Economic Outlook and Challenges for Monetary Policy

The Philadelphia Chapter of the Risk Management Association

Philadelphia, PA

January 11, 2011

Charles I. Plosser

President and CEO
Federal Reserve Bank of Philadelphia

FEDERAL RESERVE BANK
OF PHILADELPHIA

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

Economic Outlook and Challenges for Monetary Policy

The Philadelphia Chapter of the Risk Management Association
Philadelphia, PA

January 11, 2011

Charles I. Plosser
President and Chief Executive Officer
Federal Reserve Bank of Philadelphia

Introduction

Welcome to the Federal Reserve Bank of Philadelphia, and thank you for inviting me to help launch your new year. As most of you know, the Philadelphia Fed is one of 12 Federal Reserve Banks across our nation. Together with the Board of Governors in Washington, this structure of the Federal Reserve System helps ensure that monetary policy decisions are based on the full breadth of economic conditions across our diverse country.

The goals of monetary policy are set by Congress in the Federal Reserve Act, which states that the Fed should conduct monetary policy to "promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates." I have long believed that the most effective way monetary policy can contribute to maximum employment and moderate long-term interest rates is by ensuring price stability over the longer term. Price stability is also critical in promoting financial stability.

The Fed seeks to achieve these objectives by influencing the cost and availability of credit through its decisions about interest rates and the supply of money. These decisions are the primary responsibility of the FOMC – the Federal Open Market Committee – the group within the Fed charged with setting monetary policy.

Since monetary policy affects the economy with a lag, the FOMC must be forward-looking in setting appropriate monetary policy. Therefore, I want to begin my remarks with a review of the nation's economic recovery and my outlook for growth and inflation. I will then offer some observations on current monetary policy, including the Fed's current program of large-scale asset purchases.

Before continuing, I should note that my views are my own and not necessarily those of the Federal Reserve Board or my colleagues on the FOMC.

The Economic Outlook

A year ago, when speaking before a group in this very room, I said that in 2010 we would see a moderate, sustainable recovery with real GDP growth between 3 and 3½ percent. Growth in 2010 is likely to come in slightly below that forecast, but we will know more when the data are available later this month.

We started out the year with real GDP growing at a 3¾ percent pace in the first quarter, but the second-quarter growth rate fell to less than 2 percent, due in part to the expected decline in housing sales as homeowner tax credits ended. That, plus the concerns over European sovereign debt caused the economy to lose momentum and led some to worry about a possible double-dip recession. By the third quarter, though, we emerged from the summer doldrums with 2.6 percent growth.

When the final estimates are released, I expect that GDP growth will be between 2½ and 3 percent for 2010 and will pick up to 3 to 3½ percent annually in 2011 and 2012. My forecast for 2011 changed only modestly during the past year, and I remain confident that the economy is on track for continued moderate recovery. As with all forecasts, this projection carries some risks. But for now, I expect moderate growth overall, with strength in some sectors more than offsetting weakness in others.

Housing is one sector that I believe will remain weak into 2011. We entered the recession highly over-invested in residential real estate, and the sector is unlikely to fully recover until inventories decline. Commercial real estate markets also remain weak. Nonresidential construction spending declined in 2010, and I do not see much growth in this industry until we are well into a healthy expansion. That said, I do not believe the weakness in commercial real estate or housing will prevent a recovery of the broader economy.

Business spending on plant and equipment has been a bright spot and appears to be strengthening. While some smaller firms report difficulties in getting access to credit, banks have begun to ease credit terms and loan rates are at historic lows. Larger firms have been able to finance investment out of retained earnings or to issue new debt on very favorable terms. Some investments have been used to replace aging equipment; some have gone toward productivity improvements, which are good for the economy in the long run.

The Philadelphia Fed's monthly Business Outlook Survey of regional manufacturers has been consistent with an improving economy, showing significant gains in general activity, orders, and shipments in November and December, following some weakness during the summer months.

The survey's measures of expected future activity indicate that businesses are becoming more optimistic as well. So I expect business to continue to make these fixed investments at a healthy pace over the coming year.

Consumer spending, which makes up about 70 percent of GDP in the U.S., has expanded at a moderate pace. Holiday spending reports in both stores and online have been positive. November's retail sales were up about 8 percent from last year, with auto sales up 12 percent. December retail sales will be out on Friday. While the snowstorm in the Northeast and rain in California likely weighed somewhat on sales at the end of December, major retailers remain generally optimistic and consumer confidence has improved since the summer.

Stronger consumer spending will occur as households recover more of the net worth destroyed due to falling house prices and the decline in equity portfolios during the recession. Households have been steadily shoring up their balance sheets, and as debt levels fall and savings are rebuilt, consumers will be in a better position to increase spending.

Unemployment

The private sector added over a million jobs in 2010. Unfortunately, the pace of employment growth hasn't been strong enough to have much of an effect on the unemployment rate. However, recent data have been somewhat more encouraging. New claims for unemployment insurance have been trending down, as have continuing claims. In December, the economy added about 100,000 jobs and payrolls were revised up in both October and November. In addition, the unemployment rate fell from 9.8 to 9.4 percent in December. I expect this number may bounce around in the near term, but the unemployment rate will gradually recover as hiring improves enough to allow the unemployed as well as those people who have left the labor force to find jobs.

I wish I could forecast a faster improvement, but it will take time to resolve the difficult adjustments now under way in the labor markets. Many workers may be forced to find jobs in new and unfamiliar industries. For instance, the contraction in the real estate sector and in sectors closely related to residential construction, such as mortgage brokerage, means that many workers will likely need to find jobs in other industries or fields and that will take time.

The productivity gains occurring in other sectors also suggest that many workers may need updated skills to find their next job. This may be particularly relevant for the long-term unemployed. Monetary policy cannot do much to help these types of adjustments in the labor markets even if we wish it could.

Inflation

Turning to inflation, the headline consumer price index (CPI) has risen about 1 percent over the last year. Core CPI inflation, excluding food and energy, has been just less than 1 percent this past year. While inflation is currently lower than the 1½ to 2 percent level many monetary policymakers would prefer, it does not follow that sustained deflation is imminent or even likely. While I do expect that inflation will be subdued in the near term, I do not see a significant risk of a sustained deflation.

Respondents to the Philadelphia Fed's fourth-quarter Survey of Professional Forecasters released in November and the Livingston Survey released in December also saw little chance of deflation in 2011.

It is useful to remember that the U.S. saw average consumer price inflation of just 1.3 percent through most of the 1950s and early 1960s. This period of low inflation did not lead to fears of deflation nor did it lead to economic stagnation. Low inflation is not generally a bad thing.

Moreover, brief periods of lower-than-desired inflation or even temporary deflation are unlikely to materially affect economic outcomes as long as longer-term inflation expectations remain well anchored and the public continues to see the Fed's promise to maintain price stability as credible. The Fed's challenges are greater, however, when monetary policy finds it difficult to respond because rates are already near zero. In that case, a loss of credibility resulting in a decline in inflation expectations would lead to an increase in the real interest rate, which would encourage consumers and businesses to save more and spend less.

Given that the Fed's policy rate is now close to zero, a decline in inflation expectations would be unwelcome and could undermine the recovery. Fortunately, this is not happening. Expectations of medium- to long-term inflation have remained relatively stable because people expect the Fed to take appropriate action to keep inflation low, positive, and stable. As the recovery continues, I anticipate that inflation will accelerate toward 1½ to 2 percent over the course of the next two years. We are already beginning to see acceleration in some commodity prices. Manufacturers responding to our monthly Business Outlook Survey are increasingly reporting rising cost of inputs, including energy and raw materials, and they are projecting that they will be forced to pass on these cost increases to consumers and businesses in 2011.

As we begin the new year, many forecasters are revising their outlooks to incorporate the latest economic data and the anticipated effects of the tax package approved by Congress in December. Although most forecasts assumed that some tax package would be approved, the details are now being factored into many models. My own view is that the tax compromise's biggest impact derives from the reduction in uncertainty about tax rates for consumers and businesses over the next couple of years. Unfortunately, fiscal challenges still loom large for the new Congress and the economy.

Monetary Policy

Let me now turn to some observations on monetary policy. The last couple of years have been an extraordinary time for policymakers. We have been forced to react with speed to new challenges that have sometimes been outside the usual frameworks we rely on for policy guidance. That does not mean that economic models are no longer helpful; they most definitely are. But because of the unusual environment, there is less consensus among economists about the right answers to some of the most difficult and challenging questions. As a result, it is not surprising that the debate about what constitutes the most desirable policy is vigorous, with bright and talented people on every side. That is as it should be, in my view. I am fond of quoting the American journalist Walter Lippmann, who said, "Where all men think alike, no one thinks very much." Healthy debate is necessary for informed decisions and results in better policy decisions.

These debates have gone on inside the Fed, just as they have gone on in the media and in the economics profession. Some have suggested that it is counter-productive for policymakers to express differing opinions, as it confuses markets and creates uncertainty. I find such arguments misdirected.

First, the uncertainty is real. It would be disingenuous and misleading to suggest otherwise. The central bank owes the public clear communication and as much transparency as is feasible. For policymakers to project a false sense of certainty would fail that test and deeply trouble me.

Second, for monetary policy to be successful, policymakers, and the Fed as an institution, must earn the public's confidence. Confidence is important in preserving the Fed's credibility, which is something that is hard to earn but easy to lose. One way to undermine confidence and credibility is to fail to communicate the difficult choices we face and the thoroughness of our debates. Unanimity is not the natural state of affairs in life – nor is it inside the halls of the Federal Reserve. For policymakers to feign unanimity only serves to undermine the institution's transparency.

In November, the FOMC decided to purchase an additional $600 billion of longer-term Treasury securities through the end of the second quarter of 2011. It is no secret that I have expressed doubts about whether the benefits of this policy, commonly referred to as QE2, exceed the costs. These doubts were based on my reading of the economic outlook and the nature of the challenges that the economy faced.

The first round of large-scale asset purchases began nearly two years ago, after the Fed reduced the federal funds rate to near zero. That program, completed in March 2010, added roughly $1.75 trillion in agency mortgage-backed securities, agency debt, and long-term Treasuries to our balance sheets. If the Fed completes the full amount of the second round, the Fed's balance sheet will have more than tripled since mid-2007.

Proponents of the program to acquire Treasuries expect these purchases to lower longer-term interest rates through a portfolio balance effect. That is, as the supply of longer-term Treasuries available to the public is reduced, prices of Treasuries should rise, which means yields should fall. Yields on similar assets are also expected to fall as the public rebalances portfolios away from Treasuries to other similar assets. Just as in conventional monetary policy, lower interest rates would stimulate business and consumer demand and increase exports, thus lending support to the recovery.

The Fed's first purchase program worked to lower interest rates, although estimates of the effect vary quite a lot. These purchases were done at a time when financial markets were highly disrupted and asset risk premiums were extremely elevated. But markets are no longer disrupted. Thus, it seems unlikely that we can expect the effects to operate through the same channels as before. Even if we did, it is not clear to me that a modest reduction in long-term interest rates will do much to speed up the reduction in the unemployment rate.

Some commentators thought that even if the benefits were limited, the costs were small and the action was worth taking, given the concerns that many had about the state of the economy. Other commentators argued for the policy because the fiscal authorities were unable to act, even though fiscal policy would have been the more appropriate policy tool to address some of the challenges we faced. I view both of these arguments as flawed.

It is a serious mistake to view monetary policy as a substitute for fiscal policy. Doctors must diagnose the disease correctly in order to prescribe the right medicine. If the wrong drug is administered, the physician might not only fail to cure the patient, but might also make matters worse. To suggest that monetary policymakers must act simply because fiscal policymakers were unable or unwilling to act is not the proper way to conduct policy.

As to the cost-benefit analysis, the costs of this policy are likely to be seen only in the future, but they must be part of the analysis when the policy is undertaken, not dismissed to be dealt with later. History tells us that exiting from an accommodative monetary policy is always a bit tricky. It is easier to cut rates than it is to raise them. As I discussed earlier, monetary policy must be forward-looking because it works with a lag. This means that the Fed will need to begin removing policy accommodation before the unemployment rate has returned to an acceptable level in order to avoid overshooting, which would result in greater instability in the economy.

So how do we exit from this accommodative policy? While the high level of excess reserves on the Fed's balance sheet is largely benign now, that will change as banks become more willing to lend. As economic conditions improve and those excess reserves begin to flow out into the economy, inflationary pressures will grow. And given the magnitude of those reserves, these pressures could be significant. This is one reason I feel confident that sustained deflation is highly unlikely. To prevent inflation from becoming a serious problem, the Fed must be able to remove or isolate those reserves. The Fed is developing and testing tools to help us prevent such a rapid explosion in money to address this looming challenge. But we won't know the full effect of these new tools until we use them. Nor will we know how rapidly or how high we may need to raise rates. The larger our balance sheet, the greater our challenges to successfully navigate an exit strategy without disrupting the economy and while keeping inflation under control.

The FOMC statements in November and December indicated that we will regularly review the asset purchase program in light of incoming economic information and adjust it as needed to foster our long-run goals of price stability and maximum sustainable employment. I have taken this intention to regularly review the program seriously.

If the economy begins to grow more quickly and the sustainability of this recovery continues to gain traction, then the purchase program will need to be reconsidered along with other aspects of our very accommodative policy stance. We are a year and a half into a recovery, although a modest one. The aggressiveness of our accommodative policy may soon backfire on us if we don't begin to gradually reverse course. On the other hand, if serious risks of deflation or deflationary expectations emerge, then we would need to take that into account as we adjust our policy stance.

Conclusion

In conclusion, our nation's economy is now emerging from the worst financial and economic crisis since the Great Depression. A slow but sustainable economic recovery is under way, and I expect annual growth to be in the 3 to 3½ percent range over the next two years.

As the economy continues to gain strength and optimism grows among businesses, hiring will increase. The unemployment rate, however, will decline to acceptable levels only gradually. The shocks and dislocations we experienced from the financial crisis were significant, and it will take some time for the imbalances in labor markets to be resolved.

The Federal Reserve remains committed to promoting price stability over the intermediate to longer term. This is the most effective way in which monetary policy can contribute to economic conditions that foster maximum sustainable employment and economic growth. Finding the right path for monetary policy in such challenging times will require thoughtful deliberation. We should acknowledge the debate as a healthy process that adds to transparency and enhances credibility.

As we move forward, I will continue to monitor incoming economic developments and update my economic outlook as necessary. Should evidence suggest that monetary policy is not consistent with our longer-term goals, then I will support an appropriate adjustment to policy.