Resetting Monetary Policy

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Chair Huizenga and members of the Subcommittee, I appreciate this opportunity to present views on the Federal Reserve's monetary policy. You directed today's hearings to focus on the Federal Reserve's departure from conventional monetary policy and whether it has worked and how monetary policy can reliably support economic growth going forward.

An assessment of the conduct of monetary policy in recent years provides important lessons for the Fed and its proper role and economic policymaking in general. This is particularly true now that an economic policy regime shift is underway.

The Fed's unconventional policies in 2008-2009 deserve credit for helping to lift the economy and financial markets from crisis. However, it is striking that in recent years while the Fed's unconventional policies of sustained negative real Fed funds rate, quantitative easing and forward guidance have successfully stimulated financial markets, lowered bond yields, encouraged risk-taking and boosted asset prices, they have failed in their ultimate objective of stimulating the economy. Nominal GDP growth has actually decelerated to 2.8 percent in the last year from its subdued 3.9 percent average pace of the prior six years, and real growth has languished.

Extending excessive monetary ease well after economic performance normalized and the Fed's dual mandate was largely achieved has been costly. Instead of stimulating aggregate demand, monetary policies have contributed to mounting financial distortions and disincentives and are inconsistent with the Fed's macro-prudential risk objectives. Unfortunately, the Fed and financial markets now may be beginning to pay the price for the Fed's extended excessively easy monetary policy.

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I will now describe some reasons why the Fed's policies have not stimulated faster growth and how the Fed should change its conduct of monetary policy and make some suggestions for strengthening the economy.

Throughout this slow economic expansion, consumption and housing have grown firmly, but business investment has been disappointingly weak despite the lower the costs of capital and strong corporate profits and cash flows. Soft capital spending has contributed to very slow productivity gains and diminished estimates of potential growth. The Fed has reduced its estimates of potential growth to 1.8 percent and the Congressional Budget Office to 2.0 percent, dramatically lower than their estimates of 2.6 percent in 2007. This has far-reaching implications for employment, wages and standards of living.

Recent trends make it increasingly clear that economic performance has been constrained by factors that are beyond the scope of monetary policy. The slow growth has much less to do with the Fed than real, nonmonetary issues, particularly growth-depressing economic, tax and regulatory policies. However, the Fed's excessive monetary ease has not helped and may have harmed economic performance. It has generated mounting financial distortions that eventually must be unwound.

The Fed's approach to monetary policy has changed little even with the unemployment rate below 5 percent and inflation rising toward 2 percent. The Fed has kept the Fed funds rate well below inflation and continues to reinvest maturing assets to maintain its bloated balance sheet and nearly $2.5 trillion of excess banking reserves. Whether maintaining a negative real Fed funds rate for eight consecutive years is deemed "unconventional" —it has never happened before in Federal Reserve history—it certainly reflects poor policy judgment. Moreover, the Fed's fully discretionary approach to conducting policy, highlighted by its ever-changing explanations for delaying rate increases, adds confusion and has created a very unhealthy relationship with financial markets.

Factors constraining investment and growth

Government policies have been a key source of the weak economic performance and have constrained the Fed's efforts to stimulate growth. The adverse impacts have been particularly apparent in business investment and the availability of bank credit. The negative economic impacts of the rising public debt overhang and expectations of future tax increases have been widely discussed. In addition, to some extent the weak business investment reflects the rising share of GDP in less capital intensive production, rising overseas investment and measurement issues.

However, it is clear that a growing web of government regulations, mandated expenses and higher tax burdens have weighed on banking and the financial sector, business investment and the broader economic environment. In banking, the burdensome micro regulations imposed by Dodd-Frank have deterred bank lending, even by medium and smaller banks that do not face the Fed's stress tests. This has worked at crosscurrents to the Fed's easy monetary policy, clogging the normal channels through which monetary policy affects economic activities. In financial markets, the distortions generated by persistently negative real interest rates, excess liquidity and Fed-induced risk-taking are widespread, and now must be unwound.

In nonfinancial sectors, an array of new regulatory policies and government mandated expenses that have been imposed by Federal, state and local governments increase operating costs, contribute to inefficiencies in production processes and labor inputs, and lower after-tax rates of return on investment. They add an additional layer of uncertainty in investment decisions. A lot of these tax and regulatory burdens and government mandated expenses stem from administrative rulings and sometimes questionable interpretations of laws. Anecdotal evidence and business surveys indicate that in addition to slow product demand, government taxes and regulations are the largest concerns of businesses. Considered separately, most of these policies have little macroeconomic impact. However, their cumulative effects are large and generally not captured in standard macro models, including the Fed's FRB-US.

While the Fed's monetary policies have lowered the real costs of capital, the governments' economic and regulatory policies and related uncertainties have led businesses to raise their hurdle rates required for capital spending and expansion projects. Potentially productive expansion plans have been sidelined. Some government mandated expenses and labor laws have induced businesses to adjust labor inputs, including relying more on part-time workers. With less new capital, employee training has been cut back. Businesses have expanded overseas and bought foreign firms for tax reduction purposes. Businesses have issued more bonds in the Fed's low interest rate environment, but the proceeds are being used to buy back shares to meet the demands of yield-hungry investors. This raises corporate leverage but not capital spending or productive capacity.

Household behavior is also affected. Dimmed expectations of future disposable incomes have led to more precautionary saving, and real consumption has not quite kept pace with real disposable incomes. Working households are allocating more out-of-pocket spending to medical care and health insurance that have resulted in part by the Affordable Care Act, so they have less to spend on other goods and services. Tight mortgage credit standards and more onerous administrative costs have adversely affected the housing market.

These policy-induced constraints on economic growth and productive capacity are beyond the scope of monetary policy. Yet up until recently the Fed has perceived that the underperformance in labor markets and the economy has reflected insufficient aggregate demand that can be remedied by monetary stimulus. It has expanded the role of monetary policy on many dimensions. Monetary policy is involved in credit allocation through Fed purchases of mortgage-backed securities. It attempts to manage and fine-tune the real economy, respond to labor force participation rates, wages and an array of international trends that have little impact on the US. The Fed has frequently argued that had it not pursued aggressive monetary ease, economic performance would have been much worse. Again, the Fed deserves credit for lifting the US from crisis in 2008-2009, but it grossly overstates the efficacy of monetary policy in recent years.

Recently, the Fed has expressed the view that its monetary policy is having a diminishing economic impact and some Fed members are expressing concerns about mounting financial distortions. Noteworthy, former Fed Chairman Ben Bernanke stated in a recently blog that there may be supply constraints inhibiting economic growth, and if so, the Fed cannot do anything about it. That sets the stage for the current situation.

What Should the Fed Do?

I recommend that the Fed should reset the conduct of monetary policy. It should: 1) raise rates gradually but persistently toward a neutral policy rate consistent with its estimates of potential growth and its 2 percent inflation target, and cease reinvesting its maturing assets, 2) de-emphasize short-run economic and financial fine-tuning and not allow monetary policy to be influenced by global and financial turmoil that does not materially influence US economic performance, 3) shift the focus of its communications, including its official Policy Statements, toward the Fed's long-run objectives and away from short-run economic and financial conditions that are always subject to volatility, and emphasize that the scope of monetary policy is limited and that the economy is influenced by other factors including the government's economic and regulatory policies, and 4) shift toward a more rules-based guideline for conducting monetary policy that provides flexibility for the Fed but at the same time avoids the big mistakes of discretionary policy deliberations.

Gradually raising rates would leave monetary policy easy. It would not harm and may even help economic performance. The financial system is awash with excess reserves and the real Fed funds rate is roughly negative 1.3 percent, far below the Fed's 1 percent estimate of the appropriate long-run real policy rate (The median FOMC member's estimate of the appropriate Fed funds rate is 3 percent, 1 percentage point above the Fed's 2 percent inflation target.) During prior economic expansions when the Fed has raised rates following monetary accommodation, growth has been sustained. Witness the sustained growth when the Fed raised rates in the early 1980s, mid-1990s, or the mid-2000s. Raising rates would actually stimulate more bank lending and loosen the intermediation process. A clear Fed explanation of why it is normalizing rates—and why there is no need to delay—would boost confidence.

Ceasing to reinvest the proceeds from maturing assets in its portfolio would allow for a very gradual and passive unwind of excess reserves and would have no impact on credit supply. The Fed's reinvestment strategy is based on its fear that any change would signal faster interest rate normalization that may jar financial markets. That policy has not stimulated capital spending or economic growth and has only raised the costs of eventual monetary normalization, and should end.

A clearer explanation by the Fed of the non-monetary policies and factors that have contributed to lower potential growth, weak capital spending and productivity, and structural unemployment would help steer the economic policy debate toward the issues that really matter for performance. The Fed needs to correct the misperceptions that monetary policy is capable of managing every aspect of economic performance. It needs to emphasize that monetary policy is not a substitute for growth-depressing fiscal or regulatory policies and also dispel the notion that activist monetary policy is necessary and appropriate because the government's economic and fiscal policies and processes are misguided and dysfunctional.

The Fed should also spell out clearly how its low policy rate and bloated balance sheet have reduced the government's net interest costs and allowed fiscal policymakers to avoid making necessary fiscal and budget reforms.

Clarifying a more limited role of monetary policy may not sit well with those who have come to rely excessively on the Fed, but it would constructively reset monetary policy and enhance the Fed's independence and credibility.

Several observations on fiscal and economic policies

First, the Fed and others have been advocating for fiscal stimulus to boost the economy. ***It is critically important to distinguish between fiscal reform and fiscal stimulus that simply involves more deficit spending***. With the economy in its eighth consecutive year of expansion and growing at a pace close to current measures of potential, and the unemployment rate at or below standard estimates of full employment, countercyclical fiscal stimulus in the form of increased deficit spending is unwarranted and inappropriate.

Second, the focus of fiscal policy should be on tax and spending reforms that raise potential growth. This should involve tax reforms aimed at creating an environment conducive to investment and expansion. Spending initiatives should focus on reallocating spending toward productive activities while reducing wasteful spending, and changing the structure of entitlement programs to lower the government's future long-run unfunded liabilities. These changes can be made in fair and efficient ways that do not affect current retirees. There is a lot of impetus toward more infrastructure spending. Such initiatives must aim at improvements and upgrades that add to productive capacity and provide benefits that exceed costs, while avoiding the pitfalls and political impulses toward more deficit spending aimed at short-term fiscal stimulus and temporary job creation. Moreover, initiatives that improve education, training and human capital are critically important to improving the nation's infrastructure.

Third, regarding regulatory initiatives, banking and financial regulations should focus on establishing high capital adequacy standards while easing micro regulatory burdens that constrict bank credit. In the non-financial sectors, reform efforts should involve reducing burdensome regulations that inhibit business investment and expansion and constrict labor mobility and whose economic costs far exceed benefits.

The Fed must be prepared to raise rates higher if new economic policies raise potential growth.

Thank you for your attention today. I would be pleased to answer any questions.