

Economic Outlook and the Limits of Monetary Policy

Southern Chester County Chamber of Commerce

October 11, 2012

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President and Chief Executive Officer

Federal Reserve Bank of Philadelphia



FEDERAL RESERVE BANK
OF PHILADELPHIA

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Introduction

Thank you for inviting me to speak today at this fall luncheon of the Southern Chester County Chamber of Commerce. Your group, like so many other chambers of commerce throughout our region, represents diverse segments of our economy and provides valuable support to many businesses and the communities they serve.

I'd like to share with you some thoughts on the nation's economy and my assessment of the outlook. I should begin by warning you that providing an economic outlook is difficult even in normal times. It has been even more difficult over the last few years in the wake of the housing collapse and the financial crisis. Thus, I approach my effort to provide clarity about the economic outlook with a healthy dose of humility.

I will also share some of my views on monetary policy, which also requires a degree of humility. Congress has instructed the Federal Reserve to conduct monetary policy in a manner to "promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates." Yet, I am concerned that over the years, people have come to expect too much from monetary policy. Chairman Bernanke has noted many times that monetary policy is not a panacea for all our economic challenges. Nevertheless, there are still those who seem to believe otherwise.

The Federal Open Market Committee, or the FOMC, is the body within the Federal Reserve responsible for determining monetary policy to meet these mandated goals. By

design, policy is set by 12 voting members on the FOMC — the seven members of the Board of Governors in Washington always have a vote, as does the president of the New York Fed. The remaining four votes come from among the other 11 Reserve Bank presidents, who serve one-year terms on a rotating basis.

Whether or not they vote, though, all Reserve Bank presidents contribute to the discussion. This ensures that the Committee considers a wide range of independent assessments of the economy and the policy we should pursue.

Before continuing let me 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 an overview of the economy as we enter the final quarter of 2012. We are now in the third year of the economic expansion that officially began in mid-2009. Yet economic growth has come in fits and starts, taking two steps forward, only to then stall or take one step back. The general path has continued to be forward, but we've made far slower progress than anyone would like.

This sluggish growth has had its most profound effect on the millions of Americans and their families who have lost their jobs. Last Friday, we learned that the unemployment rate improved to 7.8 percent. That's a better outcome than many had expected. And it is the lowest unemployment rate since January 2009. Yet, there are still millions of unemployed and many others who have dropped out of the labor force.

So far, in 2012, employment growth has averaged 146,000 jobs per month, compared with an average monthly gain of 153,000 in 2011. While the economy continues to add jobs, we are simply not making progress as fast as we would like.

In order for labor market conditions to improve, we need to have faster overall real growth in the economy. We finished 2011 on a strong note, with 4.1 percent growth in the fourth quarter. But growth of real gross domestic product slowed to 2 percent in

the first quarter of this year and then to 1.3 percent in the second quarter. We are likely on a trajectory that will lead to growth of about 2 percent for the full year.

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. This should allow for some steady improvement in labor markets and lead to a gradual decline in the unemployment rate.

But we need to keep in mind the size and nature of the shocks that hit the economy. The economy lost 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, we will not see greater job gains and a more rapid recovery until a number of adjustments occur. These required adjustments arise from the nature of the shocks we experienced. And I believe these adjustments are unlikely to be significantly accelerated through government policies, especially monetary policy.

We entered into this recession over-invested in the housing and financial sectors. Those sectors are shrinking as a share of the economy, and labor and capital must be reallocated to other uses. The labor force needs to be at least partially retooled to match the skills employers demand. This adjustment takes time. It is painful to be sure, but it will lead to a healthier economy in the long run.

Consumer spending accounts for about 70 percent of the nation's GDP. So without robust consumer spending, the economy will be sluggish. Here too, the nature of the financial crisis and the recession play an important role in understanding the slow recovery to date and the underlying adjustments that are occurring. The housing collapse that precipitated the crisis destroyed a lot of the equity that families had built up in their homes. Thus, a huge chunk of their savings vanished. Many households had been counting on their savings to help send their children to college or to help fund their retirement. With that wealth gone, it is only natural, and rational, for consumers to want to rebuild savings. Consequently, private savings rates have risen substantially and consumption by households has been restrained.

To be specific, between 2000 and 2007, private savings averaged less than 5 percent of GDP, whereas between 2008 and 2011, this savings rate averaged 7½ percent. This desire to save for the future rather than spend today is a drag on near-term growth but is good for longer-term growth prospects. I believe consumers are unlikely to provide a very robust boost to current demand until the health of their balance sheets has significantly improved.

Manufacturing activity has also been sluggish. Firms have been unwilling to invest and hire to any significant degree. For example, 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 in the summer of 2011 surrounding the congressional debate over the debt ceiling and then returned to positive numbers last fall through this spring. We have seen a return to negative numbers over the past five months. Still, the most recent readings have been improving, and September's survey indicated that manufacturing activity in the region was essentially flat from the prior month. A bright spot is that the survey's indicators of future activity six months ahead have remained positive throughout the recovery. In fact, the September future activity index showed a nice bounce up, suggesting that manufacturers have regained their optimism. We will see if these trends continue when the October results come out next week.

Of course, the weakness in domestic consumer demand is one reason for the sluggish growth in the manufacturing sector. Another reason is the slowdown in global demand, due in large part to the economic turmoil in Europe, which is hovering near recession. This slowdown, combined with the weakness here at home, has restrained world trade. In the early part of our recovery, U.S. exports boosted manufacturing. Now with the slowdown in Europe, U.S. exports have slackened and, with it, our manufacturing sector.

Uncertainty is another factor restraining growth. The fiscal issues in Europe remain unresolved. While leaders in Europe have, so far, avoided the financial implosion that some fear, they are far from resolving the underlying fiscal issues they confront.

Of course, uncertainty is not limited to Europe. Many U.S. firms have taken a wait-and-see attitude with respect to hiring and investing as businesses and consumers wait to see how our own fiscal problems will be resolved. Will tax rates rise or will spending be cut? Or will we see some combination of the two? U.S. fiscal policy is clearly on an unsustainable path that must be corrected. Yet, there remains significant uncertainty about the choices that will be made. And that uncertainty is a drag on near-term growth.

Finally, in terms of the prospects for near-term growth, I should mention the effects of the drought in the Midwest 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, but the return to normal conditions will boost growth by a similar amount over the first half of next year.

In case you didn't notice, nowhere in my list of factors restraining growth did I mention that financial conditions were too restrictive. Indeed, interest rates are at historic lows, and markets are generally functioning well. Therefore, I do not believe a lack of monetary accommodation is restraining near-term growth prospects – a point I will return to shortly.

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 a risk of higher inflation, or deflation, in the near term. Indeed, over the medium to longer term, I expect inflation to be near our 2 percent target. But this expectation is based on my assessment that the appropriate monetary policy is likely to become tighter more quickly than the Committee anticipated in its latest statement. Thus, I do see some risks to inflation in the longer run, given the current stance of monetary policy.

Monetary Policy

Let me now turn to monetary policy. The Fed has put into place an extraordinary amount of accommodation to support the recovery over the past few years. It has kept the federal funds rate near zero for nearly four years; it has more than tripled the size of its balance sheet through two rounds of asset purchases; 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 dramatically changed the composition of the Fed’s portfolio from mainly short-term Treasuries before the crisis to mostly longer-term Treasuries and housing-related securities today.

In September, the FOMC began a third round of quantitative easing, commonly known as QE3, with an open-ended plan to purchase \$40 billion of additional agency mortgage-backed securities per month. The FOMC statement indicated that the Fed would make these purchases and more and would employ other policy tools as appropriate until the outlook for the labor market improves substantially 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.

There is a reason for telling the public that the Committee expects to keep substantial accommodation in place even after the recovery strengthens. The Fed is hoping to reassure households and businesses that the recovery will remain intact, even in the face of future adverse shocks. This should induce households and firms to spend more today rather than save, which should, in turn, spur hiring.

However, I opposed the Committee’s actions in September because I believe that increasing monetary policy accommodation is neither appropriate nor likely to be very

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 benefits.

While the unemployment rate is expected to remain elevated above FOMC participants' estimates of its longer-run level for some time, it is not at all clear that monetary policy can speed 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 share this skepticism and so do not believe that attempts to lower 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. None think that lowering nominal interest rates by a few basis points will alter their behavior. Hopefully, the uncertainties will abate over time, but the central bank can do little to alleviate them.

And as far as households are concerned, it seems unlikely that a small drop in interest rates will overcome the strong desire to save and, instead, induce households to spend more. In fact, driving down interest rates 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 an action will help speed up the recovery risks the Fed's credibility. This can be 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.

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. 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 exit strategy will involve using tools we have not used before, such as the interest rate on reserves, term deposits, and asset sales. 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 greater 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. We know that monetary policy can control

inflation, but its ability to manage the unemployment rate is far more dubious. Chasing an elusive goal for unemployment could well risk losing control over inflation. That was the lesson of the Great Inflation during the 1970s.

Finally, I also opposed September's decision to purchase additional mortgage-backed securities. In general, central banks should refrain from allocating credit toward one sector or industry. 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 in the financial markets.

The Fed's most recent actions carry 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.

I'd like to close with a quotation from the Nobel Prize-winning economist, and my former teacher, Milton Friedman. While the quote is now over 40 years old, I believe it

is as applicable today as when Milton admonished our profession on the limits of monetary policy in his presidential address to the American Economic Association:

“....we are in danger of assigning to monetary policy a larger role than it can perform, in danger of asking it to accomplish tasks that it cannot achieve, and, as a result, in danger of preventing it from making the contribution that it is capable of making.”*

* Milton Friedman, “The Role of Monetary Policy,” *American Economic Review*, 58:1 (March 1968), pp. 1-17.