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# Santomero *Speaks*

*The Philadelphia Federal Reserve President takes on inflation, interest rates, and the future of the American economy. A* TIE *exclusive interview.*

*Philadelphia Fed President* **Anthony Santomero:** *A neutral Fed funds rate is not "a number but a path through time."*

***TIE:*** **Let's begin with the whole concept of a neutral Fed funds rate. I'm sure you're aware of the huge debate about where the neutral rate falls—in the 5 percent range or the 3 percent range and so forth—a debate made more complex by questions such as how strong productivity is, and what the historical trends are. A number of the other Federal Reserve Bank presidents and governors have shared their views on this, and we were wondering where you stand?**

**Santomero:** I don't view neutral as a number, but rather as a path through time. The main issue is the state of the economy and demand/supply relationships, and therefore the true question is, where does the interest rate need to be in that context? Accordingly, I view the neutral rate as being dependent upon many factors that change through time, such as technology, savings, and the demand/supply relationships in both the government and foreign sectors. More specifically, one would expect that the level of interest rates that would be defined as neutral in the late 1990s would be higher than it would be in the early part of this decade. We ought to be thinking less about a single number and more about where the interest rate should be given what's going on in the economy at a particular point in time. That's why you haven't seen me opine on a single number because it's the wrong way of thinking about the problem.

**TIE: The Fed has clearly communicated that the economy seems balanced now and on a more sustainable path, and therefore rates should be normalized. But as you said, you shouldn't really focus on a rate anyway because the notion of neutral is somewhat of a theoretical construct. How do you know when you've normalized the situation?**

**Santomero:** That's a fair follow up question. There are a couple of ways of thinking about the process. What do we know about this rate even though it may move around? Can we scale it, if you will? We know historically that the neutral rate has been positive and therefore in the early phases of this recovery our rate was clearly stimulative. We know that as the economy goes through its recovery and then expansion, the nature of demand shifts, with consumption driven less by low interest rates and more by increases in income. Consequently, interest rates can move to more normal levels as we go forward.

What does that all mean from the point of view of the dynamics of this cycle? It means that early on it was clear that rates were quite low, but as the expansion continues we need to be more data-driven, analyzing how to proceed from here to a more normal interest rate. We should try to extract the stimulation as higher incomes replace low interest rates as the driver of consumption and business investment. So the challenge before us in the fourth year of this expansion is to move the interest rate up even as income and sales are driving domestic spending, and to try to allow the economy to continue to expand somewhat above trend even while we are reducing the stimulation associated with low interest rates.

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**TIE: The ten-year Treasury bond has performed beyond expectations recently. Very few people at the Fed or anywhere else would have predicted the U.S. bond market to rally each and every time the Fed has tightened short rates during this cycle, causing a flattening of the yield curve.**

**A couple of theories try to explain this. Some at the Fed say the performance of the bond market is the result of a great deal of savings sloshing around the globe without enough investment opportunities. Others credit the Fed's superb performance in fighting inflation. And others say weakness in the global market may be over the horizon—the rest of the world doesn't look so great, particularly Germany and Japan, with Japan having to revise down its growth numbers. China is essentially a**

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**bubble about to burst. The loss of the carry trade is increasing, which could have a negative wealth effect on consumption in the United States. How do you explain why the long bond is where it is today despite all the Fed tightenings?**

**Santomero:** It clearly is true that the rest of the developed economies are growing but could be growing faster. I would welcome a bit more strength in Japan although the recovery there seems to be well in place. I would like to see the Western European economies growing a bit faster although they are improving. And there's been a bit of easing in the growth rate of China from unsustainably high rates to significant growth nonetheless going forward, as best we can tell.

When I look at the long rate and try to figure out what the markets are telling us, I side with the notion that the markets are convinced that the Federal Reserve will take necessary steps to keep inflation well-contained. We used to call that credibility, now we talk about anchored expectations. But it is unusual during a period of Fed tightening to see the five- and ten-year rates move in the direction they have. I believe the market is telling us it understands the Fed's commitment to price stability and sees our movement toward a more normal interest rate environment as consistent with that commitment.

So, from where I sit, it's really a situation of reaffirming the market's expectation that the Fed stands ready in an important way to maintain price stability. The world's liquidity for some time has found its way into the United States—a strong economy with strong upside potential and growth in our equity markets, particularly as compared with a number of our trading partners. So I think what's happening in the intermediate and long sides of the market is a ratification of the expectation of price stability going forward and the commitment of the Fed to price stability. It indicates the desire internationally for dollar-denominated assets which is keeping rates at moderate levels.

***TIE:*** **But it's also happening on the corporate side, too.**

**Santomero:** The credit spreads by historical standards have been quite tight. Tight spreads are not consistent with the argument that relatively low risk free rates are a symptom of market weaknesses. In fact, tight intermediate- and long-term credit spreads suggest the market expects continued expansion in the world market and in the U.S. market, and once again are symptomatic of an economy that continues to expand at a moderate but reasonable rate. The narrow credit spreads speak well for the willingness to take on credit exposure.

***TIE:*** **That's an interesting point. As the Fed has moved the funds rate up toward "neutral," the yield curve has flattened out immediately. Some analysts say that as the yield curve flattens, the carry trade gets squeezed, creating a potential liquidity squeeze that becomes part of the slowing-down process. Would you expect credit spreads to widen if that's the case, or is the flattening of the yield curve telling us anything?**

**Santomero:** As you know, credit spreads are often very difficult to explain in short periods of time, but they tend to move with the cycle. What they're telling me is that the market sees a reasonably robust expansion going forward and therefore the credit spreads have not gone up. Some in the banking community have argued that bank asset quality is about as good as it can get, suggesting that it has only one way to move from here. But the markets are saying that relatively low spreads are consistent with an ongoing expansion of the U.S. economy. Remember that the last business cycle had a ten-year expansion. We're entering our fourth and the markets seem to be telling us our expansion can go on at this pace for some time.

***TIE:*** **The credit spread situation and the anchoring of the ten-year bond is also a great tribute to the Fed's credibility. However, some private forecasts expect inflation to creep up a little, but if you look at some of these broader measures such as the PCE core rate there's still really no sign of it. That may explain as you say some of the ten-year bond performance. Are you still optimistic?**

**Santomero:** If you look at the numbers carefully, it's fair to say we have not seen very much inflation pressure yet. Interestingly, some of the rising raw material costs have been essentially taken out of margins because purchasers have been very reluctant to accept higher prices. Productivity has allowed fringe benefit costs to rise, along with moderate nominal wage increases, but unit labor costs have not gone up and rising raw material

costs have really been absorbed by compressions in margins. The marketplace has been the disciplining agent in this process over the past year or two as producers have found it difficult to pass higher costs on in final product costs.

Looking forward, how will this change? Studies of price dynamics suggest that the driver tends to be unit labor costs. They are starting to increase rather than stay contained because productivity growth is now moving more toward its structural level than its cyclical level. This is a source of cost pressure that firms are facing. In addition, the revaluation of the dollar over the last year has made the discipline from outside the United States a little less severe, suggesting that there may be some potential of passing on these higher costs. I've been listening closely to my contacts, and gained the impression that while some face cost pressure, up to this point they have not been able to raise final goods prices. There are nonetheless producers looking for an opportunity to do so. This means the Fed must remain vigilant, looking for evidence that cost pressure is starting to lead to higher prices. So far, in terms of broad statistics, we're not seeing it. But we have to remember that we're in the fourth year of an expansion and it is not unexpected that the dynamics of price will begin to shift.

The pattern of GDP growth in this cycle has worked to keep inflation well-contained to the extent that we did not get a big bounce-back after the recession. Our GDP growth is just slightly above potential. So the economy's dynamic is working in a manner that appears to allow growth to continue without increasing inflation pressure, but we've got to remain cautious and vigilant as this proceeds.

***TIE:* As you said, a lot depends on productivity. Productivity performance has been exceptional. Some of that has been cyclical but Chairman Greenspan and others still appear to be optimistic. What do you think about the trend rate of productivity growth? Some have said this last quarterly number—0.8 percent—was an aberration and they've been expecting upward revisions.**

**Santomero:** That's a good question. As you know, our productivity measure tends to be somewhat of a residual. We can measure output and labor, and from there we can get a productivity number. At best it's a very difficult number to nail down. Before I came to the Federal Reserve I looked at productivity in the financial sector and the question of how productivity changes as technology spending increases. We discovered that productivity is not as tightly tied to capital spending as many people think. It was characterized in the banking industry as, "Stop buying computers and teach people how to use them." The idea is that productivity is the result of appropriate alignment of new productive capacity with the workers who use that capacity. This means productivity advances filter through the economy for several years instead of jumping up and down with every new chip or new computer.

*At best productivity is a very difficult number to nail down.*

As a result, in the early stages of this cycle when productivity was expected to decline because business investment in software and hardware went down, what happened instead was that productivity continued at historically high rates. It's natural for productivity to have two components—a secular and a cyclical one. But the secular component itself doesn't bounce around—it's about employing technology effectively. As we look forward, the most recent number was quite low by my estimation of long-term structural productivity. Whether it gets revised or it's a one-period variance from long-term trend I can't answer. Productivity enhancement remains a driver of our economy because of the flexibility of our production processes and the dynamic of the U.S. economy. But we should expect as we go forward in an expansion that productivity measures will be more consistent with long-term structural estimates. I'm convinced we are still on a path of relatively strong productivity growth and somewhat uniquely high in the United States relative to some of our counterpart industrial economies.

***TIE:* Some of your colleagues say they're happy when the productivity growth rate is around 1.8 percent or higher. Is this your view?**

**Santomero:** Because I don't see much precision in such estimates, I'd be reluctant to give you a number. If I were less reluctant I'd say something around 2 percent seems reasonable. This is a number that will vary from time to time as innovation changes the potential and as employment of that innovation changes. But it's higher than it was prior to the revolution in information technology. We still have the ability of redesigning our processes so as to get numbers like 2 percent out of structural productivity. At some point we may fall back to the century-long trends, but there are still exciting things going on in the

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deployment of technology and the reorganization of businesses leading to higher output per worker.

***TIE:* In fact, one of the interesting things even at this stage of the expansion is that corporations still seem very reluctant to be aggressive on the capital spending or hiring fronts. Businesses are getting a little more optimistic as time goes by but uncertainties remain. Companies are awash in cash and yet they still don't seem to be willing to put that to work in big aggressive capital spending projects. How do you see this?**

**Santomero:** There are a lot of parts to that observation, all of which are important and worthy of comment. First, it is true that we are seeing the dynamics of business spending evolve in what I would describe as a reasonable fashion. After the dramatic falloff in business spending associated with the 2001 recession, we are seeing growth in all categories of business investment—software, hardware, warehouses, commercial space, and so forth. What we saw come back first was software. Next came some increases in spending on hardware, and then we started to see some expenditures for warehousing and that kind of space as opposed to fairly standard plant and equipment space. All of these are somewhat easier to turn around over a short horizon. The pace of plant and equipment expenditure has been the slowest to come back in, partly because there was there was excess capacity and partly because there was a need for long-run stability in the outlook for cash flow. To the extent that businesses are more disciplined, they're less willing to throw money at projects until they see the market demanding the capacity. Even though we were getting good numbers on business spending over the last eight quarters, the spending was focused on the shorter end of the market.

On the employment side, we've seen first a lack of need to hire more workers due to higher structured productivity, then a reluctance to hire, which meant we were getting even more productivity than was sustainable in the long run. Firms were reluctant to commit to the fixed cost of fringe benefits and other costs associated with higher employment, so we saw the emergence and growth of the temp business. Some of us look at the temporary worker numbers as leading indicators of full-time stable employment because many firms are hiring in a temp-to-perm transition in the U.S. market.

Having said that, 2004 was a period in which we had growth of non-farm payrolls of about 180,000 per month. Looking forward, I believe that we're looking at 150,000 to 200,000 jobs per month in 2005. The real question: how much capacity do we really have out there in the labor market? We get indications from some firms and some industries that finding the right employee is more difficult than before, and more difficult than they thought it would be.

Some have expressed concern that we may not be creating the right kind of jobs. So we did a study recently here in Philadelphia that examined the kinds of jobs created industry by industry, both high-paying jobs and low-paying jobs, trying to get a handle on the jobs we have been creating in this expansion. The results were actually quite interesting. The dynamics of the labor market suggest that when the labor market turns around, the number of relatively low-paying jobs accelerates first. The idea is that it's less expensive, less of a long-term commitment,

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and less of a difficult task to hire relatively low-paid workers. Then as the expansion takes hold, there's a shift into more professional, knowledge-based workers. If you look at the U.S. economy, we have shifted from phase one to phase two—the relative growth of high-paying jobs is accelerating and the sectors that are seeing the growth are consistent with this dynamic.

Now, how many unemployed people are out there who have the knowledge and expertise that firms need? The press and others are beginning to discuss this. Universities are talking about good jobs for their new graduates. The search-engine company Google was saying they can't grow as fast as they would like because they can't find exactly the people they want. We're starting to see economic growth being affected by the capacity to find the kind of workers.

***TIE:*** **One of your fellow Committee members mentioned that it seems as if every analyst in the country comes in and tells the Fed the dollar needs to be depreciated by 40 percent—that's always the magic number—to reduce dramatically or eliminate the current account imbalance. Where do you stand on the level of the dollar? Are the dangers being exaggerated even though the current account imbalance is reaching 6 percent of GDP?**

**Santomero:** Clearly the current account as a percent of GDP is at a very high level and not sustainable over the long run. But looking at the international balance in a broader perspective, we must realize that a lot of this is associated with a long-term trend of capital inflows as people view the United States as a desirable investment location and the dollar a desirable investment currency. This inflow has not only financed the trade balance, but in some sense has caused the trade imbalance. In addition, since the U.S. economy has grown faster than those of our major trading partners, with one obvious exception, the net result has been that growth in our imports has accelerated and growth of our exports has not kept pace. Now, in 2004 we did have the revaluation of the dollar by a significant amount but we know from both theory and practice that it takes a while for this to work its way through the system. Some recent data suggest the deficit may be leveling off. It will take time before trade patterns adjust fully. Clearly the current account imbalance is not at a sustainable level and must drop to more reasonable levels. Having said that, we have to recognize that the United States has run and will run a current account deficit for some time.

I won't predict where the dollar's going. The nice part about being a Fed president is that we're not allowed to do two things: engage in politics and predict the dollar. The reality is it's very difficult to know how the markets will revalue a currency and how capital will evolve—whether the international capital markets will start to diversify out of the dollar into other currencies. It's only slightly harder to predict the exchange rate than it is to predict long-term bond rates, and you know how easy that is.

*One of the problems with inflation targeting is that everybody has a different notion of what it means.*

***TIE:*** **It's a good point. Dollar depreciation and current account imbalances certainly haven't upset the bond market so far and part of the picture is continued capital inflows. It's still hard to see how this imbalance will get corrected when the major industrial countries outside the United States don't show any prospect for growing faster than the United States, and Asian countries are all basically developing for export to the U.S. market. The United States seems to be the consumer of last resort for the world. Even with a correction in the dollar, the exporting countries will probably absorb most of the price increases in order to keep market share.**

**Some argue that we're seeing a de facto emergence of a dollar bloc in which China and Japan and the other Asian satellites are all tied to the dollar, with an informal understanding that the United States will serve as the consumer of last resort and thus the Pacific Rim central banks cannot afford for the dollar to take a free fall. They know that if the United States catches a cold, economically speaking, they will develop pneumonia. How do you see this?**

**Santomero:** Let me talk first about the underlying forces. It is appropriate to point out that our trading partners in the developed world have in fact improved their relative performance. Japanese GDP is growing at up to 2 percent annually over the last two years; this rate should continue. Western Europe has in fact expanded its output somewhat. Clearly I'd like that to accelerate, and they would too as far as I can tell from their comments in the press. Second, while we point to China as a big trade mismatch, about 50 percent

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*Fed Chairman* **Alan Greenspan's** *value is that he is first an economist and second the head of the central bank. He listens, he understands, he takes into account the discussion, and he's been a consensus builder. As we move ahead, Greenspan leaves a legacy of price stability and a strong FOMC for his successor.*

*—A. Santomero*

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of the value of China's imports into the United States is actually product that is produced elsewhere, assembled, and shipped back. The real trade imbalance associated with China is thus somewhat overstated. That doesn't take away the underlying reality of the current account mismatch, but there are economic forces at work to reduce the severity or at least level it off, and some of the numbers may in fact be a bit exaggerated if you look closely. Regarding exchange rate regimes, as an old monetary economist for the finance department for so many years, I like market-determined exchange rates. They allow the market to adjust over time and prevent abrupt political decisions about the value of one currency vis-à-vis another. Whether the dollar/yuan relationship will ever be determined by the market and how we will get there is clearly in the hands of the Chinese government, but I've always had and continue to have a preference for floating exchange rates myself.

***TIE:*** **Final topic—the flavor of the month. Where do you stand on the inflation targeting issue?**

**Santomero:** I have spoken in favor of inflation targeting as the logical next step in transparency and communication in the central bank. I have in fact looked closely at this in part because of some early comments made by Fed Governor Ben Bernanke that led me to try to make an evaluation for myself of where I stood on this topic.

One of the problems with inflation targeting is that everybody has a different notion of what it means. I believe it would be constructive for the market to have some notion of what we think is a reasonable inflation environment, best described as a stable price environment in the United States. Inflation targeting would anchor expectations as we go forward and solidify the successes of the past twenty-five years as both the Volcker and the Greenspan eras moved us from what is now being called "the great inflation" of the 1970s to a period of price stability.

People have spoken on both sides of this issue. Some see inflation targeting as a way of creating credibility, and say that given that the Federal Reserve already has credibility, why do we need to go to an inflation targeting environment? My answer is that this is a way of committing to the marketplace and being explicit about what we're trying to do. Exactly how you handle inflation targeting really matters. All inflation targeting is not the same, and the regime must be carefully thought out.

In a speech recently to the National Association of Business Economists, I laid out one such scheme as a starting point. I said in order to go to an inflation targeting regime, first the Fed needs to select an index and then be quite explicit about its target. I prefer a range rather than particular point and that range ought to be defined as a range over some period of time. My specific proposal was for a 1–3 percent core PCE over a four-quarter period as a way of saying to the marketplace, "This is where we want to be and we will stay in this range as we move forward." That would firmly anchor expectations by making us more accountable. And it would allow us the flexibility of responding to disturbances aggressively if necessary and still maintaining the integrity of our stable price environment. Others have offered alternative ideas and I'm not so wedded to my proposal that I would reject them out of hand.

***TIE:*** **Ben Bernanke makes an argument that Alan Greenspan has such a superb record and intuitive feel for monetary policy that it is unlikely that anyone else could fill Alan's shoes as Fed Chairman. Therefore in the future, the markets need a Fed system that provides clear guidelines for monetary policy.**

**Santomero:** As an academic, on joining the Fed I had to write a letter saying I resigned my lifetime tenure at the university. The fact that I joined the Federal Reserve under Chairman Greenspan made that letter a lot easier to write. It's been a wonderful experience for me. Greenspan's value is that he is first an economist and second the head of the central bank. He listens, he understands, he takes into account the discussion, and he's been a consensus builder. As we move ahead, Greenspan leaves a legacy of price stability and a strong FOMC for his successor. One way of continuing this process is to be fairly clear about what we're trying to do. ◆