John C Williams: Moving toward "normal" US monetary policy

Remarks by Mr John C Williams, President and Chief Executive Officer of the Federal Reserve Bank of New York, at the Joint Bank Indonesia-Federal Reserve Bank of New York Central Banking Forum, Nusa Dua, Indonesia, 10 October 2018.

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Thank you and good morning. It's a pleasure to speak at the Central Banking Forum co-organized by Bank Indonesia and the Federal Reserve Bank of New York. This is our second joint conference, and I am very much looking forward to the exchange of ideas and views on important economic issues affecting our regions. At the outset, I would like to thank Governor Perry and Bank Indonesia for their leadership and support in sponsoring this conference, amid what I am sure has been a very busy time with the IMF/World Bank meetings. Let me also say that our thoughts and hearts go out to everyone affected by the recent devastating earthquake and tsunami.

In my remarks, I will focus on the outlook for U.S. monetary policy. The good news is that on the 10th anniversary of the worst days of the global financial crisis, the U.S. economy is doing very well. From the perspective of the Fed's dual mandate of maximum employment and price stability, quite honestly, this is about as good as it gets. As a result, the Fed has naturally been moving toward more "normal" monetary policy.

And that brings me to a theme of my remarks today: What does "normal" monetary policy look like going forward? Before I say even one more word, I should stress that what I have to say represents my own views and not necessarily those of the Federal Open Market Committee (FOMC) or anyone else in the Federal Reserve System.

Strong, Strong, Strong

My view on the U.S. economy is well summarized by the most recent FOMC statement, in which variations on the word "strong" appeared five times in describing the U.S. economy.[1] Central bank communication can be difficult at times, but, at least in this case, our message is very clear. Indeed, the Federal Reserve has attained its dual mandate objectives of maximum employment and price stability about as well as it ever has. Most indicators point to a very strong labor market—including an unemployment rate of 3.7 percent—and inflation is right on target.

With fiscal stimulus and favorable financial conditions providing tailwinds to the U.S. economy, the outlook is for more strong growth. Let me put some hard numbers to that: I expect real GDP to increase by around 3 percent this year and by 2.5 percent in 2019. Assuming this forecast comes to fruition, this will be the longest expansion in U.S. history based on data going back over 150 years. This above-trend pace of growth should lead to continued solid job gains and further declines in the unemployment rate. I expect the unemployment rate to edge down to slightly below 3.5 percent next year, the lowest level in nearly 50 years.

In keeping with this strong economic outlook, I expect price inflation to move up a bit above 2 percent. Importantly, I don't see any signs of greater inflationary pressures on the horizon. This is all very good news, especially in the context of the slow recovery and low inflation that has persisted in the years since the financial crisis.

In light of the progress we've made on our monetary policy goals, the FOMC has been in the process of gradually normalizing monetary policy for the past few years. Looking forward, I continue to expect that further gradual increases in interest rates will best foster a sustained economic expansion and achievement of our dual mandate goals.

Since first raising rates from near-zero back in December 2015, the FOMC has continued to

raise the target range for the federal funds rate as the economy has improved and moved toward our maximum employment and 2 percent longer-run inflation objective. Our most recent rate increase came in late September, when the FOMC set the target range between 2 and 2.25 percent.[2]

Throughout, we've repeatedly stressed that we foresaw this to be a process of gradual normalization, reflecting the balancing of risks to reaching our goals. In particular, downside risks to the achievement of our employment and inflation goals amid very low interest rates were compelling arguments for a relatively cautious and predictable approach to policy. This proved its worth: The U.S. economy continued to expand at a healthy pace even as the Fed raised rates numerous times.

For those who follow the Fed closely, you've noticed that the FOMC has been slimming down its statements of late and using less forward guidance about the future path of policy. In this vein, the FOMC in its recent statement removed language indicating that monetary policy remains accommodative.[3] Let me make clear, these more concise statements do *not* signify a shift in our monetary policy approach. Instead, they represent the natural evolution of the language describing the factors influencing our policy decisions in the context of the strength of the economic outlook and inflation being near our 2 percent longer-run goal.

These changes in our communication of policy views are a sign that we are nearing the end of the process of normalizing monetary policy and are inching closer to conducting normal monetary policy. Arguably, it's been a long time since monetary policy was normal, so it's worth describing what "normal" looks like in some detail.

At its most basic level, monetary policy-making will remain the same: The path of interest rates will continue to be guided strategically by our dual mandate objectives and shaped tactically by the data and their implications for the economic outlook. We'll continue to be transparent about our thinking about the economy and monetary policy.

But, changing circumstances call for some changes in how the FOMC communicates its policy views. Now that interest rates are well away from zero and the economy is humming along, the case for strong forward guidance about future policy actions is becoming less compelling. For one, the future direction of policy will no longer be as clear as it was during the past few years. When interest rates were extremely low, it was obvious that the direction for rates was upward, toward more normal levels, and our forward guidance reinforced that point. At some point in the future, it will no longer be clear whether interest rates need to go up or down, and explicit forward guidance about the future path of policy will no longer be appropriate.

In addition, as we have moved far away from near-zero interest rates, it makes sense to shift away from a focus on normalizing the stance of monetary policy relative to some benchmark "neutral" interest rate, often referred to as "r-star." Now, I have spent a good deal of my career studying r-star and I find it to be a useful concept for describing the economy's longer-run behavior.

Having said that, at times r-star has actually gotten too much attention in commentary about Fed policy. Back when interest rates were well below neutral, r-star appropriately acted as a pole star for navigation. But, as we have gotten closer to the range of estimates of neutral, what appeared to be a bright point of light is really a fuzzy blur, reflecting the inherent uncertainty in measuring r-star.[4] More than that, r-star is just one factor affecting our decisions, alongside economic and labor market indicators, wage and price inflation, global developments, financial conditions, the risks to the outlook… the list goes on and on.

I've talked a lot about normalizing our policy around interest rates. In addition, about a year ago we started the process of gradually reducing the Fed's balance sheet as we work to unwind the

asset purchase policies put in place during the crisis. In the now-standard Fed practice of communicate, communicate, and communicate, we published detailed plans well in advance on how we would gradually and predictably reduce the balance sheet.[5] This process has proceeded smoothly without creating undue market disruption or volatility.[6]

With balance sheet normalization well underway, the Fed is studying the question of what exactly the new normal looks like. We have indicated that we plan to shrink the balance sheet to the smallest size consistent with the efficient and effective conduct of monetary policy—and that, in the long run, the asset side of the balance sheet will consist primarily of Treasury securities.[7] That's our strategy, but its execution will depend on the operating framework of monetary policy, among other factors.

Here, the Fed basically has two choices. We could return to a system similar in spirit to that used before the financial crisis, in which the supply of reserves in the banking system was kept relatively scarce, and the interest rate was set by adjusting reserves on a frequent basis through open market operations. Alternatively, we could continue with the system that we've been using since the crisis, in which bank reserves are abundant and the federal funds rate target is achieved through adjustments to administered rates. This approach is working very well at controlling interest rates and has proven to be easy to communicate and adaptable to changing market conditions.[8] The Fed will be looking closely at these options in the coming months and will subsequently make a decision on the future operating framework. And, as is our standard practice, we will be sure to communicate our thinking and decisions on this issue as soon and as thoroughly as practicable.

Global Dimensions of U.S. Monetary Policy

So far, I have described the economic and monetary policy outlook from the perspective of the U.S. economy and policy. This should not be surprising given that the Fed's mandate—as defined by the U.S. Congress—concerns domestic economic conditions. Of course, that does not imply that one can view the U.S. economy and our policy actions in isolation from global economic and financial developments. Far from it.

In today's highly interconnected global economy and financial system, international developments affect the U.S. economy, and our policy actions in turn impact the rest of the world. Therefore, we devote considerable effort to monitoring and analysis of developments around the world to understand how our actions affect the global economy and indirectly feed back to our own economy. These considerations play an important role in my thinking about the economic outlook and the appropriate path for monetary policy, as well as how we best communicate our perspectives and plans.

Moreover, we actively engage with international counterparts in a range of forums, such as today's. These exchanges help us understand economic and financial conditions affecting our respective regions and provide opportunities to share perspectives and insights. A key lesson about policy-making in an interconnected world is that transparency and open lines of communication are critical to minimizing misunderstanding, market disruption, and volatility that can interfere with our common goals of having strong and stable economies. As I have mentioned a number of times already, effective communication that provides clarity and predictability to our policy actions is a critical component of successful policy-making.

Conclusion

Monetary policy-making has perhaps never been more challenging than it was following the financial crisis. But, as we move toward more "normal" conduct of monetary policy, we must not rest easy. We will confront our own fair share of future challenges. The most important monetary policy challenge in the United States today is sustaining the long economic expansion

without allowing risks to grow that ultimately undermine economic prosperity. Whatever the future may bring, I will be guided by our dual mandate, a heavy dependence on data, and a steadfast commitment to transparency. Such an approach, in my view, will help support prosperity both in the United States and abroad.

Thank you.

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[1] See FOMC Statement and Implementation Note, September 26, 2018.

[2] See FOMC Statement and Implementation Note, September 26, 2018.

[3] See FOMC Statement and Implementation Note, September 26, 2018.

[4] See Jerome H. Powell, Monetary Policy in a Changing Economy, August 24, 2018.

[5] See FOMC issues addendum to the Policy Normalization Principles and Plans, June 14, 2017.

[6] See Simon Potter, Confidence in the Implementation of U.S. Monetary Policy Normalization, August 4, 2018.

[7] See Policy Normalization Principles and Plans, as adopted effective September 16, 2014.

[8] See Simon Potter, Confidence in the Implementation of U.S. Monetary Policy Normalization, August 4, 2018.