The Economy and Monetary Policy: A conversation with Fed Vice Chair Richard Clarida

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SETH CARPENTER: You talked a couple times about the Fed being willing to use all of its tools. I think Chair Powell has used similar language. Chair Powell has used lots of adjectives to describe just how powerful he sees the tools that you have at your disposal. So that forces me to ask a question. When we look at, for instance, the September summary of economic projections, the median FOMC member doesn't have inflation getting above the two percent level, which is part of your newly described objectives. And the measurement of unemployment, relative to the long run estimates, looks like it's getting to full employment. But as you noted, other considerations like labor force participation, wage inflation need to be met. So it seems that from that projection, the Committee really isn't meeting its objectives for three years. But the precondition or the assumption for those projections are the Committee is doing, "appropriate monetary policy." So seems to me, one can infer one of two conclusions: either, at least three years, perhaps longer, is a fully acceptable time horizon to get back to the Committee's objectives? Or, we're basically tapped out and the Fed's using all the tools that they have, but this is about as good as it's going to get? Can you walk us through how we should do that inference?

RICHARD CLARIDA: Well Seth, I think there's a third possibility. It won't surprise you. And that is, is that the coronavirus pandemic leveled a severe, really unprecedented blow to the economy in the spring of this year. We had a 22 million increase in unemployment. We had a 30% annualized decline in activity. And I think what our September projections reflect is the fact that the economy is in a very deep hole and we're starting to dig out. And the business cycle has not been repealed, monetary and fiscal policies are powerful tools, but this is really an unprecedented hit. So I think the only inference here is that it will take some time to recover under the median projection, but that doesn't really reflect our judgment that our tools are not up to the task. It just really reflects the depth and severity of the shock that we're recovering to. You know, the economy is a complex place, but in general, modest shocks can generate faster recoveries than very deep shocks. So it's really more of a reflection of the shock than the judgment on the tools.

CARPENTER: Thanks.

ANNETTE VISSING-JORGENSEN: Sticking with the new framework, I was happy to see a bit more guidance on how you think about that in your comments. Are you worried that markets might have an inflation tantrum once inflation is allowed to go over two percent? I noticed that you mentioned that you're going to base your thinking on survey expectations rather than actual inflation averages. Do you think there'll be some concern that there's not enough guidance about how much above two percent for how long?

CLARIDA: Well thank you, Annette. As I made clear in my in my remarks, the Committee has a number of communication vehicles as we approached that time, for communicating both how long and how much. And this actually gets back to Seth's question. If we were launching this new framework in a different set of circumstances, then these would be in the horizon right now. But the shock just, as the hand we were dealt, as we were ready to roll out the framework, the pandemic hit. But that being said, we will be able, and I'm sure we will communicate, and certainly we would try to avoid, any such phenomena as you describe. But I think the Committee, I know the Committee, because we got unanimous support with Chair Powell’s leadership, the Committee felt that we really had an opportunity to demonstrate that an important element of price stability is inflation expectations that are anchored at two, and our concern was simply that if we always are running policy to get inflation to two and stop, and we're successful, then on average inflation will be below two, because of the ELB. And we wanted to avoid that. And so I think we're communicating what the goal is. Long run price stability is still two percent. I’ll be looking at surveys, but also market measures and model-based measures. And so, one of the reasons, just to give me a chance to plug the fine work by the Fed staff, one of the reasons I like the staff's new CIE index, is that it is a model agnostic approach to extracting a common factor across 20 different measures. And I think it's quite useful in that regard. But we'll certainly do everything we can. I think we'll be able to avoid that scenario that you laid out there.

CARPENTER: Inevitably, one possible concern with inflation is there being a tantrum because people are worried that it goes too high. I think the natural question, though, could be in the opposite direction, so too low. Phrased, hopefully not unkindly, the Fed had a target of two percent for a long time, formally since 2012 and never actually hit it. So if the Fed hasn't been able to hit two, where's the confidence that the Fed's going to be able to hit something higher than two?

CLARIDA: Yeah. Okay. Well let's look at the videotape, as they used to say. The virtual videotape. I joined the Fed in September 2018. Core PCE and headline PCE were actually running a nudge above two, when I got to the Fed. Policy had been normalized gradually, the labor market was in the vicinity of full employment. And I would argue, and indeed I was on the Committee for the tail end of that episode, that policy was doing exactly what it should do, under the old framework, which is to get inflation to two, and to keep it there. What occurred in 2019 was that we had a sharp slowdown in the global economy that we in the private sector did not forecast. And we had, as a result of that decline in global economic activity and that slowdown in activity, we had some softening in inflation and we responded to that. On a year-over-year basis in February 2019, core PCE was again back up to 1.9. So I would push back a little bit about the Committee's ability to engineer a return to two percent inflation from below. That indeed is what we achieved in in 2018. The challenge, of course, is in the world of low rates, and when we began the review, I should point out was in the early part of 2019, when the ELB was not a binding constraint. We were about well above the ELB, but we were concerned that, in the next downturn, we could get there. Of course, that's what turned out to be the case. So that's really the way I think about that period of time.

VISSING-JORGENSEN: So sticking with the average inflation targeting, at Jackson Hole, Yuriy Gorodnichenko presented some interesting evidence that households tend to take high inflation as a bad thing, and start downgrading their expectations for growth. Is that something you're concerned about, in terms of that counteracting any sort of initial increase in inflation? And what is the plan in terms of communicating with households to not be concerned about this?

CLARIDA: Annette, I am aware of that work, and it's one of a series of papers that he and co-authors have focused on this topic. You know, it is an important one. I guess what I take away from it is I think for a lot of households, just intuitively, probably don't have sophisticated econometric models. They're not looking at the TIPS breakeven curve. But they are looking at actual inflation. And so that's one of the reasons why in our framework, we really are focusing on a desire to have inflation average two percent over time, is precisely because we think that will help support inflation expectations. Again, I’d like to study the worksome more. I would also point out that people typically like to get wage increases. And they don't oftentimes think that a wage increase is inflation. But of course, typically those two move together. So I think it's a little bit more of a complex picture. But I do agree it is important and we're committed to communicating as best as we can about the new framework. But that is an important consideration, yeah.

DAVID WESSEL: As you mentioned in your answer, this is - we are not living in ordinary times. The COVID virus seems to be on the rise again. Long-term interest rates have risen a little bit. You and Chair Powell assure us that the Fed is not out of ammunition. But, I wonder, if you could talk a little bit about: what ammunition do you have left? Is there something you could do with the composition of asset purchases? Or something? What is it that you can do to get us closer to full employment and price stability?

CLARIDA: Excellent question, and I'm going to touch on a couple of points before I directly answer your question, which I promise to. But the first thing I would say is, although the hit the economy took, the global economy took, from the pandemic shock, or as my colleague Vice Chair Quarles calls the "COVID event," was a severe shock, as we all know. But the recovery from the COVID event has also been, initially, quite robust. About half of the jobs lost have been regained. We're still in a deep hole. But certainly, if you look at where most forecasts were in, say, April or May, it would not have had an unemployment rate now of 6.9 percent, and the strong recovery that we had. And in particular, I would point to the fact that in the recovery in both employment and economic activity that we saw beginning in the summer, we saw it was the interest-sensitive sectors that were actually powering the recovery: durable goods, housing starts, capital spending. And so there had been some concern in the spring: oh this shock is different, low interest rates, accommodative, supportive financial conditions won't be effective. I think it's clear now that the tools still have their power. But it's also, as I said and the answer to the earlier question, we're in a deep hole now. Answering more directly your question, I think most recent data has been really moving in opposite directions. So the economy entered the fourth quarter with good momentum in the macro data, both in the labor market and in the GDP data. We also got some very, very, very encouraging news on the vaccine recently. On the other side, though, of course, infection rates in the U.S. are definitely increasing at a very, very high rate, hospitalizations. And I think, as Chair Powell indicated in remarks last week, the next couple of months, the next several months, especially given the colder weather in much of the country, and given what we're seeing in terms of the COVID infection rates, could be a challenging time for the economy. That said, in terms of our tool kit, we do think that our tool kit is amply stocked, in terms of the way that we think about, that is: as the Chair indicated in the press conference last week, specifically with regards to asset purchases. And in our November meeting, we discussed various aspects of the program including the composition of the portfolio, the pace of purchases, and the life cycle of the program. Right now, as of our November meeting, we like the way that policy is calibrated. But we will continue to monitor developments and assess the outlook, and we'll make adjustments as needed.

WESSEL: Does the fact that we don't appear to have any additional fiscal support on the horizon lead you to accelerate the plans to think about changing your tools, using your tools?

CLARIDA: Well, I'm not going to get ahead of what we discuss at our December meeting. Certainly, in our most recent November meeting, we liked where we were in terms of the calibration of policy, both asset purchases and guidance. What I would say, and I have said before publicly, is I do believe that further support from both fiscal and monetary policy will likely be needed. Obviously, as we always say, that's a decision for the legislative branch and the executive branch. But in my professional opinion, I do believe additional fiscal support will likely be needed. And obviously, as we meet in December, we will factor in our projections for that in terms of our assessment of what we need to do on policy.

WESSEL: What will determine whether you and the Treasury decide to extend the emergency lending facilities that are otherwise set to expire at the end of December?

CLARIDA: Yeah. Well, let me say a couple of things about that. First and foremost, I believe that the so-called 13-3 facilities have been very successful. They've served their purpose broadly. They, in essence, are backstop facilities. I've always said, and we've said, the metric is not how big are they getting, but are they supporting the flow of credit? And I believe in most circumstances they are. So I think through the rear view mirror, they have been successful policies. Now looking ahead, of course, they are due to expire at the end of this calendar year. And by statute, that is a decision that will be made jointly by the Treasury and the Federal Reserve. And as Chair Powell indicated in his press conference, we're just turning to a discussion of that with our colleagues at the Treasury. And I don't have anything more for you on that right now.

WESSEL: You don't want to share your particular position, not on behalf of Treasury and the FOMC?

CLARIDA: I think I'll leave my answer at that.

CARPENTER: David's question just before that, he was being extraordinarily Washington polite, and I think I've been in New York long enough to be slightly more direct. I mean, part of the thrust was about the asset purchase program. I will say, Wall Street is asking, all the time: is the Fed going to change that? Why wouldn't they do more? You mentioned the sort of estimated models that you rely on to sort of have justification for temporary price level targeting and things like that. Those same models would say: absolutely, at the sell-off in the 10-year from 65 basis points up to 95 basis points, if you were to reverse that, it would ease financial conditions and, those models would say, would accelerate the paceof recovery. So then, it gets back to three years of, to get back to the Fed's objectives is clearly sort of happy with that calibration, because otherwise the Committee would just buy more longer term securities and push down the ten year. How should we unpack that?

CLARIDA: Well, I would say several things. First of all, we're buying a lot of Treasuries. We're buying 80 billion a month. That's comparable to the pace of QE2, and it's roughly the duration pull, and so, these are big programs. The mortgage program is also quite substantial. I would point out that, with long-term yields at historically low levels and below both current and projected inflation, financial conditions are accommodative. I always say more broadly, Seth, we also look not just at borrowing rates themselves, but also at the access and availability of the credit. And thecorporate bond market is functioning, and capital's being allocated in that way. So I think, relative to concerns many of us had the week of March 16th, I would say the financial system is really supporting recovery. And we're certainly doing our part in that. I guess the final thing I would say, and of course you and I could go into length about this offline, but the reality is that you look at a move in the 10-year yield, that's really reflecting the inflation component, the real rate component, and the term premium component. And so any assessment of what the market is telling you, you really need to sort of dig down a little bit and look at that. But I can say for myself, I was not concerned when the yield on the 10-year went from 80 basis points to 92 or whatever. You consider the range that it's in, and it's certainly still a very accommodative range.

VISSING-JORGENSON: I wanted to follow up a bit on what David asked about the extension of the emergency facilities. Without extensions, are you worried that we might see something like we saw in March in terms of market disruption? So do you think the good vaccine news might be enough to prevent that?

CLARIDA: Well I think, I don't think I'm going to go beyond what I said in response the earlier question. I think the facility's been very successful. I think that they have certainly served a very good purpose. And by statute, this is a joint decision with the Treasury. And we're just beginning to turn to that now as Chair Powell said. And I will leave it at that.

WESSEL: Mr. Clarida, when you talk about the options you have, is yield curve control getting more attention than it did before? Or is that still something that's much more in the back pocket?

CLARIDA: Yeah. Well, yield curve control is one element of the toolkit that our review did look at, simply because other central banks, including the RBA and the Bank of Japan, are using versions of yield curve control. So we thought it would just make sense to analyze the pros and cons of implementing them in the U.S. What I'd say about yield curve controls: we did look at it in our framework review. I think it is still in the tool kit. I think right now it's not something that we're considering, because we actually think the current approach to our asset purchases is working well. I've also said before, and believe, that the most natural way to think about yield curve control is as a complement to 'date-based' forward guidance. And what I would say on that is, in September, of course, we the Committee decided not to offer 'date- based' guidance but really 'macro outcome-based threshold' guidance. And that also, I think, influences the role that yield curve control can or cannot play. So the bottom line is that it is in the tool kit. But it's not something that we're actively considering right now.

CARPENTER: Yeah. So after you were very gracious allowing me to sort of push a little bit hard in one direction with the tool, let me think in sort of the other direction. In this crazy Zoom world we live in, I was on a different conference panel earlier today about central banks in the future, and part of that discussion was about inclusion and equity and distributional effects. You all have made, I think, very very clear how important many of those issues are for you at the Fed, how important full employment, measured very flexibly, to actually try and capture the crux of it, is important. So then, as you're thinking about the cost benefit analysis with these tools, one of the other criticisms that gets laid against the Fed is that their asset purchase program, their forward guidance, and keeping rates low, is just pushing up asset prices, exacerbating wealth inequality. So when you're thinking about that trade-off, on the one hand, if you didn't do anything and all the models are correct, presumably we have worse outcomes in terms of employment, inequality, or income inequality. But if you use your tools, then you potentially exacerbate wealth inequality. How can you walk through that struggle, that cost benefit analysis?

CLARIDA: Yeah. And of course this is one instance where we have 17 members on the Committee, and each will have his or her own particular weighting in that calculation. What I would say is one of the things that we learned from our review and the Fed Listens events, and I think it's something that many if not all of us understood conceptually, but it really resonated with us in the context of Fed Listens, is, and this idea goes all the way back to Arthur Okun in the early 70s and of course Janet Yellen did some very good work on this, and others. But the basic idea is that when the labor market improves, it doesn't improve evenly, and historically, the groups who benefit the most when the unemployment rate, say, goes from five to four, or six to five, are disproportionately at the lower end of the income distribution. There are folks who are being pulled into a hot labor market. They're getting job experience. They're getting contacts. And the value to society of being able to support a low unemployment rate is substantial. And, in particular, if achieving that low unemployment rate does not push up inflation, then there's not even any reason not to aim it to try to do it. And that's why, I in my remarks today and in previous remarks, I have made the distinction between preemptively hiking rates based upon a particular econometric model of full employment, versus actually looking at the data. And I've really come down on the view that because there's an opportunity cost to the economy of not achieving low unemployment, that it's worth trying to get there if you don't see it in the inflation data. Now let me be a hundred percent clear, for this Vice Chair: if you push the unemployment rate to a level where you see it in actual inflation, and you see that wage gains are way ahead of productivity, and it's not being absorbed in margin compression, then of course we have a dual mandate, we would, I think, we would act. But I think it does it does change the calculus. In my academic work, I spent a lot of time thinking about monetary policy needs to be forward-looking. And I still believe that. But monetary policy also needs to be robust. And I think the challenge, with regards to the labor market, is if our models are not very good, or if they're out of date, then there's a real cost to engaging monetary policy on the wrong model. Well, let me also say: although we have a powerful set of tools, they're pretty limited in number. They're either rates or the balance sheet. And we do not have tools that can ameliorate or improve a number of aspects of the labor market that we don't like. Those are really in the domain of fiscal policy. And so really what we can do, and I think what our new statement says we want to do, is to achieve the maximum level of employment that is consistent with price stability. Now, finally on your point of income and wealth distribution, there, I think it's important to note that we saw some important improvements in the income distribution data in the later two or three years of the last cycle. So, sometimes, income and wealth distribution can go in the same direction. Sometimes, they can go in the opposite direction. But I would say the best thing that monetary policy can do in tandem with other policy makers is, as quickly and sustainably as possible, getting the unemployment rate down to a low level. That'll do a lot for the income distribution.

WESSEL: Thank you for that. I'm struck by how interesting this conversation is, compared to the ones that we used to have about monetary policy, where sometimes it seemed like getting inflation down was the sole goal. So I think things have changed a lot in my time in Washington. Looking over the questions that people sent in, Mr. Clarida, there were a number of people who asked about digital currencies. Do you think that it would be a good idea for the Fed to have a Fed-backed digital currency? Do you see this as being something transformative in the way financial services work? Is this something that is 100 years away? Or something that you can see happening in the coming single-digit years?

CLARIDA: Well, as a number of my colleagues, including Governor Brainard and Chair Powell and Vice Chair Quarles have indicated, central bank digital currency is something that is under active study in the Federal Reserve System, at the Board, in the Reserve Banks, and in partnership with MIT. And obviously the U.S., the Fed, is very much integrated into the BIS's innovation hub, which is also looking at that from the point of view of global central banking. As Chair Powell indicated in some recent remarks, however, the dollar is the global reserve currency. And so our focus is not on not necessarily on getting there first, but getting there in a way that makes sense, given the role of the dollar. I would also point out that we don't have the problem that the demand for our currency is evaporating. In fact, the growth in currency demand has been has been picking up in the last decade in the last two or three years. So, unlike some say Nordic countries, where basically nobody holds cash anymore, that's not an issue for the U.S. So central bank digital currency is on the radar screen. It's under intensive study in the system. We're working closely with central banks and around the world and others through the BIS. But as Chair Powell said, our focus is on getting it right not necessarily getting there first. So I'll leave it at that.

VISSING-JORGENSEN: I wanted to touch on something we haven't discussed yet, which is the issue of moral hazard. And there's a debate about the moral hazard effects of the Fed's very successful policies this year. On the one hand, some people argue that the COVID shock was exogenous. But on the other hand, there's been a large run up in corporate debt before COVID, so firms and investors have made themselves a bit more susceptible to shocks. I wonder where you came down on that issue and whether you're worried about more moral hazard going forward? I noticed the last Financial Stability Report started discussing some regulatory initiatives. There was a lot of talk about fixed income funds. If you could just talk to what your thinking is on the moral hazard issue, that would be great.

CLARIDA: Yeah, I think there are two pieces to moral hazard. The first is easy and the second's a lot harder. The easier one is, and I think in one of my first interviews in March or April, when I was asked this question, what I said is: I'm not at all concerned that, by stepping in as we did in March, that we validated a moral hazard calculation before, because I think no one took on debt in 2019 or 18 saying if there is a pandemic shock, the Fed will step in. So I'm not too worried about that one. What I would say is that we did step in, under 13-3 authority, not so much in size, in the corporate, or the muni markets. But we did step into markets that historically we had not stepped into. And obviously, the fact that we've done that, indicates something about, at least conditions, under which it is feasible. From my own perspective, I view these, I'm still maybe, I'm a little bit old-fashioned. I'm still in the camp that thinks these 13-3 facilities should be unusual and exigent circumstances. I have no trouble going to sleep at night saying that the COVID shock was both unusual and exigent. So, I wouldn't revisit that one. And as Chair Powell has indicated, I've said and others have said, when the time comes we do want to put these tools away. I think the broader issue, that you hinted at perhaps, and Vice Chair Quarles has also discussed this, is, there is I think a global recognition of a need to not only understand better but to calibrate and assess the interplay between the non-bank financial system and the bank financial system. And I think anyone, don't want to put you on the spot, but I think most people would have to agree that our banking, our U.S banking system went through the ultimate real world stress test in March and April and passed with flying colors. And so the efforts that were undertaken post the GFC, in terms of capital liquidity leverage ratios and the like, did serve the purpose of having a very resilient banking system that was a source of support for the economy through lending and not part of the problem. So I think we should acknowledge success when we see it. And I think those efforts were successful. And so I think that's the way that I that's the way I sort of put those issues together in my own mind.

WESSEL: Mr. Vice Chair, that implies you think maybe we ought to pay more attention to the non-banks.

CLARIDA: Well, I think non-banks are an important part of our financial system. More than half of all credit in the U.S. is intermediated outside of the banking system. Obviously, that part of the system is something that's overseen through different parts of the of the oversight architecture, where the SEC, the OCC, and the CFTC, and the like. And that's all coordinated through the FSOC process.

WESSEL: Could you draw any conclusions from the difficulties that the U.S Treasury market had in March, prompting the Fed to step in with a lot of buying to calm things down, get that important market functioning again?

CLARIDA: Well I think it's fair to say and I'll just, I'll confess to your viewers that that event did take me by surprise. It was not something that I expected based upon the historical behavior of the Treasury market. There's typically a flight to quality, a flight to safety. And that week of March 16th, and really the week of March 9th, we were not seeing that. And so, after the fact, in retrospect, I have a better understanding, and my colleagues have a better understanding, of the interplay in that market, between some technical factors, between the dynamics of dealer balance sheets, the way in which those trades are cleared. I'm not an expert on it. There was a recent, we recently hosted our annual virtual Treasury conference, and had a panel or two on that. So I think it is an important issue. Obviously the Treasury market is, you know, the single most important fixed income market in the world. So it's crucial that it function efficiently and with a high degree of liquidity.

WESSEL: Another topic there's been increasing pressure on central banks around the world to get involved in responding to climate change. I noticed that recently I think it was the Vice Chair Quarles or maybe it was the Chairman said that the Fed was prepared to become more active in this network for greening the financial system. So I wonder if you could talk a little bit about what role do you think a central bank like the Federal Reserve should and can play in the climate change context?

CLARIDA: Well, David, the way I think about it is that we have a very important role to supervise and regulate a number of financial institutions. And the public has a right to expect that we will calibrate and assess their risk and capital adequacy and liquidity in terms of all the risks that they confront. And that includes risk to their investment in their portfolios from climate change. And so that's the way I think that we really think about it is our role as a regulator and a supervisor. Obviously a number of central banks around the world are also looking into this now, through the network for the greening of the financial system. We're working through the process of becoming a member of that group, although we've been very active in different working groups of that. But, in my own perspective, I really think about it, really our bread and butter responsibility as a regulator and supervisor of banks. And to the extent that there is exposure in their portfolios to extreme weather or climate events, that's something we should factor into those assessments.

CARPENTER: So far the conversation has been, pretty much, let's speed up the Fed, and look at all the things that can go wrong. There's been a lot of really positive news for the economic outlook. This morning, with Moderna's report on their vaccine. Pfizer last week. Curious how you all have been thinking about calibrating the recovery from COVID? It was, as you noted, massive hole we fell into, maybe the initial phase, the recovery happened faster than we thought. Everything is very clearly slowing down, now into the fourth quarter. And then we get this news, not just that a vaccine will be available, but that the efficacy is higher than just about anybody anticipated. Talk about a hard forecasting environment! How are you thinking through that, the range?

CLARIDA: That's an excellent point . And I'm glad we do have a chance to talk about the upside, because there is an upside . Sometimes in this job, I do have to remind myself that probability distributions have both right and left tails. It seems as a central bank they always focused on the left tail. But no, there is some good news. And again, the momentum that the economy had going into the fourth quarter was very solid. I would say, my own personal forecast and projection for '21, always had a baseline that there would be a vaccine. But that was not a table pounding conviction. And so I have been. First of all, I'm not an epidemiologist, and don't play one on TV. But obviously, the news has been very good, to have now two successful trials with above 90 percent efficacy. And so what that tells me, personally, is that I've got more conviction in my baseline for next year and more conviction that the recovery from the pandemic shock in the U.S. can potentially be more rapid, potentially much more rapid than it was from the global financial crisis. So, for example, Seth, if I get back the SEP in September, folks including today pointed out that it took three years to get, according to the SEP medians to get up to get to a low rate of unemployment and to get inflation up to two. But that took like more than seven years in following the Global Financial Crisis. And so deep shocks do tend to have some prolonged recoveries. But there is an upside here. Also, I would also point out that there's an enormous quantity of pent-up saving. Fiscal policy was so successful that this is the only downturn in my professional career in which disposable income actually went up in a deep recession. And so, and a lot of that has been saved. A lot of that has been forcibly saved, because people haven't been able to go out and necessarily spend all that. So when you combine the good news on the vaccine with north of a trillion dollar of accumulated saving, then there's a very very attractive right tail to this distribution as well. And obviously the odds of that have gone up relative to where we were before the vaccine news. So I'll leave it at that.