

Monetary Policy and the Maginot Line

**(With Reference to Jonathan Swift, Neil Irwin,
Shakespeare's Portia, Duck Hunting,
the Virtues of Nuisance and Paul Volcker)**

Monetary Policy: Debate, Dissent and Discussion with Richard Fisher
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The views expressed are my own and do not necessarily reflect official positions of the Federal Reserve System.

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Thank you Willow [Bay]. Willow is more than an accomplished journalist. She is a hallowed figure in our family for having introduced my son Miles to his wife, Lucy. So, above and beyond Willow's remarkable formal credentials, I am beholden to her. Her kind invitation to return to LA and the University of Southern California today was a command, and I snapped to it!

Let me cut to the chase: I am increasingly concerned about the risks of our current monetary policy. In a nutshell, my concerns are as follows:

First, I believe we are experiencing financial excess that is of our own making. When money is dirt cheap and ubiquitous, it is in the nature of financial operators to reach for yield. There is a lot of talk about "macroprudential supervision" as a way to prevent financial excess from creating financial instability. My view is that it has significant utility but is not a sufficient preventative. Macroprudential supervision is something of a Maginot Line: It can be circumvented. Relying upon it to prevent financial instability provides an artificial sense of confidence.

Second, I believe we are at risk of doing what the Fed has too often done: overstaying our welcome by staying too loose too long. We did a good job in staving off the deflationary and depression risks that were present in the aftermath of the 2007–09 financial crisis. We now risk falling into the trap of fighting the last war rather than the present challenge. The economy is reaching our desired destination faster than we imagined.

Third, should we overstay our welcome, we risk not only doing damage to the economy but also being viewed as politically pliant.

The Rub

Willow, to put all this in context, I was uncomfortable with QE3, the program whereby we committed to a sustained purchase of \$85 billion per month of longer-term U.S. Treasury bonds and mortgage-backed securities (MBS). I considered QE3 to be overkill at the time, as our balance sheet had already expanded from \$900 billion to \$2 trillion by the time we launched it, and financial markets had begun to lift off their bottom. I said so publicly and I argued accordingly in the inner temple of the Fed, the Federal Open Market Committee (FOMC), where we determine monetary policy for the nation. I lost that argument. My learned colleagues felt the need to buy protection from what they feared was a risk of deflation and a further downturn in the economy. I accepted as a consolation prize the agreement, finally reached last December, to

taper in graduated steps our large-scale asset purchases of Treasuries and MBS from \$85 billion a month to zero this coming October. I said so publicly at the very beginning of this year in my capacity as a voting member of the FOMC. As we have been proceeding along these lines, I have not felt the compulsion to say much, or cast a dissenting vote.

However, given the rapidly improving employment picture, developments on the inflationary front, and my own background as a banker and investment and hedge fund manager, I am finding myself increasingly at odds with some of my respected colleagues at the policy table of the Federal Reserve as well as with the thinking of many notable economists.

Here is the rub as I see it: The Fed as the nation's monetary authority has been running a hyper-accommodative monetary policy in order to lift the economy out of the doldrums and counteract a possible deflationary spiral. Starting six years ago, we embarked on a path to make money costless and abundantly available. We did so in several stages that are by now well known, culminating by shifting into high gear with the aforementioned QE3 program whereby we have since more than doubled the Fed's balance sheet to \$4.5 trillion.

Previously, we influenced financial markets and the economy by managing the federal funds rate, the overnight rate that anchors the yield curve. Presently, 75 percent of Federal Reserve-held loans and securities have remaining maturities in excess of five years, and we own roughly 40 percent of the stock of U.S. Treasury bonds and a similar proportion of MBS. This is an unprecedented profile for the portfolio of the keeper of the watch for the global financial system.

When we buy a Treasury note or bond or an MBS, we pay for it with reserves we create. This injects liquidity into the economy. This liquidity can be used by financial intermediaries to lend to businesses to invest in job-creating capital expansion or by investors to finance the repairing of balance sheets at cheaper cost or on better terms, or for myriad other uses, including feeding speculative flows into financial markets.

Much of what we have paid out to purchase Treasuries and MBS has been put back to the Fed in the form of excess reserves deposited at the Federal Reserve Banks, such as the Dallas Fed. As of July 9, \$2.517 trillion of excess reserves were parked on the 12 Fed Banks' balance sheets, while depository institutions wait to find eager and worthy borrowers to lend to.

But with low interest rates and abundant availability of credit in the nondepository market, the bond markets and other trading markets have spawned an abundance of speculative activity. There is no greater gift to a financial market operator—or anyone, for that matter—than free and abundant money. It reduces the cost of taking risk. But it also burns a hole in the proverbial pocket. It enhances the appeal of things that might not otherwise look so comely. I have likened the effect to that of strapping on what students here at USC and campuses elsewhere call “beer goggles.” This phenomenon occurs when alcohol renders alluring what might otherwise appear

less clever or attractive. And this is, indeed, what has happened to stocks and bonds and other financial investments as a result of the free-flowing liquidity we at the Fed have poured down the throat of the economy.

Lessons from Swift and Irwin

At the Fed, as with any great university like USC, there is a culture of citing serious academic studies to document one's thesis (especially if you are the lead or coauthor of the study!). You needn't be an academic economist, however, to understand the danger of too much money. A student of literature can cite Jonathan Swift and his "Poems," written in 1735:

*Money, the life-blood of the nation,
Corrupts and stagnates in the veins,
Unless a proper circulation
Its motion and its heat maintains.*

As evidenced by the buildup in excess bank reserves, the money we have printed has not been as properly circulated as we had hoped. Too much of it has gone toward corrupting or, more appropriately stated, corrosive speculation.

To get a sense of some of the effects of excess liquidity, you need look no further than Neil Irwin's front-page, above-the-fold article in the July 8 issue of the *New York Times*, titled "From Stocks to Farmland, All's Booming, or Bubbling." "Welcome to ... the Everything Bubble," it reads. "Around the world, nearly every asset class is expensive by historical standards. Stocks and bonds; emerging markets and advanced economies; urban office towers and Iowa farmland; you name it, and it is trading at prices that are high by historical standards relative to fundamentals." Irwin's comments bear heeding, although it may be difficult to disentangle how much these lofty valuations are distorted by the historically low "risk-free" interest rate that underpins all financial asset valuations that we at the Fed have engineered.

I spoke of this early in January, referencing various indicia of the effects on financial markets of "the intoxicating brew we (at the Fed) have been pouring." In another speech, in March, I said that "market distortions and acting on bad incentives are becoming more pervasive" and noted that "we must monitor these indicators very carefully so as to ensure that the ghost of 'irrational exuberance' does not haunt us again." Then again in April, in a speech in Hong Kong, I listed the following as possible signs of exuberance getting wilder still:

- The price-to-earnings, or P/E, ratio for stocks was among the highest decile of reported values since 1881;
- The market capitalization of U.S. stocks as a fraction of our economic output was at its highest since the record set in 2000;
- Margin debt was setting historic highs;

- Junk-bond yields were nearing record lows, and the spread between them and investment-grade yields, which were also near record low nominal levels, were ultra-narrow;
- Covenant-lite lending was enjoying a dramatic renaissance;
- The price of collectibles, always a sign of too much money chasing too few good investments, was arching skyward.

I concluded then that “the former funds manager in me sees these as yellow lights. The central banker in me is reminded of the mandate to safeguard financial stability.”¹

Since then, the valuation of a broad swath of financial assets has become even richer, or perhaps more accurately stated, more careless. It is worrisome, for example, that covenant-lite lending has continued its meteoric revival and has even surpassed its 2007 highs.

Macroprudential Supervision: A Maginot Line?

There are some who believe that “macroprudential supervision” will safeguard us from financial instability. I am more skeptical. Such supervision entails the vigilant monitoring of capital and liquidity ratios, tighter restrictions on bank practices and subjecting banks to stress tests. Although these macroprudential disciplines are important steps in reducing systemic risk, I also think it is important to remember that this is not your grandparents’ financial system. The Federal Reserve and the banking supervisory authorities used to oversee the majority of the credit system by regulating depository institutions; now, depository institutions account for no more than 20 percent of the credit markets. So, yes, we have appropriately tightened the screws on the depository institutions. But there is a legitimate question as to whether these safeguards represent no more than a financial Maginot Line, providing us with an artificial sense of confidence.

If you look up “Maginot Line” in Wikipedia—the source of most of the world’s conventional wisdom—it notes that “... experts extolled the Maginot line as a work of genius.” It did prevent Germany from leading a direct attack on France during World War II. But it was ultimately ineffective as the Germans outflanked it through neighboring Belgium. “Genius” proved insufficient to thwart a determined force. Thus, the term “Maginot Line” is commonly used to connote a strategy that clever people hoped would prove effective, but instead fails to do the job.

With this in mind, and given that our direct supervisory authority covers roughly only a fifth of the credit system, the Dodd–Frank legislation called for the creation of the Financial Stability Oversight Council (FSOC). This committee composed of members from the Fed and other regulatory authorities is tasked with identifying and monitoring risks posed by so-called systemically important financial institutions. These financial institutions—banks and nonbanks alike—are better known as “SIFIs,” an acronym that appropriately sounds like something you

might get from wanton behavior. Just last week, Fed Vice Chair Stan Fischer spoke of the need to fortify the FSOC process. I agree with him that this is a sensible thing to do.

And yet one has to consider the root cause of the “Everything Boom.” I believe the root cause is the hyper-accommodative monetary policy of the Federal Reserve and other central banks. This was recently written about and documented at length in the annual report of the Bank for International Settlements, a report I highly recommend to you.² The Fed and other central banks have been the catalysts for a search for yield. Markets discount risk liberally if they are under the spell of a presumed central bank “put” that will diminish the risk of loss. They will continually seek a financial Belgium or some other venue to bypass the protective wall that macro-financial supervision and oversight bodies such as the FSOC are believed to represent, however fortified.

An Adjustment to the Stance of Monetary Policy

I am not alone in worrying about this. In her recent lecture at the International Monetary Fund, Fed Chair Janet Yellen said, “I am also mindful of the potential for low interest rates to heighten the incentives of financial market participants to reach for yield and take on risk, and of the limits of macroprudential measures to address these and other financial stability concerns,” adding that “[a]ccordingly, there may be times when an adjustment in monetary policy may be appropriate to ameliorate emerging risks to financial stability.”

Here is the message: At some point you cross the line from reviving markets to becoming the bellows fanning the flames of the “Booming and Bubbling” that Neil Irwin writes about. I believe we have crossed that line. I believe we need an adjustment to the stance of monetary policy.

Our duty as the nation’s central bank is not to engineer a “put” to the markets. Our duty is mandated by Congress and the amendments it made under the Federal Reserve Act in 1977. Specifically, the amended act states: “The Board of Governors of the Federal Reserve System and the FOMC shall maintain long run growth of the monetary and credit aggregates commensurate with the economy’s long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices and moderate long-term interest rates.”

Take It from Shakespeare’s Portia

In my opinion, we have certainly taken liberty with the definition of “moderate interest rates.” The Oxford English Dictionary defines “moderate” as “avoiding extremes.” And, aptly, it cites among the first uses of the adjective “moderate” Portia’s monologue in Shakespeare’s *Merchant of Venice*: “O love be moderate, allay thy ecstasy. In measure rain thy joy. Scant this excess. I feel too much thy blessing. Make it less. For fear I surfeit.”³

“Joy,” “ecstasy,” “excess,” “surfeit,” “too much”: These words are certainly descriptive of the current status of the credit, equity and other trading markets that have felt the blessing of near-zero cost of funds and the abundant rain of money made possible by the Fed and other central banks that have followed in our footsteps.

Some are willing to tolerate the consequences of the blessings that the Fed poured upon the financial markets because, in their view, we have yet to close in on the other parts of our mandate, to wit: “promot[ing] effectively the goals of maximum employment and stable prices.” So where do we stand on those two fronts? Answer: closer than many think.

I will be arguing at the upcoming FOMC meetings that while it is difficult to define “maximum employment,” labor-market conditions are improving smartly, quicker than the principals of the FOMC expected. The commonly cited household survey unemployment rate has arrived at 6.1 percent a full six months ahead of the schedule predicted only four weeks ago by the central tendency of the forecasts of FOMC participants. The most recent data indicate that nonfarm employment surprised to the upside, increasing by 288,000 in June, and prior months’ increases were revised upward. The U.S. Bureau of Labor Statistics’ so-called JOLTS (Job Openings and Labor Turnover Survey) data indicate that job openings are trending sharply higher, while “quits” as a percentage of total separations continue to trend upward—a sign that workers are confident of finding new and better opportunities if they leave their current positions.

And there are areas where jobs are going unfilled. If you had opened the July 8 edition of the *Wall Street Journal* to page A2, you would have seen an eye-catching headline: “Help Wanted: In Truck Cabs.” This article noted that not only are we presently short 30,000 long-distance truck drivers who earn an average annual pay of \$49,540, but also that “[b]usinesses with openings across the pay and education spectrum are struggling to hire house cleaners, registered nurses, engineers, software developers and other workers.”

Both statistically and anecdotally, we are now getting a consistent message from a variety of sources that the labor market, broadly considered—and not just in booming regional economies like Texas’—is tightening. The employment gap is closing faster than most forecasters foresaw.

It should come as no surprise that wages are beginning to lift. For example, median usual weekly earnings collected as part of the Current Population Survey are now growing at a rate of 3 percent, roughly their precrisis average. The latest survey of the National Federation of Independent Business, released last week, shows the net percentage of small firms planning to raise wages is up sharply over the past year. In short, the key variable of the price of labor, which the FOMC feared was stagnant, appears to have taken on life and is beginning to turn upward. It is not doing so dramatically. But the relationship between the unemployment rate and wage growth is nonlinear, so that as the unemployment rate falls, the incremental impact on wage growth accelerates. And wage growth is an important driver of inflation.

The FOMC has a medium-term inflation target of 2 percent as measured by the personal consumption expenditures (PCE) price index. It is noteworthy that the 12-month consumer price index (CPI), the Cleveland Fed's median CPI, and the so-called sticky CPI calculated by the Atlanta Fed have all crossed 2 percent, and the Dallas Fed's Trimmed Mean PCE inflation rate has headline inflation averaging 1.7 percent on a 12-month basis, up from 1.3 percent only a few months ago.⁴ PCE inflation is clearly rising toward our 2 percent goal more quickly than the FOMC imagined.

I want to be clear on this: I do not believe there is reason to panic on the price front. Just as I did not worry when price increases were running below 2 percent, I am willing to tolerate temporarily overshooting the 2 percent level in the case of supply shocks, as long as inflation expectations are firmly anchored. But given that the inflation rate has been accelerating organically, I don't believe there is room for complacency.

Lessons from Duck Hunting

One has to bear in mind that monetary policy has to lead economic developments. Monetary policy is a bit like duck hunting. If you want to bag a mallard, you don't aim where the bird is at present, you aim ahead of its flight pattern. To me, the flight pattern of the economy is clearly toward increasing employment and inflation that will sooner than expected pierce through the tolerance level of 2 percent.

Some economists have argued that we should accept overshooting our 2 percent inflation target if it results in a lower unemployment rate. Or a more fulsome one as measured by participation in the employment pool or the duration of unemployment. They submit that we can always tighten policy ex post to bring down inflation once this has occurred.

I would remind them that June's unemployment rate of 6.1 percent was not a result of a fall in the participation rate and that the median duration of unemployment has been declining. I would remind them, also, that monetary policy is unable to erase structural unemployment caused by skills mismatches or educational shortfalls. More critically, I would remind them of the asymmetry of the economic risks around full employment. The notion that "we can always tighten" if it turns out that the economy is stronger than we thought it would be or that we've overshot full employment is dangerous. Tightening monetary policy once we have pushed past sustainable capacity limits has almost always resulted in recession, the last thing we need in the aftermath of the crisis we have just suffered.

Diluting the Punch from 108 Proof

So, what to do?

One might posit that by tapering our large-scale asset purchases with an eye to eliminating them in October, we have begun advance targeting with an eye to living up to our congressional

mandate. My sense is that ending our large-scale asset purchases this fall, however, will not be enough.

Many financial pundits protest that weaning the markets of über-accommodation, however gradually, risks wreaking havoc, so dependent on central bank largess have the markets become. As a former market operator, I am well aware of this risk. As I have said repeatedly, a bourbon addict doesn't go from Wild Turkey to cold turkey overnight. But even if we stop adding to the potency of the financial punchbowl by finally ending our large-scale asset purchases in October, the punch is still 108 proof.⁵ It remains intoxicating stuff.

I believe the time to dilute the punch is close upon us. The FOMC could take two steps to accomplish this after ending our large-scale asset purchases.

First, in October, we could begin tapering our reinvestment of maturing securities and begin incrementally shrinking our portfolio. I do not think this would have significant impact on the economy. Some might worry that paring our reinvestment in MBS might hurt the housing market. But I believe the demand for housing is sufficiently robust to continue improving despite a small rise in mortgage rates. The economy is improving. An acceleration of income growth that will result will likely buttress a recovery in housing and compensate for the loss of momentum that occurred during the winter freeze. (As a sidebar, I note that according to the National Association of Realtors, overseas buyers and new immigrants accounted for \$92 billion, or 7 percent, worth of home purchases in the U.S. in the 12 months ended in March, with one-fourth of those purchases coming from Chinese buyers. As Californians, you might find it of interest that Los Angeles was the top destination for real estate searches from China on realtor.com; San Francisco was second; Irvine was third.⁶)

Importantly, I think that reducing our reinvestment of proceeds from maturing securities would be a good first step for the markets to more gently begin discounting the inevitable second step: that early next year, or potentially sooner depending on the pace of economic improvement, the FOMC may well begin to raise interest rates in gradual increments, finally beginning the process of policy normalization.

Protecting the Fed as a Political Nuisance

I mentioned at the onset that I think it imperative that the Fed be wary of giving rise to concerns that we will be politically pliant. I'll conclude with some comments on this, especially since congressional hearings are currently underway to consider structural changes that might be called for on the occasion of the Fed's 100th anniversary.

A little history helps put current events in perspective. When the German Reichsbank was formed in 1871, German Chancellor Otto von Bismarck was reportedly taken aside by his most trusted adviser, Gerson Bleichröder, and warned "... that there would be occasions when

political considerations would have to override purely economic judgments and at such times too [politically] independent a central bank would be a nuisance.”⁷

It is no small wonder that the political considerations of the First World War and the impulse to override what might have been the purely economic judgments of Germany’s central bank led to the hyperinflation of the Weimar Republic and the utter destruction of the German economy.

At great personal risk, former Fed Chair Paul Volcker made clear that the Federal Reserve would not bequeath a similar destiny to the United States. Those of us who are the current trustees of the Fed’s reputation—the FOMC—must be especially careful that nothing we do appears to be politically motivated. In nourishing growth of the economy and employment, we must avoid erring on the side of coddling inflation to compensate for the inability of fiscal and regulatory policymakers in the legislative and executive branches to do their job. We must not flinch from insisting that our work is best done in a deliberate manner and never, ever for the sake of satisfying the voyeurism of the media or politicians. We must all, Federal Reserve principals and staff, and ordinary citizens alike, continue to protect the independence of the Fed and its ability to be a political nuisance.

And now, Willow, in the best tradition of central banking, I will do my best to avoid answering any questions you and the audience might have.

Thank you.

Notes

¹ See “Beer Goggles, Monetary Camels, the Eye of the Needle and the First Law of Holes (With Reference to Peter Boockvar, the Book of Matthew, Sherlock Holmes, ‘The Wolf of Wall Street’ and Denis Healey),” speech by Richard W. Fisher, Jan. 14, 2014; “¡Ándale Pues! Having Made the Tough Choices, Mexico Stands to Benefit from Reforms and Navigate Fed’s Tapering with Relative Ease,” speech by Richard W. Fisher, March 5, 2014; and “Forward Guidance (With Reference to Monty Python, Odysseus, Apollo, Paul Fisher, Deng Xiaoping and Mario Draghi’s Old Man),” speech by Richard W. Fisher, April 4, 2014, www.dallasfed.org/news/speeches/fisher/index.cfm.

² “84th Bank for International Settlements Annual Report, 2013/2014,” June 29, 2014, www.bis.org/publ/arpdf/ar2014e.htm.

³ *Merchant of Venice*, by William Shakespeare, Act 3, Scene 2.

⁴ The 12-month trimmed mean rate stands at 1.7 percent as of May, up from 1.3 percent as recently as March.

⁵ Wild Turkey Rare Breed is 108 proof.

⁶ “Southland Homes Draw Foreign Cash,” by Tim Logan, *Los Angeles Times*, July 9, 2014, www.latimes.com/business/la-fi-foreign-home-buyers--20140709-story.html.

⁷ *Lords of Finance: The Bankers Who Broke the World*, by Liaquat Ahamed, New York: Penguin, 2009, p. 88.