John C Williams: Remarks at the 42nd Annual Central Banking Seminar

Remarks by Mr John C Williams, President and Chief Executive Officer of the Federal Reserve Bank of New York, at the 42nd Annual Central Banking Seminar, Federal Reserve Bank of New York, New York City, 1 October 2018.

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It is my pleasure to welcome you to the Federal Reserve Bank of New York to participate in the 42nd annual Central Banking Seminar. This is truly an impressive group—our largest ever—with so many countries, institutions, and central bank departments represented. The program and speakers are similarly wide-ranging: You can expect to hear not only about the global economy, monetary policy, financial stability and supervision, technology, operations, and payments, but also about issues outside the usual central banking orbit. We see this breadth of coverage and participation as a key distinction and strength of the Seminar.

The long history of the Central Banking Seminar reflects the New York Fed's deep commitment to strengthening central bank cooperation over the long term. Such cooperation is vital to better understanding the world around us and the execution of our responsibilities. Those relationships are also essential during times of financial stress, and were critical to managing events during the Global Financial Crisis.

A broad perspective is absolutely necessary for central bankers today given the tremendous array of issues we face, the high level of economic and financial integration across the globe, and a range of uncertainties within and outside our traditional remit. A short list of current issues includes policy normalization in the advanced economies; potential spillovers to emerging market economies (EMEs); fragility in some EMEs; ongoing economic and financial adjustment in China; trade policy tensions; and Brexit.

So, there should be no shortage of things to talk about. Diverse perspectives often lead to better thinking and outcomes, and given the variety of experiences represented today, I expect a very fruitful set of discussions.

In my remarks today, I will focus on monetary policy, highlighting the evolution of Federal Reserve policy actions and communications as we've exited from the extraordinary stimulus that followed the crisis and recession. The good news is that 10 years after the crisis, the U.S. economy is doing very well overall. 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 key theme of my remarks today: What does "normal" monetary policy look like? Before I go any further, I should note 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 take on the economy is well summarized by the most recent FOMC statement, in which we used variations on the word "strong" five times in only four short paragraphs. The statement references "strong" labor market conditions, "strong" job gains, and a "strong" rate of growth in economic activity, household spending and business fixed investment.[1] Although this may suggest that we really need to consult a thesaurus, at least we can't be accused of ambiguity.

The Fed has attained its dual mandate objectives of maximum employment and price stability

about as well as it ever has, with most indicators pointing to a very strong labor market indeed—including an unemployment rate below 4 percent—and an inflation rate very near our longer-run goal of 2 percent.

With fiscal stimulus and favorable financial conditions providing tailwinds to the economy, the outlook is for more of the same. Let me put some hard numbers to that: I expect real GDP to increase by 3 percent this year and by 2.5 percent in 2019. This above-trend pace of growth should lead to continued solid job gains and further declines in unemployment. I expect the unemployment rate to fall slightly below 3.5 percent next year, the lowest level in nearly 50 years.

In keeping with the strong economy, I expect price inflation to edge up a bit above 2 percent, but don't see any signs of greater inflationary pressures on the horizon. And, 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.

I should hasten to add that not everyone has shared equally in this otherwise strong economy. The unevenness of the recovery is evident in my travels around the Second District, where, for example, the economic recovery in upstate New York continues to lag the nation as a whole. So, while the national economy is in good shape, longer-run economic challenges have meant that not all Americans have benefited from the improvement in the economy. Beyond supporting a strong overall economy, monetary policy has limited reach into these issues, which are best addressed through other means, such as investments in education, workforce development, and economic development.

Three Stages of Monetary Policy Normalization

In thinking about the outlook for monetary policy, it's useful to remember how we got to where we are today. The financial crisis and the Great Recession led the FOMC to lower the federal funds rate target to near zero and to keep it there for seven years. This lengthy spell at zero reflected the long shadow of the crisis—evident in the subsequent subdued growth rate and inflation rate—and the need for the economy to convalesce after enormous trauma. With the unemployment rate still very high and inflation low, the Federal Reserve embarked on a long journey through *terra incognita* of unconventional monetary policy actions, including large-scale asset purchases and forward guidance on the future path of interest rates. We weren't alone: Indeed, some central banks across the globe went even further down the road of unconventional policies.

In part due to the Fed's actions, the U.S. economy gradually recovered, and as a result the FOMC has been slowly but surely moving monetary policy "back to normal." This process can be thought of in three stages.

Stage 1: Lift-off

The first stage in policy normalization focused on the lift-off of the federal funds rate target from near zero, which occurred in December 2015. But, well before that happened, the FOMC went to great effort to communicate its thinking to the public to better prepare it for the upcoming change in policy.[2] Importantly, we also made extensive preparations to ensure that we were ready and *able* to raise rates as needed, in the context of a very large Fed balance sheet and bank reserves. And, consistent with the Fed's aim to be as transparent as possible, we published our plans on how we would use interest rates paid on bank reserves and overnight reverse repurchase agreements to keep the federal funds rate within the FOMC's target range.[3]

At the time—in light of the shallow recovery and low inflation—the FOMC was very focused on balancing the risk of a premature removal of accommodation against concerns that excesses could eventually develop in the economy. In the end, lift-off went without a hitch. The approach developed back then has served us extremely well in controlling the federal funds rate, and has proven to be flexible as market conditions have evolved. I will come back to this point later.

Stage 2: Normalization

The second stage of normalization followed lift-off and has involved two processes: 1) raising the federal funds target closer to more normal levels, reflecting the ongoing improvement in the economy, and 2) gradually reducing the Fed's balance sheet as we work to unwind the asset purchase policies put in place during the crisis.

Let's start with interest rate normalization. Since lift-off, we've raised interest rates as the economy moved toward maximum employment and our 2 percent longer-run inflation objective. We continued this process with our most recent rate increase this week.[4] 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 cautious and relatively predictable approach to policy. This approach proved its worth: The economy continued to expand at a healthy pace even as the Fed raised rates numerous times.

I'll now turn briefly to the normalization of the balance sheet. We began this process about a year ago. 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] As with lift-off, this process has proceeded smoothly without market disruption or volatility—and that's the way we like it.[6]

Stage 3: "Normal"

This brings me to the third stage, that of "normal" monetary policy. As interest rates have moved well away from zero and the balance sheet has started shrinking, a natural question arises: What does normal monetary policy look like? As before, I'll start with interest rate policy and finish with the balance sheet.

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 this week removed language from its statement indicating that monetary policy remains accommodative.[7] 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 how we communicate our policy views are a sign that we are nearing the end of the second stage of the normalization process, 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, 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.[8] 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… I think you get the point.

Returning to the balance sheet, the question of what exactly the new normal looks like is still being analyzed and discussed at the Fed. 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.[9] 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. As I said, this approach is working very well at controlling interest rates and has proven to be easy to communicate and adaptable.[10] 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.

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 shouldn't rest easy and think we won't confront our own fair share of future challenges. The most important one in front of us 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.

Thank you.

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

2 2 See Minutes of the Federal Open Market Committee, March 17–18, 2015.

3 3 See FOMC Communications related to Policy Normalization, and Simon Potter, Money Markets and Monetary Policy Normalization, April 15, 2015.

4 4 See FOMC Statement and Implementation Note, September 26, 2018.

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

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

7 7 See FOMC Statement and Implementation Note, September 26, 2018.

[8] 8 See Jerome H. Powell, Monetary Policy in a Changing Economy, August 24, 2018.

[9] 9 See Policy Normalization Principles and Plans, as adopted effective September 16, 2014.

[10] 10 See Simon Potter, Confidence in the Implementation of U.S. Monetary Policy Normalization, August 4, 2018.