

# The Economic Outlook and Some Challenges Facing the Federal Reserve

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2009 Economic Outlook Panel

University of Delaware

Newark, Delaware

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President and CEO  
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The views expressed today are my own and not necessarily those of the Federal Reserve System or the FOMC.

# **The Economic Outlook and Some Challenges Facing The Federal Reserve**

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## **Introduction**

The Federal Reserve has been a busy place during the past 18 months. In the face of a deteriorating economy and a growing financial crisis, the Fed has undertaken a number of extraordinary actions. We have aggressively eased monetary policy by reducing the target federal funds rate by 500 basis points, so that it is now trading in a narrow range close to zero. We've also put into place a number of lending facilities intended to provide liquidity and credit to an economy threatened by frozen financial markets and a major contraction in lending.

These actions have been creative. Yet, they are not without risks, and they pose a number of challenges for the Federal Reserve. Today, I will briefly review my outlook for the economy. I then want to discuss some of the difficulties in conducting monetary policy when the target fed funds rate is near zero and some of the challenges created by our lending facilities. Such challenges underscore the potential risks to our central bank's independence, which has served the U.S. economy very well, and the need for a well-articulated exit strategy from these various facilities when the time comes.

Let me begin with my views on the economic outlook.

## **Economic Outlook**

Economic growth has slowed significantly since last summer. Data released during the final months of 2008 became more and more discouraging. Consumer confidence fell to record lows, and many retailers became convinced the Grinch did indeed steal Christmas.

Real GDP growth declined slightly in the third quarter, but it is likely to record a much sharper decline in the fourth quarter. The first half of 2009 is not likely to be much better. I don't expect to see a turnaround until the second half of the year. Overall growth for 2009 (fourth-quarter-to-fourth-quarter) is likely to be well below 2 percent after negative growth in 2008. Given this forecast, the current recession could well be one of the longest in the post-World War II era.

Despite its length, though, I don't expect this recession to necessarily rival the deep recession in the early 1980s in terms of unemployment. In the early 1980s, the unemployment rate rose above 10.5 percent. I do not expect the unemployment rate to stray into double digits during this recession. Yet, I also don't expect it to begin coming down soon. Keep in mind that unemployment is a lagging indicator. It will not begin to come down until after the economy is well on its way to recovery.

I expect the housing sector will finally hit bottom in 2009 and the financial markets will gradually return to some semblance of normalcy. So my forecast sees the economy starting to slowly recover in the second half of 2009 and building up more momentum in 2010.

As for inflation, the declines in energy and commodity prices in recent months have substantially lowered the year-over-year increases in the headline consumer price index. Even excluding food and energy prices, inflation has moderated in recent months. As a result, expectations of inflation for this year and next have also moderated. My own projection is for inflation — both headline and core — to be below 2 percent for the next year.

Forecasting is difficult even in the best of times, and the current environment is fraught with much more than the usual challenges. So be warned: a great deal of uncertainty surrounds any forecast today.

### **Challenges Facing the Federal Reserve**

The unprecedented actions the Fed has taken to help stabilize the economy and financial markets, including lowering the fed funds rate target to near zero and establishing a series of new lending facilities, create risks and their own set of policy challenges for us going forward.

Perhaps the best way to understand these complexities is to understand how the Fed typically makes funds available to the banking system. In normal times, the Fed expands or contracts its balance sheet through the purchase or sale of Treasury securities. Such actions increase or decrease our asset holdings in the form of government securities and increase or decrease our liabilities in the form of bank reserves. This is the standard mechanism through which the Fed expands money in circulation.

However, since early 2008 the Fed has introduced a number of new lending facilities. Instead of buying Treasuries, the Fed has been lending to a wide array of primarily financial institutions in an effort to make credit markets function more effectively. Until September, most of that lending was offset — or, as economists say, sterilized — on our balance sheet through the sale of other assets, mostly Treasuries. However, with the loans to AIG, the assistance to money market mutual funds, and the purchases of commercial paper and other such interventions, we were no longer able to sell securities in sufficient quantities to prevent a substantial increase in our assets, which had the effect of adding very large quantities of reserves or new money to the banking system. As a

result, the balance sheet has grown from just over \$900 billion in early September to over \$2.2 trillion at the end of the year. The Fed has already announced plans for additional programs that are likely to further expand our balance sheet in 2009.

### *Monetary Policy near the Zero Lower Bound*

Let me first discuss monetary policy in this new environment.

Before joining the Federal Reserve and since then, I have repeatedly stressed that the primary responsibility of the central bank and monetary policy must be to ensure price stability. This means the Fed should seek to deliver a low and stable rate of inflation over the intermediate term. Only the central bank can ensure price stability, so this goal warrants our considerable attention and effort. Let me stress that price stability does not just mean avoiding unusually high inflation. It also means avoiding excessively low rates of inflation or deflation that may be inconsistent with price stability.

Our attention to price stability, however, does not mean that monetary policy should be indifferent or unresponsive to economic conditions. Indeed, monetary policy should be managed in a way that yields the best economic outcome given the environment at the time. As long as inflation and inflation expectations are well-anchored at a level consistent with price stability, the target federal funds rate should fall with market rates when the economy weakens, and increase as market rates rise when the economy strengthens.

The severity of the economic downturn and the financial crisis in 2008 called for unusually low inflation-adjusted, or real, interest rates, which led the FOMC to cut its target very aggressively. Nominal interest rates, however, cannot fall below zero, and this fact can pose a problem for monetary policy. For example, if the economy is weak and nominal interest rates are at or near zero, then a fall in inflation expectations can lead to an increase in real interest rates. This increase would be contrary to what optimal policy would suggest and this is what economists call the zero lower bound problem.

A credible commitment to price stability — that is, low and stable inflation — is critical to anchoring these expectations about the future course of inflation and thus an essential element of any sound monetary policy. Last spring and summer, there was great concern that rising headline inflation rates, due to rapid and dramatic increases in the prices of oil and other commodities, would lead to rising inflation expectations, which in turn would contribute to a more persistent rise in inflation rates. That is why I and other FOMC members continued to remind the public that the FOMC was committed to maintaining price stability and would resist any unanchoring of inflation expectations.

By like token, significant declines in oil prices and other commodities have recently led to declines in the consumer price index, prompting some commentators to suggest that the U.S. is facing a threat of persistent deflation, as it did in the Great Depression or as Japan faced in the 1990s.

I am not particularly concerned about the possibility of persistent deflation. When oil and commodity prices stabilize, the negative rates of inflation we have seen in the CPI are likely to disappear. Moreover, I am confident that the FOMC is committed to maintaining price stability. Nonetheless, we must act to ensure that expectations of deflation do not take root, just as we must act to ensure that expectations of higher inflation do not emerge. The failure to maintain well-anchored inflation expectations can wreak havoc with the real economy, foster unnecessary volatility, and make it more difficult for the Fed to deliver on its dual mandate to keep the economy growing with maximum employment and price stability.

I and others have long proposed establishing an explicit inflation target as one way to signal the FOMC's commitment to price stability and help anchor expectations. Such a commitment not only helps prevent inflation expectations from rising to undesirable levels, but it can also help prevent expectations from falling to undesirable levels.

As most of you know, the federal funds rate target has been the traditional instrument of monetary policy and is widely used to interpret the stance of policy. However, with the target funds rate at essentially zero, we must consider alternative mechanisms for conducting policy and ensuring we meet our objectives.

The FOMC has stressed that it will use the Fed's balance sheet, broadly defined, to ensure that monetary policy provides ample liquidity to the economy and to ensure deflation does not become a problem. Consistent with this, as I have noted, the Fed's balance sheet has more than doubled in the last few months and narrow measures of money, such as the monetary base, have expanded dramatically. The Committee pointed out that the attention of policy at this point is not, however, on the traditional quantitative measures of money, but on the asset side of the balance sheet and the credit the Fed is providing through its unprecedented lending programs.

Since we are in uncharted territory, I believe we must proceed with caution. While the lending programs are designed to improve the flow of credit, they are currently injecting enormous amounts of liquidity into the system. I believe we need to monitor that liquidity and its composition closely so that we are able to withdraw it when the time comes or else we risk fueling inflation in the future. Thus, it is not appropriate to ignore quantitative metrics in this new policy environment.

We must remember that to successfully deliver on its goal of price stability, monetary policy must establish a nominal anchor for the economy. In practice, that anchor can be the path of either a nominal interest rate or a nominal quantity of some measure of money.

In the current environment, with the targeted funds rate effectively at zero, it cannot serve as a nominal anchor. On the other hand, quantitative measures — such as the stock of money, reserves, or the monetary base — have a long and venerable tradition in monetary theory and policy. Indeed, many countries have used quantitative targets quite successfully over the years, including Germany and Switzerland. However, these metrics

do not assess the distribution of Federal Reserve assets across its lending programs, a focus of credit policy.

Nonetheless, while traditional measures of money may not be the best metrics for policy in this zero interest rate environment, the size of the balance sheet does offer a possible nominal anchor for monitoring the volume of our liquidity provisions. While attention is currently focused on credit policy, ignoring or failing to take into account the consequences of unconstrained growth in our balance sheet could be costly down the road in terms of our ability to ensure price stability or support a credible commitment to that goal.

How we calibrate or decide the appropriate scale and composition of our balance sheet remains an open question that we must address and then communicate to the public. In addressing such concerns, we must ensure that our overall balance sheet's size and evolution are consistent with our responsibility to promote price stability. Credit policy alone is not sufficient to ensure sound monetary policy.

#### *Lending Facilities, Moral Hazard, and Exit Strategies*

In addition to the challenge of implementing monetary policy when nominal rates are at zero, the lending facilities themselves pose a number of problems that the Fed must confront.

As I have mentioned, the lending programs have dramatically altered the types of assets on our balance sheet as well as its size. We must consider how we will shrink our balance sheet when the time comes — as it surely will.

When financial markets begin to operate normally and the outlook for the economy improves, real market interest rates will again tend to rise. At that point, the demand for excess reserves will fall, and our balance sheet must contract if we are to maintain price stability. Some of the new facilities will naturally unwind in a gradual manner once they are terminated. For example, the commercial paper lending facility only purchases commercial paper of 90 days or less. Once we stop new purchases, those assets will mature and begin to shrink our balance sheet.

Yet some of the assets will not go away so quickly. For example, we are in the process of purchasing \$500 billion of mortgage-backed securities, which will not roll off our balance sheet for many years unless we consciously sell them in the marketplace. We are about to embark on the purchase of nearly \$200 billion of asset-backed securities whose maturity will be about three years. Will we face challenges when we attempt to liquidate these longer-term assets from our portfolio? Will there be pressure from various interest groups to retain certain assets? Will there be pressure to extend some of these programs by observers who feel terminating the programs might disrupt “fragile” markets or that the economy’s “headwinds” are too strong? Such pressures could threaten the Fed’s independence to control its balance sheet and monetary policy. We will need to have the

fortitude to make some difficult decisions about when our policies must be reversed or unwound.

Beyond monetary policy, the Fed's recent lending presents other challenges. The growth in Fed lending and its unusual form are intended to reduce interest rate spreads in key credit markets. To the extent that these elevated spreads signal a lack of liquidity, the Fed's actions as lender of last resort should help reduce spreads.

However, if the widening of these spreads reflects counterparty risk that investors are pricing into the marketplace, expanding liquidity may not be effective in narrowing these spreads, even when trading volumes increase. Indeed, in some markets, despite the ongoing efforts of the Fed's lending programs, large credit spreads have persisted. So, we will need to continue to monitor these markets and be cautious in expanding our balance sheet, since neither liquidity nor credit policy can solve the problem of counterparty risk.

Finally, we must create an exit strategy from these various facilities. They were created for extraordinary times and involve significant intervention in the credit markets. They are not part of the normal operation of a central bank and should not be expected to continue.

As I have indicated, some of our new lending facilities were created to replace impaired or poorly functioning private credit markets. We must consider the possibility that our presence in these credit markets will deter private-sector participants from returning to and restoring these markets. To prevent our policies from having these perverse effects, we should consider a gradual increase in the cost of borrowing from these facilities to discourage their use and encourage other participants to return to these markets. This should be an important element of our exit strategy.

Unfortunately, simply terminating the special lending programs is not enough to avoid some knotty problems. The mere act of creating the programs has created moral hazard. To the extent that market participants now feel more comfortable asking for the central bank's support when they get into trouble, they may be inclined to take on more risk than would otherwise be prudent — thus sowing the seeds for the next crisis. In exiting such programs, it will be important for the Fed to develop clear objectives and boundaries for lending that we can commit to follow in the future. Clarifying the criteria under which we will intervene in markets or extend credit, including defining what constitutes the “unusual and exigent” circumstances that form the legal basis for the Fed's non-traditional lending, will be essential if we are to mitigate the moral hazard we have created.

In general, our aggressive lending, while intended to help the economy and financial markets recover, poses its own set of challenges. We must develop a well-articulated exit strategy if we are to maintain control of monetary policy and encourage the revival of strong and disciplined credit markets.

## Conclusion

To sum up, 2009 will be a challenging year for the U.S. economy and for policymakers. The Fed has taken extraordinary actions in both monetary policy and its lending operations to address the deteriorating economic outlook and the ongoing stresses in financial markets. This is new territory for our central bank and raises a number of challenges, some of which I have touched on today.

I have stressed that operating with the target federal funds rate near zero and using the Fed's lending programs to implement policy pose some challenges for policymakers. Without the target funds rate as a nominal anchor, it will be important for us to develop relevant quantitative measures to assess the appropriate size and composition of the Fed's balance sheet.

We also must develop appropriate strategies for our lending programs to ensure that the economic and financial market stability we have fought so hard to obtain remains in place in the future. In my mind, that means more than just maintaining control of our balance sheet and the volume of liquidity we inject into the economy. It also means designing exit strategies that will allow us to end these lending programs and drain that liquidity in a timely manner. What's more, it means that we must clearly articulate the boundaries of future lending to reduce the moral hazard we have created.

One thing that remains constant is the importance of anchoring expectations about inflation. The central bank's price stability objective is just as critical to the effective functioning of the economy and financial system in the midst of this crisis as it was before this crisis began. Inflation targeting can help central banks signal their commitment to low and stable inflation and thus help prevent expectations from drifting too high or too low. Ultimately, we must act in a way that is consistent with our price stability objective, for that is the key to our ability to deliver on our dual mandate.