Session 5
A conversation on US monetary policy: Forward Guidance- Fad or the Future of Monetary Policy?

Keynote Speaker: President Richard Fisher (Federal Reserve Bank of Dallas)

Chair: Prof Ron Anderson (LSE)

Discussant: Prof. Jean-Pierre Zigrand (LSE)

Richard Fisher

I was very impressed to hear the Chancellor, excuse me, the provost, speak of Janet Yellen and Mervyn King and the distinguished people that began their academic careers here. My exposure to LSE was a little bit different. As Ron just said I went to Oxford. I graduated from Harvard in 1971 and came straight here. And I came to the LSE frequently because we missed the demonstrations that we used to have, and there were none at Oxford. The Oxford Union didn't quite do it for us. And I will tell you that my wife, who I met at Oxford, and I came here to engage in political activity. We occupied the Chancellor's office for example because it was great fun. When I told her that I would be a keynote speaker at the LSE and I would be wearing a suit rather than the way I was dressed before, and that people would listen carefully to what I was going to say, hopefully, I asked her, and this is literally the conversation:

"Nancy, in your wildest dreams did you ever think that I would be a keynote speaker at LSE?"

Do you know what her answer was? "Richard, we have been married 40 years, you do not appear in my wildest dreams."

Great humbling experience.

So the topic is forward guidance, it is the subject de jour of central bankers. We've seen it popularised by the Bank of England and of course on my side of the pond by the Federal Reserve, and we are embarking on this after having run a very hard course, a strong course of quantitative easing. I thought Governor Kuroda, a dear friend of mine and former trade colleague of mine, covered much of it and I think also Ron's questions were quite good but I do want to address the subject. I think it's timely. By the way, the February issue of *The Economist* described forward guidance as "the latest monetary fad" and the *Financial Times* as Clare Jones in a blog of March 9th, I believe it was, did exactly the same thing. Now a philologist, a study of words, would consider this a most interesting description. The Oxford English Dictionary traces the word "fad" back to the sermons of the second Bishop of Manchester, James Fraser, and then to Trollope's *Chronicles of Barset.* Here's how it defines a fad, "a crotchety rule of action, a peculiar notion as to the right way of doing something, a pet project especially of social or political reform to which exaggerated importance is attributed." In a wider sense a crotchet, hobby, craze perhaps most aptly by the way given that I serve on the Federal Open Market Committee chaired for the first time in its history by a woman, Janet Yellen. The OED cites Trollope's original use in this following sentence, "She may take up another fad now".

So is forward guidance a crotchet? By the way, further defined by the OED as a fanciful device to which exaggerated importance is attributed. Have we at the Open Market Committee just taken up another fad? Or is this a real lasting phenomenon? And I just want to address that in a short manner today and then open myself up to your questions.

In essence what we have done is we have exhausted the efficacy of our quantitative easing. Again I won't compare myself to the Bank of Japan or our body to the Bank of Japan, nor to any other central bank; we are all at different stages of this exercise. But we have added massively to our balance sheet. You all know that it exceeds 4 trillion US dollars, previous to the crisis we were slightly under 900 billion. The way this has manifest itself is that we've seen a huge build up in the reserves of the depositary institutions of the United States. Only 30% of the financial assets in our country are in the hands of depositary institutions. They have accumulated on our balance sheet and in their own reserves and their own balance sheets. Or deposited in terms of excess reserves for which we pay 25 basis points per annum at the 12 Federal Reserve banks including mine, a total of 2.75 trillion dollars. That's up from 64 billion as the norm before the crisis. So that's been a huge multiple of accumulation and therefore we have a monetary base which is stout and rich and full and deep, and the issue really is now the next phase of transforming from that to anchoring the base interest rate.

I mentioned the build up in reserves because clearly we're yet to see it activated or see velocity pick up such that it transfers itself into the job creation that we, as uniquely in a central banking role having dual mandate, are responsible for assisting. Not only must we maintain price stability and move towards the 2% target, which was mentioned by Governor Kuroda, but we also have the responsibility to conduct monetary policy in a way that engenders full employment over the intermediate term.

So this really is the issue for us presently. We had lunch today at the Waldorf Hotel. It's convenient to me that in 1926 Winston Churchill spoke in the room in which we had lunch and here's what he said:

"In finance everything that is agreeable is unsound and everything that is sound is disagreeable."

It appears to me that the reaction to the statement we issued 2 days ago and the summary provided by our chair person, Janet Yellen, was less anxious than that which we engendered a year ago, in the spring, when we first voiced this transition and the possibility of its existence. But nonetheless I understand why it would be considered disagreeable, even if it is sound, by some market operators and on this I pull no punches. It's my firm belief that we have made the life of money market operators quite easy because we have taken volatility out of the market place. When you move in one direction it's pretty easy then for people to assume that, that direction will be continued forever. And again we are at a different stage than the previous speaker in terms of our management.

But basically where we are right now, when I talk about efficacy, is that we have with quantitative easing, whether it is the total amount we have done or the amount that we did before we embarked on the third leg of that quantitative easing, is we have enriched the balance sheets of the private sector. Kuroda mentioned that the private sector was doing quite well in Japan and I don't know if he gave the number in his speech but if my memory is correct, it roughly grew by about 3% last year. We estimate that our private sector grew at about 4 % last year but was held back by fiscal drag and also by weaker external account, so that our numbers were substandard in terms of total GDP growth.

In essence what we have done is we have enabled corporations to become muscular financially, to rebalance their balance sheet and to be prepared to create jobs. But they haven't done so yet and the question is: what is the incentive that we're providing? We've driven down nominal rates to historic records. For a short while we had the lowest interest rates in 237 years of American history. They have come up somewhat but nonetheless they're still quite attractive and we are seeing, in my opinion, some exhibitions of excess of risk and I've spoken of these publicly. First of all if you look at stock market capitalisation relative to overall GDP, if you look at the bull-bear spread and if you look at margin accounts being now at an historic high. But most importantly if you look at the credit markets, which is what I find to be the most important tool for us to assess the efficacy of what we do. And we see extraordinarily low interest rates on a nominal basis as I mentioned, but also other activity which raises at least one eyebrow, if not leads one to conclude that we might be stirring the waters a little bit too richly. And I'll point specifically in this instance to the spread between junk, triple C credits, historically low or near historic lows, but most importantly on top of extremely low investment radials.

So basically what we have done is by driving down yields to that extent, investment grade corporate yields have been lower than at the S & P 500 Forward earnings. Net provides an arbitrage incentive for corporations to issue bonds and then use the proceeds not to expand Capex, particularly job creating Capex, but instead to buy back shares and to engineer their bottom lines on an earnings per share basis, such that their stocks keep appreciating including dividend pay-outs, but this is not the original intention although it's an understandable by-product and a benefit of quantitative easing. At any rate it has been the majority of the decision; in fact it's been unanimous in the Open Market Committee, both hawks and doves, a distinction I should add parenthetically I don't like. Pigeons come from the same family as doves. None of us are pigeons, and I like to think of ourselves as wise owls rather than hawks or doves. But obviously, unanimously, we took a decision three meetings ago to begin paring back the amount that we would buy. We have now gone from 85 billion a month and expanding our balance sheet in buying treasuries, of which we now own 40% of the stock of treasuries and 30% of the stock mortgage backed securities. And we are close to buying 100% of gross issuance of mortgage back securities, to 55 billion per month. And that is unanimously agreed to in the Committee. The difficult part here is now the way that we express our transition to anchoring the base rate and how we basically provide the guidance of what we will do going forward.

Now I am looking at my Blackberry here because I had an interesting discussion with Paul Fisher about this yesterday at the Bank of England, and you may remember that Mr Chris

Giles of *The Financial Times* devoted a substantial amount of attention to the discussion of forward guidance and here is the entry from October 2nd 2013 and I am quoting Chris Giles:

"Forget triggers, thresholds, lockouts and long list of conditions. Paul Fisher Bank of England's Head of Market says: everyone is wrong to think forward guidance is complicated. The policy was summarised in a simple sentence of the Bank of England's explanatory document he said in a speech today."

This is the sentence and I'm quoting Giles quoting Paul:

"In essence, the MPC judges that until the margin of flack within the economy has narrowed significantly it will be appropriate to maintain the current exceptionally stimulative stance of monetary policy, provided that such an approach remains consistent with its primary objective of price stability and is not in danger of financial stability."

Giles then goes on to write:

"Apart from the grammar and superfluous words I am sure we can all do better than that. My translation, [Giles's translation of this sentence] would be the MPC will let the recovery run for as long as it can."

And then he writes:

"I am sure others will have better, more elegant and more accurate sentences. All thoughts gratefully retrieved and received here."

And he gives his email address and then later that day he announced the winner of the contest on Twitter. Forward guidance in one sentence is "We'll see". I think that's pretty accurate. We are all aiming for the same objective and that is whether it is the Bank of Japan or the Federal Reserve Bank of the United States or the Bank of England. We're all seeking to make sure that we have a sustained recovery and we will conduct monetary policy accordingly.

It is in the nature of anybody who follows economics, and particularly given the mathematisation of economics that has occurred over time and econometrics, and of course those who build models for profit or for academic interest, to want to have as much specificity as possible. But basically what we have done is we have de-quantified our guidance and are seeking to provide qualitative indicators of how we might proceed. And I guess I would, as a member of the Open Market Committee, again only speaking for myself, ask for your forbearance on that front because by its very nature qualitative guidance will be a little bit sloppy. People look to us for exact precision and I know Governor Kuroda just as we do, we all have models. We struggle with models, models of real time history. Data is history. We're trying to move forward in unexplored territory. We've taken a revolutionary approach to monetary policy. We're not alone, we're altogether in this. And what we're trying to do now is articulate to the best possibility we can, what happens after we finish our massive quantitative easing.

You are at a different stage than we are; we are close to the end of that. If you did the numbers, as Janet Yellen said in her press conference the other day, it's pretty clear that by

October, if we continue at this pace of reducing by 10 billion per meeting, then our large scale asset purchases will be terminated. Then the question is lift off. And by the way I'm one of the dots. The Dots were a singing group in the 1950s, I remember them very well, and I marvel at the obsession with the dots from our extrapolation exercise that we provide. And let me provide some clarity here because there are questions of her at that press conference. Each of us is asked to give a forecast on "our assumptions about the conduct of monetary policy" at year end each year. And what happened was by virtue of the change of the composition of the voting structure, remember the Presidents rotate their votes into the committee, and I'm voting this year. We moved up by 25 basis points- the end of 2015 expectation- and for 2016 and the longer term, by 50 basis points, and somehow this was read as a massive shift in the expectations of the committee. These are our best guesses at best. Whether we refer to our models like Fervis which is a great economic model or the Dallas Feds model or other models, these are expectations for year end. I am fascinated by the fact there is a fixation if not a fetish on the dots. In fact there is a market in dots, you may not know that. So this effort to be more transparent complicates the business of qualitative forward guidance and the reality is that you cannot quantify with specificity what's likely to happen several years hence. Nobody has that capacity, not even Nostradamus would have been a good member of the Federal Open Market Committee.

So that's where we are, we'll see. Deng Xiaoping had an apt description "we will cross the river by feeling the stones." We feel the stones with the bottom of our feet, the central bankers, and I know that you demand, whether it's Governor Kuroda, whether it's Mark Carney or whether it's the Federal Reserve of the United States, as much specificity as you can because you want as much certainty as is possible. And we will endeavour to articulate that in the best way we possibly can but you cannot expect specific quantitative guidance without mistakes being made. And then our reputation is put at risk because we issued a forecast that people find, couldn't quite be lived up to because of the changes in conditions.

So I want to come back basically to that basic conclusion, it was articulated by Mr Giles in the FT based on Paul Fisher's comments, "We'll see". Thank you very much.

In the tradition of great central banking I would now be very happy to avoid answering any questions you have.