

On the Path of Monetary Policy Normalization

Remarks by

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The views expressed by the author are her own and do not necessarily reflect those of the Federal Reserve System, its governors, officers or representatives.

I'd like to thank the organizers of this year's Minsky Conference for inviting me to speak. The topics to be addressed at this event highlight a number of policy choices facing our nation today. The implications of those choices are far-reaching not only to the Main Streets of this country but also to economies around the world. Central bank monetary policies loom large among those policy choices.

Over the past 15 months, the Federal Open Market Committee (FOMC) has begun the process of gradually removing nearly a decade of monetary accommodation. That accommodation came in the form of both conventional interest rate policy, which lowered short-term rates to near zero, and a series of more unconventional policy actions – namely, large-scale asset purchases and forward guidance. The actions were both lauded and criticized. Indeed, in March 2009, one member of the FOMC commented on the very difficult situation of determining an appropriate policy response at that time, noting “we’re in a position where doing the right thing is not obvious.”¹

If doing “the right thing” was not obvious at that time, then the path to unwinding these extraordinary policy actions and returning to more conventional policy approaches is no less fraught with questions about the FOMC’s decision-making framework. How will conventional and unconventional policy accommodation be removed and what are the implications? Is the process of normalizing policy “behind the curve?” What linkages exist between balance sheet adjustments and interest rates? What level of interest rates best supports long-run price stability?

My remarks today will not attempt to answer many of these important questions. Instead, I will focus on the process of policy normalization and its challenges, particularly as it relates to unwinding the Federal Reserve’s balance sheet. I’ll begin with the economic backdrop under which the FOMC is considering these policy adjustments.

¹ Donald Kohn, FOMC meeting transcript, March 17-18, 2009.

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The U.S. Economic Outlook

For the most part, the economy looks to be on solid footing. Consumers are confident and they are spending, household balance sheets are in better shape, and house prices are rising. Employment has gained traction, bringing the unemployment rate down to 4.5 percent. Business investment and productivity growth have been somewhat sluggish for most of the recovery, but profitability has again increased. The energy and manufacturing sectors also are bouncing back with the stabilization in oil prices and the foreign exchange value of the U.S. dollar. In general, the economy has come a very long way since the financial crisis that began nearly a decade ago and has weathered a number of shocks over the course of this lengthy expansion.

Despite the apparent health of the economy, risks are always on the horizon. Today, however, there is a sense that outcomes could actually be better than expected, rather than worse. For example, in the FOMC's latest Summary of Economic Projections, more participants now see risks that real GDP growth and inflation could be higher than forecast, rather than lower. This shift in risk assessment is in sharp contrast to the more pessimistic views that dominated past projections. Such an outlook has allowed the FOMC to continue the process of normalization.

Unwinding the Balance Sheet

Prior to the financial crisis, the business of setting monetary policy involved few moving parts. FOMC decisions could be steered with a fair amount of precision by the Federal Reserve's

Open Market Desk and with a relatively modest amount of intervention in financial markets. There were other aspects to the process, but the tools and considerations were generally well understood and relatively straightforward.

Today, conducting monetary policy is considerably more complicated, owing in part to the size and composition of the Federal Reserve's balance sheet. Prior to the financial crisis and recession, the Fed's balance sheet was slightly less than \$1 trillion with a portfolio of short-term Treasuries. Over the period from 2009 to 2014, a series of large-scale asset purchases swelled the balance sheet to nearly \$4.5 trillion, and the portfolio shifted to include mortgage-backed securities and long-term Treasuries.

These unprecedented actions were carefully considered with a desire to boost economic activity. Faced with the prospect of potential nearer-term benefits, the associated costs were generally difficult to quantify and viewed to be well into the future, perhaps making them easier to discount. As a voting member who dissented in 2013, I believed these costs outweighed the benefits at that time.

The key challenge for monetary policy today is to unwind this large balance sheet in the least disruptive manner. It is an important step and one that the FOMC anticipated going back to June 2011 when exit strategy principles were initially framed. Following decisions to expand the balance sheet further, the FOMC revisited the exit strategy principles in 2014 and outlined its approach to monetary policy normalization in September of that year.

It is difficult to know with a high degree of confidence just how the economy and financial markets will react once the FOMC announces and then takes steps to reduce the size of its securities holdings. Some believe that the benefits of the actions that swelled the balance sheet were modest, and as a result, the costs of its unwinding also could be of little consequence to the

broader economy. Others believe that the effects on the economy were substantial and that actions to reduce its size need to be taken with a great deal of care and caution. Of course, it is also possible that any benefits gained from the balance sheet expansion won't reverse when it shrinks. While evidence from a variety of sources and studies will inform decisions about possible effects and how to proceed, the implications for the economy are uncertain.

In addition, balance sheet actions have the potential to complicate interest rate policy. There is likely some tradeoff between adjusting interest rates and shrinking the balance sheet, but the specifics of the tradeoff are hard to quantify. This uncertainty and additional complexity raises the risk of a policy error or could spark a bout of financial market volatility.

Beyond the mechanics of shrinking a large balance sheet, establishing a sound framework for the timing of balance sheet adjustments will be important. To that end, the FOMC discussed at its most recent meeting in March various aspects of an appropriate decision-making framework to guide its actions.

Balance sheet adjustments will need to be gradual and smooth, which is an approach that carries the least risk in terms of a strategy to normalize its size. Importantly, once the process begins, it should continue without reconsideration at each subsequent FOMC meeting. In other words, the process should be on autopilot and not necessarily vary with moderate movements in the economic data. To do otherwise would amount to using the balance sheet as an active tool of policy outside of periods of severe financial or economic stress, and would increase uncertainty rather than reduce it.

Avoiding Monetary “Fine Tuning”

Based on economic conditions, I would support beginning the process of reducing the balance sheet this year. This would further normalize the stance of policy and leave more highly liquid, safe securities available to the market. I do not favor prolonging action for the purpose of allowing inflation to overshoot the 2 percent goal or to press labor markets into a condition where they are overheating.

At the time the FOMC adopted the 2 percent inflation target in 2012, the unfamiliar nature and unknown consequences of large scale asset purchases had piqued concerns about the implications for inflation expectations. Anchoring these expectations with a more explicit commitment to price stability was appropriate. I supported that decision. In the years following, however, inflation ran below the stated target – although at times only slightly below – and only recently has it moved above the target to 2.1 percent.

In its annual Statement on Longer-Run Goals and Monetary Policy Strategy, the FOMC talks about the nature of its inflation objective. Specifically, inflation that persistently deviates above or below the 2 percent objective would be cause for concern, but monetary policy need not react to temporary deviations. Importantly, I do not interpret the strategy as calling for inflation to linger above 2 percent to make up for past shortfalls, but rather for inflation to move toward 2 percent in the long run without any deliberate overshooting. Continuing highly accommodative policy or adjusting monetary policy in response to modest shortfalls or overshoots from the inflation goal is an attempt at monetary fine tuning that is often not practical and may ultimately prove costly.

Although inflation is running close to 2 percent today and is expected to remain there, the prices of different goods and services rise at very different rates. For example, services inflation

has been running well above 2 percent, and housing rents in particular have been playing a key role in moving inflation higher. By several measures, rents are rising faster than aggregate wages. Keeping monetary policy easy to achieve higher inflation has the potential to push rents still higher, negatively affecting a large percentage of households. Consequently, I am not as enthusiastic or encouraged as some when I see inflation moving higher, especially when it has been driven by a sector like housing. Inflation is a tax and those least able to afford it generally suffer the most.

Such concentration and persistently rising prices in one area suggests the economy is struggling to reallocate resources. For housing, it could reflect several factors such as tight lending standards faced by home builders and scarcity of skilled craftsmen needed to construct homes. I expect the market to eventually solve for, or at least adapt to, such factors. Using monetary policy however to compensate for them could easily end up hurting the population the policy is intended to help.

Conclusion

Overall, I am encouraged by the start of the normalization process and want to see it continue. Resisting the temptation to react to near-term fluctuations in the data will be necessary. Looking ahead, we should expect inflation to move up and down around 2 percent. A modest decline in inflation or an overshoot may not necessarily warrant the monetary policy normalization process to slow or accelerate. Such attempts at monetary fine-tuning can easily backfire, so a more forward looking view of inflation is needed. This is not uncommon and it is why many economists and policymakers emphasize the importance of inflation expectations. In

fact, the FOMC also has long-emphasized their importance, typically with specific mention in each FOMC statement.

The important factor is that the public, markets, and policymakers see the setting for monetary policy supporting the 2 percent inflation goal in the long run, rather than expect a policy that tries to keep inflation squarely pinned at 2 percent under all circumstances.

While both the inflation rate and the unemployment rate are in range to meet the FOMC's objectives, the federal funds rate is far from its longer-run level and the balance sheet remains large with reinvestment of maturing securities. Continuing along the path of normalization even in the face of uncertainty is necessary to achieving long-run objectives for the economy, including price stability and full employment on a sustained basis.