# William C Dudley: Unconventional monetary policies and central bank independence

Remarks by Mr William C Dudley, President and Chief Executive Officer of the Federal Reserve Bank of New York, at the Bank of Mexico international conference "Central bank independence – Progress and challenges", Mexico City, 15 October 2013.

* * *

It is a pleasure to be here today. Does the implementation of unconventional monetary policies pose a threat to central bank independence? My short answer, which I will elaborate on, is that while the threat is low, central bankers need to be cognizant of such risks, and clearly explain the motivations for their actions in order to mitigate such risks.

The best way for central banks to maintain their independence is to use all their available monetary policy tools to best achieve their objectives. Because the use of our unconventional monetary policy tools has been in pursuit of our dual mandate objectives of maximum sustainable employment in the context of price stability, I do not see the use of these tools as creating significant new risks to our independence.

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

To start, it is important to be clear on what we mean by unconventional monetary policies. In my remarks, I am going to focus only on the set of unconventional monetary policies that are relevant today in an environment in which central banks are constrained from lowering their policy rate any further due to the zero lower bound. I will not discuss the type of extraordinary interventions that occurred at the height of the financial crisis.[1]

A starting point is that the independence of the central bank with respect to its budget supports its overall independence. The Federal Reserve's traditional monetary policy framework has helped to assure this budgetary independence. The liability side of our balance sheet consisted primarily of currency and reserve balances on which we did not pay any interest. The asset side consisted primarily of Treasury securities. There was no meaningful credit risk and the interest rate risk was limited because assets were generally held to maturity. This, combined with the zero cost of the Fed's liabilities, resulted in the Federal Reserve turning over a large amount of earnings to the Treasury each year after covering all of its operating costs and retaining a small portion of its earnings to maintain a level of surplus capital equal to the amount of capital paid-in by member banks.

Thus, one key question is how this budgetary independence might be threatened through the use of unconventional monetary policies. After all, some of these policies do have implications for the Federal Reserve's remittances to the Treasury and, thus, could conceivably create a potential threat to the Federal Reserve's budgetary independence.

To step back, the Federal Reserve's set of unconventional monetary policies has consisted of three major components:

- Forward guidance with respect to the path of the federal funds rate target.
- Large-scale asset purchases of longer-term Treasury securities and agency mortgage-backed securities (MBS).

[1] However, it is important to note that some of those interventions did indeed result in tighter limits on the central bank's authority as a lender of last resort. For example, the Fed's scope to provide liquidity to troubled firms in unusual and exigent circumstances – under Section 13(3) of the Federal Reserve Ac – was curtailed somewhat by the Dodd-Frank Act. This underscores the fact that central bank actions can have consequences with respect to independence.

- A maturity extension program in which shorter-dated Treasuries were sold and the proceeds used to purchase longer-dated Treasuries.

With respect to forward guidance, it is important to distinguish between two specific forms that this guidance may take. In the first form the central bank provides its forecast for the future path of the policy rate and, possibly, some sense of the degree of uncertainty around this path. In the second, the central bank pre-commits to a specific future path for its policy rate.

Providing a forecast for the policy rate by itself does not create any budget or reputational risk for the Federal Reserve, so I generally do not see the first form of forward guidance as posing much risk to central bank independence.[2]

The second form of forward guidance – pre-commitment to a policy rate path – could create more risk for the central bank. In particular, consider a scenario in which the central bank decided to increase monetary accommodation by committing to maintain a low short-term interest rate for a long time even if this commitment resulted in inflation overshooting the central bank's objective in the future. I could see how this could create a potential threat to the central bank's independence. That is because the commitment could force the central bank in the future to conduct monetary policy in a way that was inconsistent with the inflation portion of its mandate.

Although this second form of forward guidance could create greater risk for the central bank with respect to its future independence, this is not a policy that has been adopted by the Federal Reserve. There are implementation challenges with this approach. In particular, it is difficult for a monetary policy committee today to institutionally bind future monetary policy committees to follow actions that could conflict with their objectives in the future. Without such a credible forward commitment, such policies would likely be ineffective in affecting expectations in the manner needed to provide additional monetary policy accommodation.

In contrast, I think there are greater potential risks to central bank independence from the Fed's large-scale asset purchase programs and the Treasury maturity extension program. These programs do create some budget risk for the Federal Reserve. The issue here is not that the Fed is taking credit risk because the Fed's purchases are restricted to Treasuries and agency MBS. Instead, the budgetary risks stem from the fact that these asset purchase and maturity extension programs expose the Federal Reserve to increased interest rate risk that could affect the level of net interest earnings and therefore the amount of the Fed's remittances back to the U.S. Treasury. If the Federal Reserve needed to raise short-term rates to attain its objectives, it would do so by raising the interest paid on its reserves. As a result, net interest earnings would fall due to the increase in interest cost. If the rise in rates were sufficiently large, the Federal Reserve's net interest margin could turn negative, resulting in losses for the Federal Reserve.

The Fed's earnings could also be adversely affected by asset sales. For example, if the Fed determined that it needed to reduce the aggregate level of reserves through asset sales, the Fed might incur losses by selling these assets at prices below their amortized costs.

Although this risk is real, I believe it is not a big threat to the Federal Reserve's independence for two reasons. First, the potential for this outcome is mitigated by the fact that the Federal Reserve has considerable non-interest bearing liabilities on its balance sheet – namely currency. These liabilities incur no interest expense regardless of the stance

[2] While I have categorized providing a forecast for the future path of the policy rate as a form of unconventional monetary policy, this may be a misnomer in that some central banks use this form of forward guidance as part of their standard communication strategy, and the Federal Reserve may choose to continue to provide this form of forward guidance even after its policy rate is no longer constrained by the zero lower bound.

of monetary policy. This means that short-term interest rates have to rise appreciably before the Federal Reserve's net interest margin turns negative.

Second, even if the Federal Reserve were to incur an operating loss either because of an increase in interest expense or because of realized losses on asset sales, the Federal Reserve can create a deferred asset on its balance sheet, obviating the need for funding from the Treasury to the Federal Reserve. In this sense, the Federal Reserve would retain its budgetary independence.

In the case where the Fed recognizes a deferred asset, its remittances to the Treasury would cease until that deferred asset was paid down. Is there a risk to budgetary independence that might emerge if the Federal Reserve did not remit any income to the Treasury for a considerable period of time? My response here is that we should take a long-term perspective when we assess the potential fiscal costs associated with the Federal Reserve's enlarged balance sheet. The fact is that the Fed's reimbursements to the U.S. Treasury have been around $80 billion per year in recent years, far higher than the $20 to 30 billion range that applied before the financial crisis. Under most scenarios, the Federal Reserve's total remittances to the Treasury will be larger than they would have otherwise been in the absence of the asset purchase and maturity extension programs.

More importantly, the Fed's cumulative earnings understate the fiscal implications of the Federal Reserve's actions. To the extent that the asset purchases have resulted in easier financial conditions that have promoted stronger economic activity, this in turn has had a positive fiscal consequence for the U.S. government. In addition, the Fed's asset purchase programs have pushed longer-term interest rates below what they would otherwise have been, reducing the overall funding expenses of the U.S. Treasury. Once we take into account the broader fiscal consequences of the unconventional monetary policies put in place by the Fed, they are quite likely to cumulatively have an overall positive impact on the government budget. As a result, the use of unconventional monetary policy tools should pose no significant threat to the Fed's independence.

Now some worry that a large balance sheet may cause the Federal Reserve to deviate from the monetary policy that is consistent with its dual mandate goals with respect to unemployment and inflation. The argument is made that concerns about the impact of policy changes on the level of remittances might constrain the conduct of monetary policy. In particular, some argue that the Federal Reserve might pull its punches and not raise short-term interest rates in as timely or as aggressive a manner as needed to keep inflation in check.

I think that the size and composition of the Federal Reserve's balance sheet actually creates incentives that reinforce the pursuit of the Federal Reserve's objective with respect to inflation. Consider what would happen if the Federal Reserve failed to tighten in a timely way. Inflation and long-term interest rates would rise, and this would necessitate a larger rise in short-term interest rates and even greater pressure on the Federal Reserve's net interest margin and earnings in the future. In contrast, by tightening in a timely way, the Fed would prevent inflation pressures from emerging and this would limit the need for a larger rise in short-term rates in the future. The current size of the balance sheet would also discourage a premature interest rate hike. In the absence of solid improvements in labor market activity, a sharp increase in short-term rates would unnecessarily reduce the Federal Reserve net interest income without any benefits in terms of achieving its dual mandate goals. Thus, the current size and composition of the Federal Reserve's balance sheet actually create strong incentives to adjust policy in a timely way.

A far more important threat to central bank independence than the use of unconventional monetary policy is whether the fiscal authorities act in a manner consistent with the central bank's objectives. As recent history has shown, central banks may not be able to achieve their objectives when an inconsistent fiscal regime is in place. That is, monetary and fiscal authorities need to share the same objectives. When the objectives differ, fiscal dominance can become a major problem for the central bank. For example, if the budget trajectory were clearly unsustainable, then monetary policy may no longer be able to credibly act in a way that keeps inflation expectations in check. But I don't think the issue of fiscal dominance is linked back to whether the central bank pursues unconventional monetary policies or not.

At the end of the day, I think that the best way to maintain independence is for central bankers to use all their available monetary policy tools, including unconventional monetary policy tools when needed, to best achieve their objectives. The historical record is clear: Central bank independence tends to lead to better monetary policy outcomes. But, the causality also runs in reverse: Good monetary policy outcomes help ensure monetary policy independence.

Thank you for your attention.