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A Fed Retrospective

Al Broaddus, until recently Chairman of the Richmond Federal Reserve Bank, tackles the bond market, inflation targeting, and Chinese capital flows. A TIE *exclusive interview.*

J. Alfred Broaddus, Jr., *was Chairman of the Federal Reserve Bank of Richmond from 1993 to 2004.*

TIE: How do you compare the challenges facing the Fed today with those when you first became president of the Federal Reserve Bank of Richmond? Has much changed?

Broaddus: It has changed in two ways. When I first took over as president of the Richmond bank at the beginning of 1993, the Fed had not yet achieved price stability although it had made significant progress. Price stability remained a longer-term challenge. Now, however, I think it has established strong credibility for ensuring price stability, both on the upside and the downside. That was not the case earlier. The challenge now is to maintain rather than to attain price stability.

The other difference is that in early 1993 nobody had any thought of the possibility of deflation or what sometimes we euphemistically describe as excessive disinflation. Of course, over the last several years we've had to cope with that risk. We're past the immediate threat of deflation at this stage of the game. But when you have an inflation rate as low as the United States does now—despite the recent run-up in fuel prices—and given the roughly half-percentage-point upward bias in our inflation measures, then we need to be aware of the risk to inflation in both directions.

TIE: That's a good point. Given that the Fed is in this "maintain" mode now, do you see the transmission mechanism for monetary policy differently today than before? How does monetary policy work its way into the system now, and has that changed?

Broaddus: If you look at parameters and coefficients in a formal macro model, you may see some changes in some of the coefficients, but the basic overall structure is still pretty much in place. I think about it in two stages. In terms of real effects, monetary policy operates to a large extent through interest rates. If you look at the yield curve, the Fed directly affects the funds rate and—via expectations of its near-term

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policy actions—the short end of the curve. But our actions and our credibility also have a significant effect on the longer end of the curve. As far as inflation is concerned, I have enough monetarist blood in my veins to believe that this is largely determined by the rate at which we are supplying money. While we can't very effectively target the monetary aggregates any more, that's an underlying relationship that we need to at least keep track of as we conduct policy in the short run.

TIE: What do you make of what's going on with the long bond? It's interesting that the Fed has taken four tightening moves but the long bond yields have gone down at every stage. We've never seen this kind of flattening going on at the front end of a tightening cycle. What do you make of that?

Broaddus: That's a puzzle, but I don't see as much of a puzzle as some. This is the first early stage of a tightening cycle in decades where the United States has not had an underlying inflation problem. The Fed has significant credibility on price stability and that's bound to be one factor at work. The other is that the inflation rate is very low now, and in many market segments expectations of intermediate-term inflation and probably longer-term inflation are still quite low. I agree that it is an unusual circumstance. While there's still a lot of downside risk in the outlook, the data still suggests that the recovery is pretty healthy, especially with the strong October jobs report. So it's interesting that we haven't seen a little more of an uptick in real rates as we go out further on the curve.

TIE: Have you ever heard the theoretical argument set forth that in fact there was no 2000–01 recession? What we saw three or four years ago was essentially the dot-com and telecommunications bubbles being burst? Thus, unlike normally at the end of a recession where badly hit consumers show huge pent-up demand, consumers actually did fine this time. Consumers have already bought everything they can conceivably buy, so to induce them to buy further, retailers must offer large discounts and companies have very little pricing power. Therefore, the economy is really just in the middle to later stages of an ongoing expansion. Although we had a brief period of large monetary and fiscal policy stimulus post-9/11, a 3.5 percent growth rate is probably what you would expect right now in the latter stages of an expansion. By not overreacting, the Fed's policy of a short-term rate around 2 percent and a long rate around 4 percent is fairly reasonable, a 200-basis-point differential. What do you think of such a notion to explain the performance of the long end?

Broaddus: To answer your first question, I wouldn't rule out something like that as part of the explanation. The 2001 recession obviously had a very different profile from other post-World War II recessions. Whether it should be called a recession or not I don't know. The NBER committee called it a recession although it was obviously a pretty mild one.

But in terms of understanding why bond rates have remained so low, I would go back to the answer I gave earlier as a bit more convincing explanation than the scenario that you described, although I couldn't rule it out. I made the point that some of the recent data looked pretty firm, but I don't want to overstate that. We still have an output gap. There is still significant downside risk in the economy in some areas. I don't expect a near-term recession but it's quite possible that we'll see moderate growth and close that gap slowly. So that may be consistent with both your scenario and the one I laid out earlier.

TIE: Do you see the economy continuing in this kind of pattern over the next year? How do you see things going forward?

Broaddus: Honestly, there are downside risks still in the outlook and we all know what they are. Barring a major

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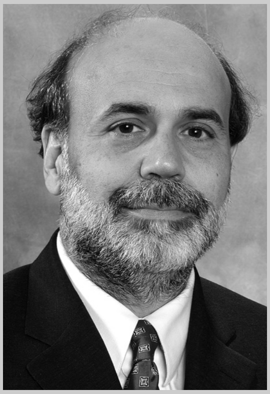

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negative shock to the economy, I'm reasonably optimistic that we will continue to close the output gap and that the economy will remain on an upward trajectory over the remainder of this year and next year. The fiscal stimulus may be waning now and of course the partial-expensing tax incentive for business ends this year, but monetary policy is still quite stimulative, real interest rates are still low, and that's going to undergird continued reasonably strong growth. We keep being told that the housing sector is going to weaken but we haven't really seen that. Investment is volatile. Business investment and equipment has a lot of noise in it in the short run but it's been on a good upward trend. One thing that's important is the potential for further growth in productivity. There's a lot of cyclical movement in productivity growth in the near term and we may see some reduction in the quarterly numbers, but the underlying trend growth in productivity still seems high, and it may still be rising, which undergirds my own personal optimism.

TIE: Do you have an opinion on where a neutral short-term interest rate is? The Fed rightly is being very cautious. It is historically between 3.5 percent and 5 percent?

Broaddus: That's the range that I carry around in my head. If in fact productivity growth were still reasonably high, that would tend to push the equilibrium rate up. In conducting monetary policy you don't know whether that's the case and you should be cautious. The range that you've mentioned of 3.5 percent to 5 percent—some would say that current circumstances put the lower limit at 3 percent—is a reasonable range and maybe the Fed ought to focus on the bottom of it for the time being since we're not there yet. There's still downside risk in the outlook, and given the fact that measured inflation is still very low I think it's entirely appropriate for the Fed to be cautious in this tightening.

TIE: Our sense is that most people at the Fed see the oil price situation as a contractionary threat. If oil prices stay as high or higher over the next six months, will that feed into the monetary policy discussions?

Broaddus: Well, higher oil prices will certainly get attention both from the standpoint of the implications for inflation going forward and from any impact that they may have on real growth. But as you know, this is not the 1970s. The real price of oil is still well below the peak back in those days and oil-based energy is not as large a part of our input nexus as it was. So while we obviously need to watch trends in this sector, we shouldn't go overboard just on the basis of the nominal price of oil. The one thing that's a little different this time that does need attention is that oil futures prices are not signaling a return to lower fuel prices as was the case in some earlier episodes. We may be moving toward a higher plateau level of these prices and we need to take that into account. But we shouldn't overreact. The real price is still relatively low and Saudi Arabia recently announced that they're going to make some fundamental investments that will increase their longer-term output.

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TIE: What do you think of these discussions about moving to an inflation target? Since the economy appears to be in the range of price stability, are you in favor of moving to some acceptable range as kind of a clear communication device?

Broaddus: I am a strong proponent of inflation targeting. It's been controversial but I'm very much in line with Fed Governor Ben Bernanke and my Richmond Fed colleague Marvin Goodfriend on this point. I don't think that inflation targets will work miracles but they will help to reinforce confidence in the Fed's commitment to price stability. Obviously with inflation targets you would need to work out the operational implications. How quickly and how strongly you react to movements outside of the target range, for example, are details that would have to be decided. But we have the experience elsewhere in the world of the use of inflation targets. They would lock in the Fed's commitment to price stability in the minds of financial market participants and would be very good discipline for the FOMC going forward.

Now that I'm no longer at the Fed, I can be a little more blunt. We currently have a great Chairman who has enormous credibility throughout the country so right now inflation targets aren't needed so strongly. Obviously that situation can't persist forever. Going forward, inflation targets would be a useful addition to our arsenal.

TIE: What do you think are the politics within the Fed on this issue? Do you think inflation targets are conceivable for the Fed to implement by itself or would they need to be externally imposed by Congress?

Broaddus: At this point, implementing inflation targets would be an uphill battle. As everyone knows, there are differing points of view about inflation targets within the FOMC. My sense is that the possibility of instituting inflation targets is getting a little more attention lately. People are willing to listen to arguments in favor of them. But there isn't overwhelming support for them at this stage of the game. Having said that, as much as I favor inflation targets, I don't think it would be healthy for them to be imposed from the outside. Ideally, the Fed would build a consensus internally and then sell targets to the public on their merits.

TIE: The politics seem to work better when there's downside risk, as with the Japanese.

Broaddus: That's a good point. One additional argument for inflation targets is the downside risk. We faced a challenging situation last year when the inflation rate was so low and the Fed funds rate was already at 1 percent. That's the point at which some sort of key signal of the need to move strongly can be useful. The Fed did move strongly in the absence of these targets, but having a target wouldn't have hurt.

TIE: In a situation like that—and such a situation remains possible—it's amazing that so many bond traders and market professionals seem to be acting based on traditional Fed tightening cycles and they don't seem to grasp the fact that when you're around price stability the Fed can't afford a huge preemptive mistake.

We can sense two opinions in the market. Let's assume the Fed funds is at 2 percent, then the move from 1 percent to 2 percent is either a modest development—the taking back of an earlier insurance policy—or else a whopping 100 percent increase in short-term interest rates. If the latter view is correct, it is no wonder the long end is rallying. Do you have a sense—having left the Fed—how you would interpret the move of the Fed funds rate to the current level?

Broaddus: The move to date is a partial reversal of a very strong easing that took place earlier and an appropriate move back towards a more neutral rate. The issue is, where is the neutral rate now? We still see very low inflation, and that combined with the downside risk that still exists in the oil sector may indicate that at least for the time being the neutral rate may be lower than it has been in some other upswing cycles. We are reversing a very accommodating policy. The reversal that needs to take place now may be less than what would be the case if we had more uniformly positive signs throughout the economy.

TIE: There is a sense that ten years ago, 300 basis points of tightening in short rates would definitely do the job of bringing the economy to equilibrium. Four or five years ago, 150 basis points looked like it did the same job. Are we in a situation now where even less tightening could do the job?

Broaddus: The short answer to that would be, "Yes, it might." I don't know. But that's a reasonable speculation.

TIE: How do you assess the Fed's gradual shift toward more transparency over the past few years? They're

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is the potential for further growth

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clearly trying to get it right with communicating to the market but what do you think is the underlying basis for moving in that direction? And do you think they're doing a good job with it?

Broaddus: I like the move toward greater transparency. It's amazing how differently the issue of transparency is viewed from just a decade ago. The rationale for it goes back to your earlier question about the monetary transmission mechanism. We move the funds rate and that affects the short end of the curve, but then expectations of future policy actions and longer-term expectations about the prospects for inflation intermingle to determine rates further out along the yield curve. That mix varies toward more weight on inflation prospects in the longer term. Since so much emphasis is given to expectations either of future policy or inflation, it's desirable that those expectations be as well informed as possible. That's a strong argument for the increase in transparency we have instituted. Whether we have done a perfect job of it is another question. I don't think it's been perfect and most in the Fed System would acknowledge that we're still learning and gaining experience in how to do this right. I frankly think we've done a pretty good job overall. There have been some glitches here and there—including some confusion in the late spring of 2003 in the bond market—and we learned a lot from that and I guess that we will become more adept at communicating what we know without communicating more than we know in the future.

One other point I would make is that the analytical apparatus for understanding how to communicate effectively is getting increased attention by our excellent staff at the Board and elsewhere in the System. Of course, having a Governor like Ben Bernanke who is at the cutting edge of this kind of research and knowledge is a great advantage. I'm optimistic that over time we will do a better job of conducting monetary policy in this environment.

TIE: Shifting a bit, how do you think the international situation fits into the Fed's considerations? Obviously they're going to be looking at how it affects inflation, but is globalization a bigger factor in the Fed's thinking than it used to be?

Broaddus: In my time on the Committee there was always a strong focus on international conditions and their implications for the U.S. economy and for monetary policy. The world economy currently seems to be reasonably strong and growing rapidly reflecting in no small measure the strength in east Asia and in China in particular. To make things concrete, we know that there are both downside and upside risks in the world economy just as there are in the domestic economy. It appears that there may be some slowing in China, and if that slowing becomes more abrupt than is generally anticipated that could have an effect on U.S. exports and some impact on our growth path going forward. The Fed in conducting monetary policy needs to take account of that risk just as we take account of the risk that domestic consumer spending is going to be weakened by rising oil prices. We've been doing that and obviously we will need to continue to do that.

TIE: How do you feel about the current account deficit? So many analysts and policymakers are throwing up red flags as it increases toward the 6.0–6.5 percent range. Do you think the concern is merited or is it overdone?

Broaddus: I'm somewhere in the middle on that, but leaning in the direction of this being overdone. If you looked at a spectrum of all people between those who think the current account deficit is a huge, immediate problem and those who don't think we ought to worry about it, put me toward the direction of the latter. But certainly I think it's a significant issue in that it reflects an imbalance in the domestic U.S. macro economy but also imbalances elsewhere in the world economy. I don't lose sleep at night worrying about a sudden huge capital outflow from the United States given what I think I know about the international economy now. But over time, we clearly need to reduce the risk of that happening and the way to do that is to slowly but surely hack away at the imbalances around the world. Our low savings rate is a big part of that. Obviously. But the inflexibility of the Chinese and some others on foreign exchange rates, the various things that retard growth in Europe that we're all well aware of—all these things need to be addressed. We have these G7 meetings and people talk. I just wish we could get more action.

TIE: The other day a senior Democratic official involved with the Kerry campaign said that the U.S. current account imbalance is out of control, approaching 6.5 percent of GDP, and the budget deficit is also out of control, but the only reason these twin deficits have not yet produced problems such as a dollar crisis and dramatic, abrupt rate hikes from the Fed is that the Chinese and the Japanese have been heavily buying U.S. Treasury bonds. The implication was that the Asians made sure George Bush got reelected. This is obviously overdone, but is there a sense that the Treasury market has been helped along by foreign governments interested in propping up the dollar?

Broaddus: The capital inflow from the Chinese and other central banks has helped make it possible for this imbalance in the world economy and in global capital markets to persist without huge damage. But what if the Chinese suddenly decided they weren't going to buy Treasuries any more? The Chinese currency would appreciate, which would help cure the current account imbalance. Especially in the political arena, pundits will pick out some one aspect of this imbalance like the U.S. current account deficit and talk about it like it floats out there by itself. But broader adjustments in the international economy would happen simultaneously that would tend to cushion the shock and deter a major crisis unless we made some huge policy mistake.

TIE: Many analysts don't seem to realize how dollarized the world economy is today. If we get a cold here in the United States, the rest of the world is probably going to get pneumonia. Financial integration is tremendously significant.

Broaddus: That's right. The multiple adjustment paradigm is a way that helps me to think about these things. The fact that the United States has a big imbalance on its current account means that there's other imbalances elsewhere in the system. If suddenly the imbalance in our current account goes away, it's going to mean that something is happening elsewhere in the world that will hopefully attenuate the impact on the U.S. economy. So I don't lose sleep over this. I hope I'm not overconfident about this.

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TIE: Like you said, if the Chinese were to stop buying U.S. Treasury bonds overnight, and let their currency rise sharply, then they would quickly shut down their own economy.

Broaddus: Correct. The likelihood the Chinese will decide to stop buying Treasuries abruptly strikes me as small.

TIE: The final question is one you probably won't answer. Who's going to be the next Fed Chairman?

Broaddus: [Laughter] I don't know. That's a key question. It's interesting that the chairmanship of the Fed was not much of an issue in the presidential campaign. Nominees to the Supreme Court were an issue, but not much was seen in the popular press about how the election might impact who the next Chairman would be—to me a huge issue. We've had two great chairmen in my opinion since 1979—great in different ways—who've led the Fed with distinction. We need somebody who can do that—I don't know whom—but I expect that both the Administration and the Congress will give it careful consideration.

TIE: As long as Chairman Greenspan's healthy, why fix something that's not broken? There's always that loophole where Greenspan can continue to serve if President Bush doesn't nominate somebody new right way.

Broaddus: That's certainly true. The timing of replacing the Fed chair is not absolutely nailed down. The Administration could delay action if economic conditions are unsettled in early 2006. Or they could make an announcement sooner to reduce uncertainty and nervousness about the appointment. We'll just have to wait and see.

TIE: You're right. That's a good point. They could do it sooner.

Broaddus: For that very reason, President Bush reappointed Chairman Greenspan as Chairman last time far ahead of the deadline, and if markets seem to be getting a little antsy then they might move.

TIE: Thank you very much. ◆