

Economic Conditions and Monetary Policy

Risk Management Association

Philadelphia, PA

November 18, 2013

Charles I. Plosser

President and CEO
Federal Reserve Bank of Philadelphia



FEDERAL RESERVE BANK
OF PHILADELPHIA

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

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Highlights:

- President Charles Plosser provides his economic outlook and reports that since there is little evidence that additional asset purchases will improve economic recovery, the time has come to phase out the purchase program.
- He indicates that the Federal Open Market Committee (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.
- He also suggests the FOMC should communicate the amount of assets it intends to purchase in the current program and bring it to an end.
- President Plosser expects growth of about 3 percent in 2014. He expects unemployment rates near 7 percent by the end of this year or early next year and about 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.

Introduction

I thank Bill Githens and his staff for inviting me here today. It is my honor to welcome you to Philadelphia as the Risk Management Association (RMA) begins its commemoration of a century of promoting sound risk principles in the financial services industry.

Next month, the Federal Reserve System also begins its centennial year, marking 100 years from when President Woodrow Wilson signed the Federal Reserve Act on December 23, 1913. Our centennial period will continue until next November, the 100th anniversary of when the 12 Federal Reserve Banks first opened their doors on November 16, 1914.

Therefore, the RMA and the Federal Reserve System each have a long and rich history. I also noted that Philadelphia and Rochester, New York, figure prominently in your organization's history and my own biography. The first meeting of what was then known as the "Robert Morris Club of the National Association of Credit Men" was held in Rochester in June 1914. I arrived in Rochester more than 60 years too late to attend, but I enjoyed more than 30 years at the University of Rochester before joining the Philadelphia Fed in 2006.

During these past seven years, I have found that many people still find our nation's central bank a mystery. People often hear about the Fed in the news, yet not everyone knows what we do or how we are structured. So, I will begin with a little background on the Fed before I share some thoughts on the economic outlook and monetary policy.

Before I begin, though, I should note that my views are not necessarily those of the Federal Reserve System or my colleagues on the Federal Open Market Committee (FOMC).

A Historical Look at a Decentralized Fed

So first, let me share a little history with you. I have often described the Federal Reserve System as a uniquely American form of central banking – a decentralized central bank. To understand how the Fed came to be, we need to look at two earlier attempts at central banking in the United States. Just a few blocks from here stand the vestiges of both institutions, dating back to the early years of our nation when Philadelphia was the nation's major financial and political center.

Alexander Hamilton, who was an aide to Robert Morris during the American Revolutionary War and later became our nation's first secretary of the Treasury, championed the First Bank of the United States to help our young nation manage its financial affairs. The First Bank received a 20-year charter from Congress and operated from 1791 to 1811. Although this 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, as with the First Bank, Congress did not renew the Second Bank's charter. Both institutions failed to overcome the public's mistrust of centralized power and special interests.

Nearly 80 years later, 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. This unique structure helped overcome political and public opposition that stemmed from fears that this new central bank would be dominated either by political interests in Washington or by financial interests in New York.

To balance political, economic, and geographic interests, Congress created the Federal Reserve System with independently chartered regional Reserve Banks throughout the country, with oversight provided 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.

The committee held meetings in 18 cities around the country before submitting a report to Congress in April 1914, naming the 12 cities as sites for Federal Reserve Banks we have today. These Reserve Banks distribute currency, act as a banker's bank, and generally perform the functions of a central bank, which includes serving as the bank for the U.S. Treasury. Another important priority for central banks, especially those in a world of fiat currency, is to ensure the purchasing power of a nation's currency through its monetary policy.

Within the Federal Reserve, the body that makes monetary policy decisions is the Federal Open Market Committee, or the FOMC. Here again, Congress has designed a number of checks and balances into the system. In 1935, Congress gave voting rights on the FOMC to the seven Governors in Washington and five Reserve Bank presidents. Under the current arrangement, the New York Fed president serves as a permanent

voting member, and four of the other 11 presidents serve one-year terms on a rotating basis.

This structure ensures that our national monetary policy is rooted 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 FOMC meets eight times a year to set monetary policy. It discusses economic conditions and, in normal times, adjusts short-term interest rates to achieve the goals of monetary policy that Congress has set for us in the Federal Reserve Act.

Congress established the current set of monetary policy goals in 1978. The amended Federal Reserve Act specifies that the FOMC "shall maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, 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 and the economy is operating at full employment, many have interpreted these instructions as being a dual mandate to manage fluctuations in employment in the short run while preserving long run price stability.

Economic Conditions

With this mandate in mind, the Fed monitors the economy and makes its policy decisions. The current economic expansion began in July 2009 – more than four years ago. While economic growth has come in fits and starts, the underlying path is one of continued moderate expansion. The recent readings on third-quarter growth and the labor market are consistent with an economy that is experiencing a moderate, self-sustaining recovery.

We saw an advance estimate of 2.8 percent GDP growth in the third quarter, a bit higher than the 2.5 percent growth in the second quarter. That upward trend continued from the 1.1 percent growth in the first quarter of this year and the nearly flat 0.1 percent in the fourth quarter of last year.

This acceleration in growth rates reflects steady progress in the private-sector economy and a waning drag from the government sector.

Despite the increase in payroll taxes at the start of the year, consumer spending continues to increase at a moderate pace. Even more encouraging is the robust, double-digit growth we've seen in residential investment. Sales of existing homes are on the upswing, surpassing the 5 million mark, or about the same levels experienced before the housing boom. Home prices remain below their pre-crisis peaks, but prices have made strong double-digit gains over the past year, according to the national indexes.

Manufacturing has also shown improvement. The national ISM Manufacturing index has indicated industry expansion for the past five months. Here in the Third District, the Philadelphia Fed's Business Outlook Survey of manufacturers shows a similar pattern, with increased activity for five consecutive months as well as strong optimism regarding activity over the next six months.

Nevertheless, as I travel through the District and the country and talk to business leaders about their plans for capital spending and hiring, I hear a common theme of uncertainty about the course of fiscal policy and regulation. Most mention the dysfunction in Washington and the uncertainties over tax and spending policies, and especially health care. Without a doubt, such factors are restraining investment and hiring, and generally contributing to the sluggishness of the recovery.

As some of this uncertainty abates — I don't expect it to vanish — I anticipate overall economic growth to accelerate somewhat 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;

nevertheless, it does represent steady progress and a gradually 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, and accelerating to 2.9 to 3.1 percent in 2014.

The October jobs report came in stronger than many analysts expected. The economy added 204,000 jobs in October. In addition, upward revisions to the August and September figures added another 60,000 jobs.

The unemployment rate ticked up a tenth of a point to 7.3 percent, but federal employees on temporary furloughs affected the household survey. The underlying detail showed an increase of 448,000 workers on temporary layoff in October. The data do not let us precisely measure how much of the increase is directly related to the shutdown, but that sharp increase was enough to push the unemployment rate higher than it otherwise would have been, possibly by as much as a third of a percentage point. Of course, we will have a better idea of how the labor market has progressed when we have the November report, which should not be distorted by the temporary shutdown.

Substantial improvement in labor market conditions was one condition that the FOMC set last September for ending our current asset purchase program, popularly called QE3 for the third round of quantitative easing. I believe the labor market has made important progress. Monthly job gains have averaged 191,000 since last September, far better than the 130,000 average in the six months leading up to the announcement of the program. And the unemployment rate has fallen by 0.8 percentage points since last August.

I anticipate that the unemployment rate will continue to decline over the next year 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 2014. This makes me somewhat more optimistic than my FOMC colleagues, many of whom don't see the unemployment rate reaching 6.5 percent until sometime in the first half of 2015.

Turning to inflation, 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 1.1 percent. This is below the FOMC's long-run goal of 2 percent, and some have voiced concerns about the risks of further disinflation. If this trend continues, it would be troubling. We must defend our 2-percent inflation target from below and above. One encouraging factor is that inflation expectations remain near their longer-term averages and consistent with our 2-percent target. But we must be vigilant that expectations remain anchored.

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. But 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 any lower, the Fed has attempted to provide additional accommodation through large-scale asset purchases, or quantitative easing. As I mentioned earlier, we are now in our third round of these purchases, or QE3. 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 forward guidance that is intended to inform the public about the way monetary policy is likely to evolve in the future. As for interest rates, the FOMC has

reported 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 the outlook for inflation one to two years is projected to be no more than 2.5 percent and the public's inflation expectations remain well anchored. The Committee also anticipates that the highly accommodative stance of monetary policy will remain appropriate for a considerable time after the economic recovery continues to gain strength.

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. As I noted, I believe that labor markets have substantially improved from a year ago and that we should begin to wind down these asset purchases.

There was widespread public expectation that the FOMC would begin to slow the pace of its asset purchases in September. Yet, at that September meeting and again in October, the Committee decided not to change the pace of purchases. 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 is now just shy of \$4 trillion in assets and growing at a pace of about \$85 billion a month. The decision to maintain the pace of purchases in September and await more evidence of sustained economic progress came as quite a surprise to the public, generating widespread public debate about the FOMC's communications surrounding its policy intentions.

Not dissuading the public from its expectation of a tapering and then not taking action undermines the credibility of the FOMC and reduces the effectiveness of forward guidance as a policy tool. The failure to follow through also contributes to additional uncertainty regarding the future course of monetary policy. In some quarters, the decision not to begin tapering was also interpreted as a sign that the FOMC had become much less confident that growth would be sustained. 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. So, I disagreed with the decision not to go forward with a modest reduction in the pace of our asset purchases.

In my view, this whole episode also demonstrates how difficult it is to fine-tune our open-ended asset purchases and our forward guidance about them. We cannot continue to play this bond-buying game by ear and risk the Fed's credibility while creating lingering uncertainty about the course of monetary policy.

We need to define simple, clear dimensions to "right-size" the program. This will reduce policy uncertainty and move the economy forward. My preference would be for the FOMC to announce a fixed amount for QE3, just as we did for the two prior rounds of asset purchases. When we reach that amount, we should stop the asset purchases, and then reassess the state of the economy to determine if further action would be beneficial. At that point, monetary policy would still be highly accommodative.

We are still learning how asset purchases affect the economy, but many believe it is the ultimate size and composition of the assets, rather than the flow of purchases, that influences interest rates and thus the economy. This was the premise of the early rounds of purchases.

Setting the ultimate size of our asset purchase program will lead us away from trying to fine-tune our decision about purchases based on the latest numbers and creating uncertainty from meeting to meeting about the FOMC's next step. We should be gearing our asset purchase policy to the underlying trends in the economic expansion rather than the most recent month-to-month variations, which reflect very noisy signals of the economy at best. Just recall the surprises in the revisions to the employment data we experienced. By specifying a fixed amount, we would help the public understand that reducing the pace of asset purchases does not signal a change in our policy rate. Indeed, even an end to purchases only stops the efforts to increase accommodation. It is not a tightening of policy. As I said, after our purchases stop, policy will remain highly accommodative. An end to the purchase program does not

imply that increases in the policy rate are imminent. We will simply set our policy rate consistent with promoting the FOMC's goals of price stability and maximum employment.

Conclusion

In summary, I believe that the economy is continuing to improve at a moderate pace. We are likely to see growth 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 within the next few months and 6.25 percent by the end of 2014. I also 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 communicate the amount of assets it intends to purchase in the current program and bring it to an end. We should then reassess the economic trends and the outlook to determine if further efforts to increase accommodation are required. This approach would also yield a simpler program — one that is easier for policymakers to manage, easier to explain to the public, and easier to exit when the time comes.