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The Honorable William C. Dudley

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Roger Ferguson: Well good afternoon everyone and welcome. I'm Roger Ferguson. I'm the Chairman of the Economic Club of New York. And I'd like to welcome you to the 428th meeting of the club in our 106th year. As you know, the Economic Club of New York is the nation's leading nonpartisan forum for economic policy speeches. Throughout our long history we've had more than 1,000 guest speakers appear before us establishing a strong tradition of excellence. I would like to begin by recognizing the 181 members of our Centennial Society who have contributed their support to the club. Thanks to all of you for helping to ensure the club is able to continue to fulfill its mission. I'd also like to welcome the students who are with us today from Adelphi University and Hunter College whose attendance is made possible by our members. So welcome to all the students. We're certainly glad to have you with us.

Now it's my pleasure to introduce today's speaker who also is the Vice Chair of our club, William Dudley. Bill is the tenth President and the CEO of the Federal Reserve Bank of New York, a position he's held since January of 2009. In that capacity he is also Vice Chairman and a permanent member of the Federal Open Market Committee, the group that is responsible for formulating the nation's monetary policy. Last year Bill was appointed Chairman of the Committee on the Global Financial System, one of the sub-committees of the Bank for International Settlements. Prior to becoming President of the New York Fed, Bill managed the System Open Market account for the FOMC. And for a decade before that he was Chief U.S. Economist at Goldman Sachs. Bill received his PhD in Economics from the University of California at Berkeley and his Bachelor's degree from New College of Florida. Bill, we're eager to hear what you have to say. The podium is yours.

The Honorable William C. Dudley

Thank you. Well, it's a pleasure to have the opportunity to speak to the Economic Club of New York again. Today I'm going to focus on the economic outlook and the role of monetary policy. I will argue that the fundamentals underpinning the U.S. economy are improving and that monetary policy is gaining traction. But this may not immediately lead to stronger growth because of the recent increase in fiscal restraint. As a result I expect that labour market conditions will improve only slowly and that inflation will remain muted.

Consequently it will be appropriate for monetary policy to remain very accommodative. As always my views reflected are my own and may not necessarily reflect those of the Federal Open Market Committee or the Federal Reserve System.

So turning to the U.S. economy, the U.S. economy remains on the slow growth track that's persisted since the recession ended in the middle of 2009. In fact, in 2012 real GDP grew just 1.6 percent. That's below the 2.2 percent rate of the prior two years. This lackluster and disappointing performance masks the fact that the underlying conditions that support growth are gradually improving. However in the near term this improvement in fundamentals have been offset by increased fiscal drag.

So let's first examine the fundamentals which have improved in at least six ways.

First, household dual averaging is now well advanced. Household debt has declined significantly relative to income. In the same vein, the household financial obligations ratio has fallen to levels last seen in the early 1980s.

Second: The structural adjustment in housing has largely run its course. Activity and prices are firming supported by low interest rates. Over the past four quarters housing starts rose by 33 percent, existing home sales climbed 12 percent, and home prices as measured by CoreLogic National Home Price Index were up over 7 percent.

Although the pace of recovery varies regionally, the U.S. housing sector is now, as a whole, clearly rebounding. I see the recovery in home prices as particularly important. Houses are a significant component of household wealth. In addition, as home prices begin to rise we're likely to see more transactions and more building activity. Moreover, rising home prices are likely to encourage a further loosening of credit and appraisal standards that remain unduly tight.

Third: The international economic outlook has improved somewhat. Global financial market strains relating to concerns about Europe have receded though recent developments in Cyprus highlight the challenges that remain. Chinese growth appears to be climbing again after a slowdown in 2012. And Japan is making renewed efforts to grow faster and exit from a long period of deflation.

Fourth: U.S. corporate profits relative to national income are at an all-time record and cash balances are very high. As uncertainty recedes and the outlook improves, I expect that the corporate sector will increasingly shift towards real investment, away from mainly buying back shares and hoarding cash.

Fifth: The U.S. is in the middle of an energy revolution marked by a steady rise in oil and national gas production. Just as significant the sharp in natural gas prices in the United States has created a huge impetus to investment in energy-intensive manufacturing such as petrochemicals. Because the lead times on such investments are long, this impulse will likely persist for many years.

Sixth: The financial conditions have become increasingly accommodative as monetary policy easing has passed through to a broad range of financial asset prices. Credit spreads have narrowed and the U.S. equity market has risen sharply. As the price and availability of some types of consumer loans, notably auto loans, has also improved.

So that leads to an obvious question. If all this is taking place, why isn't the U.S. economy growing more quickly. The fact that fiscal policy has turned significantly more restrictive is the most important reason. The impulse from state and local governments that subtracted from growth earlier in the recovery has gone from neutral, gone from restrictive to close to neutral. But this has been overwhelmed by the sharp shift in fiscal restraint at the federal level from mild restraint in 2012 to much greater restraint in 2013. The increase in payroll taxes, the rise in high income tax rates, the increase in taxes associated with the Affordable Care Act, and now the sequester, if sustained, will result in fiscal drag of about 1 3/4 percentage points of GDP in 2013.

I view this as an unfortunate outcome. While the U.S. must put its public finances on a sustainable footing, this should be done in a manner that best achieves both our near-term and longer term objectives. In my opinion a U.S. fiscal policy well-suited for the current set of circumstances would start with a very mild degree of restraint in the near-term that would credibly build to substantial consolidation over the next several decades.

Of course it's for Congress to judge what combination of tax increases and spending cuts should be undertaken to achieve this. Nevertheless, the aging of our population and simple math suggests that entitlement reform would need to be part of such a plan. Also, in an ideal world fiscal policy would have broad-based bipartisan support. That would reduce uncertainty and reassure households and businesses that the U.S. was on a sustainable long-term path.

Instead we have nearly the opposite. Significant retrenchment in the near term but no credible action over the long term with partisan divisions and significant uncertainty about what will happen next. Will the sequester, for example, be sustained or not?

Now looking at the outlook for 2013, I believe that growth in the first half will be sluggish as the fiscal contraction blunts the economy's forward advance. While first quarter GDP growth will likely rebound to a 2 to 3 percent annualized rate following the weakness that we saw in the fourth quarter, this will be due in large part to temporary factors. I'd also emphasize that there remains considerable uncertainty about the economic outlook. In particular we can't be confident about how much fiscal drag will blunt growth. Ultimately though the drag should abate. And when that happens, presumably later this year, the economy should strengthen.

Inflation as measured by the Personal Consumption Expenditure Deflator is currently below the Federal Reserve's two percent objective. Substantial slack remains in labor and product markets and underlying measures of inflation are subdued. With weak labor compensation growth, the trend growth in unit labor costs is less than one percent annualized which is well below the rate of price inflation. Moreover, inflation expectations remain well anchored at levels consistent with the FOMC's two percent longer run objective. Thus I conclude that the risk that inflation could significantly exceed our two percent objective is quite low over the next few years even if the recovery were to strengthen considerably.

Now turning to the Fed's monetary policy initiatives, beginning in September, the FOMC made a number of important changes to monetary policy in order to promote a stronger recovery in the context of price stability. First, the FOMC began purchasing an additional $40 billion of agency mortgage-backed securities each month. Second, the FOMC stated for the first time they would continue buying assets and employ its other policy tools as appropriate until there was substantial improvement in the labor market outlook. Third, the FOMC stated its intention to maintain a highly accommodative stance on monetary policy for a considerable time even after the recovery strengthens.

Two additional initiatives followed in December. First, consistent with the September statement, the FOMC began a new purchase program of $45 billion of long-dated treasuries per month. And second, the FOMC shifted to economic thresholds from the earlier calendar rate guidance.

The FOMC committed to keep the federal funds rate at its current level of zero to 25 basis points at least as long as unemployment remains above 6.5 percent, projected inflation on a one to two-year horizon is below 2.5 percent, and inflation expectations stay well anchored. Both elements of the policy stands were reaffirmed at last week's FOMC meeting.

So why did we make these changes? Well, the additional asset purchases do provide further monetary stimulus. This is appropriate given that we were falling short of our objectives. But moving to an outcome-based purchase program also has other advantages. In particular expectations of the ultimate amount of purchases should change as the economic outlook evolves. This is important because it acts as an automatic stabilizing mechanism. In particular, the FOMC statement that purchases will continue until the labor market outlook improves substantially provides additional support for the recovery by reducing downside tail risk.

The shift to rate guidance based on economic thresholds was not intended to provide additional accommodation at the time it was implemented. But the adoption of thresholds does support the recovery by changing the risk profile in an important way. The thresholds make it clear that short-term rates will not be raised at the first sign of economic improvement, before a sustainable economic recovery has been secured. As a result, households and businesses should be more confident in undertaking additional spending and investment today.

The shift to thresholds-based rate guidance has other benefits. Relative to calendar-based guidance, it provides more information about the economic conditions the Fed would need to see before raising rates. Importantly, the shift to thresholds should also make the eventual normalization of monetary policy smoother. This is a subject I'll return to a bit later.

But this raises an obvious question. If quantitative thresholds are good for interest rate guidance, why not also have such thresholds for the asset purchase program? There are two reasons. There is somewhat more uncertainty about the efficacy and costs associated with asset purchases compared to rate guidance and we are likely to learn more about the efficacy and costs of the purchase program as the program unfolds.

So what is this likely to mean in practice? In my view, we should calibrate the total amount of purchases to that needed to deliver a substantial improvement in labor market conditions, by allowing the flow rate of purchases to respond to material changes in the labor market outlook.

This makes sense because the benefits of additional accommodation will gradually diminish as we get closer to our full employment and price stability objectives and as we become more confident that we will reach them in a timely manner. At some point, I expect that I will see sufficient evidence of economic momentum to cause me to favor gradually dialing back the pace of asset purchases.

Of course, any subsequent bad news could lead me to favor dialing them back up again. As Chairman Bernanke said in his press conference last Wednesday “when we see that the situation has changed in a meaningful way, then we may well adjust the pace of purchases in order to keep the level of accommodation consistent with the outlook.”

So how are we doing relative to our objective of substantial improvement in the labor market outlook?

Since we provided additional stimulus in September there has been some improvement in labor market conditions. The unemployment rate is modestly lower and private non-farm payroll growth is a bit higher than earlier in 2012 and that’s certainly welcome. However, other indicators including the employment-to-population ratio and job-finding rates are essentially unchanged. This suggests that the labor market is still far from healthy.

Moreover, our policy is based on the outlook for the labor market, not the level of employment or unemployment today. In this context I note that the recent improvement in payroll employment growth, which gets most of the attention, is out-sized relative to the growth rate of economic activity that supports it. Unfortunately we have seen this movie before. When this happened in 2011 and 2012, employment growth subsequently slowed. Because growth this year will be constrained by fiscal consolidation, there’s a risk that this could happen again this year. As a result, it is premature to conclude that we will soon see a substantial improvement in the labor market outlook.

Now our asset purchase program is also conditional on our ongoing evaluation that the efficacy of the program exceeds the costs. That clearly has been the case to date—affirmed by our policy decisions. Since we put the outcome-based approach in place in September, my assessment is that efficacy has been as high or higher than I expected at the onset of the program, and costs the same or lower.

Efficacy has two components: the effect of purchases on financial conditions and the effect of financial conditions on the economy. Our latest purchase program has been associated with a substantial easing in financial conditions, higher equity prices, and narrower credit spreads. The resumption of additional agency MBS purchases in September pushed down MBS yields. With some lag, much of the drop in yields has passed through to primary mortgage rates.

Meanwhile, the impact of improving financial conditions on the real economy has been somewhat stronger than I had expected. Since September we have seen considerable strength in the interest rate-sensitive sectors of the economy, including housing, autos and durable goods, in spite of the uncertainty in fiscal drag from fiscal policy. Improvement in these sectors suggests that monetary policy may be gaining additional traction. This is important because it suggests that the benefit from a given amount of asset purchases may have increased.

On the cost side, I conclude that the costs specific to balance sheet expansion have turned out to be no greater than I had anticipated and, because we have less uncertainty now about those costs, they are lower than I would have expected in a risk-adjusted sense. So let me start with three commonly cited potential costs–impairment of market functioning, the potential un-anchoring of inflation expectations, and potential threats to financial stability.

We carefully monitor financial markets for signs that market functioning has been impaired. We look at metrics such as trading volumes, bid-offer spreads, failure to deliver securities and our own ability to execute transactions. On some of these metrics, market functioning has actually improved in recent months. Of course, we'll need to continue to monitor this, particularly if a rise in interest rates leads to less mortgage-backed securities issuance. But so far, so good, on the market functioning front.

In terms of inflation expectations, a wide range of measures remain well anchored. For example, the five-year, five-year forward measure of inflation expectations that's calculated from the difference between Treasury TIPs and nominal Treasury yields is well within the historical range of recent years.

In contrast, assessing the potential costs in terms of financial stability is more difficult. Indeed, it's not even clear to me which way the sign goes. Do asset purchases increase or reduce financial stability risk?

On the one hand, information received since September suggests there is slightly greater reason for concern about potential excesses in certain corners of the financial markets. In particular, some areas of fixed income–notably high-yield bonds and leveraged loans–do seem somewhat frothy. However, I view the expected cost to society from bad outcomes in these areas as relatively low. The broad and rapid credit creation associated with the most dangerous types of asset bubbles has been absent. The size of the asset classes in question is relatively modest and most of the investors in these assets are not highly leveraged. So if asset valuations were to adjust sharply and some investors faced painful losses, I do not expect that such a shock would threaten financial stability.

Nevertheless, we will have to keep a close eye on financial asset prices. As I noted in my first speech to the Economic Club of New York three years ago: "Despite the fact that it is hard to discern bubbles, especially in their early stages, I conclude that uncertainty is not grounds for inaction. Instead, the decision whether to act depends on whether the appropriate tools can be deployed to limit the size of the bubble and whether the benefits of acting and deploying such tools are likely to exceed the costs."

On the other hand, there is a financial stability case for doing more purchases in the current context. To the extent that risky behaviors and incipient asset price bubbles are fueled by an expectation that interest rates will be "low for long," asset purchases that strengthen the economic recovery and bring forward the date of liftoff should promote financial stability. Also, to the extent that asset purchases increase the likelihood of a sustainable economic recovery, this reduces the financial stability risks associated with a Japanese-style outcome of chronic deflation.

Now although the costs specific to the asset purchase program do appear to be well-contained, it's also true that the costs do increase as the program gets larger. In part, this is due to the fact that as the Fed's balance sheet increases in size, the risk of a period of low or zero remittances to Treasury in the future also increases. As we acquire more longer-dated assets funded with reserves, the Fed takes on more interest rate risk. This is how the policy works. A byproduct of this is that our net income and remittances will be unusually elevated for a while, then they're likely to fall substantially for a period before returning to more normal levels. This is because our interest expense will increase substantially when we begin normalizing interest rates. Also if we were to sell assets in a rising rate environment, we could also experience some capital losses on those sales. In combination, depending on the future trajectory of short and long-term interest rates, remittances could even fall to zero for a period.

There are several important points to make here. First, the potential impact of the purchase program on future Fed remittances was known at the onset of the program. We have no new information here. The outcome depends on how the economy evolves, how we respond, and whether we decide to sell long-dated assets in the portfolio or not.

Second, it's important not to put excessive weight on the possibility of a period of zero remittances. Our mandate after all is economic, not fiscal. Our job is to return the economy to full employment and price stability. Moreover, in considering the fiscal consequences of our actions, what matters is not what happens to our remittances–that's far too narrow a perspective–but how our actions affect the overall federal debt burden, the federal debt-to-GDP ratio over time. This is the metric we should be focusing on in assessing the potential fiscal consequences of our actions.

In this respect, it's important to note that the narrow impact of Fed remittances on the federal debt-to-GDP ratio depends on the cumulative amount of remittances, not the timing of remittances. Cumulative remittances to date have been hundreds of billions of dollars higher, all else equal, compared to if the Federal Reserve had not expanded its balance sheet. And according to Congressional Budget Office projections, even if remittances were to drop sharply in future years, cumulative remittances would still likely be higher compared to the counterfactual program in which the Fed had not expended its balance sheet. In addition, because Fed purchases put downward pressure on long-term interest rates, this generates interest savings for the Treasury, and this benefit should be included in the fiscal cost calculations.

Finally, and most importantly, to the extent that asset purchases are effective in pushing the trajectory of economic growth above what would otherwise have been the case, this will lead to higher government tax revenue and lower safety net spending outlays during the recovery period. This means that across a broad range of scenarios, our large-scale asset purchase program is likely to result in a lower federal debt-to-GDP ratio.

So to sum up, the better choice is for the Fed to pursue the policy that best achieves its mandated objectives and puts the U.S. government in a better fiscal position. This dominates a policy of fewer purchases simply so that we at the Federal Reserve can avoid potentially having to explain why our remittances may have fallen to zero for a short period.

Finally, I'd like to talk about some of the other issues associated with the normalization of monetary policy. In general, I think it's premature to spend much time focusing on exit when we have not yet secured a sustainable economic recovery. That's putting the cart before the horse in my opinion. That said, though, we nevertheless do need to understand the issues surrounding exit so that we can design the best monetary policy regime to achieve our objectives.

On this topic, let me ease three concerns I frequently hear expressed. The first is that the large amount of excess reserves in the banking system will be "dry tinder" and this will fuel a rise in inflation in the future. As I have mentioned repeatedly, the ability of the Federal Reserve to pay interest on excess reserves ensures that we can control the credit creation process and prevent an upsurge in inflation. The second concern is that when the Fed ultimately raises the rate it pays on excess reserves, it will be providing a subsidy to the banks. The interest rates on excess reserves is not a subsidy to the banks. In attracting deposits or other liabilities, competition among banks will ensure that higher interest payments to banks on their reserves will be passed through to bank liability holders.

I look forward to the day when the economy is strong enough for us to raise the interest rate we pay on excess reserves. When that happens, deposit rates will also rise. That will be important because ultra-low rates have been a burden for many seniors and others heavily reliant on this kind of income. When we raise the interest rate on excess reserves, it will be my mother and my mother-in-law and others like them, not bankers, who will mainly benefit.

The third concern is the notion that the Federal Reserve will be slow to tighten monetary policy because this will reduce the amount of the Fed's remittances to the Treasury. This doesn't add up. The Fed is a central bank, not an asset management company–our commitment is to our dual mandate economic objectives–not maximizing net income or remittances. Moreover, even if we were to put any weight on this consideration, the incentives go the other way. Our enlarged balance sheet creates an additional reason to tighten monetary policy in a timely way. If the Fed were to delay in raising short-term rates to try to protect its current earnings, inflation would rise and this would push long-term rates higher. This would just necessitate a bigger rise in short-term interest rates in the future and a greater loss of earnings later.

A much more important issue with respect to policy normalization is to moderate the risk of a sharp snap-back in longer-term interest rates. But this has less to do with the size of the balance sheet specifically than the challenge of normalizing the current stance of monetary policy in all its different dimensions. There is always a risk that market participants will shorten the Fed's actions. Market participants could collapse an extended sequence of steps back to the date of the first move towards normalization resulting in an abrupt tightening in financial conditions.

In this regard the move to economic thresholds-based guidance should help. While the thresholds are certainly not triggers, they should help market participants adjust expectations about the likely timing of liftoff in a relatively continuous manner and guard against these expectations being pulled further forward in time than is actually warranted by changes in the economic outlook.

Nevertheless, we will need to communicate our broader intentions very clearly. Even when purchases cease, the enlarged balance sheet will provide substantial ongoing stimulus. It's important to recognize that the Fed could remain in this posture with policy on hold for a significant period. As the threshold framework should make clear, there is no fixed time-frame between completing purchases and raising short-term rates.

Long-term yields rose sharply in 1994 and 2004 when economic recoveries got underway in earnest after sustained periods of unusually low short-term rates. Compared to those episodes, the risk of a spike in long-dated yields this time around may be somewhat lower for two reasons. First, this risk is receiving a terrific amount of attention. Big market moves are typically associated with surprises. For the market to re-price suddenly, I presume there would need to be some new information that caused investors to significantly revise their view either of the outlook or the Fed's reaction function.

Second, the Fed's expansion of its own balance sheet may be a stabilizing influence. For example, the rise in interest rates during those prior episodes was amplified by convexity-related hedging generated by the fact that as interest rates went up, the duration of mortgage assets extended. This should be a much less powerful force this time around because the Fed holds a substantial portion of the agency MBS market and we're not going to delta hedge.

However, we should keep up our guard. The regulatory community must continue to take steps to mitigate the vulnerability of the economy to a sharp rise in long-term rates. This includes monitoring banks' exposure to duration risk and the quality of their risk management and capital planning while also looking outside the banking system because some risks may reside elsewhere. In this regard, agency mortgage REITs and the risk of large outflows from bond mutual funds are issues that deserve ongoing attention.

So in conclusion, the FOMC is committed to the dual objectives of maximum sustainable employment in the context of price stability. Currently we are falling well short of our employment objective and the restrictive stance of federal fiscal policy is a factor. On inflation, we are also falling short but by a considerably smaller margin. As a consequence, we need to keep monetary policy very accommodative.

I do not claim that there are no costs or risks associated with our unconventional monetary policy regime. But I see greater cost and greater risk in moving prematurely to a policy setting that might not prove sufficiently accommodative to ensure a sustainable, strengthening recovery. I remain confident that the benefits of a stronger and earlier economic recovery will trump the costs associated with our unconventional monetary policy measures.

Thank you for your kind attention. Now I'm prepared to take a few questions.

QUESTION AND ANSWER PERIOD

ROGER FERGUSON: Bill, thank you very much for that speech. As he has already indicated, as is our custom there will be some questions from two members of our club. Doing the duties today will be Ed Hyman who is the chairman and founder of ISI, and Ralph Schlosstein who is the President and CEO of Evercore Partners. If you have any questions in the audience, you can email them to questions@econclubny.org. That's questions@econclubny.org. And our President, Jan Hopkins, will read them. Ed, you have the first question.

EDWARD HYMAN: Roger, thank you. Bill, thank you for being here today and thank you for serving our country. Your speech was so complete, I don't have any questions left.

THE HONORABLE WILLIAM C. DUDLEY: Mission accomplished.

EDWARD HYMAN: It was excellent. I'm interested in a general question about monetary policy and lags. The work that we've done finds like a one and two-year lag between monetary policy and what happens in the economy. So one part of this is, you know, what do you think of that? Some people think that we were too accommodative in '04 and that, you know, one or two years later created more strength than we wanted in housing and that we might have been too tough in '07 and that might have pushed us down a little bit more. And so when I look at current policy, I wonder if it's not in the context of 2014 and what we're going to be doing then. So I would be very interested in your thoughts on those topics. Thank you.

THE HONORABLE WILLIAM C. DUDLEY: Well, I certainly agree, Ed, the famous adage is that lags of monetary policy are long and variable. So I'm not sure I would necessarily subscribe to one to two years. You know certainly we're not seeing that much positive benefit of monetary policy showing through to the real economy. We're not getting the economic growth that we desire. I think that's partly due to two major factors. One, fiscal drag, which is quite significant right now. And two, because of the fact that the monetary transmission mechanism of the monetary policy had been quite impaired for quite a while. The good news is that I think that the impairment of the monetary transmission channels, that's becoming less severe. And the thing that I think is very, very important in that regard is housing. The fact that housing is now recovering, I think is very, very important and actually letting monetary policy accommodation actually show through a little bit more to the real economy. So I think it's certainly possible that in 2014 or even earlier we can start to see the economy pick up steam more rapidly than most people's forecast. You know as I outlined in my speech there are a lot of really good things underneath the surface that are being sort of camouflaged by the fiscal drag that we're going through at present. So it's certainly possible that the economy could strengthen more dramatically than what we're currently anticipating. And if that happens, that's very good news. That would be a very, very desirable outcome. Obviously, you know, we're driving the car down the road based on where the road goes. And if the economy strengthens more rapidly than we expect, then of course we'll react to that. Conversely, if the economy is disappointing relative to our expectations, we'll react to that too. So I think we're not making our monetary policy decisions today for all time. We're making it based on what we know today, recognizing that we'll learn more as we go through time.

RALPH SCHLOSSTEIN: Bill, I echo Ed's comments. Your speech was so comprehensive you left very few stones unturned. But let me ask a question. How would you and the Open Market Committee define exit from quantitative easing? Either ceasing of any further purchases of Treasury and mortgage-backed securities? Or actually shrinkage of the balance sheet in the direction of pre-crisis levels? And however you define it, is that a necessary precondition before short-term interest rates are adjusted?

THE HONORABLE WILLIAM C. DUDLEY: Well, I think that our view is that in terms of asset purchases, that it's really about the stock of assets that we have on our balance sheet, not the flow of assets that we're purchasing. So if we were to stop purchases and yet keep our balance sheet at the same size, continue to reinvest maturing assets so the balance sheet didn't change in terms of composition or duration, then policy would stay at the same degree of accommodation. Obviously there would be a momentary adjustment as whatever we did collided with whatever market expectations were, so obviously there would be some short-term adjustment. But in general, it's really about how long, how big is our balance sheet and how long do we hold those assets that we have on our balance sheet. That's really where the push for monetary policy comes from. In terms of, you know, the exit, we've made it pretty clear. We've published exit principles back in June 2011 that basically said that interest rates will start to rise before we will contemplate doing anything in terms of balance sheet sales. And the chairman and others have raised the possibility that we could take another look at this because the balance sheet today is very different than what it was in June 2011. But the ordering would certainly be interest rate rises first, and if we were to undertake balance sheet sales, balance sheet sales second. And the lag between the two might be, you know, quite long or short. It would all depend on what's happening to economic conditions.

EDWARD HYMAN: So Bill, as you and I were cohorts in this business, I grew to really admire your ability to study the economy and make good forecasts. If you could give us some inside baseball, it's clear from your speech that employment is important, that housing is important. But I was curious if there are any other specific economic indicators that you watch currently that you think are most helpful in determining how the economy is faring, whether it's maybe house prices or bank lending or consumer confidence, or auto sales, or what?

THE HONORABLE WILLIAM C. DUDLEY: I wish I had that, you know, one key thing that I could say this works every time. But I think as you know, Ed, there is no such magic economic variable. I look at a lot of different things, but more than just looking at the economic news that's coming across The Transom, I'm trying to also think to myself, well, what's really going on underneath the surface? Because as you know, I think in forecasting the economy it's best to have a framework for what's really driving the economy forward. And right now we have this essential tension between financial conditions becoming more accommodative and the pass-through of financial conditions, the real economy working more effectively, but that colliding with a significant amount of fiscal restraint and also uncertainty about the near-term outlook for fiscal policy. So putting those two things together, you know, my conclusion is that the greatest danger in terms of economic forward momentum is probably the next three to six months. And that if we can get through the next three to six months in good shape, then I would definitely be more confident after that because then I would feel that the fundamentals would likely start to be the dominant influence. You know I think it's too soon to take too much cheer from the recent economic news. It's actually been better than expected because we've seen these kinds of accelerations before and they've often been short-lived, especially the fact that the fiscal restraint is hitting right now. We've already heard reports in terms of the sequester starting to affect, for example, research grant hiring is one example, repair of naval ships being postponed. So all these things in terms of sequester are going to sort of gradually show up over the next three to six months. So if we can come through that in good shape, then I'll definitely become more optimistic about the outlook. But it's not like one piece of economic news that I sort of really focus on. It's the whole constellation. Think of me as an impressionist.

RALPH SCHLOSSTEIN: Bill, let me switch gears a little bit to something you didn't discuss in your excellent speech. There's been a lot of discussion in Washington and among experts in banking about the Fed's concern about the size of our largest banking institutions. Is there a conscious policy to cap the size of the four or five largest institutions in our country or in fact to shrink them in size over time? And if there is such a policy, to what extent do you take into account the global competitiveness of our industry as a factor?

THE HONORABLE WILLIAM C. DUDLEY: I think where there is a consensus is to end "too big to fail" and I think where the debate is, is about how best to do that. There's essentially sort of two schools of thought right now on "too big to fail." One school of thought is let's keep going down the path we're on working on a whole variety of different margins to end "too big to fail." So that's higher capital, higher liquidity, greater simplicity of structure, a resolution strategy that actually could work, a strengthened financial market infrastructure so if a failure occurred there would be much less amplification through the financial system, that the financial system could handle such a failure. So that's one approach. The other approach is, no, that's not going to work. We actually need to force the banks to be much, much smaller so we don't have any institutions in this country that could possible be systemic. And I think that, you know, it's good that we're having this debate. My own view is I'd like to keep pushing on the first approach as hard as possible and see what sort of progress that we can make there. But as I said in a speech not too long ago, if we can't end "too big to fail" by working on these various margins of capital, liquidity, resolution, complexity, interconnectedness, then we may have to turn to the other approach which is actually forcibly downsizing the size of some of the major financial institutions. But that debate is, you know, sort of ongoing and I think we'll sort of see how things evolve.

EDWARD HYMAN: So it seems increasingly that we're in a global economy. And we do a lot of work looking at the global easing cycle, you know, rate cuts in countries outside the U.S., the quantitative easing program in the U.K. and Europe, and now the program I guess about to start in Japan. And I was curious, sort of how you put those into perspective and also any thoughts you'd like to share with us on the Bank of Japan's program for the next say three to six months.

THE HONORABLE WILLIAM C. DUDLEY: Well, I think we need to see what that program actually is in terms of the Bank of Japan. I mean at this point it would be just sort of speculation exactly what they're going to do. Look, I think it's, you know, the global economy is weak and a lot of countries are dealing with the same issues that the U.S. is dealing with which is inadequate momentum relative to the amount of slack that's in the economy. And so it's completely appropriate for those countries to pursue very accommodative monetary policies. So to the extent that other countries want to help push global growth along, provide more momentum to the global economy, I view that as a very good thing for the U.S. and something that we should be very supportive of. You know I think the G20 drew the line in the sand pretty clearly a few months ago where they basically said pursuing aggressive monetary policy for domestic purposes to stimulate the economy is perfectly acceptable. Engaging directly in the foreign exchange markets to try to push down one currency versus another, not. And I think I share that view.

ROGER FERGUSON: Ralph, you'll have the last one.

RALPH SCHLOSSTEIN: Okay. Cyprus, over the last week, was a vivid reminder that Europe is still well behind us in the re-equitization of their financial institutions and reducing over-leverage. Sitting here today, do you think that the risks from Europe are roughly the same or lower, or significantly lower than they were a year ago? And second, are there any other exogenous events or factors that the Fed worries about other than the fiscal policy that you obviously highlighted so strongly in your speech.

THE HONORABLE WILLIAM C. DUDLEY: We worry about everything, Ralph. We worry about everything. In terms of Europe, I think the risks are definitely less today than a year ago because one of the sort of bad equilibrium outcomes that could have happened where interest rates go up in the peripheral countries which increases their debt service cost which then causes their interest rates to go up further. And so they get caught in this sort of debt service spiral. The ECB essentially cut that off last summer with the OMT proposal which is, it's one of the most amazing economic proposals of all time in the sense that it's never been used but it's actually been completely effective. So it's a great thing. Basically what it does is underscores the importance of credible backstops. If you have a credible backstop, you can actually keep private investors engaged. And if you do that, you can actually have a pretty good outcome. So I think things are much better. I think the other thing that's really, I think it's a significant improvement compared to months ago is we have a road map now. We sort of know where we're going. You know the ECB has taken on the job of being the Pan-European Bank regulator and I think that's really, really important. It's going to be hard. It's going to take a while. But once they accomplish that and get the European banks well scrubbed so people are actually confident in the financial position of the European banks, I think that's going to be extraordinarily important. So I'm, you know, there's going to be bumps in the road as we've seen over the last week, but I definitely am more optimistic than I was a year ago.

ROGER FERGUSON: Well, thank you Bill, thank you Ed, and thank you Ralph for that interesting speech and then dialogue back and forth. Before lunch is served, I'd like to hold on to your attention for two important announcements. First, I'm happy, indeed I'm proud to announce that the second Economic Club of New York Leadership Award will go to none other than Paul Volcker. That award will be presented at a lunch here at The Hilton on May 29 and we'll also get the chance to hear from Paul on that day. My second announcement is that our April 10 luncheon will feature IMF Managing Director, Christine Lagarde. She'll deliver her kickoff speech to the IMF World Bank spring meetings to us here in New York rather than in Washington, DC as has been the custom. So we're thrilled to have both of these events to look forward to. In the meantime, thank you very much for coming today and please enjoy your lunch. Thank you very much.