Economic Outlook and Monetary Policy

CFA Society of Philadelphia/The Bond Club of Philadelphia

September 25, 2012

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Introduction

Let me welcome you all to the Federal Reserve Bank of Philadelphia and to thank both the CFA Society and the Bond Club for inviting me to speak today. In October of 2006, I gave my first speech as president of the Federal Reserve Bank of Philadelphia to the CFA Society of Philadelphia. Well, a lot has happened since then, and the world is a different place. So I will use my time with you today to offer my perspective on the current state of the economy and monetary policy.

Our gathering comes at an opportune time, since less than two weeks ago, I participated in the most recent meeting of the Federal Open Market Committee, or the FOMC, which, as you know, is the body within the Federal Reserve responsible for determining monetary policy.

Four times a year, and most recently at our last meeting, FOMC participants submit their economic projections for output growth, inflation, and unemployment, based on their latest assessments of appropriate monetary policy. The Summary of Economic Projections, or SEP, gives a perspective on participants' views of how monetary policy can best achieve the goals that Congress has set forth for it. Specifically, the Federal Reserve Act states that the Fed should conduct monetary policy to "promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates." Since moderate long-term interest rates generally result when prices are stable and the economy is operating at full employment, it is often said that Congress has given the Fed a dual mandate.

Monetary policy actions generally affect the economy with a lag, so the FOMC must be forward-looking in calibrating the appropriate stance of 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 actions announced at our last meeting.

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.

Economic Outlook

So let me begin with the state of our economy. We have now seen three years of economic expansion since mid-2009 when the recession officially ended. Yet, no one would describe our nation's economic state of affairs as satisfactory. Economic growth has come in fits and starts, taking two steps forward, only to then take one step back. Most disheartening is that the unemployment rate remains high, affecting millions of Americans and their families.

After finishing 2011 with 4.1 percent growth in the fourth quarter, growth of real gross domestic product slowed to 2 percent in the first quarter of this year, and then to 1.7 percent in the second quarter. We are likely on a trajectory that will lead to growth of about 2 percent for the full year.

Looking out a little further, I anticipate that the pace of growth will pick up somewhat to about 3 percent in 2013 and 2014 – a pace that is slightly above trend. That outlook places me near the high end of the central tendency of FOMC participants' forecasts for 2013 and near the low end for 2014. In September's projections, the central tendency showed real GDP growth of 1.7 to 2 percent this year, followed by growth of 2.5 to 3 percent in 2013 and 3 to 3.8 percent in 2014 and 2015.

One temporary factor contributing to sluggish growth in the very near term is the drought in the Midwest and its effects on this year's crops. Estimates vary, but the drought will probably cut about half a percentage point off growth in the second half of this year.

Sluggish manufacturing activity has been another reason for the recent moderating growth estimates. The Philadelphia Fed's monthly Business Outlook Survey of manufacturers has been a useful barometer of national trends in manufacturing over many years. The survey's general activity index posted a few negative readings last summer and then returned to positive numbers through this spring. We saw a return to negative territory this summer. While the readings for the past five months have been negative, the recent readings have been improving, and the latest survey suggests that manufacturing activity in the region was essentially flat from August to September. Despite weak current activity, the survey's indicators of activity six months ahead have remained positive throughout this recovery and showed a nice bounce up in the September report, suggesting that manufacturers are optimistic about the future.

Consumer spending, which accounts for about 70 percent of the nation's GDP, also continues to make modest gains. In July, the Bureau of Economic Analysis reported that personal consumption expenditures (PCE) increased $46 billion, or 0.4 percent. That followed a weak reading in June, when consumer spending increased just $3.5 billion.

We need to keep in mind, though, the extent of the shocks from the financial crisis and the ensuing recession. The housing bust that precipitated the crisis destroyed a lot of household wealth. It is only natural for consumers to want to rebuild the savings that were lost as a result of the decline in housing wealth – savings they might have used to send their children to college or to help fund their retirement. Consequently, private savings rates have risen substantially. Between 2000 and 2007, private savings averaged less than 5 percent of GDP, and between 2008 and 2011, the savings rate averaged 7½ percent. Thus, it is not surprising that consumers are not the engine of growth they normally are in economic expansions. And they are unlikely to provide a very robust boost to demand until the health of their balance sheets has been significantly improved.

There are, however, encouraging signs that the housing sector is beginning to improve. Of course, we entered the recession over-invested in residential real estate, and we are not likely to see a strong housing recovery until the surplus inventory of foreclosed and distressed properties declines. Moreover, we should not want housing activity to return to those heady days of 2005 and 2006. Such activity was unsustainable and a prime contributor to the financial meltdown.

On the labor front, the pace of employment growth this year hasn't been strong enough to have much of an effect on the unemployment rate. Firms added an average of 226,000 jobs per month in the first quarter of the year. This slowed considerably to just 67,000 jobs a month, on average, in the second quarter. Through the first two months of the third quarter, employment has picked up slightly, to about 118,000 a month. At 8.1 percent, the unemployment rate is still elevated, but we should remember that it is a full percentage point lower than it was at this time last year.

In the FOMC's economic projections in September, the FOMC participants' central tendency suggested that unemployment in the fourth quarter would be close to where we are now, between 8 and 8.2 percent, and then fall gradually to between 6 and 6.8 percent by the end of 2015. My own forecast is at the low end of that central tendency.

I wish we had better numbers to report. The sizable shocks that hit the economy resulted in a loss of 8.8 million jobs from the peak of employment in January 2008 to the employment trough in February 2010. We have regained fewer than half of these jobs. In my view, unfortunately the frictions and structural adjustments that are holding back improvements in labor markets cannot be cured by monetary policy, nor can monetary policy do much to speed up the slow progress we are making on the labor front.

Turning to inflation, it has been running near our longer-term goal of 2 percent. Although the drought in the Midwest and higher gasoline prices are likely to push up inflation in the near term, these effects should be transitory. Thus, I do not see much evidence that we will have an outbreak of inflation in the near term, nor do I see elevated risks of deflation. Indeed, over the medium to longer term, I expect inflation to be near our 2 percent target. But this expectation is incumbent on appropriate monetary policy, and my assessment is that the appropriate policy is likely to be tighter going forward than anticipated by the Committee at this point. Thus, I do see some risks to inflation in the longer run given the current stance of monetary policy, as I will discuss in a few moments.

Of course, other risks cloud the forecast. While the recent policy actions in Europe may have calmed markets and eased financial conditions somewhat, many fundamental issues remain unresolved. Thus, there is still a great deal of uncertainty as to whether the Europeans will make the difficult choices needed to put Europe back on a sustainable fiscal path.

Our own fiscal policy is also uncertain. While I believe we will avoid the worst-case scenarios related to falling off the fiscal cliff, the U.S. needs to forge a path toward sustainable fiscal policy. These uncertainties constitute significant hurdles for the economy and are retarding near-term growth.

Monetary Policy

Let me now turn to some thoughts on monetary policy. Even before the actions taken this month, the Fed had put into place an extraordinary amount of accommodation to support the recovery. The Fed has kept the federal funds rate near zero for more than 45 months; it has completed two rounds of asset purchases that more than tripled the size of the Fed's balance sheet; and it is implementing a maturity extension program, known as "operation twist," which is lengthening the maturity of our holdings of Treasury securities. These actions have changed the composition of the portfolio from mainly short-term Treasuries before the crisis to mostly longer-term Treasuries and housing-related securities today.

Many of these actions were taken at the height of the financial crisis and during the ensuing deep recession. But the financial crisis has substantially abated and the economy has been healing, if somewhat more slowly than we would like. In fact, if you compare today's economic and financial conditions to the conditions that prevailed when the FOMC previously took bold actions, you will see that the economy is undoubtedly in a better position.

At its latest meeting in September, the FOMC decided to begin a third round of quantitative easing, commonly known as QE3, with the purchase of additional agency mortgage-backed securities at a pace of $40 billion per month. The FOMC statement indicated that if the outlook for the labor market does not improve substantially, the Fed would make these purchases and more and would employ other policy tools as appropriate until such improvement is achieved within a context of price stability. I interpret "within a context of price stability" to mean so long as the inflation outlook remains near the Committee's goal of 2 percent. The FOMC statement also said that the Committee expects a highly accommodative stance of monetary policy to remain appropriate for a considerable period after the economic recovery strengthens. It also stated that the Committee currently anticipates that exceptionally low levels for the federal funds rate are likely to be warranted at least through mid-2015.

The Committee's decision was based on the view that with unemployment far above the level typically seen in normal times and inflation near its goal, increasing the amount of monetary accommodation should help bring unemployment down without jeopardizing our inflation goal. And since the Fed said it expects to keep substantial accommodation in place even after the recovery strengthens, people and businesses should be reassured that the recovery will remain intact, even in the face of future adverse shocks. This should make households and firms comfortable spending more today rather than saving, which should, in turn, spur hiring.

I opposed the Committee's actions in September because I believe that increasing monetary policy accommodation is neither appropriate nor likely to be effective in the current environment. Every monetary policy action has costs and benefits, and my assessment is that the potential costs and risks associated with these actions outweigh the potential meager benefits.

Given the magnitude and nature of the shocks that hit our economy, one should not be particularly surprised by the slow recovery. Both the housing and the financial sectors suffered large declines, and it will take time for the economy to adjust. While unemployment is expected to remain above FOMC participants' range of estimates of its longer-run level for some time, it is not at all clear that monetary policy can speed up that transition. In other words, the slow pace of the recovery should not be taken as evidence that the stance of monetary policy is inappropriate or that ever more aggressive accommodation can speed up that pace.

Indeed, many economists expect that further asset purchases by the Fed are unlikely to reduce long-term interest rates by a significant amount; some studies suggest that the effect will be quite small and transitory. Given our current economic situation and my reading of the empirical evidence, I do not believe that lowering interest rates by a few more basis points will spur further growth or higher employment. Business leaders who have talked to me continue to cite uncertainty about fiscal decisions – here and abroad – as the greatest hindrance to hiring and investment. Hopefully these uncertainties will abate over time, but the central bank can do little to alleviate them.

And as far as households are concerned, they continue to try to repair their balance sheets in the wake of substantial losses of housing wealth, as I indicated earlier. They are deleveraging and saving more. It seems unlikely that a small drop in interest rates will overturn the strong desire to save and, instead, induce households to spend more. In fact, driving down interest rates even further may encourage consumers to save even more to make up for lower returns.

Thus, in my view, we are unlikely to see much benefit to growth or to employment from further asset purchases. If I am right, then conveying the idea that such action will have a substantive impact on labor markets and the speed of the recovery risks the Fed's credibility. This is quite costly: If the public loses confidence in the central bank, our ability to set effective monetary policy in the future will be harmed and households and businesses will feel the consequences.

The recent actions risk the Fed's credibility in other ways as well. The rationale for the actions leading to increased spending today depends on the Fed's ability to convince the public that it will conduct policy in a fundamentally different way than it has in the past. People must believe that we will delay raising interest rates compared to when we normally would and, by so doing, make the economy stronger than it otherwise would be. At the same time, people must believe that we will ensure that inflation expectations do not take off and threaten longer-run price stability. Making such a change in the policy regime believable will be very hard to do. If the public doesn't believe that we will delay raising rates, they won't bring spending forward and the policy will be ineffective. But if they do believe we will delay raising rates, they may infer that the Fed is willing to tolerate considerably higher inflation. This may spur an increase in inflation expectations, which would require a response from the FOMC, or else risk the credibility of its commitment to keep inflation low and stable. I do not think it prudent to risk that hard-won credibility. The subtlety and complexity of successfully managing expectations in this manner make this quite a risky policy strategy in my view, with little evidence of quantitatively meaningful results for employment.

Continued expansion of the Fed's balance sheet has other costs as well. By greatly expanding the size of the Fed's balance sheet, the new asset-purchase program will exacerbate the challenges that the Fed will face when it comes time to exit this period of extraordinary accommodation, risking higher inflation and harm to the Fed's reputation and credibility. I have been a student of monetary theory and policy for over 30 years. One constant is that central banks tend to find it easier to lower interest rates than to raise them. Moreover, identifying turning points is difficult even in the best of times, so timing the change in the direction of policy is always a challenge. But this time, exit will be even more complicated and risky. With such a large balance sheet, our transition from very accommodative policies to less accommodative policies will involve using tools we have not used before, such as the interest rate on reserves, term deposits, and asset sales. Once the recovery takes off, long rates will begin to rise and banks will begin lending the large volume of excess reserves sitting in their accounts at the Fed. This loan growth can be quite rapid, as was true after the banking crisis in the 1930s, and there is some risk that the Fed will need to withdraw accommodation very aggressively in order to contain inflation. At this point, it is impossible to know whether such asset sales will be disruptive to the market. A rapid tightening of monetary policy may also entail political risks for the Fed. We would likely be selling the longer maturity assets in our portfolio at a loss, meaning that we may be unable to make any remittances to the U.S. Treasury for some years. Yet, if we don't tighten quickly enough, we could find ourselves far behind the curve in restraining inflation.

While these risks are very hard to quantify, it is clear that the larger the Fed's portfolio becomes, the higher the risk and the potential costs when it comes time to exit. And based on my economic outlook, that time may come well before mid-2015. In my view, to keep the funds rate at zero that long would risk destabilizing inflation expectations and lead to an unwanted increase in inflation. In fact, some are interpreting the FOMC's statement that we will keep accommodation in place for a considerable time after the recovery strengthens as an indication that the Fed is focused on trying to lower the unemployment rate and is willing to tolerate higher inflation to do so. This is another risk to the hard-won credibility the institution has built up over many years, which, if lost, will undermine economic stability.

Some of my colleagues on the FOMC have advocated giving quantitative triggers or thresholds for the level of unemployment and inflation to explain the economic conditions that would lead the Fed to consider a change in policy stance. For example, the Fed might indicate that extraordinary accommodation would remain in place if unemployment were above, say, X percent, so long as its outlook for medium-run inflation was not higher than, say, Y percent.

I believe that policy should be state-contingent and systematic, and that the FOMC should strive to explain its policy reaction function – how it expects to change policy as economic conditions change. A Taylor rule is one such reaction function, but research indicates that other simple rules are good guides to policy even when the true model of the economy is uncertain. These rules involve policy responding aggressively to deviations of inflation from its target and also responding to deviations of output from some concept of its potential. In addition, the rules tend to involve some smoothing of the policy rate over time rather than sharp jumps in rates. Using such robust rules as guides to policy is, in my view, the appropriate way to communicate policy guidance. As a result, as many of you know, I have never been an advocate of calendar-date forward guidance. I thought it was a mistake when we implemented that language, and it remains a nettlesome communication problem.

But while the unemployment-inflation thresholds do move away from calendar-date guidance and toward economic conditions, they fall short of a reaction function that I would like to see, since they say nothing about how monetary policy will change after such levels are reached. Will the FOMC tighten quickly? Or slowly? How will the Committee decide? In addition, the unemployment rate is not the only factor to consider in judging the state of labor markets. Indeed, it fell two-tenths of a percentage point in August, yet few think that represented improved labor market conditions. The reduction stemmed from a decrease in the participation rate rather than an increase in employment. In addition, I am not convinced that the inflation trigger would prove to be much of a constraint. While the unemployment trigger is based on the current value, the inflation trigger is based on the <u>outlook</u> for inflation, and if monetary policy is being set appropriately, this outlook should be consistent with price stability. Thus, I believe that using thresholds or triggers could easily put us behind the curve, if we have a tendency to underestimate future inflation.

Finally, I also opposed September's decision to purchase additional mortgage-backed securities. In general, central banks should refrain from preferential support for one sector or industry over another. Those types of credit-allocation decisions rightfully belong to the fiscal authorities, not the central bank. Engaging in such actions endangers our independence and the effectiveness of monetary policy.

Conclusion

In summary, the U.S. economy is continuing to grow at a moderate pace. I expect annual growth of around 3 percent in 2013 and 2014.

Prospects for labor markets will continue to improve only gradually. I believe inflation expectations will be relatively stable and inflation will remain at moderate levels in the near term. However, with the very accommodative stance of monetary policy in place for nearly four years, we must guard against the medium- and longer-term risks of inflation and the further distortions such accommodation can create.

The Fed's most recent actions carry with them significant risks. I am not forecasting that those risks will necessarily materialize and I hope they will not. But if they do, they could prove quite costly to the economy. It is therefore important that we understand those risks and evaluate them in assessing policy. A common error in policymaking is an excessive focus on the short term and an underestimation of the longer-term consequences of policy choices. I take the longer-term risks I have outlined today quite seriously. In my view, the potential costs outweigh what appear to be meager potential benefits of further asset purchases and extended forward guidance.

It is important that the Fed's policymaking remain credible to the public. This has important benefits to our economy. I believe the FOMC should continue to work toward increasing the public's understanding of how policy will react systematically to changes in economic conditions using robust rules. Improving the transparency of our monetary policy decision-making process will help to improve the effectiveness of monetary policy and the Fed's accountability to the public. Thus, I would prefer that we pursue such systematic rules rather than simple thresholds or triggers.