William C Dudley: Panel remarks at the International Symposium of the Bank of France

Remarks by Mr William C Dudley, President and Chief Executive Officer of the Federal Reserve Bank of New York, at the International Symposium of the Bank of France "Central Banking: The Way Forward?" Paris, 7 November 2014.

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If all goes according to our forecast and the U.S. economy continues to make progress towards the Fed's dual mandate goals of maximum sustainable employment and 2 percent inflation, the Federal Reserve will likely begin to raise its federal funds rate target off the zero lower bound sometime next year. For the United States, the start of the normalization of U.S. monetary policy will be a very welcome development. It will indicate that the U.S. economy has made great strides in healing itself from the damage caused by the U.S. housing boom and bust, and the financial crisis.

However, this shift in policy will undoubtedly be accompanied by some degree of market turbulence. Moreover, it could create significant challenges for those emerging market economies (EMEs) that have been the beneficiaries of large capital inflows in recent years. What can the Federal Reserve do to minimize these risks? These are some of the very important issues raised by Helene Rey's work.

Let me begin by highlighting some of the key points I will be making. As always, the thoughts I offer today are my own, and should not be interpreted as representing the position of the FOMC or the Federal Reserve System.

First, what we may see in terms of market strains and macroeconomic adjustment during this normalization process will not be new. Changes in Fed policy, and especially the tightening of monetary policy, have often created challenges for countries abroad, especially in EMEs. Second, these countries, as a group, are better equipped today to handle those challenges than at perhaps any time in the past. This reflects the fundamental improvements and stronger policy frameworks that many EMEs have put in place over the past 15 years. Third, given the dollar's role as the global reserve currency, the Federal Reserve has a special responsibility to manage U.S. monetary policy in a way that helps promote global financial stability.

Like other central banks, our monetary policy mandate has a domestic focus. But, our actions often have global implications that feed back into the U.S. economy and financial markets, and we need to always keep this in mind. For most of us, the market volatility that we saw during the so-called "taper tantrum" in the spring and summer of 2013 still remains fresh in our minds. EME financial markets were hit hardest, with declines in equity prices, a widening in sovereign debt spreads and a sharp increase in foreign exchange rate volatility. In the U.S., we saw a spike in Treasury yields, with the 10-year rate rising by more than 100 basis points from early May before peaking in early September.

Most commentary about this period has focused on the shift in expectations with respect to U.S. monetary policy – and, in particular, to uncertainty about the timing and implications of Fed tapering – as the catalyst for these moves. This focus seems generally right to me, although other factors also played a role.[1]

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[1] Market participants also had to evaluate the possibility that growth in China and other EMEs might be slowing even as growth in the U.S. and other advanced economies was picking up. The subsequent market movements as investors withdrew funds from EME investments were an abrupt shock for these EMEs generally, especially after the long earlier period of abundant liquidity and ample inflows.

From one perspective, the unconventional nature of recent U.S. monetary policy adds little that is fundamentally new to the challenges that face the EMEs. These policies simply represent a way of easing, necessitated by our coming up against the zero lower bound. Central bankers have managed differences across countries in cyclical positions and policy stances many times in the past. This time should not be fundamentally different. But, from another perspective, we have less experience operating with unconventional monetary policy, and this creates more potential uncertainties. These uncertainties put a premium on keen listening skills on our part and continued dialogue both among central bankers as well as between central bankers and the market. In my view, it is important to recognize that our large scale asset purchase programs affect the size of term risk premia globally. This new set of monetary policies affects financial asset prices in a different way compared to changes in short-term interest rates, and we should be humble regarding what we claim about our understanding of the importance of this distinction.

Looking ahead, it seems likely that markets will remain focused on vulnerabilities that they might have ignored prior to the taper tantrum in 2013. The greater premium on strong fundamentals, policy coherence and predictability will likely remain. There will be no one right answer in managing the trade-offs that come with the changed environment, and adjustment will sometimes be difficult. Moreover, we will undoubtedly experience further bumps in the road. The renewed volatility we saw last month is evidence enough of that. Yet, I think we can remain generally optimistic on the outlook so long as market participants continue to appropriately discriminate across countries, rather than treating EMEs as a homogenous group.

Furthermore, many EMEs generally appear to be better equipped today to handle the Fed's prospective exit from its exceptional policy accommodation than they were in past tightening cycles. This reflects the fundamental reforms these EMEs have put in place over the past 15 years, as well as the hard lessons they learned from past periods of market stress. Among the positives are:

- The absence of the pegged exchange rate regimes that often were undermined violently in the past during periods of stress;
- Improved debt service ratios and generally moderate external debt levels;
- Larger foreign exchange reserve liquidity cushions;
- Clearer and more coherent monetary policy frameworks, supporting what are now generally low to moderate inflation rates;
- Generally improved fiscal discipline; and
- Better capitalized banking systems, supported by strengthened regulatory and supervisory frameworks.

Of course, progress has not been uniform across EMEs, and more work remains to further strengthen institutional structures in some countries. In particular, vulnerabilities remain in several important EMEs. Still, the fundamental improvements I've cited leave many EMEs better positioned than in the past to weather those times in the cycle when the external environment turns from welcoming to wary.

The impact that changes in Fed policy can have beyond our borders has led to calls for us to do more to internalize those impacts, or even further, to internationally coordinate policymaking. As I've already noted, Fed policies have significant effects internationally, given the central place of U.S. markets in the global financial system and the dollar's status as the global reserve currency. In pursuing our policy responsibilities, we seek to conduct policy transparently and based on clear principles. We are mindful of the global effects of Fed policy. Promoting growth and stability in the U.S., I believe, is the most important contribution we can make to growth and stability worldwide.

There is, of course, the argument that Fed policy has been too accommodative for too long, creating risks for financial stability worldwide. Here, I think it's important to consider carefully the counterfactual. Would countries beyond our borders really have been better off with a weaker U.S. economy? The fundamental issue is whether U.S. monetary policy has helped support our dual objectives of stable prices and maximum sustainable growth, and whether this support is consistent with a healthy global economy.

Moreover, it is far from clear that explicitly coordinated policy would produce better outcomes for the global economy generally, or the EMEs specifically. Central banks have challenges enough in tailoring policies to their own domestic circumstances. I believe that it would be taking on too much to attempt to collectively fashion policy in reference to global conditions. Monetary policy meant to suit everybody is likely in the end to suit nobody. Similar considerations underlie the widespread move in the emerging world away from fixed exchange rate regimes. Policymakers worldwide have learned that a framework capable of responding in a disciplined but flexible manner to changing domestic conditions works best over the long run.

While explicit coordination looks neither feasible nor desirable, there is more that central banks in general, and the Fed in particular, could do to be better global stewards. As an example, recent events demonstrate the importance of effective Fed communication. It is clear in retrospect that our attempts in the spring of 2013 to provide guidance about the potential timing and pace of tapering confused market participants. In particular, markets seemed to conflate tapering with monetary policy tightening and raised their expected paths for policy rates. Lately, we seem to have done better: markets now seem to understand that policy rates will likely remain exceptionally low for a considerable period of time even now that the asset purchase program has been completed.

As you know, we've taken a number of steps in recent years to increase transparency and improve our communications. This includes regular press conferences following Federal Open Market Committee (FOMC) meetings by the Fed chair; the publishing of growth and inflation forecasts of FOMC participants; and a concerted attempt to lay out the guideposts that the FOMC will look at to assess progress toward our mandate. We are, though, still learning how to more effectively communicate, especially given our new and expanded set of policy instruments.

A second area in which we can and must do better is safeguarding financial stability. Simply put, we failed to act both early enough and decisively enough to stem the credit excesses that spawned the financial crisis and the Great Recession. The U.S. was not alone in this shortcoming, but given our position in the global financial system, we especially should have done better. We've taken important steps reflecting both new legislative mandates and a broader effort to rethink our regulatory and supervisory framework. In particular, systemically important banking organizations must now hold amounts of capital and liquidity that are better aligned with their risk profiles, compensation schemes for these institutions will be more focused on rewarding long-term results and the official sector is making progress in solving the "too-big-to-fail" dilemma.

All of this remains very much a work in progress. But, these efforts should help us to avoid repeating the mistakes of the recent past, and to take a more proactive stance toward mitigating potential future vulnerabilities. Of course, we at the Fed are not alone here. Since the recent financial crisis, central banks worldwide have been engaged in a broad rethinking of how to better fulfill their mandates.

Let me close with a final thought. The largest problems that countries create for others often emanate from getting policy wrong domestically. Recession or instability at home is often quickly exported. Equally important, growth and stability abroad makes all our jobs easier. This means that there are externalities in the work we do, so that more effective fulfillment of our domestic mandates helps to bring us to a better place collectively. Ensuring global growth and stability is and will remain our joint and common endeavor.