Monetary Policy and a Brightening Economy

Presented at the 35th Annual Economic Seminar
sponsored by the Simon Business School with JPMorgan Chase & Co.,
Rochester Business Alliance, and the CFA Society of Rochester

Rochester, NY

February 5, 2014

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President and CEO
Federal Reserve Bank of Philadelphia

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those of the Federal Reserve System or the FOMC.

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Highlights

- President Charles Plosser provides his economic outlook for 2014 and reports that the decision of the Federal Open Market Committee (FOMC) to reduce the pace of asset purchases was a step in the right direction.
- President Plosser expects growth of about 3 percent in 2014. He also expects the unemployment rate to continue its steady decline and to reach about 6.2 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.
- Based on the economic progress that has been made and his economic outlook, President Plosser believes it is appropriate to end asset purchases, and he supported the FOMC's decision in January to continue to reduce the pace of purchases.
- A case can be made for ending the current asset purchase program sooner to reflect the improvement in the economic outlook and to lessen some of the communications problems the FOMC will face with its forward guidance.

Introduction

This is the 35th time that I have had the pleasure of speaking at this annual event. That is quite a long time. While I am a lot older than when I first started giving these talks, I do not feel particularly wiser. So I guess I have to keep trying until I get it right.

You may wonder why, after more than seven years at the Philadelphia Fed, I still look forward to returning to Rochester each winter. Well, it is certainly not the weather! Although, I'll note that you certainly handle the snow better than we do in Philadelphia.

No, it's about friends and colleagues, and a community that remains vibrant and positive. So, even in the wake of the "Polar Vortex of 2014," I am delighted to be here and to see old friends and familiar faces. Thank you for having me back and for such a warm welcome.

I have acquired a great deal of respect for weather forecasters over the years, especially in turbulent seasons, because as I have noted on many occasions, forecasting even in good times can be a humbling experience. Nonetheless, I am once again going to offer you a forecast for the economy as well as my views on monetary policy. I should note, though, that my views are my own and do not necessarily reflect those of the Federal Reserve System or my colleagues on the Federal Open Market Committee.

Let me begin by noting that this is a special time for the Federal Reserve. We are observing our 100th anniversary. The Federal Reserve Act was signed into law by President Woodrow Wilson on December 23, 1913, and the 12 Federal Reserve Banks opened their doors on November 16, 1914.

To balance political, economic, and geographic interests, Congress created the Federal Reserve System made up of these 12 regional Reserve Banks with oversight provided by a Board of Governors in Washington, D.C. This decentralized central bank was structured to overcome political and public concerns that its actions would be dominated either by political interests in Washington or by financial interests on Wall Street.

The 12 Reserve Banks perform several roles. They distribute currency, act as a bankers' bank, and generally perform the functions of a central bank, which includes serving as the bank for the U.S. Treasury. They also play a critical role in supervising many banks and bank holding companies.

Moreover, the Reserve Banks ensure that the Federal Reserve stays in touch with Main Street. The Reserve Banks have boards of directors, many also have Branch boards, and all have advisory councils that provide economic insight and information. These

contacts allow the Reserve Banks to keep up to date and knowledgeable about economic conditions in their regions. The Reserve Banks also collect data, run surveys of economic activity, and provide economic analyses. This rich array of information and the diverse views from around the country help paint a mosaic of the economy that is essential as we formulate national 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 the system with a number of checks and balances. Since 1935, the composition of the FOMC has included the seven Governors in Washington, the president of the New York Fed, and the presidents of four other Reserve Banks who serve one-year terms as members on a rotating basis.

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 has eight regularly scheduled meetings a year to set monetary policy, and our first one in 2014 was held last week. In normal times, the Committee votes to adjust 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 price stability in the long run.

Economic Conditions

In order to determine the appropriate monetary policy to promote these goals, the FOMC must monitor and assess economic developments. So, let me turn to an assessment of our economy.

As a reminder, last year at this time, I anticipated that we would see real economic growth of about 3 percent in 2013, that the unemployment rate would reach 7 percent in the fourth quarter, and that inflation would gradually rise toward the Fed's target of 2 percent. That turned out to be a "not too shabby" forecast. Real growth for the year is currently estimated at about 2.8 percent, and the unemployment rate was 7 percent for the fourth quarter. Inflation has not risen as much as I thought it would, but it has stabilized nonetheless.

So let's look at some of the details of how the year ended and the implications for the coming year. The message is that the economy is on firmer footing than it has been for the past several years.

Real output grew at a 3.2 percent annual pace in the fourth quarter of last year, following a 4.1 percent growth rate in the third quarter. That means economic growth in the second half of 2013 was double that of the first half. Consumer spending and business investment in equipment ended the year with strong increases. Inventory investment and net exports also contributed to growth, while a decline in residential investment and a sharp decrease in federal government spending subtracted from growth in the fourth quarter of the year. I expect that there will be less fiscal drag in 2014 and that housing will continue its recovery.

Personal consumption, which accounts for more than two-thirds of GDP, advanced at an annual rate of 3.3 percent in the fourth quarter, the highest personal consumption growth rate since fourth quarter 2010. Rising house prices and stock prices have helped improve consumer balance sheets, and steady job growth has added to wage and salary growth, all of which have supported spending. The recent December employment

report showed payroll gains of 74,000 jobs, which came in below many analysts' expectations. Yet, December's number was likely affected by the unseasonably cold and snowy weather, although it is not yet clear by how much. The number is also subject to revision, and such revisions can be significant.

Because of the month-to-month volatility and data revisions, I prefer not to read too much into the most recent number but, instead, look at averages over several months, and here the news remains positive. Firms added an average of 182,000 jobs per month last year, comparable to the pace in 2012. This consistent pace of job growth was enough to drop the unemployment rate to 6.7 percent in December. This means that the unemployment rate fell 1.2 percentage points last year. It also ended the year at a lower level than the FOMC anticipated in its Summary of Economic Projections in September 2012, when we started the current asset purchase program. That is, the labor market has performed noticeably better than expected, according to the unemployment rate measure.

Should we be skeptical of the unemployment rate as an indicator of labor market conditions? Some people are because the decline in the unemployment rate reflects declines in labor force participation as well as increases in employment. There is even concern that the unemployment rate will move back up significantly when discouraged workers reenter the labor force. Based on research by my staff, I am less concerned about this possibility.[1]

First, it is important to realize that labor force participation rates have been declining since 2000. The declines are driven primarily by demographic changes, most notably the aging of the baby boomers. This trend is ongoing and was expected to accelerate.

Second, detailed analysis of the Current Population Survey's micro data indicates that

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[1] Shigeru Fujita, "On the Causes of Declines in the Labor Force Participation Rate," *Research Rap Special Report*, Federal Reserve Bank of Philadelphia, November 19, 2013.

much of the decline in participation since the start of the recovery can be accounted for by increased retirements and disability. Some of these increases might have been driven by the state of the economy as some baby boomers may have moved their retirement decision forward after losing a job. Nevertheless, few of these individuals are likely to reenter the labor force. In addition, there has been an increase in the number of people out of the workforce who are going to school, which means there is less concern about skill depreciation for this group. So, I do expect some discouraged workers to reenter the labor force as the expansion picks up, and while they search for a job, there could be upward pressure on the unemployment rate. Nonetheless, I believe the overall unemployment rate remains the best summary statistic of labor market conditions.

The business sector is also entering the year on a positive note. At the national level, manufacturing activity accelerated over the final three months of 2013. The Philadelphia Fed's Business Outlook Survey of regional manufacturing, which is a reliable indicator of national manufacturing trends, also showed that manufacturing activity picked up in the second half of 2013. In January, the survey's general activity index posted its eighth consecutive positive number. Expectations for manufacturing activity six months ahead also remained positive. This gives me some hope that business fixed investment, which has been generally lackluster during the course of the recovery, will pick up somewhat this year. Indeed, we saw a nice rebound in equipment spending in the fourth quarter.

Inflation has been running below the FOMC's long-run goal of 2 percent. The Fed's preferred measure of inflation is the year-over-year change in the price index for personal consumption expenditures, or PCE inflation. It came in at 1.1 percent last year. It is important to defend our 2 percent inflation target from both below and above. But I believe inflation is likely to firm up. Economic growth is accelerating, and some of the factors that have held inflation down, such as the one-time cut in payments to Medicare providers, are likely to abate over time. An additional and important determinant of

actual inflation is consumer and business expectations of inflation. I am encouraged that inflation expectations remain near their longer-term averages and consistent with our 2 percent target. Thus, I anticipate, as the FOMC indicated in its most recent statement, that inflation will move back toward our target over time. Indeed, given the large amount of monetary accommodation we have added and continue to add to the economy, I think there is some upside risk to inflation in the longer term.

Although growth in the first quarter is likely to be somewhat slower than the rapid pace we saw in the fourth quarter of last year, overall, I anticipate economic growth of around 3 percent this 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 an improving economy. My forecast is largely in line with those of my colleagues on the FOMC, whose most recent projections saw growth in the 2.8 to 3.2 percent range in 2014.

Growth will continue to lead to declines in the unemployment rate over the next year to about 6.2 percent by the end of 2014. Like my forecast last year, this makes me somewhat more optimistic than most of my FOMC colleagues, who reported a central tendency of 6.3 to 6.6 percent by the end of 2014.

Of course, with any forecast, there are risks. The current volatility in emerging market currencies could pose a risk if it were to spill over more broadly to other financial markets. But at this point, I do not consider it a significant risk to the U.S. economy. While there continues to be some downside risks, for the first time in a few years, I see a potential for some upside risks to the economic outlook. We need to consider this possibility as we calibrate monetary policy.

Monetary Policy

Over the past five years, the Federal Reserve has taken extraordinary policy 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 more than 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. We are now in our third round of these purchases, or, as it is commonly called, 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 as a policy tool, which is intended to inform the public about the way monetary policy is likely to evolve in the future. In this dimension, the FOMC has indicated that it intends to leave the policy rate near zero well past the time that the unemployment rate falls below the 6.5 percent threshold. The FOMC had previously indicated this was the earliest point at which it would consider raising interest rates, especially if projected inflation continues to run below the Committee's 2 percent target. 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.

Yet, with the economy having improved substantially over the last year and the outlook brightening, the time has come for the FOMC to slow the pace at which it is adding monetary accommodation, which is to say, ease our foot off the accelerator. My personal view is that the process should have started sooner and proceeded more expeditiously. Nevertheless, the FOMC did decide in December to take a very modest step in this direction by reducing asset purchases from $85 billion to $75 billion per month, and last week's decision reduced this by another $10 billion to $65 billion a month.

The FOMC indicated that if incoming information broadly supports its expectation of ongoing improvement in labor market conditions and inflation moving back toward its longer-run objective, then we'll likely reduce the pace of purchases in further measured steps at future meetings. Former Chairman Ben Bernanke indicated in his December press conference that if we are making progress in terms of inflation and continued job gains, then the program would be concluded late in 2014.

Notice that even though we are reducing the pace at which we are purchasing longer-term assets, we are still adding monetary policy accommodation. As I noted earlier, I believe the economy has already met the criteria of substantial improvement in labor market conditions, and the economic outlook has improved as well. So my preference would be that we conclude the purchases sooner rather than later.

Indeed, before the decision to taper in December, I had proposed that we set a total amount of additional securities we planned to buy and then stop the asset purchases once that amount was reached. In my view, this would have reduced policy uncertainty, thereby benefiting the economy.[2] In December, the FOMC announced a reduction in the purchase pace, indicating that purchases were not on a preset course. The Committee continued on this path in January, and while this wasn't my preferred path, I supported the action as a step in the right direction. I reasoned that by following through with another measured step to reduce purchases, the Committee was strengthening the signal that the process would continue and thus it was reducing policy uncertainty. While I may have preferred a more aggressive scale-back, I was pleased that the FOMC has taken the first two steps on the path toward ending the program.

That said, I believe a good case can be made for speeding up the pace of our taper if the economic outlook plays out as I expect. As I noted earlier, the unemployment rate fell 1.2 percentage points last year, to 6.7 percent in December. This was a much sharper decline than anticipated when we started the purchase program in September 2012. In fact, back then, the central tendency of the Committee's economic projections for unemployment in the fourth quarter of 2013 was 7.6 to 7.9 percent compared to the 7 percent fourth-quarter average that the economy actually achieved. If the unemployment rate continues to drop at that pace, we will soon be at the 6.5 percent threshold in our forward guidance for interest rates.

[2] Charles I. Plosser, "Economic Conditions and Monetary Policy," remarks before the Risk Management Association, Philadelphia, PA, November 18, 2013.

Although the FOMC has indicated that it doesn't anticipate raising rates when the economy crosses that threshold, I do believe that we will have complicated our communications if we are still purchasing assets at that point. What is the argument for continuing to increase monetary policy accommodation when labor market conditions are improving rapidly, inflation has stabilized, and the outlook is for it to move back to goal? The longer we continue purchases in such an environment, the more likely we will fall behind the curve in reducing the extraordinary degree of monetary policy accommodation. With the economy awash in reserves, the costs of such a misfire could be considerably higher than usual, fomenting higher inflation and perhaps financial instability.

My preference is to scale back our purchase program at a faster pace to reflect the strengthening economy. I would like to see purchases concluded before the unemployment rate reaches the threshold, which is likely during the first half of the year.

Conclusion

In summary, I believe that the economy is continuing to improve at a moderate pace. We are likely to see growth of around 3 percent in 2014. Prospects for labor markets will continue to improve, and I expect the unemployment rate will continue its decline, reaching 6.2 percent by the end of 2014. I also believe that inflation expectations will be relatively stable and that inflation will move up toward our goal of 2 percent over the next year.

On monetary policy, we must begin to back away from increasing the degree of policy accommodation in a manner commensurate with an improving economy. Reducing the pace of asset purchases to $65 billion a month is moving in the right direction, but that may prove to be insufficient if the economy continues to play out according to the FOMC forecasts. I believe the economy has met the criteria of significant improvement in labor market conditions for ending the program and that further increases in the

balance sheet are unlikely to provide appreciable benefits for the recovery. A case can be made for ending the current asset purchase program sooner to reflect the improvement in the economic outlook and to lessen some of the communications problems we will face with our forward guidance.

Even after the asset purchase program has ended, monetary policy will still be highly accommodative. As the expansion gains traction, the challenge will be to reduce accommodation and normalize policy in a way that ensures that inflation remains close to our target, that the economy continues to grow, and that we avoid sowing the seeds of another financial crisis. This means the Fed still has considerable work ahead.