Thomas M Hoenig: Monetary policy and the role of dissent

Speech by Mr Thomas M Hoenig, President of the Federal Reserve Bank of Kansas City, at the Central Exchange, Kansas City, 5 January 2011.

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My January presentation at the Central Exchange, greater Kansas City's business women's association, has become an annual event and an opportunity that I have enjoyed immensely.

In particular, I want to recognize the WIN/WIN program initiated by the Central Exchange. I am personally a supporter of this campaign to increase the number of women on boards of directors and in executive positions in greater Kansas City to a level of 20 percent by 2015. More importantly, I am a believer in the business case for gender diversity and am fortunate to have an outstanding leadership team at the Federal Reserve Bank of Kansas City. It happens that 50 percent of those positions are filled by women. Currently the immediate past chairman and current deputy chairman of our Board is Lu Cordova, an entrepreneur's entrepreneur from Boulder, Colo. She was an outstanding chair during difficult economic and financial times. The Tenth Federal Reserve District, and the entire Federal Reserve System, benefitted from her outstanding leadership. Lu will be speaking here at the Central Exchange in March, and I encourage you to attend that program as well.

Today I want to discuss two related topics. First, I will outline my economic outlook for 2011. And since it is because of my outlook for the economy during this past year that I have found myself in the minority view among my colleagues at the Federal Reserve, I will to spend just a few minutes discussing the monetary policy process.

The economic outlook

As we begin 2011, recent economic data indicate a firmer tone in the outlook, and I am increasingly confident that the recovery is both sustainable and likely to gain strength over the next several quarters. That said, I expect the recovery to be moderate, with real GDP growing about 3 ½ to 4 percent a year over the next couple years.

To put this outlook into perspective, it is important to remember that a major and necessary rebalancing – including the deleveraging of consumers, businesses, and financial institutions – is taking place within our economy. Moreover, this is occurring while state and local governments are struggling with budgets and mounting debt loads. With these adjustments, growth necessarily will be more modest than in past recoveries. Under such circumstances, the fact that we can talk about the likelihood of a sustainable recovery is highly encouraging.

Before turning to the outlook for this year, let me begin with a brief look back at economic events in 2010. Last year began with solid gains in the first quarter. The nation's real GDP grew at an annual rate of 3.7 percent and employment rose 261,000. Then the economy hit a soft patch in the middle of the year with growth in output and employment slowing. Fortunately, though, we appear to be coming out of that soft patch with the economy growing at a 2.6 percent rate in the third quarter and expected to accelerate to about a 3 percent rate in the fourth quarter.

Over the last few months, we have seen clear signs of improvement. Consumer spending has steadily trended up and is likely to gain further strength as confidence rebounds, personal incomes continue to rise, and the labor market gradually improves.

The trend in business spending has been supportive of growth. For example, over the last year, spending on equipment and software increased almost 20 percent. And I expect that strong corporate profits – they grew 26 percent last year – and sales growth will keep business investment a key source of strength going forward.

Also, the recently passed fiscal actions, in which Congress and the president extended the Bush-era tax cuts and unemployment insurance, and then also temporarily reduced payroll taxes, will provide a further boost to aggregate demand next year, although not without longer-run risks to the economy.

While the consumer and business sectors of the economy are rebounding, the same cannot be said for housing. As you know, housing lost momentum after the end of the homebuyer tax credit, and house prices continue to decline. Moreover, the inventory of unsold homes is exerting downward pressure on house prices and housing activity. As the broader economy continues to grow, though, I expect that we will see a turnaround in housing this year. However, there are many issues tied to the housing crisis that could impede recovery, and much depends on how these issues are addressed in the next several months.

Employment is the other issue that seems difficult to understand and solve. Unfortunately, while private jobs are being added to the economy, the pace of job gains is not strong enough to bring unemployment down to where we would all like. In fact, although the United States added over 1 million net new jobs through November, the unemployment rate remained at 9.8 percent. Forward-looking surveys, including our Bank's manufacturing survey, point to gains in employment over the next six months, and if history is any guide, we should see these increases accelerate over the course of the year. I would also note that our manufacturing survey points to expected gains in production and capital spending, which will contribute to improving job growth. Even so, with the number of people out of work and the growing numbers of new job entrants, it will be some time before we see the unemployment rate well below 9 percent.

Given the immediate levels of slack in the economy, core inflation will remain modest in the near term. However, given the degree of monetary and fiscal stimulus in place in the economy currently, inflation should move higher over the medium and longer term, depending on what further steps are taken in these policy areas. Also, the risk of further disinflation or outright deflation is small and, with an improving economy, should only decline further in the coming months. It is also noteworthy that long-run inflation expectations even now remain above 2 percent and should exert upward pressure on inflation during the course of the recovery.

There are, of course, risks to the outlook. First, I am concerned about what might happen to the economy if we fail to deal successfully with our long-run fiscal challenges. The budget deficit is the largest we have seen, as a share of GDP, since World War II. With these large budget deficits, total federal debt outstanding is almost $14 trillion, or about 94 percent of GDP. Moreover, projections of deficits and debt show the federal debt will continue to increase, suggesting that fiscal policy is unsustainable and must be changed soon. As we have seen elsewhere, the reaction of interest rates and exchange rates to unsustainable fiscal policy can be sharp and disruptive. While specific recommendations on fiscal policy are not the purview of the Federal Reserve, I would urge serious consideration of proposals that have been offered by several groups, including the Simpson-Bowles deficit reduction plan. These are reasonable starting points for addressing the intractable problem that may have very serious ramifications for future monetary policy.

A second concern I have is the consequences that will follow when we combine our current fiscal projections with a highly accommodative monetary policy. In essence, the Federal Open Market Committee (FOMC) has maintained an emergency monetary policy stance in a recovering economy and has continued to ease into the recovery. I believe these actions risk creating a new set of imbalances, or bubbles. Importantly, such actions as they continue are demanding the saving public and those on fixed incomes subsidize the borrowing public.

To summarize, I am pleased to be able to say that in my view the economy is in recovery, although at a moderate pace. Over time, barring unexpected surprises, the recovery should gain momentum, which will encourage hiring and slowly bring down the unemployment rate. While we would all like to see the unemployment rate come down more quickly, and in fact should gain momentum, we must also acknowledge that our economy is adjusting to decades of excess consumption, high government debt and spending, and a low domestic savings level. These factors must also adjust, and this will take time as well. The very fact that we are in what appears to be a sustained recovery speaks well of our economy and its flexibility to adjust and regain strength over time.

Dissent and monetary policy deliberations

My view of the economy's prospects and the appropriate stance of monetary policy differ from the majority view among my Federal Reserve colleagues.

Last year, I was a voting member of the Federal Open Market Committee. Reserve Bank presidents vote in rotation, so I will be a participant rather than a voting member this year. It is a matter of public record that I dissented, or cast a "no" vote in all eight meetings in 2010. Based on audience questions, news coverage and pundit columns throughout the year, it has become obvious to me that the role of dissent in the FOMC is misunderstood and viewed without context. The idea that a dissenting vote is confusing, counterproductive, and generally undesirable is unhealthy. It is also historically inaccurate.

In my remaining time today, I will discuss why dissenting views at the FOMC are critical to the success of the Federal Reserve System and that public debate was the intent of its congressional founders. I will also describe how open debate and dissent are fundamental to achieving transparency of FOMC deliberations and to supporting the credibility of the committee in difficult economic times.

History

When the Congress created the Federal Reserve nearly a century ago, it believed very strongly that the best policy is not made in isolation, but encompasses a wide range of views from all affected interests. A Federal Reserve Bank was established in Kansas City, as well as 11 other major cities across the United States, to make sure the views of communities nationwide had a voice in Federal Reserve policy. The founders knew that such broad-based participation would lead to better decision making.

This structure is replicated on the Federal Open Market Committee, which is the body that makes decisions about our nation's monetary policy through changes in an interest rate known as the federal funds rate, and, over the last couple of years, changes in the size of the Federal Reserve's balance sheet and the interest rate it pays on excess reserves. The FOMC is made up of 12 members: Seven of them are the Federal Reserve governors who have been appointed by the president and confirmed by the Senate. Governors always have a vote at the FOMC. The other five members are presidents of the regional Federal Reserve Banks who are appointed by their local boards of directors. The New York Bank's president always has a vote, and the other 11 presidents share the remaining four votes in a set rotation. As a result, while all 12 Reserve Bank presidents are active participants in the FOMC debate, the seven politically appointed governors always have a majority of votes over the five voting Reserve Bank presidents.

The regional Bank presidents fill a critical role at the Fed's policy table. They have the responsibility of representing their respective Federal Reserve Districts in providing their unique perspective on national policy issues. As dictated by the FOMC's structure, Washington and Wall Street not only participate in all discussions but have a permanent vote. Therefore, it is crucial to have independent voices at the table that regularly interact with Main Street business and community leaders in the rest of the country.

In this structure, it is a key point to remember that each member was given a vote, not an advisory role. In FOMC policy votes since 1995 – which is essentially the current era of Fed policy – there was a dissenting vote about one-third of the time. Going back a bit earlier in the 1990s to the ’90–91 recession, there were far more significant levels of dissent for both tighter and less restrictive monetary policy. During the Paul Volcker era, the chairman nearly lost one policy vote. In addition, there were 30 dissenting votes cast in Volcker’s final 30 meetings as Fed chairman.

Transparency

There are, of course, commonalities between the end of the Volcker era, the 1990–91 recession and today: In each of these periods the economy was poised at a critical juncture and broad disagreement prevailed about the appropriate policy course – and not just around the Fed policy table. By the very nature of our political system, these were also periods of extreme political pressure to provide increased stimulus with an eye toward short-term gains and with a promise to take appropriate steps at some later point to remove that stimulus before inflationary pressures could become a problem.

Leaving those issues aside, last year some suggested that dissenting votes confuse the market and that public disagreement among members reduced the effectiveness of Fed policy, including the second round of quantitative easing, known as QE2.

As an economist, I cannot be certain that my views are correct. Certainly, a majority of my counterparts on the FOMC last year did not agree with my views. But it is important to recognize that in the face of uncertainty, arriving at the best policy decision is built on divergent opinions and vigorous debate.

Because of this, the role of open dissent is at least as critical to FOMC monetary policy decisions as it is to deliberations by the Supreme Court, the United States Congress or any other body with important public responsibilities from the local through the federal level. If you find it unusual to consider the FOMC as being similar to these other deliberative bodies, it is perhaps because many–including some former Federal Reserve officials–tend to speak of Fed policy as being done by a single actor.

In 2004, then-Fed Governor Ben Bernanke talked about this issue in a speech where he noted the “diversity of views and opinions likely to exist among the members of a large committee create further challenges of effective communication.”[1]

Despite these challenges, he went on to talk about the importance of making these divergent views broadly known: “Although at times it feels cacophonous, the willingness of FOMC members to present their individual perspectives in speeches and other public forums provides the public with useful information about the diversity of views and the balance of opinion on the Committee.”

Credibility

Some would suggest, of course, that monetary policy is not like a Supreme Court ruling. This line of reasoning comes from an idea that a unanimous FOMC is more likely to foster the confidence that is so critical to the functioning of our economy and financial system. To this line of thinking, dissent becomes even more dangerous in periods of high uncertainty.

A deliberative body does not gain credibility by concealing dissent when decision making is most difficult. In fact, credibility is sacrificed as those on the outside realize that unanimity – difficult in any environment – simply may not be a reasonable expectation when the path ahead is the most confounding. The question then becomes: Should the debate that is happening privately remain hidden from the public eye until the meeting minutes or

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[1] Jan. 3, 2004

transcripts are later released? And in the interim, is the nation somehow better served by giving the public the impression that the entire body is in agreement to the prescribed approach even when that is not the case?

In the mid-1980s, after the vote Chairman Volcker nearly lost created a bit of a media circus, Herbert Stein wrote a very interesting column about the issue for *The Wall Street Journal*. Mr. Stein, who had been chairman of the Council of Economic Advisers under two presidents, wrote that divergent views at the policy table should not be worrisome. It is more important, he wrote, that there are visible principles at work in shaping these views.

Stein wrote that in creating the central bank of the United States, "Congress intended diversity (of views) and the Federal Reserve … benefits from the appearance that diversity is at least possible."[2]

To suggest that public support is somehow encouraged by unanimous decisions suggests little appreciation for the public and their understanding about the challenges we face. To me, that fosters a loss of confidence that can be difficult to recover. As a result, the body becomes less able to respond to a crisis and is left more vulnerable to its critics.

The Federal Reserve's founders recognized this a century ago. I hope we continue to recognize its critical importance in the years to come. As for me, I recognize that the committee's majority might be correct. In fact, I hope that it is. However, I have come to my policy position based on my experience, current data and economic history. If I had failed to express my views with my vote, I would have failed in my duty to you and to the committee.

[2] The Wall Street Journal, April 4, 1986