Economic Conditions and Monetary Policy

Presented to the Economic Development Company and Economic Development Finance Corporation of Lancaster County Annual Meeting

Lancaster, PA

March 6, 2013

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President and CEO
Federal Reserve Bank of Philadelphia

FEDERAL RESERVE BANK
OF PHILADELPHIA

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I want to thank the Economic Development Company and the Economic Development Finance Corporation of Lancaster County for the invitation to speak to you this morning. It is a pleasure to be here today. At the outset, I should note that the views I express here are my own and not necessarily those of the Federal Reserve Board of Governors or my colleagues on the Federal Open Market Committee.

In my conversations around the country, I am often asked about the Federal Reserve System. To many people, the Fed is a mysterious organization. Since the Federal Reserve is nearing its centennial later this year, I thought I would start by providing a little background about the Fed before turning to the economic outlook.

Congress created the Federal Reserve System with the Federal Reserve Act, signed into law on December 23, 1913. The act created 12 independent Reserve Banks, overseen by a Board of Governors in Washington, D.C. The Federal Reserve Bank of Philadelphia serves the Third District, which includes Delaware, the southern half of New Jersey, and the eastern two-thirds of Pennsylvania.

The Reserve Banks distribute currency, act as a banker's bank, and generally perform the functions of a central bank, including serving as the federal government's fiscal agent. They also provide supervisory and regulatory oversight of many banking institutions within their respective Districts.

Each Reserve Bank has a nine-member board of directors selected in a nonpartisan way to represent a cross-section of banking, commercial, and community interests. Scott Smith, a member of your group who is the retired chairman and CEO of Fulton Financial Corporation, serves as one of three directors representing the banking community. Six other directors, all <u>non</u>bankers by law, come from a wide variety of backgrounds and perspectives. These directors not only fulfill the traditional governance role of overseeing the Bank's performance but also provide valuable insights into economic and financial conditions in the District and the nation.

The monetary policy arm of the Fed is the Federal Open Market Committee, or FOMC. The Committee includes the seven politically appointed members of the Board of Governors in Washington and five of the 12 Reserve Bank presidents: the president of the New York Fed and four other presidents, who serve one-year terms on a rotating basis. The Committee meets eight times a year to set monetary policy. It discusses economic conditions and, in normal times, adjusts short-term interest rates to best achieve its objectives of longer-run price stability and maximum employment.

Whether we vote or not, all Reserve Bank presidents attend the FOMC meetings, participate in the deliberations, and contribute to the Committee's assessment of the economy and policy options. Each of us prepares for the meetings by gathering information from our boards of directors and advisory councils; through conversations with local and international business leaders, including events like this one today; as well as briefings on economic conditions by our Research staffs. All this helps to contribute to a rich and comprehensive mosaic of the national economy.

This decentralized structure of the Fed is one of its most important features. It has deep roots in our nation's federalist structure. Independent Reserve Banks ensure that policy reflects the economic and geographic diversity of the nation. Americans have always been skeptical of too much centralized authority. The structure of the Fed was deliberately designed to preserve a diversity of views and to provide checks and balances.

Indeed, I believe the diversity of opinion around the FOMC table is one of its great strengths and serves to improve the quality of our policy decision-making. As the famous American journalist Walter Lippmann once said, “Where all men think alike, no one thinks very much.”

Let me now turn to an assessment of economic conditions. I want to start with a discussion of inflation. Preserving price stability, in my view, is the most important function of a central bank. In our modern economy, there is no other government agency that has the responsibility or the capability to ensure the stability of the purchasing power of our nation’s currency.

I will be the first to admit that over the 100-year history of the Federal Reserve, its track record has been mixed. At times, it has been successful, and at other times, it has failed spectacularly. We have seen periods of deflation in the early 1920s, the Depression of the early 1930s, and spiraling inflation in the 1970s. Economists and central bankers have learned many lessons from these various episodes, which can be seen by looking at our inflation performance over the last few decades. From 1972 to 1992, the average inflation rate, as measured by the personal consumption expenditure, or PCE, price index, was 5.5 percent, largely reflecting the Great Inflation episode of the 1970s. But since 1992, inflation has averaged 2 percent per year. Of course, these averages mask some ups and downs, but I believe that the Fed has done a pretty good job over the last two decades in achieving its inflation objective.

You may remember that early last year, the FOMC announced an explicit long-run inflation target of 2 percent a year. While you might argue, correctly, that 2 percent inflation is not truly price stability, it is widely believed because of measurement problems and the risks of deflation, or falling prices, that a 2 percent average inflation target is a reasonable compromise when weighing all the costs and benefits. In fact, most central banks around the world have a similar target.

Average inflation over the last three years has been running about 1.8 percent, a little under our 2 percent target. I expect that PCE inflation will remain close to our goal over the next year or two. However, as they say in the investment community, "Past performance does not guarantee future results." The Fed must remain vigilant. Inflation is a monetary phenomenon. It often evolves slowly and what sometimes appear to be purely temporary or transitory movements in volatile individual prices, like oil or other commodity prices, can prove to be precursors of more sustained movements in prices in general.

Nevertheless, I expect that inflation will be near our 2 percent target over the medium to longer term. But to achieve this outcome, the FOMC will likely need to begin stepping back from the extraordinary accommodation it has been applying. I will return to this point shortly.

Let me turn now to other aspects of the economy, including the prospects for growth and employment. The link between monetary policy actions and economic growth and employment is quite different from monetary policy's link with inflation. Economists understand that in the long run, inflation is a monetary phenomenon. Yet, in the long run, monetary policy cannot determine the growth of either output or employment. Even in the short run, the links between monetary policy and employment or output are tenuous at best and hard to predict.

The FOMC explained in its January 2012 statement of longer-terms goals and objectives that factors other than monetary policy play the dominant role in determining the maximum level of employment. As a result, it is not feasible or desirable for the monetary authorities to specify a numerical objective for employment or unemployment.

Nevertheless, I have become increasingly concerned that many people inside and outside our government have come to expect too much from monetary policy. Monetary policy is not a panacea for all our economic ills. If society pressures monetary policy to over-reach its capabilities, it will surely fail and, in doing so, will undermine not only the Fed's credibility but also monetary policy's ability to deliver on the goals that it is most capable of achieving. The public and central bankers should scale back their expectations of the role and power of monetary policy.

Let me talk a little about the real economy, how I see it evolving, and why I think the recovery has been so tepid. The recovery officially began nearly four years ago, in June 2009, yet real GDP growth has averaged just 2.1 percent a year since then.

According to the latest estimate, the economy grew just 1.6 percent in 2012, measured on a fourth-quarter-to-fourth-quarter basis. Growth in the fourth quarter was particularly weak, eking out just a 0.1 percent gain. Most economists pointed to a number of temporary factors that adversely affected performance in the fourth quarter. In particular, Hurricane Sandy had an enormous impact on economic activity in the Northeast. We also experienced a sharp decline in inventory investment, which is likely to be reversed. Defense spending declined at about a 20 percent annual rate. Such a large decline is unlikely to persist. Beneath the very weak headline number, there were some signs of improvement in consumption, business investments, and residential investments. Thus, there is reason to be somewhat optimistic for the coming quarters.

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. My outlook is somewhat more optimistic than that of some forecasters. For instance, the median forecast in the Philadelphia Fed's first-quarter Survey of Professional Forecasters is for the economy to grow at a 2.4 percent pace from the fourth quarter of 2012 to the fourth quarter of 2013.

My forecast of 3 percent growth should allow for continued improvements in labor market conditions, including a gradual decline in the unemployment rate, similar to the improvements we have seen over the past two years.

So why has the recovery been so tepid? To understand this, we need to understand the nature of the shocks that have hit the economy. We now understand that we entered the most recent recession over-invested in the housing and financial sectors. The economic adjustments as a result of the boom and bust in housing have been painful. The housing and financial sectors have both shrunk as a share of the economy, and it would not be particularly wise to seek to return those sectors to their pre-crisis highs. We learned the hard way that those levels were not sustainable. Thus, labor and capital must be reallocated to other uses. Moreover, the labor force needs to be at least partially retooled to match the skills employers now demand. This adjustment takes time. It is painful to be sure, but it will lead to a healthier economy in the long run.

The housing collapse also significantly reduced consumer spending, which accounts for about 70 percent of the nation's GDP. The sharp decline in housing values destroyed a lot of the equity that families had built up in their homes. Thus, a huge chunk of their savings vanished. With that wealth gone, it is only natural for consumers to want to rebuild savings. Consequently, private savings rates have risen substantially, and consumption by households has been restrained.

I believe these adjustments cannot be significantly accelerated through traditional government policies that seek to stimulate aggregate demand. This is especially true in the case of ever more aggressive monetary policy accommodation.

The conventional view is that by lowering interest rates, monetary accommodation tends to encourage households to reduce savings and thus consume more today. However, as I've noted, in the current circumstances, consumers have strong incentives to save. They are deleveraging and trying to restore the health of their balance sheets so they will be able to retire or put their children through college. They are behaving wisely and in a perfectly rational and prudent way in the face of the reduction in wealth.

In fact, low interest rates and fiscal stimulus spending that leads to larger government budget deficits may be designed to stimulate aggregate demand or consumption, but they could actually do the opposite. For example, low interest rates encourage households to save even more because the return on their savings is very small. And large budget deficits suggest to households that they are likely to face higher taxes in the future, which also encourages more saving. In my view, until household balance sheets are restored to a level that consumers and households are comfortable with, consumption will remain sluggish. Attempts to increase economic “stimulus” may not help speed up the process and may actually prolong it.

Businesses interpret increased savings and the modest growth in consumer spending as weak demand. This causes them to slow production, as well as hiring and investment. And this has made progress on employment slower than it was in recoveries from earlier deep recessions. For instance, in the recession that occurred in 1981-82, unemployment peaked at 10.8 percent. Yet, by the end of 1985, three years later, the rate had fallen 3.8 percentage points, to 7 percent.

In contrast, today’s improvement in labor markets has occurred at a relatively slow pace. The unemployment rate peaked at 10.1 percent in October 2009, but in the three years since then, the rate has fallen only about 2.2 percentage points, to 7.9 percent, where it stood in January. With the economic recovery continuing, I believe we will see the unemployment rate fall at a similar pace, to near 7 percent by the end of 2013.

Manufacturing activity has also been sluggish in recent months, although not all the news was bad. Regional manufacturers in the Philadelphia Fed’s latest Business Outlook Survey reported slightly more positive outlooks for shipments and employment. Also, the survey’s broad indicators of future activity edged higher, with manufacturers expecting overall production in the first quarter to be higher than in the fourth quarter.

Global demand has also slowed, due in large part to the economic turmoil in Europe. This slowdown has restrained world trade. U.S. exports have slackened and, with it, so has our manufacturing sector.

Uncertainty is the other factor restraining hiring and investment by businesses. Many U.S. firms have restrained hiring and investing as businesses and consumers wait to see how our own fiscal problems will be resolved.

There remains significant uncertainty about the choices that will be made. How much will tax rates rise? How much will government spending be cut? U.S. fiscal policy is clearly on an unsustainable path that must be corrected. Efforts by Congress and the administration at the end of last year reduced some of the near-term uncertainty over personal tax rates. But the impact of the sequester, the debate over the continuing resolution to fund the federal government beyond this month, and the debt ceiling, which will once again become binding in the spring, all have clouded the fiscal policy situation. So, the resultant uncertainty will likely be a drag on near-term growth.

In my view, until uncertainty has been resolved, monetary policy accommodation that lowers interest rates is unlikely to stimulate firms to hire and invest. Firms have the resources to invest and hire, but they are uncertain as to how to put those resources to their highest valued use.

To sum up, there are good reasons to expect that the recovery will continue but at a moderate pace over the next couple of years.

Let me now turn to some implications for monetary policy. The Fed has taken extraordinary steps to support an economic recovery. It has lowered its target for the federal funds rate from 5.25 percent to essentially zero. Since it cannot lower the interest rate below zero, it has engaged in unconventional policies to provide more accommodation. The Fed has purchased large quantities of longer-term assets and has provided what we call "forward guidance" on the future path of interest rates as a means to lower longer-term interest rates. The Fed is purchasing $85 billion of longer maturity assets each month ($40 billion of mortgage-backed securities guaranteed by the federal housing agencies and $45 billion of longer-term Treasury securities). The FOMC has indicated that it anticipates that the Fed will continue to purchase these assets until there is substantial improvement in labor markets.

In addition, so long as the outlook for inflation over the one- to two-year horizon does not move above 2.5 percent and inflation expectations remain well anchored, the FOMC expects to keep the federal funds rate at essentially zero as long as the unemployment rate is above 6.5 percent. It also indicated that the highly accommodative stance of monetary policy will remain appropriate for a considerable time after the economic recovery strengthens.

In taking these policy actions, the FOMC is attempting to balance the expected benefits with the expected costs. Yet, we are operating in an uncertain environment and using nontraditional policies with which we have limited experience. Given my analysis of the factors that are restraining growth, I have been reluctant to support an ever more accommodative policy in an effort to speed the recovery. With interest rates already extremely low, I believe that the benefits are few and do not outweigh the potential costs. Admittedly, these potential costs are difficult to quantify, but they are real nonetheless. The costs fall in three major areas: financial stability, market functioning, and price stability.

I have heard from various business contacts that the low interest rate environment is spurring institutional and individual investors to "search for yield." This may entail taking on more credit risk than these investors are typically comfortable with in a reach for yields that may ultimately be illusive and result in losses they are ill-equipped to handle. Very low yields may also be distorting other investment decisions, inducing firms to undertake long-run investment projects that may prove to be unprofitable in a rising interest rate environment. Of course, the intention of accommodative monetary policy is to ease credit conditions so that risk-taking and investment increase. However, there can be too much of a good thing with interest rates as low for as long as they have been. We do not want monetary policy to sow the seeds of financial instability.

Financial instability, for example, may arise from the higher levels of interest rate risk that investors, including financial institutions, are holding by funding long-term, low-yielding assets with short-term liabilities. When interest rates rise, the losses these firms will face could be a source of financial instability.

We also do not know whether the Fed's growing presence in the market for mortgage-backed securities will distort the functioning of this market in the longer run. But with the large volume of purchases the Fed is making, this possibility needs to remain on our radar screen.

I also believe that our current, increasingly accommodative monetary policy has the potential to complicate the Fed's exit from the nontraditional policies and undermine its ability to achieve long-run price stability. The Fed's balance sheet is very large – the banking system is currently holding $1.7 trillion of reserves at the Fed. As the recovery picks up momentum, long-term interest rates will begin to rise, and banks will begin to lend these excess reserves to businesses and consumers. Loan growth and economic activity will pick up, and the Fed will need to withdraw accommodation – and it may have to do so quickly – to restrain inflationary pressures.

The Fed has tools to tighten policy in such a high-reserves environment, including paying interest on reserves, offering term deposits, and engaging in reverse repurchase agreements. Even though we have tested some of these on a small scale, there remains some uncertainty about their effectiveness, since we do not have historical experience. Should the tools not work as well as expected, there is some risk that inflation expectations may rise, putting at jeopardy the Fed's ability to achieve its price stability goal.

Similarly, the Fed is using forward guidance as a policy tool, but the effectiveness of this tool to yield better economic outcomes depends on the credibility of the Fed's commitment to longer-run price stability. Allowing inflation to deliberately deviate from the central bank's longer-term goal for too long — even if not much higher than 2 percent, as indicated in our current forward guidance — runs the risk that inflation expectations could become unanchored. If that happens, whatever credibility the central bank had previously accrued could quickly vanish. As policymakers worked to reestablish their reputation, inflation, employment, and output would all suffer.

The Fed's recent policy choices also impose some risks to the institution itself, which ultimately could affect the economy in general. As a result of its policies, the Fed's balance sheet has grown nearly fourfold and is much longer in duration. This means that when interest rates rise, the Fed's remittances to the Treasury will fall. They could even be negative for some years, should the Fed have to sell some of the longer maturity assets. Negative remittances would not impair the Fed's ability to implement monetary policy and would have no direct macroeconomic consequences. Yet, the situation will not go unnoticed. This is surely true at a time when the federal government is trying to reduce its deficits and when the Fed is paying higher amounts to banks on the reserve balances they are holding at the Fed. Would such a situation spur renewed calls to reduce the Fed's independence to set monetary policy? There is a substantial body of research that shows that central bank independence results in better economic outcomes for both inflation and output. Thus, if Congress were to accede to such calls, the outcome would have long-term negative consequences for our independence and thus our ability to pursue price stability.

In my view, these potential costs outweigh the potential benefits of continuing our purchases of longer-term assets at a pace of $85 billion per month. I would like the FOMC to begin to taper these purchases with an aim toward ending them before the end of the year.

In summary, the U.S. economy continues 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, but I believe we may see rates near 7 percent by the end of this year. I believe inflation expectations will be relatively stable and inflation will remain at moderate levels in the near term.

I believe that with interest rates already extremely low and the Fed's balance sheet large and growing, monetary policy is posing risks to the economy in terms of financial stability, market functioning, and price stability. While the potential costs are difficult to measure, they are nonetheless important factors that we need to assess in setting policy. In light of what I believe are meager benefits, should economic conditions evolve as I currently anticipate, I believe we should begin to taper our asset purchases with an aim of ending them before year-end. This will allow for an orderly transition to a gradual reversal of our highly accommodative stance of monetary policy when economic conditions warrant it.