The National Economic Outlook and Monetary Policy

Presented to the Greater Johnstown Cambria County Chamber of Commerce

Johnstown, PA

October 8, 2013

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President and CEO
Federal Reserve Bank of Philadelphia

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OF PHILADELPHIA

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Highlights:

- President Charles Plosser provides his economic outlook and notes that since there is little evidence that additional asset purchases will improve the economic recovery, the time has come for an expeditious phaseout of the purchase program.
- He indicates that the FOMC missed an excellent opportunity to begin this tapering process in September, which illustrates just how difficult it will be to initiate any steps toward normalization of monetary policy.
- Delaying the decision to taper the asset purchase program without clear and significant departures from prior guidelines suggested the FOMC was changing the goalposts and deviating from June's forward guidance. Because the FOMC failed to adjust the pace of asset purchases at that meeting, he believes the FOMC undermines the credibility of its own forward guidance.
- President Plosser expects growth of around 3 percent in 2014. He expects unemployment rates near 7 percent by the end of this year or early next year and close to 6.25 percent by the end of 2014. Inflation expectations will be relatively stable, and inflation will move up toward the FOMC target of 2 percent over the next year.
- President Plosser notes that while some of the decline in labor force participation has been a result of transitory factors, the labor markets are also adjusting to longer-term structural adjustments driven by demographics and technological advancements. Monetary policy would be ineffective in counteracting such structural trends – and it should not be used to try to do so.

Introduction

I want to thank the Greater Johnstown Cambria County Chamber of Commerce and Johnstown Area Regional Industries (JARI) for hosting today's luncheon. I especially want to thank Glenn Wilson, president and CEO of AmeriServ Financial, Inc., and Bill Polacek, president and CEO of JWF Industries, who both serve on advisory councils for the Philadelphia Fed. Their valuable contributions to the councils help to ensure that your local business conditions factor into the formulation of monetary policy.

Later this year, the Federal Reserve System will begin its centennial year, marking 100 years from the signing of the Federal Reserve Act on December 23, 1913, by President Woodrow Wilson. The centennial period will run through the 100th anniversary of when the 12 Federal Reserve Banks opened their doors on November 16, 1914.

While many Americans hear about the Fed in the news every day – perhaps a bit too much these days – not everyone knows how we work or how we are structured. So, I will begin with a little background on the Fed before I talk about my thoughts on the economic outlook and monetary policy.

I have often described the Federal Reserve System as a uniquely American form of central banking – a decentralized central bank. To understand how it came to be, it is useful to review a little history. Just a few blocks from the Philadelphia Fed stand the vestiges of our country's two earlier attempts at a central bank, dating back to the early years of our nation when Philadelphia was the major financial and political center of the country.

Alexander Hamilton, our nation's first secretary of the Treasury, championed the first Bank of the United States, which received a 20-year charter from Congress and operated from 1791 to 1811. Although the First Bank's charter was not renewed, the War of 1812 and the ensuing inflation and economic turmoil convinced Congress to establish the second Bank of the United States, which operated from 1816 to 1836. However, like its predecessor, the Second Bank did not have its charter renewed by Congress. Both institutions failed to overcome the public's mistrust of centralized power and special interests.

It took nearly 80 years before Congress tried again to establish a central bank. The outcome was a new central bank with a unique governance structure designed to decentralize authority and promote public confidence. With the passage of the Federal

Reserve Act of 1913, Congress provided for the establishment of independently chartered regional Reserve Banks throughout the country, overseen by a Board of Governors in Washington, D.C.

The act created a Reserve Bank Organization Committee to divide the country into no fewer than eight and no more than 12 Federal Reserve Districts. As you can imagine, almost immediately after the law was enacted, the committee started receiving numerous letters and telegrams from local business owners, bankers, farmers, and others, making the case for why a Reserve Bank should be located in their area. The committee held meetings in 18 cities around the country before submitting a report to Congress in April 1914, naming 12 cities as sites for Federal Reserve Banks. 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 bank for the U.S. Treasury. A central bank also guides the country's monetary policy. Within the Federal Reserve, the body that makes monetary policy decisions is the Federal Open Market Committee, or the FOMC. In establishing the FOMC in 1935, Congress gave votes to the seven Governors in Washington and five Reserve Bank presidents. The current arrangement has the New York Fed president serving as a permanent member and four of the other 11 presidents serving one-year terms on a rotating basis.

This structure ensures that our national monetary policy has its roots not just in Washington or on Wall Street but also on Main Streets across our diverse nation. Whether we vote or not, all Reserve Bank presidents attend the FOMC meetings, participate in the discussions, and contribute to the Committee's assessment of the economy and policy options. 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 the goals of monetary policy that Congress has set for us in the Federal Reserve Act. Specifically, in 1977, Congress revised the act to instruct the

Fed to conduct policy “so as 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, it is often said that Congress has given the Fed a “dual mandate.”

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, but that diversity of views also requires me to note that I speak for myself and not for the Federal Reserve Board or for my colleagues on the Federal Open Market Committee.

Now let me turn to the state of our economy as we enter the final quarter of 2013.

Economic Conditions

The economic expansion began in July 2009 – more than four years ago. It hasn’t been a smooth path – frankly, it never is – and growth has been somewhat weaker than many anticipated. However, progress is being made, and there are signs of broad-based underlying strength in the economy.

The economy expanded at an annualized rate of 2.5 percent in the second quarter of this year, up from 1.1 percent in the first quarter and just 0.4 percent in the fourth quarter of 2012.

Fiscal drag, especially at the federal level, has weighed somewhat on economic growth over the past three quarters. In the fourth quarter of 2012, sharp declines in federal government spending subtracted 1.3 points from overall GDP, and in the second quarter, it subtracted 0.2 points. Most of the decline has been in national defense spending.

In contrast, the private sector has performed much better. Approximately half of the second-quarter growth came from higher personal consumption, which was well distributed across durable goods, nondurable goods, and services. The moderate pace of spending was stronger than many expected. They had feared that the increased payroll taxes and other sources of fiscal constraint would significantly depress the consumer, but those concerns proved overblown. Improvements in household balance sheets, reflecting lower leverage and higher net worth, as well as moderate growth of disposable personal income, have supported spending this year.

Business investment also contributed to growth in the second quarter, but investment has been increasing at only a modest pace so far this year. While sentiment has improved, the data on new orders and shipments of nondefense capital goods do not point to much of a pickup, at least in the near term. Better news comes from the manufacturing sector, which has shown encouraging signs of late. The September national ISM manufacturing survey and our own Business Outlook Survey of manufacturers in the Third District each registered their fourth consecutive month of expansion. Additionally, respondents to our recent survey were the most optimistic they have been since the spring of 2011.

Nevertheless, as I travel the District and the country and talk to business leaders about their plans for capital spending and hiring, uncertainty about the course of fiscal policy is a common theme in their discussions. Most mention the stalemate in Washington and the uncertainties over tax and spending policies, and especially health care. There is no question that such factors are restraining investment and hiring and contributing in a significant way to the sluggish recovery.

Housing, however, remains a bright spot. The housing sector has shown significant improvement over the past two years. Housing inventories are down, sales are up, and prices are now rising in many localities. Construction spending has also expanded, though activity has leveled off in recent months, which may reflect higher mortgage rates.

I expect overall economic growth to accelerate to around 3 percent next year, a pace that is slightly above trend. This is far from the robust growth that many would like to see, but uncertainties loom large. Nevertheless, it represents steady progress and an improving economy. My forecast is in line with those of my colleagues on the FOMC, whose most recent projections had a central tendency of growth of 2.0 to 2.3 percent for 2013, accelerating to 2.9 to 3.1 percent in 2014.

The moderate pace of expansion has supported sustained growth in payroll employment and declines in the unemployment rate. Monthly job gains averaged 180,000 for the first eight months of this year, very similar to last year's pace. The sustained expansion in payrolls means that the U.S. has regained more than three-quarters (78 percent) of the 8.7 million jobs lost in the Great Recession. Pennsylvania has seen a similar improvement, also regaining about 78 percent of the 258,000 jobs it lost.

The unemployment rate has improved, dropping from 8.1 percent in August 2012 to 7.3 percent in August 2013, the most recent number available. The total number of people unemployed has declined by 1.2 million over the past 12 months and is down 4 million since the peak in October 2009.

I anticipate that over the next year the unemployment rate will continue to decline at about the same pace we've seen over the past two years. This should lead to an unemployment rate of about 6.25 percent by the end of next year. This makes me somewhat more optimistic than many of my FOMC colleagues, who don't see the unemployment rate reaching 6.5 percent until sometime in the first half of 2015.

Many analysts have dismissed the steady decline in the unemployment rate because it has been driven to some degree by people dropping out of the labor force rather than finding jobs. Such actions depress the labor force participation rate. But even the unemployment rate measures that include these discouraged workers and those working part time for economic reasons have shown sustained declines as the recovery has progressed.

It is important to recognize that labor force participation is influenced not only by the state of the business cycle but also by longer-term factors, like demographics. For example, labor force participation for those aged 16 to 19 years has declined 7.2 percentage points since the start of the recession in December 2007, a sharp drop, to be sure. But in the seven-year period before the recession, participation by that age group fell 11 percentage points. For those aged 20 to 24 years, participation has fallen 3.6 percentage points since the start of the recession, the exact same trend as in the preceding seven-year period. In fact, every age group except those aged 55 and older saw decreasing participation rates well before the recession. And the overall participation rate was falling too.

This longer-term decline in labor force participation is separate from the decline we typically see during recessions. For example, independent of the business cycle, the entry of more women into the labor force was a major factor in the rising participation rate for several decades. Our earliest data are from 1948, and at that time, only one in three women were in the labor force. That rate nearly doubled to a peak of 60 percent in the late 1990s. Since then, though, female participation has been drifting down. In addition, the male labor force participation rate has been declining steadily since we started collecting data in 1948. Some of the decline in both male and female participation is attributable to the aging baby boomers, who entered their prime working years in the 1970s and 1980s. As that generation moves through older age brackets, participation becomes lower, bringing down the overall rate. A broad research agenda is attempting to distinguish how much recent declines in participation can be explained by these demographic trends and how much is cyclical or transitory, but the estimates vary greatly.[1] Still, there is widespread acknowledgment that the monthly job

[1] Researchers at the Federal Reserve Bank of Chicago estimate that nearly half of the decline in participation over the past 13 years is attributable to these long-running demographic trends. See Daniel Aaronson, Jonathan Davis, and Luojia Hu, "Explaining the Decline in the U.S. Labor Force Participation Rate," Chicago Fed Letter, No. 296, March 2012. Also, the Chicago Fed estimates that the monthly job growth required to bring down the unemployment rate is sharply lower than what was required in the 1980s and 1990s, when labor force participation rates were increasing. See Daniel Aaronson and Scott Brave, "Estimating the Trend in Employment Growth," Chicago Fed Letter, No. 312, July 2013.

growth required to bring down the unemployment rate is considerably lower than what was required in the 1980s and 1990s when labor force participation rates were increasing. Consequently, while some of the decline in labor force participation is cyclical, there is certainly a secular component too. Monetary policy would be ineffective in counteracting such demographic and secular trends – and it should not be used to try to do so.

What monetary policy is designed to do, at least over the long run, is control inflation. In my view, price stability is the key part of our mandate. The Fed's preferred gauge for inflation, the change in the price index for personal consumption expenditures, or PCE, has averaged about 1.8 percent over the past three years and 2 percent over the past 20 years. Over the past year, it has averaged 1.2 percent. This is below the FOMC's long-run goal of 2 percent, and some have voiced concerns about deflation. I do not perceive that we will have a deflation problem. Some of the lower readings on inflation appear to reflect some transitory factors, such as the cut in payments to Medicare providers imposed earlier this year as part of the sequester. More recent readings have been closer to goal, and I anticipate, as the FOMC indicated in its most recent statement, that inflation will move back toward our target over the medium term. I do see some upside risk to inflation in the intermediate to longer term given the large amount of monetary accommodation we have added and continue to add to the economy.

Monetary Policy

So let me turn to some observations about monetary policy. Over the past five years, the Federal Reserve has taken extraordinary actions to support the economic recovery. The Fed has lowered its policy rate — the federal funds rate — to essentially zero, where it has been for almost five years. Since the policy rate cannot go lower, the Fed has attempted to provide additional accommodation through large-scale asset purchases, or quantitative easing. These purchases have greatly expanded the size and lengthened the maturity of the assets on the Fed's balance sheet.

The Fed is also using communications to inform the public about how monetary policy is likely to evolve in the future. In Fed speak, this is called forward guidance. On interest rates, the FOMC has said that it expects to keep the fed funds rate at essentially zero at least until the unemployment rate falls to 6.5 percent, so long as inflation one to two years ahead is projected to be no more than 2.5 percent and the public's inflation expectations remain well anchored. It also anticipates that the highly accommodative stance of monetary policy will remain appropriate for a considerable time after the economic recovery strengthens.

On asset purchases, the FOMC has indicated that it will continue the purchases until the outlook for the labor market has improved substantially in the context of price stability. In addition, at his June press conference, Chairman Bernanke indicated that if incoming economic data were broadly consistent with the FOMC's economic projections, which anticipated continued gains in labor markets, moderate growth that picks up, and inflation that moves back toward the 2 percent target over time, then the FOMC would begin to reduce the pace of its purchases sometime this year. And if the economy evolves as expected, we would continue to reduce the pace and end the purchases around the middle of next year.

After the June press conference and over the course of the summer, there was an increasingly widespread public belief that the FOMC would begin to reduce the pace of its asset purchases in September. Yet at that September meeting, the Committee decided to make no change in monetary policy. The Fed continues to purchase $40 billion of agency mortgage-backed securities and $45 billion of longer-term Treasury securities each month. Proceeds of maturing or prepaid securities are being reinvested. As a result, the Fed's balance sheet, which includes about $3.7 trillion in assets, is growing at a pace of about $85 billion a month. The decision to maintain the pace of purchases and await more evidence of sustained economic progress came as quite a surprise to the public and there ensued widespread public debate about the FOMC's communications surrounding its policy intentions.

In my view, the incoming data between the June and September meetings were largely in line with our June forecasts. While it is true that the FOMC projections for 2013 were revised down slightly, the differences between the central tendencies reported in June and September were statistically and economically insignificant.

To delay tapering of our current asset purchase scheme without clear and significant departures from prior guidelines suggested the FOMC was changing the goalposts and deviating from June's forward guidance. This undermines the credibility of the Committee and reduces the effectiveness of forward guidance as a policy tool. It also contributes to additional uncertainty regarding the future course of monetary policy. The decision not to begin tapering our asset purchases was also read in some quarters as a sign that the FOMC had become much less confident that growth would be sustained in the manner the Committee envisioned in June. Thus, we undermined our own credibility as well as the public's confidence in the economy. These were not the messages that I wanted to send. Thus, I disagreed with the decision not to go forward with a modest reduction in the pace of our asset purchases.

The Fed's balance sheet is expanding rapidly due to these purchases and complicating the eventual exit from this period of extraordinary monetary ease. There is little evidence that continued efforts to increase accommodation through asset purchases will lead to any significant improvement in the labor markets or economic growth. Thus, I believe the time has come for an expeditious phaseout of the purchase program.

Conclusion

In summary, I believe that the economy is continuing to improve at a moderate pace. We are likely to see growth of around 2.5 percent this year, but that pace should pick up to around 3 percent in 2014. Prospects for labor markets will continue to improve gradually, and I expect unemployment rates near 7 percent by the end of this year and 6.25 percent by the end of 2014. I believe that inflation expectations will be relatively stable and that inflation will move up to our goal of 2 percent over the next year.

Based on this outlook and the improvement in labor market conditions, I believe it would be appropriate for the Fed to begin to reduce the pace at which we are expanding our balance sheet and to bring the purchase program to a close. We missed an excellent opportunity to begin this tapering process in September. In my mind, this illustrates just how difficult it is going to be to wean ourselves off the extraordinary process of increasing accommodation we have embarked upon and begin to normalize monetary policy in a timely manner that ensures a healthy and stable economy in the future. Because the FOMC failed to adjust the pace of asset purchases in response to the improvement in economic conditions, I believe the FOMC undermines the credibility of its own forward guidance.