

The Economic Outlook and The Fed's Roles in Monetary Policy and Financial Stability

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Introduction

Good morning and thank you for inviting me to help kick off the new year. This is the time of year for both reflection and prognostication. When it comes to the economy, both are important and useful exercises. Yet both are challenging tasks. On the one hand, looking back is often helpful in understanding what happened. On the other hand, it doesn't always tell us why it happened. Indeed, economists are often very adept at offering multiple explanations for why the economy behaved as it did. Thus, while hindsight may be 20-20 in terms of the facts, it is often much fuzzier when it comes to drawing lessons for the future. Sometimes clarity materializes only many years later and may be very different from the interpretations offered in the midst, or the immediate aftermath, of some particular economic episode.

Forecasting the future is, of course, even more difficult, and a healthy dose of humility is appropriate. Nonetheless, forecasting is a necessary task if you are in business. How the economy or the market for your product is likely to evolve over the coming year is critical to actions you take today. It is no less true for policymakers, as I will argue shortly.

This morning I want to talk about the state of the economy, share with you my views about the economic outlook, and comment on the uncertainties that surround that outlook. I will also discuss some of the key challenges facing the central bank, particularly as they relate to the strains in financial markets.

Economic and Financial Conditions

Let me set the stage for 2008 by first looking back at 2007. A year ago, we were in the midst of a sluggish first quarter of 2007, with real GDP growth of only 0.6 percent. That weak pace of growth was in large part the result of a decline in housing activity, although business investment was also very sluggish. Thus there was growing concern about what such weak first-quarter growth would mean for the remainder of 2007 and even some talk about the prospects for a recession.

But the U.S. economy has, over the years, exhibited remarkable resiliency—and it did so once again. Current estimates indicate that growth of real GDP picked up to nearly 4 percent in the second quarter of 2007, and then to nearly 5 percent in the third quarter. Consumer spending generally held up in the second and third quarters despite the rise in energy prices and despite the declines in house prices in a number of regions. The changes in house prices did limit the accumulation of housing-related wealth and may have curtailed some consumer spending, although the magnitude of that curtailment has been much less than many predicted. While there were ongoing sharp declines in residential construction activity in both the second and third quarters, nonresidential construction remained quite strong and business investment in equipment and software held up quite well. The other positive development over the course of the year was the strong growth of exports.

In labor markets, the average unemployment rate for the fourth quarter was 4.8 percent, although it ended on a somewhat sour note by rising to 5.0 percent in December. Inflation seemed to moderate somewhat in the first part of the year, but the rise in prices for oil and other commodities in the second half of the year indicates that inflationary pressures are still with us.

We will not receive the first report on fourth quarter GDP until late in January. If it turns out that growth was as weak as 1 percent or so, as many forecasters expect, the economy still will have grown at an overall 2-1/4 to 2-1/2 percent rate in 2007. That seems a respectable showing considering the prolonged weakness in residential construction, the high price of oil, and the problems that developed in financial markets.

Indeed, the strains in financial markets are an important and distinguishing feature of the economic landscape that emerged in 2007 and have become a key issue facing the Federal Reserve. Episodes of financial turmoil are not uncommon – recall the stock market crash of 1987, the turmoil surrounding the collapse of Long-Term Capital Management in 1998, or the attacks of September 11, 2001 that led to severe disruptions in the infrastructure of our financial system. While such episodes are thankfully quite infrequent, they highlight the role played by the central bank in promoting the orderly functioning of our financial markets.

Monetary Policy and Financial Stability

Let me elaborate. The goals of monetary policy are to promote price stability and maximum sustainable economic growth. I believe that the most important contribution the Fed can make to sustained economic growth and employment rests on credibly committing to and achieving long-run price stability. Moreover, price stability is not only an important element in achieving sustained economic growth, it is also critical in promoting financial stability.

Yet, as in the episodes I just noted, as well as the recent turmoil surrounding the re-pricing of risk in the subprime mortgage market, there are times when financial markets

become strained or impaired in ways that can be detrimental to the economy as a whole. In such episodes it is widely expected that the central bank should take steps to promote the orderly functioning of financial markets. For this, the primary tool the Fed has at its disposal is to be the lender of last resort. Typically such lending occurs through the Bank's discount window, which provides collateralized loans to any depository institution.

Before I talk about the distinctive role of the central bank in addressing financial distress, let me spend a few minutes summarizing monetary policy so that its relationship with the Fed's role in financial stability will be clearer.

In conducting monetary policy, the Federal Reserve seeks to foster financial conditions, including growth of money and credit and a level of short-term interest rates, consistent with achieving price stability and thus promoting sustainable economic growth. The primary tool for implementing monetary policy is the federal funds rate, which is the interest rate at which banks trade overnight funds. The Fed's policymaking arm—the Federal Open Market Committee, or FOMC—controls the funds rate by buying and selling government securities in what is known as open market operations. The FOMC meets approximately every six weeks to decide an appropriate target level for the fed funds rate. The Committee's objective at each meeting is to set the target funds rate at a level that supports its longer-term goals.

The influence of changes in the FOMC's targeted funds rate on inflation and economic growth occurs with a lag, so by necessity the FOMC must be forward-looking in setting an appropriate funds rate target. It must forecast future economic growth and inflation based on available data on the economy and financial conditions, including a particular target path for the fed funds rate. As new economic data become available, the Committee may find it needs to modify its forecast of future economic outcomes because of changes in various factors affecting the outlook. When the outlook for output and inflation does change appreciably, the Committee may choose to adjust its fed funds rate target to achieve its longer-term goals. Thus, the setting of appropriate monetary policy is a dynamic process.

As I mentioned at the outset, forecasting the economy is a difficult task. But policymakers, like business leaders, really have very little alternative. Changes we make to the funds rate today will not have any appreciable effect on prices, employment, or output for at least several quarters. That means any decision we make today will depend, in part, on our forecast of the economy for the latter half of 2008 and for 2009, since that is when its effects will most likely be felt. While the forecasting task is a difficult one, we are fortunate to have an extraordinary team of economists in Washington and in the Federal Reserve Banks that help us develop our projections and assess the economic landscape.

As you are no doubt aware, the monthly statistics reported on the economy can be volatile and subject to revision. Recall that in early September we thought the economy had lost 4,000 jobs in August, only to learn in October that it actually had gained 93,000

jobs. The FOMC works hard to differentiate those factors that may have only a temporary impact on the economy or inflation from those of a more sustained nature.

Temporary disturbances that don't affect the forecast for inflation and growth over the time horizon that monetary policy affects the economy may not warrant a change in the target funds rate. But shocks that have a more lasting impact and cause the forecast for inflation and growth to deviate significantly from the FOMC's goals may call for a change in monetary policy.

The changes in the fed funds target rate that occurred this fall represent examples of the FOMC responding to changes in our assessment of the economic outlook. The revisions have largely been driven by the continued deterioration in the housing market and an estimate that weakness would persist longer than previously anticipated. There has also been some softening of the labor market since the early summer, as I have noted. More generally, there has been some concern that the strains in financial markets might have ramifications for the broader economy, although the evidence for that remains limited.

Market Turbulence and Financial Stability

This brings me back to the issue of financial stability. The disruptions in the financial markets last August were triggered by the realization that default rates on adjustable-rate subprime mortgages were likely to rise much more than anticipated. The result was that markets were struggling to reassess the risks of such assets in order to determine an appropriate price. The other concern that surfaced was that market participants were generally unsure about which firms had exposure to these mortgages and to what degree. 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.

Let me point out that the Federal Reserve cannot resolve this price discovery problem. The markets will have to sort it out. Providing liquidity to the market does not solve the fundamental problems of re-pricing risky assets and assessing counterparty risks. A necessary step in restoring both confidence and credibility in the financial system is for financial institutions to promptly recognize and disclose the extent of their losses. Of course this is easier said than done, since some of the assets that need revaluing are only thinly traded and prices are hard to come by. Nevertheless, write-downs play a necessary and important role in restoring the health of financial markets.

Nevertheless, these near-term financial disruptions can make it difficult for certain markets to function effectively. For example, some financial institutions found it difficult to obtain funds in the short-term credit markets because few investors were willing to risk the uncertainty that these institutions might have substantial exposure to the now more risky subprime mortgages. When these institutions could not roll over their short term debt, they faced the problem of having to 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 Fed did. In August, the Fed reduced the discount rate, which is the interest rate it charges on loans to depository institutions, by 50 basis points and extended the term of those loans to 30 days. The spread between the funds rate and the discount rate was thus lowered from 100 basis points to 50 basis points. This increased the accessibility and reduced the price of short-term funding to those that needed it. This is a perfect example of the appropriate role of the central bank as a lender of last resort.

Through most of September and into November, market functioning gradually improved. But in late November, problems reappeared as the interest rate spread between overnight money and term loans maturing after the New Year increased sharply. While such year-end behavior is not uncommon, the increase this year was much larger than usual as financial institutions sought to build cushions to guard against further losses while "cleaning-up" their balance sheets for end-of-year reporting.

In response to this disruption, the Federal Reserve introduced the Term Auction Facility (TAF) program. Under the TAF, the Fed auctions term funds with maturities of 28 days to depository institutions against the same wide variety of collateral that can be used to secure loans at the Fed's discount window. By allowing the Fed to inject term funds through a broader range of counterparties and against a broader range of collateral than open market operations, this facility helps promote the efficient dissemination of liquidity at times when the interbank funding markets are under stress and not functioning smoothly.

The Fed conducted two successful auctions in December under the TAF, with \$20 billion auctioned each time. Both auctions were oversubscribed, with a significant number of bidders. The interest rates that cleared the auction were between the FOMC's fed funds rate target and the discount rate. Early evidence indicates that there was some narrowing of interest rate spreads as a result of these auctions, but I expect there will be further analysis of our experience over time.

The key point to take away from this experience with the TAF, however, is that the Fed's actions to improve liquidity in term funding markets did not involve a change in the FOMC's fed funds rate target. That is, the TAF did not change the stance of monetary policy. The Fed actually withdrew funds through open market operations as it injected term liquidity through the TAF. The introduction of the TAF was aimed at addressing the Fed's objectives for financial stability, not its objectives for monetary policy.

Going forward, we must be careful to distinguish when financial conditions call for Fed actions to help markets function effectively, such as we are now seeing with the Term Auction Facility, as opposed to situations when a change in the overall stance of monetary policy is called for. My approach to making monetary policy decisions is to look at incoming information and ask whether it is consistent with my outlook. So let me now discuss my outlook in more detail.

The Outlook

As I have already noted, last fall I lowered my projection of economic growth for the fourth quarter of 2007 and the first half of 2008. I did so in response to the cumulative deterioration in the housing sector last year along with the potential adverse effects of a tightening of credit conditions. 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. The continuing high prices of oil and other commodities also suggested the potential for some slowing in the pace of economic activity as well as hinting at increasing inflationary pressures.

I expect the decline in housing activity will bottom out near the middle of the year. Residential investment should then turn slightly positive in the latter part of 2008, for the first time in more than two years. But I don't expect significant improvement in the housing sector to become apparent until some time in 2009.

The fourth quarter of 2007 and the first quarter of 2008 are going to be quite weak; that has been clear for a number of months. My forecast already incorporates the prospect that we will get some bad economic numbers from various sectors of the economy in the coming months. Since monetary policy's effects on the economy occur with a lag, there is little monetary policy can do today to change economic activity in the first half of 2008.

The below-trend growth of the economy in the first half of 2008 will likely mean slower payroll employment growth for the first two to three quarters of the year. With slower job growth for a time, the unemployment rate may rise somewhat above 5 percent during the course of the year.

I am still optimistic that the economy will improve appreciably by the third and fourth quarters of 2008, and that is when any monetary policy action today will begin to have noticeable effects. Overall real GDP growth will be faster in the second half of 2008 as the economy begins to return to its longer-run trend growth 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 near its longer-term trend in 2009.

I am concerned that developments on the inflation front will make the Fed's policy decisions more difficult in 2008. Recent data suggest that inflation is becoming more broad-based. Recent increases do not appear to be solely related to the rise in energy prices. Consequently I see more worrisome signs of underlying price pressures. Although I am expecting slow economic growth for several quarters, we should not rely on slow growth to reduce inflation. Indeed, the 1970s should be a sufficient reminder that slow growth and falling inflation do not necessarily go hand in hand. Moreover, the 1990s should remind us that we can have sustained economic growth without generating inflation.

Although inflationary expectations have crept up only slightly since early September based on inflation-indexed Treasury securities, my sense is that these inflation expectations are more fragile now than they were six months ago. If inflation expectations continue to rise, it will be difficult and costly to the economy to deliver on our goal of price stability and puts at risk the Fed's credibility for maintaining low and stable inflation.

Conclusion

How does all this get factored into my views about how to approach monetary policy decisions?

My approach to making monetary policy decisions is to look at incoming information about the economy and about financial market conditions and ask three questions:

- 1) What information is consistent with my current outlook?
- 2) What information suggests I need to change my outlook for the economy or for inflation? and
- 3) What information indicates the need for further Fed actions to ensure that financial markets function effectively?

The answers to these questions help guide my thinking about how to simultaneously address the Fed's responsibilities for monetary policy and financial stability.

To sum up, I think the U.S. economy will experience several quarters of sluggish growth in 2008 before returning to a sustained expansion over the next two years. There are risks to the downside in terms of the possibility of even weaker economic growth. A substantially weaker outlook than expected, particularly if that weakness is projected to be more prolonged than anticipated, may require further adjustments to policy.

At the same time we also face risks of higher inflation. Inflation remains a concern to me because it is uniquely the Federal Reserve's responsibility to control it. No other agency or policy arm of the government can effectively deliver on the goal of achieving and maintaining a stable price level. Price stability allows the economy to grow at its maximum potential and supports the efficient functioning of our financial markets. Consequently, we must remain vigilant on the inflation front and be prepared to act as necessary to avoid the risk of undermining public confidence in the central bank's commitment to price stability.

Overall, it should prove to be an interesting and challenging year for policymakers.