recovers. Still, for now, the pace of investment spending is tepid at best.

Finally, of course, the world situation is yet another factor contributing to the overall uncertainty about near-term economic prospects. The potential for further terrorist attacks and the tense situation in the Mideast are obviously sources of concern. Moreover, Europe seems to be encountering a "soft spot" in economic activity similar to that evident in recent weeks in the United States. And, of course, the economic difficulties in Japan and South America are well known and seem unlikely to abate significantly over the near term.

Despite the significant uncertainties, the FOMC retained an overall sense of confidence about prospects for the U.S. economy. Indeed, the FOMC statement also included the passage:

> [T]he Committee believes that today's additional monetary easing should prove helpful as the economy works its way through this current soft spot. With this action, the Committee believes that…the risks are balanced with respect to the prospects for both goals [sustainable economic growth and price stability] in the foreseeable future.

Thus, barring further adverse shocks, the FOMC perceived the economy as passing through a "soft spot" at present and viewed the current stance of policy as adequate to foster the economic recovery. Let me assure you, though, that the Federal Reserve remains vigilant and stands ready, as always, to implement any changes in the stance of policy deemed necessary to ensure progress toward achieving its twin goals of sustainable economic growth and price stability.