For Release on Delivery
2:30 p.m., EDT
April 15, 2003

Remarks by

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to the

13th Annual Hyman P. Minsky Conference
on the
State of the U.S. and World Economies

The Levy Economics Institute of Bard College
New York, NY

April 15, 2003

It is a pleasure to be with you this afternoon. I believe it was Mark Twain who said that the most difficult thing of all to forecast is the future. And certainly the extraordinary difficulty currently in trying to discern U.S. macroeconomic prospects for the next year or so is not inconsistent with Twain's observation. It is hard to recall a period when the immediate, very near-term outlook for the economy was more uncertain, and when financial market perceptions were more volatile. As everyone at this conference is well aware, the Fed's Open Market Committee at its meeting back on March 18 thought the level of uncertainty was high enough to justify omission of its usual, so-called "bias" sentence from its policy directive and post-meeting announcement.

Against this background, I want to do two things this afternoon. First, I will make a few comments about the outlook for the remainder of the year. Despite the title of this session, I will talk less about "prospects" in the usual sense of most likely outcomes, and more about the range of plausible <u>possibilities</u>. And there is a wider than normal range of possibilities currently that are in fact plausible in the sense of having relatively high probabilities. Statistically, the probability distribution of possible outcomes has fat tails. That's what I mean when I say the outlook is unusually uncertain. Second, I will focus a few minutes on how the Fed can most constructively approach this situation with monetary policy. As always, I remind you that what follows are my own views and they do not necessarily implicate any of my fellow FOMC colleagues.

<u>The Outlook for the Economy</u>

With respect to plausible economic outcomes in the period ahead, it may be helpful to note the latest Blue Chip consensus forecast as a benchmark. This is the new consensus released last Thursday, so it is conveniently recent. It calls for real GDP to increase at a 1.8 percent annual rate in the first quarter and 2.2 percent in the second quarter before accelerating to a bit over 3½ percent in the second half, where it would remain – approximately – through 2004. In this scenario, the unemployment rate rises modestly from its current 5.8 percent level through the remainder of 2003, before declining ever so gradually to 5½ percent in the final quarter of 2004. The inflation rate, as measured by the chained GDP price index, remains steady between 1½ and 2 percent over the period.

Now something like this forecast is a plausible outcome. What distinguishes the current environment, in my view at least, is that the probabilities that the economy could be appreciably weaker or stronger than the consensus are higher than usual – the fat tails I mentioned earlier. On the downside, it is obvious that any number of circumstances could lead to a weaker economy than the consensus. Conceivably, some unfavorable fallout from the war in Iraq or an escalation of the tension in Korea could give new life to the recent hesitancy of both businesses and households to commit to significant discretionary expenditures. Beyond these geopolitical risks, though, as you know, many economists believe that negative economic fundamentals will continue to restrain the economy even if things go relatively well in the Middle East and elsewhere. Both businesses and households are still adjusting to the loss of financial wealth that has resulted from three consecutive years of stock market declines. Earnings of many companies, in particular, are being reduced currently by increased contributions to pension funds diminished by stock price declines. Moreover, there is still substantial excess capacity in some industries at the current level of aggregate demand. And the continuing high rate of productivity growth, while bullish for the longer run, is restraining job growth.

These conditions obviously could undermine the recovery. Indeed, some economists believe that the recent spate of soft monthly economic reports – including (1) declining payroll employment, (2) the weak March purchasing managers' report, (3) decelerating growth in consumer spending, (4) continued weak capital goods orders, and (5) and even some signs of fatigue in housing, to name a few – are evidence of an eroding recovery rather than just the result of the unusually severe weather in many parts of the country recently, and concern about the prospective war in Iraq, that was about to start at the time most of these reports were compiled. So a plausible case can be made that the economy will be weaker – maybe significantly weaker – going forward than the Blue Chip consensus.

At the same time, I personally believe that a plausible case also can be made that the economy will be at least somewhat stronger than the consensus, even though for many people, the consensus projection is already way out on the optimistic end of the spectrum. I assert this because there are a number of positives in the current picture that may not be receiving the attention due them. Specifically, there is already considerable monetary and fiscal policy stimulus at work in the economy. With respect to monetary policy, the nominal federal funds rate is currently only 1¼ percent. Consequently, the real funds rate is at zero or possibly negative. Beyond this, financial conditions are broadly favorable. As my FOMC colleague Governor Bernanke noted in a recent speech, mortgage refinancings have had the side effect of strengthening household balance sheets.[1] And banks are in a good position to lend to both households and businesses since they are well-capitalized, profitable and liquid, and they don't face any significant industrywide credit problems such as the commercial real estate debacle that plagued the recovery from the recession of 1990-91. With these positives in mind, it seems to me that our success in Iraq and the consequent reduction of risks, especially with respect to crude oil supplies and prices, could well produce a somewhat greater acceleration in the recovery than predicted by the consensus forecast.

<u>Implication of the Outlook for Monetary Policy</u>

My point here is not to argue for any of the particular scenarios I've discussed, but rather to underline the unusually wide array of plausible outcomes for the U.S. economy in the months ahead. The question for Fed policymakers, of course, is: What does this circumstance imply for monetary policy? At one level the answer seems obvious. We must be unusually vigilant. We do not want to be surprised and fall "behind the curve," whichever curve turns out to be relevant. But simply increasing the vigilance quotient does not adequately capture what should be expected from the Fed in this situation. We need to give this notion more content and context. And I think we can do that perhaps more effectively now than in the past because of the emergence of an increasingly well-defined strategy of monetary policy in the U.S. This strategy has been discussed in recent speeches by several Fed policymakers, including Governors Bernanke and Gramlich.[2] In a talk earlier this year, I summarized this strategy as consisting of two elements: (1) a strong and credible commitment to maintaining price stability permanently, and (2) active interest rate management to help stabilize the economy in the short run.[3] The two elements are interdependent. In particular, the credible commitment to long-term price stability is a necessary condition for effective short-term stabilization policy.

In my view, the slow but steady convergence on this strategy over the last 20 years was a major contributor to the two exceptionally long business expansions in the U.S. during this period. Moreover, in light of this history, there is every reason to think that persistent pursuit of this strategy will maximize growth of the U.S. economy over the long run. It is very important, I believe, not to let the current turbulence in the economy divert monetary policy from this strategy – both elements of it. Indeed, this strategy is precisely what is required to navigate this turbulence successfully. In particular, while the short-term stabilization element of the strategy cannot fully offset real shocks of the magnitude we've experienced recently, it can reduce – and arguably already has reduced – the fallout from these shocks. Moreover, with an eye to the future, active and flexible short-term stabilization policy would seem to be an especially appropriate approach in the present environment where, as I argued above, the economy plausibly could move in any of several directions.

But the stabilization policy must be effective. And effectiveness, again, requires that these short-term actions be taken in the context of a credible commitment to long-term price stability. During the high inflation years of the 1970's and early 1980's, efforts by the Fed to stimulate the economy when it was weak ran the risk of provoking an inflation scare. Similarly, if a deflationary threat was to arise at some point, and the Fed lacked credibility as a deflation fighter, the strong action that would be needed to prevent the deflation could quickly bring the funds rate to the zero bound. I will have more to say about the latter in a moment.

To this point I have described the strategy of policy rather sparsely. Let me elaborate briefly in the light of recent developments in the economy. It would be hard to exaggerate the key importance of maintaining credibility for price stability in applying this strategy. Full credibility for price stability in the U.S. today means public confidence that <u>in</u>flation will remain contained, and that any excessive <u>dis</u>inflation or emergent <u>de</u>flation will be quickly and successfully confronted. Most economists agree that the Fed enjoys high credibility for low <u>in</u>flation currently. After all, we established this credibility the hard way: by gradually but persistently ratcheting inflation down over the better part of two decades. I am, personally, highly confident that we can maintain credibility for low inflation. But I work hard to avoid overconfidence. As I said earlier, U.S. monetary policy currently is highly stimulative by historical standards, with the real funds rate in the neighborhood of zero, and possibly negative. If the successful end of the war in Iraq results in a sharper than expected acceleration in the recovery, the present policy stance would be excessively stimulative, and it would be important to reverse course and move to a more neutral stance promptly. It is tempting to think that this could be accomplished fairly easily. Past experience, however, suggests that it may be difficult to stay ahead of the curve.

Understandably, not many observers of monetary policy are focused at the moment on the upside risks in the economy and the need to preempt any future revival of inflation. Rather, with employment declining, household spending decelerating, business spending still stagnating, and a whiff of further disinflation in recent price reports, increased attention is being given – quite appropriately – to how the Fed might react to continued disinflation or evidence that the economy might be flirting with deflation. Few believe that deflation is imminent. But there is comfort – and confidence – in being prepared. An important point here, in my view, is that the credibility of the Fed's commitment to containing inflation – and it's proven capacity to do so – does not necessarily extend to disinflation and deflation. To be sure, observers of U.S. monetary policy recognize that the increased focus on price stability as a key long-term policy objective offers some assurance against deflation. And they are confident that the Fed will avoid the mistakes of the 1930's, when the money supply was allowed to contract substantially, and the banking system collapsed. Still, the absence of a track record, and, perhaps most importantly, the current proximity of the funds rate to the zero bound, are obstacles to full anti-deflationary credibility.

The Fed is already taking steps that I believe will increase our credibility as a deflation fighter. In particular, as far back as October 1999, the Fed sponsored a conference in Woodstock, Vermont, that brought senior Fed officials and staff together with leading university economists and others to discuss conducting monetary policy in a low inflation environment, where nominal short-term interest rates are close to zero, and deflation is a meaningful risk. More recently, several FOMC members, including Chairman Greenspan, and other Fed officials have explicitly addressed the possibility of deflation and how the Fed might confront a deflationary threat operationally when the nominal funds rate has reached, or is very close to, the zero bound.[4] Frequently cited alternatives at the zero bound include (1) acting to reduce longer-term interest rates, either by purchasing large quantities of longer-term Treasury securities in open market operations or by precommiting to maintain the funds rate at a low level for some extended time period, and (2) increasing the volume of cash in the economy substantially via purchases of Treasury bills and other short-term securities.

My personal view is that the most effective step the Fed can take right now to increase its disinflation/deflation-fighting credibility would be to encourage and participate in further public discussion of the advantages and disadvantages of these and other approaches. All the approaches mentioned above have drawbacks. Taking them in reverse order, purchasing short-term securities to increase cash in the economy will have minimal impact as short-term rates reach zero. At that point the Fed will have satiated the market with reserves and currency so that cash no longer yields medium of exchange services at the margin. Hence, cash and short-term Treasury bills would be valued equally with respect to what my colleague Marvin Goodfriend calls "broad liquidity services."[5] In plain language, cash and Treasury bills would become perfect substitutes at zero nominal interest rates. Consequently, open market purchases of short-term securities would have little effect on the economy. The second alternative, precommitting to hold the funds rate down, would be difficult for the Fed to honor in practice. If, after making such a commitment, deflationary forces subsided, and the Fed was faced with emerging inflationary pressures, the public would expect policy to be tightened. Knowing this, in practice the public would almost certainly discount any such precommitment heavily.

Purchasing long-term Treasury securities, in my view, is probably the most effective way for the Fed to undercut deflation at the zero bound. In addition to a direct effect on long-term interest rates, aggressive purchases of long bonds would increase broad liquidity and stimulate economic activity via the portfolio rebalancing and credit channels of monetary policy transmission.[6]

While such purchases would be effective, however, it would be important to ensure that the supply of Treasury bonds was sufficient to meet the Fed's needs. In principle, the Fed could use alternative approaches to increase broad liquidity at the zero bound. For instance, the Fed could lend more aggressively through the discount window, or it could buy private securities. These alternatives, however, would involve the Fed in decisions regarding the allocation of credit across the economy. This would pose significant risks. It could undermine the efficiency of private credit markets, and it could jeopardize the Fed's independence in conducting monetary policy.[7]

Currently, the outstanding supply of Treasury bonds should be sufficient to meet the Fed's needs in the event the zero bound is reached. But this problem should be considered carefully at some point. Vetting these kinds of issues thoroughly, and determining how they might be resolved in practice, would increase confidence in the Fed's ability to confront successfully any deflationary threat that might arise.

Conclusion

In sum, the near-term outlook for the economy is unusually uncertain at present. I am confident, though, that the Fed's current policy strategy, with its focus on credible price stability, provides a solid foundation for confronting whatever emerges effectively. I do believe that the foundation can be made even stronger by further, transparent discussion of alternative approaches at the zero bound.

Endnotes

[1] Ben S. Bernanke, "Balance Sheets and the Recovery," remarks at the 41st Annual Winter Institute, St. Cloud State University, St. Cloud, Minnesota, February 21, 2003.

[2] See (1) Ben S. Bernanke, "'Constrained Discretion' and Monetary Policy," remarks before the Money Marketeers of New York University, New York, NY, February 3, 2003, and (2) Edward M. Gramlich, remarks to a joint meeting of the North American Economic and Finance Association and the Allied Social Science Association, Washington, D.C., January 4, 2003.

[3] J. Alfred Broaddus, Jr., "Monetary Policy in a Low Inflation Environment," remarks before the Public Policy Forum of the American Finance Association, Washington, D.C., January 3, 2003.

[4] See (1) Ben S. Bernanke, "Deflation: Making Sure 'It' Doesn't Happen Here," remarks before the National Economists Club, Washington, D.C., November 21, 2002; (2) Alan Greenspan, remarks before the Economic Club of New York, New York, NY, December 19, 2002; and (3) Vincent Reinhart, "Tools for Combatting Deflation," presentation to the National Association of Business Economists, Washington, D.C., March 25, 2003.

[5] According to Goodfriend, assets provide broad liquidity services to the extent that they can be readily converted to cash, either through a sale or through use as collateral, to meet a gap between desired expenditure and current income. The Fed can increase broad liquidity at the zero bound by injecting cash into the economy through the purchase of relatively illiquid assets. See Marvin Goodfriend, "Overcoming the Zero Bound on Interest Rate Policy," Journal of Money, Credit and Banking, November 2002, pp. 1018-32.

[6] Ibid.

[7] See in this regard J. Alfred Broaddus, Jr. and Marvin Goodfriend, "What Assets Should the Federal Reserve Buy?" Federal Reserve Bank of Richmond 2000 Annual Report. Reprinted in Federal Reserve Bank of Richmond Economic Outlook, Winter 2001, pp. 7-22.

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