

## **Economic Outlook and Central Bank Policy**

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### **Introduction**

Good afternoon. I am delighted to be back in Rochester and to have the opportunity to be with you today and see so many old friends. Last year I told you I was fortunate to have joined the Federal Reserve at what I called an interesting and challenging time.

Little did I know how much that would seem an understatement just 12 months later. As we near the end of 2007, “interesting and challenging” has taken on a whole new meaning. The fallout from the problems in the subprime mortgage market and the related disruptions in the financial markets has served to highlight some important but distinctive roles for the central bank. Today I want to talk about the state of the economy, how the economic outlook has changed since early summer, and how that has shaped my views for monetary policy.

Over the next several quarters I expect the economy to experience somewhat sluggish growth, primarily due to weakness in residential construction. But I anticipate that by mid-2008, economic activity will be returning to near trend growth. Of course the devil is in the details, and in my discussion, I will elaborate on my forecast and the risks that surround it.

I will also comment on the Federal Open Market Committee’s (FOMC’s) new practice of reporting economic forecasts on a quarterly basis, and what that means for central bank transparency and the effectiveness of our communications.

### **Economic Conditions**

When I spoke to you a year ago we were in the midst of a sluggish second half of 2006, with real GDP growing at only a 1 to 2 percent annual rate. That sluggish pace of activity was in large part the result of the decline in housing activity in 2006. The first quarter of 2007 was even weaker – with real GDP growth of only 0.6 percent – and there was rising concern about what that would mean for the remainder of 2007.

But once again the economy demonstrated its resilience. Current estimates indicate that growth of real GDP picked up to nearly 4 percent in the second and third quarters, despite weakness in both housing and autos. Consumer spending generally held up despite the rise in energy prices and despite the declines in house prices in a number of regions, which limited the accumulation of housing-related wealth and may have curtailed consumer spending. Although there were sharp declines in residential construction activity, nonresidential construction remained quite strong, and business investment in equipment and software held up quite well. Recently, exports have been one of the most significant contributors to growth; they increased at a double-digit annual rate in the third quarter.

In labor markets, the unemployment rate stood at 4.7 percent in October, nearly the same as it was this time last year. Although average monthly gains in payroll employment in 2007 have fallen to 125,000 from 189,000 in 2006, they continue to reflect a healthy demand for labor and are providing solid gains in personal income. Indeed, the October increase of 166,000 jobs was surprisingly strong.

The economy's resilience in the second and third quarters has meant that so far this year real GDP is growing at a 2-3/4 percent pace. Even though growth in the fourth quarter is expected to slow significantly, the central tendency of FOMC participants' forecasts of growth from fourth quarter 2006 through fourth quarter 2007 is around 2-1/2 percent. This is slower than the 3 percent growth rate I was expecting when I spoke to you last year, but it is a respectable showing considering the prolonged weakness in residential construction, the high price of oil, and the financial market's problems.

Indeed, the strains in the financial markets that arose in mid-August highlight important challenges for a central bank. In my view, the Federal Reserve has two related, but distinct, responsibilities. The first and primary responsibility is monetary policy, which involves ensuring price stability, which contributes to sustainable economic growth. The primary tool of monetary policy is the federal funds rate, and the FOMC meets about every six weeks to determine an appropriate target for the funds rate consistent with these longer-term goals. The Fed's second responsibility involves promoting financial stability by ensuring that the payment system and financial system function effectively.

The disruptions in the financial markets in August were triggered by the realization that default rates on adjustable-rate subprime mortgages were likely to rise much more than anticipated. Of course, those mortgages were the most risky and thus should be expected to have higher default rates than other mortgages. Nevertheless, the value the markets were assigning to such mortgages came into question. But that was only part of the surprise. The other concern that surfaced was that market participants were generally unsure which firms had exposure to these mortgages and to what degree. In other words, the market realized that not only did it not know how much these securities were worth, but it didn't know where these risky assets were held. As a consequence, there was a flight to quality and an associated reluctance to lend to institutions that were thought to hold these now questionable assets. This price discovery process is still underway, and it is likely to be some time before it is completely sorted out.

It is important to recognize that the Federal Reserve cannot resolve this price discovery problem. The markets will have to figure this out. Arbitrarily lowering interest rates or providing liquidity to the market does not provide the answers the market seeks. Indeed, in some circumstances, lowering interest rates may prolong the painful process of price discovery.

Nevertheless, in the short run, the disruptions can make it difficult for certain markets to function effectively. Some market participants, even those with strong balance sheets, for example, found it difficult to obtain funds in the short-term credit markets because few of the potential buyers of the short-term debt were willing to buy because of the uncertainty. This is the circumstance we found ourselves in for a period in August. The problem became most acute for those institutions or entities that relied on borrowing short and lending long (especially if lending long meant buying subprime mortgage portfolios). When these entities could not roll over their short-term debt, they faced the problem of having to potentially liquidate longer-lived assets at uncertain or depressed prices.

The Federal Reserve's role when markets become impaired in this way is to lend to banks with good collateral so that the side effects on sound institutions are minimized. This is exactly what the Federal Reserve did. In August, the Fed reduced the discount interest rate, which is the rate at which it loans money to depository institutions, by 50 basis points and extended the maximum term on those loans to 30 days. This action played an important role in supporting market functioning and bringing some stability and confidence to the funding markets.

Thus, disruptions in financial markets can generally be addressed using the tools available to the Federal Reserve without necessarily having to make a shift in the overall direction of monetary policy as measured by the federal funds rate. Nevertheless, when financial disruptions occur, spillover effects can impact the broader economy. Whether a change in monetary policy is required ultimately depends on whether the disruptions are significant enough to change the outlook for the economy in a way that is inconsistent with the Fed's goals for price stability and sustainable economic growth.

In my mind, such an adjustment became appropriate by late September. During August and September, the cumulative deterioration in the housing sector along with the potential for tightening of credit conditions led me to revise downward my outlook for economic activity over the intermediate term. In addition, the July benchmark revisions to real GDP growth pointed toward a slower trend pace of economic growth going forward, based on a slower average growth of labor productivity. I now estimate the trend growth of output at about 2-3/4 percent. Finally, the continuing high level of oil prices also suggested the possibility for some slowing in the pace of economic activity during the next several quarters.

Taking these factors together, in September I lowered my projection of economic growth for the fourth quarter of 2007 and the first half of 2008. In particular, the adjustment to my forecast involved pushing back the turnaround in residential construction, as low

demand for homes meant it would take longer than expected to work off the inventories of new and existing homes for sale.

I expect the decline in housing activity will bottom out by the end of the second quarter next year. Residential investment should then turn positive in the remaining quarters of the year, for the first time in more than two years. I expect that overall real GDP will grow faster in the second half of 2008 as it returns to its longer-run trend of about 2-3/4 percent. On a fourth-quarter to fourth-quarter basis, I expect that the economy will grow about 2.5 percent in 2008, close to its pace in 2007, and that it will be growing more consistently around its longer-term trend in 2009.

The below-trend growth of the economy in early 2008 will mean slower payroll employment growth for a couple of quarters, followed by a return to its longer-run trend by the middle of next year. With slower job growth for a time, the unemployment rate may rise to about 5 percent next year. This is still a historically low level of unemployment and one that is often viewed as consistent with “full employment.”

On the inflation front, the data since early spring have been encouraging. Inflation rates excluding food and energy have been stable, while headline measures have moved up and down with energy price fluctuations. Moreover, inflationary expectations have remained fairly well anchored. While I did not, and do not, take this as evidence that inflation is no longer a risk, it is encouraging.

### **Monetary Policy Decisions and the Outlook**

How has this outlook shaped my view of appropriate monetary policy? Three important factors are critical to my approach to monetary policy. First, it is widely understood that monetary policy influences the economy with a lag. Actions taken today, for example, are unlikely to have any effect on the broad economy for the next quarter or two. Thus, the FOMC must always be forward-looking in its decision-making; it must formulate an outlook for how economic growth and inflation will unfold over time. Incoming economic data help inform us about whether the economy is unfolding as expected. The Committee’s objective at each meeting is to set the target federal funds rate at a level that, in the context of the outlook, will support the achievement of its goals of price stability and sustainable economic growth.

Second, it is important to appreciate the fact that slow-growing economies exhibit real, or inflation-adjusted, interest rates that are somewhat lower than those of fast-growing economies. Monetary policymakers must be cognizant of that fact in setting the target for the fed funds rate. Failure to do so would likely result in the creation of either too much or too little liquidity, leading to too much or too little inflation or perhaps even deflation.

Third, because economic data are volatile, the report of a sharp change in one or two economic indicators is not enough to substantially change the outlook for the economy or inflation, and thus not enough to elicit a change in monetary policy. One would have to see a series of monthly numbers, or similar changes in a broad array of data, to present a

convincing case that the outlook has changed significantly. Even when the outlook does change, one still has to ask whether it has changed enough to impede the achievement of the Fed's goals of price stability and sustainable economic growth. One also needs to ask how much monetary policy can influence that forecast over the relevant time horizon, given the long lag in the response of the economy to changes in policy. For example, a change in monetary policy is unlikely to mitigate surprise shocks to the economy that are very transitory in nature. The economy simply does not respond that quickly to policy changes.

Thus, the FOMC does not base its decision to change monetary policy on any one number but, instead, assesses the impact of all incoming data for the outlook in light of its ultimate goals. It is when new information indicates that the intermediate outlook for economic growth and inflation has changed and is no longer consistent with the Committee's longer-term goals that one is more likely to see adjustments to the FOMC's fed funds rate target.

These three elements of monetary policymaking help to explain why I viewed the FOMC's September decision to lower the federal funds rate target by 50 basis points as appropriate.

In September, based on the accumulation of economic news, my outlook had changed, and I came to expect slower growth for a somewhat longer period than I had projected earlier. A slower economy means that real interest rates must decline to bring about the appropriate adjustments to restore growth. In recognition of this, I believe September's action to lower the fed funds rate target was appropriate. It is also important that the decision was conditioned on the observation that inflation through the spring and early summer seemed to moderate and inflation expectations appeared to be stable. Had this not been the case, September's monetary policy decision, in my view, would have been much more difficult.

At the most recent meeting, the FOMC decided to take out what some have called an insurance policy with respect to the risks to the forecast and lowered the funds rate another 25 basis points. As you may have read, this decision was a close call. There was very little data that we received during the inter-meeting period that suggested that the economy was performing worse than we had anticipated in September, and indeed, things had improved modestly in some dimensions. Yet the Committee felt that, given the uncertainties in the outlook, an additional reduction in the funds rate was appropriate.

### **Risks to the Outlook**

Of course, there are always risks to any outlook for the economy. For example, on the downside, housing could turn out to do even worse than has already been incorporated in my revised forecast. The related financial problems in the subprime mortgage market could lead to more significant spillovers to other parts of the economy through a further contraction in credit. We have heard that some businesses are putting some of their capital spending plans on hold until uncertainties about the cost or availability of funding

are resolved in the financial markets, and such a trend could accelerate. We also have to acknowledge that the high level of oil and other commodity prices could restrain both consumer and business spending plans.

The FOMC reduced the fed funds rate target in anticipation of a slower economy in the coming few quarters, and I expect to see some weak economic news – this is already incorporated into my forecast. Even though I expect the economy will slow somewhat in the near term, there is also the possibility that growth will rebound more quickly than is now anticipated. As I have said before, the U.S. economy has a history of being remarkably resilient, and, more often than not, it has surprised the skeptics to the upside. If so, and the outlook is revised upward, monetary policymakers will have to reassess the appropriate level of the fed funds rate target.

We also cannot rule out the possibility that the Fed's reduction in the fed funds rate target runs the risk of higher inflation and inflation expectations. While the inflationary signs in recent months have been encouraging, I do not think we are in a position to be sanguine. If inflation begins to creep up or expectations of future inflation rise in the coming months – which is a risk given the FOMC's decision to cut interest rates – the outlook will be affected and policy may have to be adjusted. To me, these risks highlight and reinforce my view of the value of a clearly articulated inflation objective. A public commitment to such an objective in this environment would contribute substantially to ensuring that inflationary expectations remain firmly anchored.

### **Announcing Projections**

As I noted earlier, I believe one should consider changing the stance of monetary policy only when there is a change in the outlook that affects the Fed's ability to achieve its policy objectives: price stability and sustainable economic growth. This makes it sound somewhat easier to do than it actually is. After all, the future is inherently uncertain, and some times are more uncertain than others. The economy almost always turns out to be better or worse than the forecast. Moreover, forecasts often vary across individuals — this is apparent in the Philadelphia Fed's Survey of Professional Forecasters and in other private-sector forecasts, and across FOMC participants as well. Indeed the FOMC's deliberations (among 19 people) entail a lengthy discussion of the outlook and the various members' assessments of how their views are evolving.

For the public and financial markets to understand when and how monetary policy will be adjusted, they need a clear picture of the central bank's outlook. They need to better understand the thinking of the FOMC and what goes into the decision-making process. Consequently, I believe that the FOMC's announcement on November 14 of its decision to provide quarterly releases of information on the economic projections of the Fed presidents and Fed Governors is a major step in providing a clearer picture of what goes into our deliberations.

More broadly speaking, such efforts to improve communications to the public and the markets contribute to making the decision-making process more transparent and the

central bank more accountable, which I believe will be very beneficial to the functioning of the economy. With more information about the Fed's outlook, individuals and market participants will all be able to make their own economic decisions armed with a better understanding of what the central bank expects to happen in the economy. I would also add that the preparation and discussion of these forecasts have an important positive impact on the internal deliberations of the Committee. Thus, the process will not only improve the Committee's communication with the public, but it focuses and improves the Committee participants' communication with each other.

Some observers may find this approach disquieting, since there certainly will be differences among the 19 participants at FOMC meetings about the outlook for the economy and inflation. These differences may raise questions about whether monetary policy will be consistent over time. But I believe these differences are a healthy thing and simply reflect the deliberative process of the central bank's decision-making body. Expressing differences and debating positions is what helps a committee arrive at better decisions. As the American writer and journalist Walter Lippmann once said: "*Where all men think alike, no one thinks very much.*" I believe the give and take at FOMC meetings reflects the fact that a lot of thinking goes into the decisions the Committee makes. If we all agreed all the time, there would be little reason for the Committee to meet.

The initiative to provide more information on our economic projections is part of the Fed's ongoing effort to improve communication and transparency. Some of you may remember that the practice of announcing changes in the federal funds rate target in a statement at the end of each FOMC meeting did not begin until 1994. Before that, markets were forced to guess what the Committee's decision was by closely following the actions of the Open Market Desk in New York. But times have changed, and I am sure the Committee will continue to improve and refine our communications in order to make monetary policy less mysterious and more transparent. While I believe that it will take some time for the public and the markets to learn how to assess this new information, they will eventually do so. In the meantime, the FOMC will be listening to feedback in order to refine and improve how we present the material so that we can improve the effectiveness of our communications.

## **Conclusion**

Before closing, I want to stress three important points.

First, for monetary policymaking to be effective, it must be forward-looking. It should depend on the outlook for inflation and economic growth, and it should not seek to target the prices of individual goods or assets. This means policy must resist the temptation to respond to short-term, transitory disturbances, unless they have a significant impact on our longer-term objectives of price stability and promoting sustainable economic growth.

Too often people seem to think that when a weak economic number is released, the Fed will respond to it immediately with a policy action. In my view, if the FOMC members already expected some bad economic numbers and had already taken those into account

in their outlooks when they set the fed funds rate target, then you should only see policymakers take action when the outlook changes significantly – not when a few pieces of bad economic news are released.

In the current environment, I am anticipating the economy to grow more slowly in the coming months, despite the FOMC's latest reduction in the fed funds rate target. Therefore, I will not be surprised to see weaker statistics making headlines. But weaker numbers will not lead me to revise my outlook or my view of the appropriate funds rate target, unless they are much weaker than already anticipated and accumulate sufficiently to generate another downward revision in my outlook.

The second point is that the FOMC's change in the stance of monetary policy by reducing interest rates does not come without some risks. One risk is that we may exacerbate moral hazard and encourage inappropriate risk-taking. It should be clear that is not our intention. As I have said, the FOMC's focus is on the broader economy and its outlook. It is not, nor should it be, the role or responsibility of monetary policy to rescue investors or borrowers from the outcomes of their financial choices. While it sometimes seems an attractive option to soothe investor concerns and soften losses with changes in monetary policy, it is bad for the economy and bad for the health of our financial institutions in the long run, as it can encourage excessive risk-taking and distort the allocation of resources.

As I mentioned earlier, the Committee's decision to lower rates at its most recent meeting was, in part, an effort at risk management and attempting to provide some insurance against uncertainties in the outlook. This brings me to the third point I want to make. Specifically, I want to stress that this risk management or insurance strategy carries with it its own set of risks and must be used with some care.

For example, there are always risks out there, and they are not all on the down side. How do you decide which risks to insure against? How do you know how much insurance is enough? After all, insurance is not free, nor should it be. These are difficult questions, and the decision to act requires considerable judgment and care.

In the current environment, providing insurance through a reduction in the fed funds rate creates its own set of additional risks. It may exacerbate moral hazard problems as I suggested earlier. Moreover, a lower funds rate creates a risk that inflation may be exacerbated and inflationary expectations may begin to rise. So far, inflation expectations have remained stable. Yet I consider those expectations more fragile now than I did four to six months ago. The rise in oil prices and the simultaneous increases in a broader basket of commodity prices suggest that significant inflationary pressures exist in the economy and thus the Fed must be very vigilant. If inflationary expectations rise, it could prove very costly to put the genie back in the bottle. Should that scenario come to pass, the insurance policy may turn out to be a very expensive one.

To sum up, I think the U.S. economy will go through a brief period of sluggish growth before returning to a sustained expansion. I expect that inflation during the coming year

will remain above the level I view as consistent with price stability, before diminishing thereafter. However, as I noted earlier, the reduction in the fed funds rate runs the risk of higher inflation and expected inflation in the future. We will have to remain vigilant on the inflation front and prepared to act as necessary to avoid the risk of undermining public confidence in the central bank's commitment to price stability.

As the nation's central bank, the goal of price stability is uniquely the Federal Reserve's responsibility. No other agency or policy arm of the government can effectively deliver on this goal. Moreover, a commitment to price stability is one of the most important contributions the Federal Reserve can make toward promoting the sustained economic growth we all seek.