Economic Outlook and Communicating Monetary Policy

The 2012 Economic Forecast Breakfast and Annual Meeting of the Main Line Chamber of Commerce and the Main Line Chamber Foundation

Gladwyne, PA

February 1, 2012

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

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Introduction

Good morning and thank you for inviting me to participate in the 2012 Economic Forecast Breakfast. We are in that season when traditionally we reflect upon the past year and look ahead. So in the spirit of the season, I will give you my take on the economic outlook. Then I want to spend the remainder of my time discussing recent steps taken by the FOMC to enhance the way we communicate about monetary policy.

Before I begin, though, I should note that one of the strengths of the Federal Reserve System and its Federal Open Market Committee is that it brings together a wide range of independent assessments of economic conditions and perspectives on policy. As that famous American journalist Walter Lippmann once said: “Where all men think alike, no one thinks very much.” So let me assure you that there is a lot of thinking going on among policymakers at the Fed, but my views are my own and not necessarily those of the Federal Reserve Board or my colleagues on the Federal Open Market Committee.

Economic Outlook

Let me start with some general comments on the state of the economy as we enter 2012. A year ago, most economists were forecasting that economic growth would be 3 percent or a bit more in 2011. Instead, the latest numbers released last Friday showed that real GDP in 2011 was 1.6 percent, compared to 3.1 percent in the prior year.

Some of this weakness is perfectly understandable, given the shocks we experienced throughout most of the year. Last year began with severe snowstorms in the East. As 2011 progressed, there were the earthquake and ensuing disasters in Japan, followed by the unrest in the Middle East and North Africa, which led to a run-up in oil prices. In addition, there were renewed concerns about European sovereign debt and the midsummer uproar in Washington over fiscal policy and the debt ceiling. All of these events weighed heavily on growth, as well as on business and consumer confidence.

Yet, the economy persevered. Indeed, growth accelerated across each of the four quarters, from less than 0.5 percent in the first quarter to around 2-3/4 percent in the fourth quarter. I anticipate that we will continue to see moderate growth of around 3 percent for 2012 and 2013, which is slightly above trend.

Business spending, especially investments in equipment and software, was relatively healthy last year, buoyed by solid growth in corporate earnings. In January, the Philadelphia Fed's Business Outlook Survey showed that regional manufacturing activity continued to expand at a moderate pace, the fourth consecutive monthly increase since a late summer lull. The survey's measures of future activity also indicated that our respondents expect activity to continue to pick up over the next six months. I take this as a sign that business sentiment is also improving.

On the housing front, I expect to see stabilization but not much improvement in 2012. We entered the Great Recession over-invested in residential real estate, and we are not likely to see a housing recovery until the surplus inventory of foreclosed and distressed properties declines. Even as the economy rebalances, we should not seek nor should we expect housing and related sectors to return to those pre-recession highs. Those exuberant days were simply not sustainable, and it would be a mistake to retain that standard as our benchmark for recovery.

The housing crash destroyed a great deal of wealth for the average consumer and the economy as a whole. The losses are real and the consequences severe for many individuals and many businesses. Moreover, the losses cannot be papered over with monetary policy nor should it try to do so. Households and businesses, however, continue to make progress on restoring the health of their balance sheets by paying down debt and increasing savings. Most economists, including myself, believe that this process will continue into 2012. But the drag on growth from this rebalancing will gradually lessen over time.

While there is a long way to go in restoring a vibrant labor market, I am encouraged by the employment reports released over the past several months. The December employment report showed a net gain of 200,000 jobs and a decline in the unemployment rate to 8.5 percent. The economy added over 1.6 million jobs during 2011, and the unemployment rate fell nearly a full percentage point. Interestingly, the last time the unemployment rate fell by this much in one year was in 1995. As growth continues and strengthens, I expect further gradual declines in the unemployment rate, with the rate falling to around 8 percent or a little less, by the end of 2012.

Of course, forecasting is a hazardous business, even in the best of times, and we should all take any economic forecast with at least a grain or two of salt – if not more. So it is important to recognize that there are some obvious risks to the growth forecast. The largest of these are the ramifications for the U.S. economy of the continuing sovereign debt crisis in Europe. An economic slowdown in the euro zone will likely restrain U.S. exports. And while strains in financial markets have been limited to European institutions so far, the situation bears watching to ensure that there are no adverse spillovers to U.S. financial institutions. Of course, regardless of how the European situation plays out, it has already imposed considerable uncertainty on growth prospects for the global economy.

That uncertainty has been compounded by our own nation's inability to establish a clear plan to put our fiscal policy on a sustainable path. Until the economic environment becomes clearer, firms and consumers are likely to postpone significant spending and hiring decisions – posing a drag on the recovery, even as economic developments in the U.S. continue to improve.

Just as growth was weaker in 2011 than many forecasters had anticipated, inflation was higher. A year ago, many were concerned about the risks of a sustained deflation. I was not among them. Instead, I thought we would see inflation at about 2 percent for the year.

It turns out we were all wrong. Total inflation in 2011, as measured by the CPI on a year-over-year basis, was 3 percent, reflecting strong increases in energy and food prices, particularly in the early part of the year. Core inflation, which excludes food and energy prices, rose to about 2.2 percent. I anticipate, however, that with many commodity prices now leveling off or falling, and inflation expectations relatively stable, inflation will moderate in the near term. Indeed, total inflation has been more subdued over the past several months.

As a policymaker, though, I focus less on the near term and more on the medium term. Given the very accommodative monetary policy that has been in place for more than three years, I believe we must continue to monitor inflation measures very carefully.

Inflation most often develops gradually, and if monetary policy waits too long to respond, it can be very costly to correct. Measures of slack such as the unemployment rate are often thought to prevent inflation from rising. But that did not turn out to be true in the 1970s. Thus, we need to proceed with caution as to the degree of monetary accommodation we supply to the economy. So let me review some of the policy actions the Fed has taken.

Monetary Policy

As you know, the Fed has kept the federal funds rate near zero for more than three years to support the recovery. We have also conducted two rounds of asset purchases that have more than tripled the size of the balance sheet and changed its composition from short-term Treasuries to longer-term Treasuries and housing-related securities, mostly mortgage-backed securities.

In the most recent meeting, the Federal Open Market Committee announced that economic conditions were "likely to warrant exceptionally low levels for the federal funds rate at least through late 2014" – that's almost three years from now. Last August when the FOMC first signaled a time frame for continued low rates, it was until mid-2013. So our announcement last week lengthened the period of anticipated very low rates by 18 months. In addition, the Committee announced that the Fed intends to continue the maturity extension program, or "operation twist," first launched last September. In this program, to be completed by the end of June, the Fed is buying $400 billion of longer-term Treasuries and selling an equal amount of shorter-term Treasuries, in an effort to reduce yields from already historically low levels. The FOMC is also continuing to reinvest principal payments from its holdings of agency debt and MBS into MBS in an effort to help mortgage markets.

You may know that I dissented from the FOMC decisions in August and September because it was not clear to me that further monetary policy accommodation was appropriate. After all, inflation was higher and unemployment was lower relative to the previous year. Moreover, policy actions are never free; they need to be evaluated based on a thorough analysis of costs and benefits. I believed that the benefits of further monetary policy easing were small at best, since, in my view, they would do little to help resolve the challenges we face on the employment front. But the potential costs of this further accommodation could translate into a steady rise in inflation over the medium term, even without much of a drop in the unemployment rate. In my assessment, the potential costs of further accommodation outweighed the potential benefits.

For similar reasons, I was not supportive of the most recent decision to extend the time frame for exceptionally low rates through 2014. In my view, economic conditions have modestly improved since our December meeting, especially on the employment front, and the downside risk of a double-dip recession that many feared in September when the Committee instituted “operation twist” has substantially abated. Thus, with the economy gradually improving, I saw little justification to further ease monetary policy and felt it risked undermining confidence in the process.

In addition, I don’t support the practice of offering forward policy guidance by saying economic conditions are likely to lead to low rates through some calendar date. Such statements are, in my mind, particularly problematic from a communications perspective. Monetary policy should be contingent on the economic environment and not on the calendar. For example, I often read comments in the media that the FOMC has “pledged” or “vowed” to keep rates at zero at least until late 2014. But this is clearly incorrect. The FOMC has made no such commitment and the statement indicates as much – if economic conditions change, then so will policy. Yet there continues to be confusion and the confusion stems from our statement. In my view, there are much better ways to communicate information about the future path of policy than the use of calendar dates. Indeed, one of these ways was provided in January when we began providing information on the policy paths that underlie FOMC participants’ forecasts.

Improving Communications

So let me turn to our communication initiatives, which have received a fair amount of attention in the financial press. Improving the transparency of monetary policy has always been high on my list of things to do since joining the Federal Reserve Bank of Philadelphia in 2006. The Federal Reserve is accountable to the public, so it needs to clearly communicate its goals and its approach to making policy decisions.

To its credit, the Federal Reserve has strived to increase transparency about its actions and its policies, particularly during the tenure of Chairman Ben Bernanke. For instance, in an effort to improve its communications to the public, the FOMC decided in 2007 to release its Summary of Economic Projections, or SEP, four times a year.

In 2011, Chairman Bernanke introduced press briefings to provide additional context for the FOMC's policy decisions following the release of the SEP. However, until now, these releases did not include any information about the assumptions policymakers made about the path of monetary policy. Therefore, it was difficult for the public to interpret the projections for growth, employment, and inflation.

Early last summer, Chairman Bernanke asked Governor Yellen, Governor Raskin, President Evans, and me to serve on a communications subcommittee. In January, the FOMC adopted two initiatives brought forward by the subcommittee. Both initiatives are important steps forward for the FOMC and are intended to serve the Committee and the public over the longer term.

The first concerned improving our communications about FOMC participants' economic projections in the SEP. So starting with our last meeting, the expanded SEP now contains information about policymakers' assumed path for monetary policy, along with the projections for growth, unemployment, and inflation. It is important to keep in mind that the Fed's SEP projections differ from those of private-sector forecasters. Private-sector forecasters explicitly or implicitly try to predict what the Fed's next move will be. In the SEP, each policymaker assumes a path for monetary policy that – based on current economic conditions – he or she believes will deliver the best outcomes for the economy.

Providing policy projections in the SEP helps the public to interpret the economic forecasts included in the SEP. For example, FOMC participants might have considerably different growth forecasts. Is it because they have different views about the underlying dynamics of the economy? Or is it because they are assuming different policy paths? Alternatively, two participants may have similar forecasts – say, the same inflation forecast – but they may believe that these forecasts will be achieved through different policy paths. The expanded SEP will now show the range of views about the assumed policy paths that give rise to the projections.

Of course, over time, policymakers' views will evolve as the economy evolves. So, the expanded SEP will add an important perspective not just of prospective policy at a point in time, but of how the policy projections are influenced as economic conditions change.

I would argue that adding policymakers' assumptions to the SEP conveys more useful information about the likely future path of monetary policy than using a calendar date as we have been doing. It has two main advantages in my view. First, it illustrates the full range of views and, in doing so, underlines the uncertainty that truly exists about future policy. Second, over time it will reveal more information about the reaction function of policymakers' views of policy to the evolution of economic conditions, which are, after all, the ultimate drivers of policy decisions. Such communication will prove useful not only in periods such as the current unusual circumstances but in more normal times as well.

The second important communications initiative adopted by the FOMC in January was to issue a consensus statement of the longer-run goals and policy strategy.

When households, firms, and markets have a better understanding of what to expect from monetary policy, they can make better financial plans and spending decisions. Thus, greater clarity helps monetary policy become more effective at promoting its congressionally mandated goals of price stability, maximum employment, and moderate long-term interest rates.

The consensus statement does three very important things never before undertaken by the Federal Reserve. First, the FOMC explicitly states its goal for inflation as 2 percent, as measured by the year-over-year change in the overall personal consumption expenditures (PCE) chain-weighted price index. Being explicit about our inflation objective will enhance the credibility of our commitment to price stability, which will help anchor inflation expectations and foster price stability and moderate long-term interest rates. Moreover, a credible commitment to price stability affords the Fed more flexibility in the short run as it attempts to mitigate the fluctuations in output and employment in the face of significant economic disturbances.

Second, the statement explains why the FOMC cannot set a fixed long-run numerical objective for the employment part of our mandate. This is not because we do not seek maximum employment or because we want to disregard or downplay its importance. Rather, it reflects the differences between the economic determinants of the inflation and employment parts of our mandate. Over the longer run, the economy's inflation rate is primarily determined by monetary policy. So, the FOMC is able to set a longer-run numerical goal for inflation and should be held accountable for achieving that goal.

On the other hand, maximum employment is largely determined by factors that are beyond the direct control of monetary policy. These factors include such things as demographics, technological innovation, the structure of the labor market, and various governmental policies – all of which will vary over time. Policymakers consider a wide range of indicators in assessing employment, but estimates of maximum employment at any point in time are subject to substantial uncertainty.   The FOMC cannot set a fixed numerical objective for something that it does not directly control and cannot accurately measure.

A third element of the consensus statement is that it makes clear that the FOMC takes a balanced approach to setting policy. By balanced approach I mean one that promotes all of our congressionally mandated objectives of maximum employment, stable prices, and moderate long-term interest rates and does not favor one over the other.

The consensus statement does not provide answers for all the hard policy choices. How best to implement this balanced approach takes a lot of judgment and may well differ across policymakers who may have different models of the economy even as they work to promote the same long-term goals for monetary policy.

Conclusion

In summary, the U.S. economy is continuing to grow at a moderate pace. I expect annual growth to gradually accelerate to around 3 percent in 2012 and 2013.

Prospects for labor markets will continue to improve, with job growth strengthening and the unemployment rate falling gradually over time. I believe inflation expectations will be relatively stable and inflation will moderate in the near term. However, with the very accommodative stance of monetary policy, the inflation situation is one that bears careful watching in order to ensure that inflation pressures remain contained over the medium run.

On monetary policy, the Federal Reserve has taken bold and significant steps to improve the transparency of its policy actions and to create better public understanding of the rationale behind the FOMC's decisions. Specifically, the FOMC now includes information about each participant's assessments for the target federal funds rate path in its Summary of Economic Projections. The FOMC has also clarified its longer-run goals and monetary policy decision-making process and clearly articulated its inflation objective.

Economic research over the past 30 years has shown that setting monetary policy in a systematic manner leads to better economic outcomes — lower and less volatile inflation and greater economic stability in general. But the benefit depends on the public's understanding of the policymaking framework. Transparency not only furthers the effectiveness of monetary policy by enhancing the credibility of the central bank but also raises the Fed's accountability to the public. Thus, I remain committed to working to increase the clarity of the Fed's public communications about current economic conditions, the economic outlook, and our policymaking framework.