Stanley Fischer: Monetary policy in the United States and in developing countries

Speech by Mr Stanley Fischer, Vice Chair of the Board of Governors of the Federal Reserve System, at the Crockett Governors' Roundtable 2015 for African Central Bankers, University of Oxford, Oxford, United Kingdom, 30 June 2015.

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I would like to thank the organizers of the conference for inviting me to this event.[1] I have been invited in the past and had very much wanted to take part – especially in light of my having been born in Zambia and having received my schooling in Zambia, South Africa, and Zimbabwe – but somehow it never worked out. I am therefore especially delighted finally to be here. In my talk today, I will focus on both the challenges facing the Federal Reserve and those facing central banks of developing countries in our increasingly interconnected world. But let me begin my remarks with a very brief digression on the history of central banking to put recent developments in context.

Historical context

Today the great majority of countries have a central bank or an institution that fulfills the functions of a central bank. But this was not always the case in the past. Even after the advanced economies began to set up central banks, it was not widely accepted that smaller nations needed one. Although the first central bank, the Swedish Riksbank, dates back to 1668, it was only in 1920 that the case for setting up a central bank in almost all countries was recognized among official circles in a resolution of the League of Nations' conference in Brussels that year, which stipulated, among other things, that "in countries where there is no central bank of issue, one should be established."[2]

At the time, the main concern of the participants in the conference was the preservation of the international monetary order, by which was meant the possibility for both the private and public sectors of all countries to engage in domestic and international transactions. Since then, as it has become increasingly apparent that central banks can fulfill many functions, the number of central banks has expanded from 23 in 1920 to over 160 currently. And not only are there more central banks, but also the functions of central banks have continued to evolve.

Until the Great Financial Crisis, both the practice and the theory of modern central banking revolved around the inflationary tendencies inherent in the conflict between the short- and long-run effects of monetary expansion and in the temptations of monetary financing of government spending.[3] Taking into account the fact that many leading central banks have recently had to deal with below-target inflation, one would have to amend the previous sentence to say that the practice and the theory of modern central banking revolve around the benefits of keeping monetary policy independent of short-term political considerations – with respect to both the stabilization of the price level and the temptations of monetary financing of the budget.

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1 The views expressed are my own and not necessarily those of others at the Board, on the Federal Open Market Committee, or in the Federal Reserve System.

2 See League of Nations (1920).

3 This sentence is adapted from the opening sentence of my paper "Modern Central Banking" (1994), which was written for the conference celebrating the tercentenary of the Bank of England. See Capie and others (1994).

The earliest central banks provided financing for governments and helped develop the financial system, often by bringing order to the note issue. As the practice of central banking developed during the 19th century, central banks took on the primary responsibility for protecting the stability of the financial system and the external value of the currency. The mandate given to central banks in legislation passed in the 1930s and 1940s typically included both monetary stability and the promotion of full employment and maximum output – and frequently other goals as well.

As the inflationary forces that eventually led to the collapse of the Bretton Woods system gathered strength in the 1960s and 1970s, the focus of monetary policy shifted to the maintenance of the domestic value of the currency. In the decades that followed, central banks began to place greater emphasis on the stabilization of inflation, and that trend has continued to date.[4]

Although this shift in emphasis originated in the advanced economies, emerging market and developing economies eventually followed suit, with many of them bringing down high rates of inflation and formally adopting an inflation targeting policy framework. Even in countries without formal inflation targeting frameworks, stabilization of inflation remains an important objective, sometimes alongside other important objectives such as stabilization of the external value of the currency, stabilization of the macroeconomy, financial stability, and the development of the monetary and financial systems.

The U.S. economy and monetary policy

In the United States, the Federal Reserve has, since 1977, been operating under a dual mandate to pursue maximum sustainable employment and price stability.[5] Our main challenge, since the global financial crisis, has been to make rapid (or at least as rapid as possible) progress toward achieving these objectives. While it has taken a long time, and extraordinary monetary policy actions, the U.S. economy is now close to full employment, with core inflation, at 1.2 percent, below our 2 percent inflation target, but, in the view of the Federal Open Market Committee (FOMC), likely to reach 2 percent within about two years.

Let me provide an update on recent progress toward the attainment of these goals and its effects on the current stance of the Federal Reserve's monetary policy.

U.S. economic activity and inflation

The U.S. economy slowed sharply in the first quarter of this year, with the most recent estimate being that real GDP declined 0.2 percent at an annual rate. Household spending slowed, while both business investment and net exports declined. Much of this slowdown seemed to reflect transitory factors, including harsh winter weather, labor disputes at West Coast ports, and probably statistical noise. Confirming that view, the latest monthly data on real consumption provide welcome evidence that consumer demand is rebounding, and that economic activity likely expanded at an annual rate of about 2.5 percent in the second quarter.

In addition, U.S. labor markets have continued to improve. For the first five months of this year, payroll job gains have averaged 217,000 per month. These gains are lower than those seen late last year but are still substantial, and they are above the rate needed to maintain the rate of unemployment at a constant rate of labor force participation. The unemployment rate has moved lower this year and registered 5.5 percent in May. Both long-term

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4 Note that the reference here is to the stabilization of inflation rather than just keeping inflation low.

5 While the dual mandate, with equal weight on employment and inflation, is exceptional among leading central banks, I believe that central banks with a legislated or declared sole or primary goal of maintaining price stability in practice rarely, if ever, act as if the level of employment or economic activity is of little concern.

unemployment and involuntary part-time employment declined as well. While these developments represents considerable progress toward strengthening of the labor market, some room remains for further improvement.

There are grounds for optimism that economic growth will be sufficient to promote further gains in labor market conditions. Consumer spending should be helped by the earlier declines in oil prices because the boost to household incomes from the drop in oil prices is substantial. Lower gasoline prices alone are estimated to be saving the typical household about $700 this year, thus providing households with the resources potentially to increase spending on other goods and services. Moreover, consumer sentiment remains solid. To be sure, with the U.S. now a major oil producer, lower oil prices have also had some negative effects on the U.S. economy. Domestic oil drilling dropped sharply over the past few months, and sectors that support this activity have seen adverse effects. But, on net, the United States should gain from the fall in oil prices, given that we are still a sizable importer of oil.

On the negative side, the substantial appreciation of the dollar since last summer has been a significant headwind to the U.S. economy. The weakness in industrial activity recently has been more pronounced in sectors that are highly exposed to international trade. The first-quarter drop in net exports was very large, not only because of the appreciation of the dollar, but also in part reflecting – as mentioned above – port disruptions and possibly also some statistical noise. Our analysis of the determinants of U.S. trade suggests that the recent appreciation of the dollar will restrain economic growth to some extent for a time even after these transitory factors have dissipated.

Evaluating all of the indicators, the FOMC expects – as outlined in its June 17 statement – that, with appropriate policy accommodation, economic activity will expand at a moderate pace, with labor market indicators continuing to move toward levels consistent with the dual mandate.

Turning to price stability, the other goal of our dual mandate, we have seen little progress toward inflation moving back to our target of 2 percent. The 12-month change in headline personal consumption expenditures prices is now close to zero – though that very low level of inflation is temporary, in large part reflecting the large declines in energy prices around the turn of 2015. The stronger dollar is also weighing on U.S. inflation by reducing the prices we pay for our imported goods and services. Core inflation is running at 1–1/4 percent and will likely remain lower than we would like in the months ahead as the exchange rate effects pass through. Over the medium term, the FOMC expects inflation to rise gradually toward 2 percent as the labor market tightens and the transitory effects of declines in energy and import prices wane; indeed, energy prices appear to have stabilized.

U.S. monetary policy

Based on our reading of economic conditions, the FOMC decided at its June 17 meeting to leave the federal funds rate target range at 0 to 1/4 percent. Importantly, our June statement included no time-based guidance about the timing of liftoff of the policy rate from zero, emphasizing, instead, conditions that need to be satisfied before the federal funds rate target range is adjusted. The Committee will assess progress – both realized and expected – toward its objectives of maximum employment and 2 percent inflation. Of course, because monetary policy affects the economy with a lag, we should not wait until we have reached our objectives to begin adjusting policy. It goes without saying that we are also mindful of the risks of tightening policy prematurely.

We anticipate that it will be appropriate to raise the target range for the federal funds rate when we have seen further improvement in the labor market and are reasonably confident that inflation will move back to 2 percent over the medium term. Thus, our policy will be data dependent, and the FOMC at upcoming meetings will weigh possible adjustments to the level of the target federal funds rate, based on its assessment of incoming data and the economic outlook.

Regarding inflation, an important factor working to increase confidence in the inflation outlook will be continued improvement in the labor market. Theoretical and empirical evidence suggests that inflation will eventually begin to rise as resource utilization tightens. And while the link between wages and inflation can be tenuous, it is encouraging that we are seeing tentative indications of an acceleration in labor compensation.

Once we begin to remove policy accommodation, the Committee's assessment is that economic conditions will likely warrant raising the federal funds rate only gradually. Thus, we expect that the target federal funds rate will remain for some time below levels viewed as normal in the longer run. But that is only a forecast, and monetary policy will, in practice, be determined by the data – primarily data on inflation and unemployment.

What about financial stability? We are aware of the possibility that low interest rates maintained for a prolonged period could prompt an excessive buildup in leverage or cause underwriting standards to erode as investors take on risks they cannot measure or manage appropriately in a reach for yield. At this point, the evidence does not indicate that such vulnerabilities pose a significant threat, but we are carefully monitoring developments in this area.

U.S. monetary policy spillovers and global interest rates

As we consider the decision of policy rate normalization, we are mindful of possible spillovers to other economies, including emerging market and developing economies. In an interconnected world, fulfilling the Federal Reserve's objectives under its dual mandate requires that we pay close attention to how our own actions affect other countries and how developments abroad, in turn, spill back into U.S. economic conditions.

In order to minimize the likelihood of surprises and thus avoid creating unnecessary market and policy volatility, we are striving to communicate our policy strategy clearly and transparently. Beyond communicating our intentions, we also emphasize that monetary policy normalization in the United States will occur in the context of a strengthening U.S. economy, which should benefit the emerging market and developing economies.

Still, one feature of the era after the first increase of the federal funds rate will, in all likelihood, be higher U.S. and global interest rates compared with their extraordinarily low levels of recent years. The increase in global interest rates could cause investors to adjust their portfolios, triggering capital outflows from emerging market and developing economies.

The financing needs of emerging market and developing countries remain substantial. As tomorrow's session on the outlook for Africa's debt capital markets will discuss, many African countries were able to issue bonds on the international financial markets in recent years – in some cases, for the first time in history. This development is due to the significant economic progress of the continent of the past several years and to commodity booms, ample global liquidity, and low interest rates.

Higher global interest rates could limit the possibilities for governments to finance their projects or budgets on the same favorable terms. The reduced ability of governments to finance their needs will likely increase the challenges faced by central banks in their efforts to assist the economic growth and development agendas of their national governments.

Emerging market and developing economies have generally done a good job of reducing their financial and economic vulnerabilities over the past couple of decades. For example, since the 1990s, many of them have made remarkable progress in reducing inflation, improving government debt ratios, building foreign reserves, and better regulating and capitalizing their banking systems. These improved economic fundamentals should bolster their resilience should normalization of monetary policy in the United States and some other advanced economies lead to financial market stresses. Even so, policymakers will be better positioned to cope with shocks, both internal and external, if they continue to strengthen these economic fundamentals.

Monetary policy in developing countries

As mentioned earlier, the Federal Reserve has operated under a dual mandate of price stability and maximum employment, which has worked well for the U.S. economy. When it comes to central banking more generally, I doubt that there is any particular monetary policy framework that is suitable for all countries for all times. The central bank's choice of monetary policy framework should depend on the objectives it aims to achieve, on the challenges that the economy faces, and on the structure of the financial markets and the economy in which it operates. And it is likely that the monetary policy framework will change over time as the domestic economy and the international financial system develop.

The exchange rate regime is a key consideration. In recent decades, developing economies have experienced increasing capital mobility and financial integration into the global economy. Over the longer term, this is a welcome development that will help meet the substantial financing needs of the private and public sectors, but greater financial integration and financial flows also complicate monetary policy in an environment in which exchange rate considerations are important – and they are generally very important. These are small open economies in which external shocks are often large, and the excessive volatility inherent in free-floating exchange rates can be costly. As a consequence, many developing and emerging market countries both intervene in the foreign exchange markets and impose restrictions on capital inflows and outflows.

Why not simply peg the exchange rate? According to the impossible triad, or the more sophisticated version developed by Hélène Rey, the impossible duo, a pegged rate, combined with capital mobility, makes it difficult for monetary policy to be used independently to achieve macroeconomic stabilization and price stability.[6] Nonetheless, some economies have successfully implemented pegged exchange rates. Hong Kong and Francophone Africa are leading examples.

Properly managed, some flexibility of exchange rates *can* help economies absorb external shocks, including swings in prices of commodities to which these economies are still heavily exposed. Accordingly, there has been a shift toward flexible, but managed, exchange rate systems among emerging market and developing economies. However, none of us should underestimate the difficulties of managing the exchange rate and of developing knowledge about when and how much to allow the exchange rate to move in response to domestic and external economic shocks.

Even beyond the management of the exchange rate, central banks in developing countries face difficult challenges in developing their monetary policy frameworks. For many years, the standard International Monetary Fund approach to monetary policy – which embodied the monetary approach to the balance of payments – emphasized money targets. But this approach has become less tenable as economies have evolved and matured. As you know, the effectiveness of such a framework depends, among other things, on the stability of the money demand function and on the structural relationship between monetary aggregates and macroeconomic variables. These relationships tend to shift as the financial system develops, making money targeting frameworks less effective – as we know from the historical experience of monetary policies in advanced economies.

For this reason, advanced economies abandoned them, and some emerging market economies followed suit, generally, in favor of inflation targeting frameworks, with short-term interest rates as the main instruments and the use of open market operations to control the liquidity in the economy. However the conditions necessary for full-blown inflation targeting achieved through adjustment of policy interest rates may not be present in some of these economies.

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6 See Rey (2015).

In the advanced economies and some emerging market economies, financial systems are relatively well developed, deep, and diversified, which facilitates the conduct of monetary policy through open market operations. In many of the developing countries, however, although financial systems are developing rapidly, they remain small and not well diversified, hindering the ability of central banks to conduct open market operations. Indeed, in many countries, interbank markets are still underdeveloped, and, even though some central banks use policy rates, changes to these policy rates have only limited effect on other interest rates and on the economy more generally. Thus, the ambitions of developing countries to modernize their monetary policy frameworks have to proceed in parallel with further efforts to develop the market institutions necessary to conduct monetary policy in a conventional way.[7]

Concluding remarks

Central banking as a profession has come a long way, striving to adapt itself to the challenges faced by economies over time, and both the practice and theory of central banking will continue to evolve. Like others, central banks in developing countries are making strides in modernizing their policy frameworks and better adapting them to the problems that their economies face. Nonetheless, significant challenges remain to develop financial systems and accelerate financial inclusion, to enhance the effectiveness of monetary policy, and to further expand the institutional and operational capacities of central banks.

I wish you – the governors and high officials of African central banks – well in carrying out your critical and difficult responsibilities, and I look forward to discussing with you the policy issues that you confront.

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[7] See, for example, Laurens and others (2015) for a comprehensive discussion on transitional monetary policy arrangements. For related papers, see Berg and others (forthcoming) and International Monetary Fund (2004, 2014).

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