

Monetary Policy Normalization: Low Interest Rates and the New Normal

Official Monetary and Financial Institutions Forum
New York, NY

January 15, 2020

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OF PHILADELPHIA

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I'm a generally inquisitive person by nature, and one of the perks of being a Fed president is that indulging my curiosity is actually a job requirement — discussions like this give us good feedback and insight, and it's important to maintain an open, transparent dialogue. So I'm very happy to be here. Though I should note the flipside: One of the perils of being a Fed president is that you open yourself to the risk that discussion turns into inquisition ...

Today's roundtable is titled "Monetary Policy Normalization: Low Interest Rates and the New Normal," and it's probably telling that those 10 relatively short words contain multitudes.

So I'd like to start with a brief recap of the key issues and recent events that influence today's conversation — or at least, as brief as I can make them — then head straight into the discussion.

First, however, as is par for the course, I'll issue the standard disclaimer that the views I express today are my own and do not necessarily reflect those of anyone else in the Federal Reserve System.

I always issue that disclaimer, but I'm highly aware that people care a lot more about what I have to say in years that I'm a voting member of the FOMC. So my New Year's resolution is to say it whenever I speak, even if I'm just ordering a sandwich ...

Our initial intent for today was to focus on the unwinding of the balance sheet, and as you can see, I'm accompanied by my colleague Roc Armenter, who is one of the principal architects of our approach. But policy does not exist in a vacuum, and, of course, there are other, connected topics, including the disruption in the money markets last September.

To set the stage then, I'll remind everyone of where we were, where we are, and where we're going.

In the Beginning — Balance Sheet Normalization

As you know, at the start of 2019, the FOMC decided that we would continue to conduct monetary policy in a regime of “ample reserves,” in which control over the federal funds rate is exercised primarily through the setting of administered rates, and the supply of reserves does not need to be actively managed.

Shortly after that, we announced our plan to cease asset redemptions and hold the balance sheet to roughly a constant size come September. As currency and other non-reserve liabilities grow, aggregate reserves see a natural, gradual decline. Our end game was for reserves to reach a level “consistent with efficient and effective implementation of monetary policy.”

There were two primary objectives to this approach. First, to reduce uncertainty about asset purchases by announcing our plans well in advance. Second, to approach the necessary level of reserves, which is itself suffused with uncertainty, with an abundance of caution.

We only have estimates of the demand for reserves, though we’ve conducted a great deal of research around the Federal Reserve System, including continued conversations with market participants. In fact, staff at the Philadelphia and New York Feds were among the first to identify that the need for reserves could be much larger than initially anticipated. To be on the safe side, it made sense to move slowly, buying time to carefully observe market developments and better assess their implications. That is, we gave ourselves time for the inevitable “unknown unknowns” of life.

Just such a surprise arose in September.

The episode was clearly triggered by the outsized flows of funds to the Treasury. But the dates for tax payments and bond settlements are not a surprise; they are fixtures of the fiscal calendar and well known to both policymakers and markets. Everyone was expecting large liquidity flows.

The impact, however, was clearly much larger than anyone anticipated, markets included.

The repo market took the brunt of the impact, as the Secured Overnight Financing Rate (SOFR) rose above 5 percent on Tuesday, September 17, with some trades executed at rates as high as 10 percent.

While this was certainly not an average day, it’s important to note that the repo market didn’t freeze. The volume of secured overnight finance remained steady, at the \$1.2 trillion level it had maintained for the past several months.

The funding pressures in secured markets passed through to the federal funds market. The effective federal funds rate rose to the top of target range on Monday the 16th, and surpassed the top of the range by 5 basis points the next day.

We immediately took action to ensure that the effective federal funds rate returned to, and stayed within, the target range. The very next day, the Desk started repurchase operations to stem the pressures on money markets, which have continued — including term operations — to date.

Since September 17, 2019, to the End of the Decade

In October, the FOMC decided to restart asset purchases to keep reserves at or above the level reached in early September, a little over \$1.5 trillion. Additionally, the Desk has been conducting term and overnight repurchase agreement operations to offset money market pressures — for instance, the quarter-end dynamics that are inevitably more burdensome at the year's end. All in all, since September, we have supplied about \$400 billion in additional reserves; about \$250 billion via repo agreements and the rest in asset purchases.

These measures clearly worked, with the effective fed funds rate maintaining a virtually constant level since October, and repo markets staying calm. Instead of wreaking havoc, the year's end was a non-event. The money markets essentially rang in the New Year by binge watching Netflix in their PJs instead of with noisemakers and popped corks.

Implementation Framework Going Forward

Going forward, the Committee remains committed to implementing monetary policy in a regime of ample reserves, which, again, does not require active management of the supply of reserves. The Treasury purchases announced in October will continue until at least the next quarter to ensure we meet that goal.

Central to this event is the question of why the liquidity did not flow smoothly to where it was needed most. Are some of the market's pipes rusty? Clogged? Are more needed? Has regulation inadvertently contributed to some erosion or blockage?

The second question is whether the Fed ought to expand our toolkit — whether we could, or should, do more to ensure interest-rate control. One possibility under discussion is a standing repo facility. We are in the process of evaluating the potential costs and benefits, and exploring possible designs as well as alternatives, so it is still very much in the discourse, rather than the decision, phase.

While September's turmoil offered perhaps too much excitement, it also provided a good deal of information. It showed that we need a larger pool of reserves than most of our estimates had initially indicated. It showed that when reserves are scarce, even for as short a period as a week or so, it can generate large spikes in money market rates. And it showed, unfortunately, that banks remain extremely reluctant to borrow from the discount window, even when that reluctance results in outsized penalties far above the primary credit rate.

Monetary Policy Review

This episode highlights that some fundamental shifts have occurred in market functioning. And, in fact, as the world's economies rebuilt over the course of the lengthy recovery, we've come out the other side to a state of normalcy that doesn't look exactly like it did before the financial crisis.

Last year, we began a broad review of the strategies, tools, and communication practices we use in pursuit of our monetary policy goals. Again, that's an important undertaking on both a philosophical level and as a general exercise in good practice. But it's also important because we find ourselves in new territory, as the U.S. economy has changed in ways that impact the efficacy of our policymaking. In particular, the natural rate of interest, both at home and abroad, appears to have fallen, increasing the possibility of moving ever closer to the zero lower bound, which, in turn, dilutes the power of our monetary policy tools in combatting downturns.

It's been said often, but bears repeating, that a change to our 2 percent inflation goal is not on the table. But it is nonetheless a wide-ranging review. As you may have seen in the minutes from the FOMC's September meeting, makeup strategies were discussed, and we reviewed the utility of unconventional policy tools — such as balance-sheet policies and forward guidance — in October. We expect to reach some preliminary findings by midyear, but we also expect these conversations to be ongoing.

I've personally found this exercise to be fascinating from an academic standpoint and vital from the policymaker's roost. But the highlight for me has really been the series of *Fed Listens* events spearheaded by Vice Chair Clarida. Each of the 12 District Banks hosted outreach and consultation events with a broad range of people and groups, including labor leaders, nonprofits, community leaders, and local business owners. Even though the economy is in good shape, it works differently for different people and places, and it's important to put context and contour to the discussion.

I'm going to end with that observation, because we're here for a discussion, not a monologue, and I'm more than ready to dive into the context and contour you bring to the discussion.