

A Perspective on the Economic Outlook

New Jersey Bankers Association

May 12, 2011

Aventura, Florida

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FEDERAL RESERVE BANK
OF PHILADELPHIA

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Introduction

Good morning. Thank you for this opportunity to speak with so many leaders from the New Jersey banking community at this your 107th annual convention. Over the years, the Federal Reserve Banks have maintained an ongoing dialogue with the banks, businesses, and other organizations in the communities within our respective Districts. That dialogue provides an opportunity for the Fed to communicate not just to the financial markets, but to citizens in communities around the country about monetary policy and the economy. In addition, through conversations with our directors, advisory councils, and various individuals one on one, we seek to gain an understanding of what is happening in the economy firsthand.

The information that you share in this two-way dialogue helps Fed economists paint a rich and comprehensive picture of our region's economy and banking conditions. This information, in turn, helps me as a policymaker bring Main Street perspectives to the national policy table each time the Federal Open Market Committee, or FOMC, meets in Washington. When such information from all the Districts comes together at our meetings, it forms a rich mosaic of our economy that helps shape our monetary policy decisions.

Sharing information and insights is especially important as we navigate changing times. Your conference theme, "Opportunities in the New Decade," is particularly relevant as the banking community navigates through these challenging economic times and strategically focuses on innovative ways to grow and bring value to the communities you serve. I am pleased to be a part of your conference today and to share my views on the economy and monetary policy.

As always, I speak for myself, and my views do not necessarily reflect those of the Federal Reserve Board or my colleagues on the FOMC.

Economic Outlook

Our economy is now nearly two years into a moderate, sustained recovery from a financial crisis and the worst recession since the Great Depression. Although first-quarter GDP growth was somewhat disappointing, at just under 2 percent, I believe this weakness will likely prove to be a temporary soft patch and that the underlying fundamentals are in place for the economy to resume growing at a moderate pace in the second half of this year and to strengthen a bit more next year. Such soft patches are not that uncommon. Indeed, last year we experienced just such a bump in the road.

A year ago, real GDP growth slowed to 1¾ percent in the second quarter after growing at a pace of 3¾ percent in the first quarter of 2010. The strength in the first quarter reflected a strong contribution from rebuilding inventories following two years of cutting during the recession. The first half of 2010 also saw dramatic swings in housing sales as the homeowner tax credits brought sales forward.

Just as the recovery was beginning to gain traction, concerns over European sovereign debt led some to worry about a double-dip recession. But after what I described as the summer doldrums, fears subsided, and by the end of the year, the economy had once again picked up momentum to give us just under 3 percent growth for the full year of 2010.

We witnessed a similar phenomenon during the first quarter of 2011. The advance numbers released in late April showed that real GDP grew at an annual rate of 1.8 percent in the first quarter, following a 3.1 percent rate in the fourth quarter, and 2.6 percent in the third quarter of 2010.

First-quarter GDP was weaker than many forecasters initially expected. A number of factors, including severe weather, uncertainty surrounding the aftermath of the disaster in Japan, political events in the Middle East and North Africa, and higher food and energy prices, contributed to this outcome. Thus, I believe the first-quarter weakness is likely to be transitory.

My forecast is for continued moderate growth of around 3 to 3½ percent this year and next. This is a somewhat stronger pace than the economy's long-term trend rate of growth. I believe overall strength in some sectors will more than offset persistent weaknesses in others, so that the recovery will be sustained and more broad-based as it continues. Improvement in household balance sheets and better labor market conditions will support moderate growth in consumer spending. Solid earnings growth will support continued strong advances in business spending on equipment and software. Housing, however, will continue to be the economy's weak spot, with flat to slightly falling prices and little new construction until the market works through the large volume of vacant properties. Yet, this picture of residential real estate is highly geographic dependent. In some areas of the country, housing activity is showing signs of life, while in others, it remains deeply depressed. The commercial real estate sector is also expected to remain weak, but I do not believe that this will prevent a broader economic recovery.

Growth in manufacturing remains one reason for optimism. Recent results from the Philadelphia Fed's Business Outlook Survey of manufacturers, which has proven over the years to be a useful barometer of national trends in manufacturing, suggest that activity in the sector continues to expand. In April, we did see the index of current activity fall from its level in March. But the March level represented the index's highest reading in nearly 30 years. Meanwhile, the survey's indicators of future activity, a measure of firms' expectations for activity six months from now, also remained at a high level.

Consumer spending, which makes up about 70 percent of GDP in the U.S., has also expanded. Households continue to pay down debt and rebuild some of the net worth that was destroyed during the recession due to falling house and stock values. Higher energy and food prices have been a drag on consumer spending by reducing real incomes. For consumers to contribute more to the continued expansion of the economy, job growth needs to strengthen.

Labor Markets

Overall, conditions in the labor markets continue to gradually improve. In April, nonfarm payrolls expanded by 244,000 jobs, and the February and March employment numbers were revised up by 41,000 jobs and 5,000 jobs, respectively. This means that we have had three consecutive months of employment growth in excess of 200,000 and the economy has added over 760,000 jobs since the first of the year. The performance of the private sector looks even better, adding some 850,000 jobs, as government employment is shrinking. April's uptick in the unemployment rate to 9 percent was a bit disappointing, but even with that, the unemployment rate has fallen by one full percentage point since last November.

In the three states in our Federal Reserve District – Pennsylvania, New Jersey, and Delaware – employment increased at an annual rate of 1.4 percent during the three months ending in March, comparable to the pace in the nation, and the unemployment rate now stands at 8.4 percent. Pennsylvania has shown considerably more strength than New Jersey, where the government sector has been shedding jobs at a rapid pace.

While labor market conditions continue to improve, millions of Americans remain unemployed. So we have a long way to go. But as the economy strengthens this year, I expect that businesses will continue to add to their payrolls. Another finding from our Business Outlook Survey is that 45 percent of our manufacturing firms expect to increase employment over the next six months. With continued growth in employment, I expect to see modest declines in the unemployment rate, to about 8½ percent by the end of this year, and then to a range of 7 to 7½ percent by the end of 2012.

Inflation

Inflation has risen in recent months as the prices of energy and other commodities have surged. These prices have been extremely volatile of late, and despite last week's sell-off, they remain considerably above their year-ago levels. There has been less of an increase in the so-called core measures of

inflation, which exclude food and energy prices. However, there are signs that firms are becoming better able to pass along some of these increased costs to their customers. For example, in response to a special question in our Business Outlook Survey in February, over 56 percent of manufacturers said they have already put through price increases since the start of the year. Nearly 60 percent of all respondents said they planned to increase prices over the next three months. Our survey's prices paid index, an indicator of firms' input costs, has been at high levels for the past six months, and the prices received index, an indicator of the prices firms are charging their customers, has steadily increased over the past eight months.

Given the higher costs they face, I expect more firms will test their pricing power, particularly as concerns about the recovery's sustainability abate. Thus, I see the inflation risks as being clearly to the upside both in our District and in the U.S. economy more generally.

In an environment with accommodative monetary policy, the key to keeping commodity price increases from passing through to general inflation is to ensure that longer-run inflation expectations stay anchored. So far, that seems to be the case, and as oil prices stabilize, headline inflation should come back down. Yet, monetary policymakers must monitor both inflation and inflation expectations carefully and be prepared to take actions if they are to ensure that longer-run inflation expectations remain stable.

We must keep in mind that ultimately it is monetary policy that creates sustained inflation, not price shocks. In looking back to the Great Inflation of the 1970s, we learned it was not high oil prices per se, but easy monetary policy in response to high oil prices that caused the rise in general inflation. Accommodative monetary policy allowed the large increase in oil prices to be passed along in the form of general increases in prices, or greater inflation. As that happened, people and firms began to expect higher inflation – they lost confidence that the central bank would keep inflation in check – and those higher expectations influenced their decisions, making it that much harder to reverse the rising tide of inflation. A key lesson from the 1970s is the importance of the credibility of the central bank's commitment to maintaining price stability. Once that credibility is lost, it is very difficult to regain, and economic outcomes are worse as a result. Neither I nor my colleagues wish to see that happen again.

Thus, I am watching inflation developments and inflation expectations closely. Expectations of inflation as measured by inflation-indexed Treasury securities have generally risen since last fall when deflation seemed to be the fear of many. Short-term expectations have risen even more in recent months, reflecting the rise in oil and gasoline prices. Expectations of inflation over the longer run have also risen since last fall, but their response to the rise in energy and commodity prices has been more muted. This suggests that much of the current inflation is likely to be temporary. At present, these longer-term measures seem within reasonable bounds. To ensure that continues to be the case, the Fed will need to take the right actions at the right time to exit the extreme accommodative policy that is now in place.

However, I must note that it is somewhat troubling to me that expectations of inflation in the medium to longer term are moving up and down as much as they are. It suggests that the public and the markets

may not have as much confidence in the Fed's ability or willingness to keep its price stability mandate clearly in focus.

I believe the Fed should do all it can to underscore its commitment to price stability. Congress set the Fed's mandate to conduct monetary policy to "promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates." Most economists, myself included, agree that focusing on price stability is the most effective way for monetary policy to promote its other two goals.

Committing to a stated goal to keep inflation low and stable can help to reduce market uncertainty and enhance the credibility and transparency of our central bank. That is why I have advocated for nearly 20 years that the Fed make explicit its commitment to a numerical inflation objective in support of all its mandates. I believe announcing an explicit numerical inflation objective would go a long way toward increasing our credibility and accountability. This would be an opportune time, in my view, to make such a commitment.

As bankers, you understand the importance of credibility in your own institutions. An institution's reputation is built on its credibility for fulfilling its commitments. Once that foundation is compromised, it is very difficult to rebuild. The Fed must not squander its hard-earned credibility.

Exit Strategy

During the last three years, the Federal Reserve has taken some extraordinary actions to support the economy. But as the economy recovers, those actions leave a legacy that must be addressed as we try to normalize our monetary policy framework. In particular, our actions to date have led to a level of the federal funds rate – the traditional instrument of monetary policy – near zero for more than two years. Moreover, our actions have resulted in the Fed's balance sheet growing more than threefold, from nearly \$900 billion before the crisis to about \$2.7 trillion today, and its asset composition shifting significantly from mostly short- to medium-term Treasuries toward long-term Treasuries and mortgage-related assets.

Some people have questioned whether the Fed has the tools to exit from its extraordinary positions. We do. The question is not can we do it, but will we do it at the right time and at the right pace. Since monetary policy operates with a lag, the Fed will need to begin removing policy accommodation well before unemployment has returned to acceptable levels. It is imperative that we have the fortitude to exit as aggressively as necessary to avoid undesirable consequences down the road.

Any exit plan will use several policy tools, including raising interest rates, shrinking the balance sheet, and altering the composition and maturity of the assets we hold. Some exit strategies would start with raising interest rates; some would begin by shrinking the balance sheet; others would do both. Because we find ourselves in unfamiliar territory, it is understandable that there are robust debates about the right actions to take, with bright and talented people on every side.

Last month, I outlined a proposal for a systematic, rule-based approach that would involve the Fed's selling assets from its portfolio as it increased its policy rate, with the pace of sales dependent on the state of the economy. The plan would get us back to a normal operating environment in a timely manner, with the Fed's balance sheet reduced to a size that would again allow the federal funds rate to be the primary policy instrument.

Perhaps more important than the details of the sequencing or pace of any exit plan is the very establishment of a systematic plan itself—one that can be clearly communicated to the markets and the public in a way that reduces uncertainty. A systematic plan will help define for the public and the markets not only where we are headed but also how we will get there.

As to when to begin exiting from accommodative policy, I will continue to look at the data on output and employment growth and on inflation and inflation expectations. Signs that inflation or inflation expectations are beginning to rise, or that growth rates are accelerating significantly would suggest that it is time to begin taking our foot off the accelerator and start heading for the exit ramp.

Some would suggest that with unemployment still too high and growth still modest, there is too much slack for inflation's risks to surface. Yet, another lesson of the 1970s is that measurements of slack can be highly misleading. Work by a former Fed researcher and now Governor of the Central Bank of Cyprus, Athanasios Orphanides, and others found that the heavy reliance on mismeasured or misperceived output or resource gaps was a significant contributor to the excessive monetary accommodation that led to the Great Inflation in the 1970s. This mismeasurement left us with high unemployment and high inflation. Allowing monetary policy to fall behind the curve can result in greater inflation and more economic instability, including higher unemployment, in the future.

During our transition from a very accommodative policy stance to a more normal operating environment, public confidence in the Fed's commitment to do so in a manner that does not let the inflation cat out of the bag is very important. If that confidence is lost we could, indeed, face the challenges of high inflation and high unemployment. Here again the willingness of monetary policymakers to publicly commit to an explicit inflation objective could reinforce the credibility of the commitment to price stability.

If the economy continues to make progress, then monetary policy will need to exit from its extraordinary accommodation in the not-too-distant future. As always, we will study the incoming information on the state of the economy. While my expectation is that oil price increases will level off and that the currently elevated inflation measures will reverse, the risks to the inflation outlook are tilted to the upside. In this environment, we must have a plan in place to begin normalization of monetary policy. Depending on how economic conditions evolve, we must be prepared to act as aggressively as necessary if we are to promote effectively our long-run goals of price stability and maximum employment.

Conclusion

In summary, my forecast is for the economy to continue to expand at a moderate pace and for inflation to move back down from its current level as oil prices stabilize. Despite weakness in the first quarter, I expect annual growth to be 3 to 3½ percent over this year and next. As the economy strengthens, prospects for labor markets will continue to improve, with the unemployment rate descending to between 7 to 7½ percent by the end of 2012.

As the economy evolves, the Federal Reserve remains committed to its long-run statutory goals of price stability and maximum employment. We must carefully watch for signals of inflation and altered expectations to ensure that monetary policy stays ahead of the curve. As we move forward in this time of change, clear communications regarding our actions and objectives will be of the utmost importance.

I believe we can be most successful in exiting from this period of extraordinary accommodation and nontraditional policies if we communicate a systematic plan that describes where we are headed and how we will get there. Such a plan would be strengthened if the FOMC adopted an explicit numerical objective for inflation, which would help ensure that inflation expectations remain well anchored.