

Timothy F Geithner: Perspectives on US monetary policy

Remarks by Mr Timothy F Geithner, President and Chief Executive Officer of the Federal Reserve Bank of New York, before Princeton University's Center for Economic Policy Studies, Princeton, NJ, 1 April 2005.

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I am glad to be here at Princeton's Center for Economic Policy Studies to have this conversation with Alan Blinder and to address some of the key questions regarding monetary policy today. I am particularly pleased to be in front of such a distinguished audience, including colleagues from the Federal Reserve who will be talking about some of the same questions at tomorrow's meeting.

I would like to start with a few propositions about the state of U.S. monetary policy and the Fed today.

The achievements in inflation outcomes of the past decade or so - low inflation, less volatility in inflation, more moderate long term inflation expectations, and less volatility in those expectations, achievements that are impressive relative to past U.S. experience as well as to the gains of other mature central banks - suggest we are close to the frontier of monetary policy credibility. These gains came alongside a significant reduction in the volatility of U.S. output. And they are impressive in light of the speed and force with which the Fed acted in several instances of systemic financial distress.

The major economic policy challenges facing the nation today - pick your favorites among the usual suspects of low public and household savings, concerns about educational quality and achievement, high and rising income inequality, the large imbalances between our social insurance commitments and resources - are not about monetary policy. Poor monetary policy choices would make these problems harder to address, but monetary policy itself can't do much to fix them.

The issues about monetary policy regimes we spend most of the time debating these days - such as those involving communications and disclosure and variants on inflation targeting - are high class problems to have. Even if they were resolved in the direction of what seems to be the broad academic consensus, they would still leave us with all the hard questions in monetary policy. The color of truth in monetary policy (apologies to McGeorge Bundy) is often grey, not black or white, and moving further along the spectrum toward greater transparency or more explicit rules, will not make easier the hard choices of what to do in the face of the normal fog that surrounds the forecast.

In thinking about the durability of these gains in monetary policy delivered under Volcker and Greenspan, there are a few aspects of our history and about the world today that deserve note.

The actions of individual chairmen have been very important in the history of the Fed. The considerable strengths of the institutional framework of the Fed - full de jure independence, the depth of technical talent, a committee designed to bring a diversity of independent perspectives to the monetary policy decision making process - have not been strong enough to deliver consistently good monetary policy decisions over time.

The constituency for price stability in the United States today seems broad and strong and reasonably bipartisan, but it's been a generation since we've had high inflation and had to face the costs of bringing it down. It seems like a long time since monetary policy has been the subject of major political or popular attention. And the extent of deference the Fed now enjoys - the extent of de facto autonomy - is a relatively recent, surprisingly recent phenomenon, and substantially due to the competence demonstrated by the past two chairmen.

Monetary policy has been the beneficiary of a long period of good fortune in the form of smaller and less adverse external shocks, a sustained and very large acceleration in productivity, the disinflationary forces produced by global economic integration, greater flexibility in the U.S. economy and improved financial sector resilience, and the effects of these factors and technological change in reducing macroeconomic volatility. We don't know much about the probabilities surrounding the future path of most of these variables.

We face a number of transitions ahead that will have important implications for U.S. monetary policy. Among these are:

- The transition from a long period of exceptionally low short-term nominal and real interest rates in the major economies and in many emerging market economies as well. Real

short-term interest rates in much of the world, as in the United States, are still some distance below the band of estimates of equilibrium.

- The approaching demographic pressures on fiscal resources, which will hit most major economies at a time when underlying fiscal positions are still likely to be in substantial deficit.
- The inevitable evolution in the exchange rate regimes of China, and the substantial number of countries that have been actively targeting their nominal exchange rate against the dollar, to a system where there is more variability in their bilateral and real effective exchange rates.
- The disposition of the global imbalances reflected most conspicuously in the U.S. current account deficit.

These are all types of disequilibria. They can be sustained for a time, but not indefinitely. They could be diffused gradually and smoothly. But the transitions to a more sustainable equilibrium could also bring a risk of greater volatility in asset prices, less stability in macroeconomic outcomes, and more uncertainty. This could mean a less benign future environment for U.S. monetary policy.

The potential uncertainties posed by these challenges may be more troubling because of confidence engendered by the stability and resilience of the U.S. economy over the past decade. We are in the midst of an unusual dynamic in financial markets, in which low realized volatility in macroeconomic outcomes, low realized credit losses, greater confidence in the near term path of monetary policy, low uncertainty about future inflation and interest rates, rapid changes in the nature of financial intermediation (role of hedge funds and the change in how credit risk is bought and managed), and a large increase in the share of global savings that is willing to move across borders, have worked together to bring risk premia down across many asset prices.

There is no reliable analytical framework one can use to determine whether we are experiencing an unwelcome or unjustified decline in expected volatility, or whether investors are giving too much weight to the relative stability of the recent past and too little to the uncertainty posed by the challenges ahead. And analysts can point to good fundamental reasons and some plausible theories to support this collective judgment of market participants about low future risk and volatility. But there is much we do not understand about how these transitions ahead will unfold - in fiscal positions, the U.S. external imbalance, and in the exchange rate system and portfolio preferences. The recognition that things that are not sustainable will eventually come to an end does not give us much of a guide to whether the transition will be calm or exciting.

These dimensions of the broader context in which we will be making monetary policy in the years ahead put a very important premium on keeping U.S. monetary policy as close to the frontier of credibility as possible. And this suggests we need to continue to examine the case for a measured further evolution in the U.S. monetary policy framework - evolution in the direction of finding ways to provide more clarity about our long term inflation objective, about the underlying forces shaping the Federal Open Market Committee's forecast, the dimensions of uncertainty that surround that forecast, and the likely implications for monetary policy, to the extent we are aware of them. We have moved a long way in this direction, even in the past 18 months.

The FOMC's record over the past 25 years suggests that the state of monetary policy and the state of the Fed is strong. The challenge in thinking about what's next in any further evolution in our regime is about how to ensure that U.S. long-term inflation expectations remain stable at a level close to reasonable definitions of price stability, while retaining the flexibility to act wisely, but with speed and force and creativity in response to changing circumstances.

Thank you.