Monetary Policy and the State of the Economy

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Thank you Chairman Frank, Ranking Member Bachus, and other members of the House Committee on Financial Services for giving me the opportunity to testify on monetary policy and the state of the economy.

As an essential prelude to assessing current economic conditions and monetary policy, I would like to begin with a brief review of macroeconomic performance in the United States and the global economy in recent years.

For the past twenty-five years the U.S. economy has experienced unprecedented economic growth and stability compared with previous times in our history. Economic expansions have been stronger and longer than in the past. Recessions have been shorter, shallower, and less frequent. Forty-seven million additional jobs have been created. And of course, inflation has been lower and more stable than in the days we now call the Great Inflation of the late 1960s and the 1970s.

For the past ten years, the economic growth trend has been even stronger. Productivity growth—the amount of goods and services that workers can produce per hour of work—has surged by one full percentage point per year, creating an additional $9 trillion of goods and services. And recently this long boom has gone global with emerging market and developing countries experiencing improvements in economic growth and economic stability. As *The Economist*[1] has recently stressed, this global growth has resulted in a large reduction in poverty—a reduction of 135 million people from 1999 to 2004 alone, "more people, more quickly than at any other time in history." And since 2002 we have not seen any of the kind of emerging market financial crises that were so common in the late 1990s.

In my view economic policy has played a key role in this improvement, and monetary policy—the subject of today's hearing—has had a particularly important role. Monetary economists have documented a marked improvement in monetary policy starting in the early 1980s, and they attribute much of the credit for this better macroeconomic performance to this improvement. Since the early 1980s monetary policy

[1] "The World's Silver Lining," *The Economist,* January 24, 2008

has been systematic in its aggressive and timely responses to economic conditions, increasing interest rates when inflation is picking up and reducing interest rates during downturns. The same type of monetary policy in other countries is a key factor in the improved *global* economic performance. Monetary policy makers at the Federal Reserve and other central banks deserve praise and thanks for this accomplishment.

Current Economic Conditions

I start with this review to illustrate the dangers in the current situation of possibly overdoing the easing of policy and moving off this proven systematic approach to monetary policy, which could bring back the problems of higher inflation as in the past, including more frequent and severe recessions. The recent signs of increased inflation are worrisome in this regard.

Of course the downside risks have received much attention recently and rightly so. The slump in housing and the related financial market turbulence have sharply increased downside risks for the economy. Economic growth was down last quarter and this quarter, compared to the third quarter of last year. One antecedent of the current economic situation was the period of extra low interest rates in the period from 2003 to 2005, one of the few departures from the policy followed in the 25 year period of excellent performance.[2] This probably added fuel to the housing boom and thereby may have led to a larger housing bust. In addition, there was a lack of information, transparency, and accountability among private financial institutions and investors about the risk in mortgages originated in the United States. These were then packaged into complex financial instruments which turned out to be far riskier than many had thought.

Financial institutions and investors must take primary responsibility for dealing with these problems. Monetary policy should respond by helping to limit spillovers beyond the financial sector by adjusting interest rates as economic growth slows, but, at the same time, stay on the course that has proved so effective for the past 25 years. Monetary policy must therefore also be concerned about inflation.

Balancing the Growth and Inflation Risks

How does one balance these risks? One way is to use a benchmark; that is, to look at what the systematic responses that worked well in the past would imply about today. Economists call such a benchmark the Taylor Rule, and according to my estimates and calculations, the current federal funds interest rate is lower than what would be consistent with such a benchmark.

With GDP growth close to zero in this and the past quarter, the gap between real GDP and the economy's potential is about 1½ percent. The actual consumer price index

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[2] John B. Taylor (2007) "Housing and Monetary Policy," *Proceedings of the Jackson Hole Symposium*, Federal Reserve Bank of Kansas City, August.

(CPI) and personal consumption expenditures (PCE) inflation rates are 4.3 percent and 3.5 percent respectively over the past 12 months. Looking at several smoothed measures of inflation (including 4 quarter averages of the inflation rate for the GDP price index, the core PCE inflation rate, or core CPI rate) the inflation rate appears to be at least 2½ percent. Using these lower estimates of inflation and the real GDP values that I just cited gives a benchmark interest rate about a percentage point above the current level. However, it seems reasonable under current circumstances to make a further adjustment for the unusual interest rate spreads that currently exist in the money market. As I explain later in this testimony, recent research and experience in the money markets suggests an additional adjustment, but this would still imply an interest rate target above current levels in my view.

Hence, these calculations, which endeavor to balance the key risks, are not consistent with further interest rate cuts at the present time. In my view the calculations appropriately balance the considerable uncertainty about both the downside risk to growth and the upside risk to inflation as now estimated. Of course, if further economic weakness pulls the growth rate down, with declining employment and production, then additional cuts would be appropriate.

Adjusting for Financial Sector Stress

An important question is whether and by how much monetary policy should adjust to financial market disturbances to prevent spillovers to the rest of the economy. Recent research by John C. Williams and me focuses on the unusual conditions in the money market during the period from August 9, 2007 to the present, and specifically on the spread between the term Libor rates and the overnight fed funds rate.[3] We document these spreads and provide evidence that they are due to counterparty risk between banks, related to concerns about securities derived from sub-prime mortgages and other assets.

The spread between Libor at 3 month maturity and an index of overnight federal funds rates expected for the same period (technically the Overnight Index Swap (OIS)) jumped on August 9 from a multiyear steady average of 11 basis points, and has fluctuated as high as 106 basis points. It is now around 50 basis points. These term rates affect many securities including mortgage originations and resets on adjustable rate contracts, and they are thus at the center of the monetary transmission mechanism. Because the Fed's new Term Adjustment Facility did not increase the total supply of liquidity and did not alter counterparty risk, our assessment is that it did not have a significant effect on this spread.

In any case, one possible approach to adjusting the systemic component of monetary policy would be to subtract a smoothed version of this spread from the interest rate target that would otherwise be implied by developments with inflation and real GDP

[3] John B. Taylor and John C. Williams (2008) "A Black Swan in the Money Market," February 21, 2008

growth.[4] Currently the adjustment would be around ½ percentage point. Such an adjustment has the advantage of being more transparent and predictable than an arbitrary or purely discretionary adjustment. At least to the extent that counterparty risk declines to normal levels, the adjustment will be temporary. When banks are better able to assess the risks of their counterparties, they will lend more freely and spreads will come down. Such an adjustment could add predictability at times of financial market stress. Currently the Federal Reserve seems to be making adjustments for the stress in the markets, and if they are to be made, it is better to be as clear and predictable as possible about them. Investors and others in the economy could then factor the adjustments into their strategies, as Paul McCulley and Ramin Toloui of PIMCO have recently suggested.[5]

We already have some experience with such a policy. The Swiss National Bank has followed such a policy since last August because it targets three month Libor rather than the overnight rate. Hence, as the Libor spread increased in Switzerland the Swiss National Bank automatically and temporarily lowered the overnight rate.

The centrality of the Libor spread to the monetary transmission mechanism provides some rationale to focus on this spread rather than on a wide variety of other possible interest rates spreads, from high-yield corporate securities to emerging market debt. Trying to adjust monetary policy to all these spreads would likely interfere with needed private sector assessments of risks.

To increase transparency further, I recommend publishing the Fed's daily balance sheet, especially the "Fed balances" that banks hold at the Fed. This would increase transparency and help reduce uncertainty. Such information would make it easier to determine whether efforts by the central bank to provide additional liquidity in the money market will or will not affect spreads in the money market. Available data on repurchase agreements does not provide this information on a timely basis. I see no reason why this greater degree of transparency could not be achieved right now.

Thank you. I would be happy to answer any questions you may have.

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[4] John B. Taylor (2008), "The Costs and Benefits of Deviating from the Systematic Component of Monetary Policy," Keynote Address at the Federal Reserve Bank of San Francisco Conference on Monetary Policy and Asset Markets, February 22, 2008

[5] Paul McCulley and Ramin Toloui (2008) "Chasing the Neutral Rate Down: Financial Conditions, Monetary Policy, and the Taylor Rule," Global Central Bank Focus Pacific Investment Management Company (PIMCO), February 21, 2008