Economic Outlook

Business Leaders Forum

Villanova School of Business

September 29, 2011

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President and CEO
Federal Reserve Bank of Philadelphia

FEDERAL RESERVE BANK
OF PHILADELPHIA

The views expressed today are my own and not necessarily
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Good morning. Thank you for the opportunity to be here at the Villanova School of Business to address this second annual Business Leaders Forum.

As leaders engaged in our business community, you are all aware of the painfully protracted pace of our economic recovery. I have been saying for quite some time that this was going to be a long, slow recovery. Moreover, this frustrating state of affairs continues despite extraordinarily accommodative monetary policy.

In my remarks today, I will discuss my outlook for the U.S. economy, as well as my views on the appropriate current and future monetary policy. As always, my remarks reflect my own views and do not necessarily represent the views of the Federal Reserve Board or my colleagues on the Federal Open Market Committee.

Economic Outlook

Let me begin with an update on the U.S. economy. Clearly, this year has not played out as almost anyone forecasted. Indeed, from the revisions to the government's economic data in July, we now know that the recession was deeper and the recovery was weaker than we had previously thought. Some of this year's weakness is understandable. We began the year with severe snowstorms in the East, then the earthquake and ensuing disasters in Japan, followed by the unrest in the Middle East and North Africa and the run-up in oil prices, and a lingering concern about sovereign debt in Europe. And all of that occurred before May.

With the arrival of summer, we faced another round of problems with the worsening of the European sovereign debt crisis, as well as our own fracas on fiscal policy and the debt ceiling debates in Washington. These events all weighed heavily on business and consumer confidence.

While many of these factors are transitory, and each will wane eventually, the cumulative effect has served to feed uncertainty and inhibit growth.

Indeed, growth in the first half of 2011 was much weaker than anticipated. In light of this performance most forecasters have revised down their forecasts for overall growth in 2011. Indeed, at the beginning of the year, I was expecting GDP growth in 2011 to be 3 to 3.5 percent. Now, I expect GDP growth to be less than 2 percent in 2011, but to gradually accelerate to around 3 percent in 2012.

Although the downside risks around this forecast are significant, I do not believe the current data signal that we are on the precipice of a so-called double-dip recession. Indeed, many of my business contacts suggest that while growth is very sluggish and uneven, they do not see the precipitous declines that the news headlines suggest.

Instead, their stories are consistent with a slow recovery due to the very nature of the recession from which we have emerged. The financial crisis was a severe shock that impacted many economies around the world and led to a recession of great depth and structural imbalances. Some sectors, such as financial services and construction, may never return to their pre-recession shares of our economy. The aftermath of the financial stress and the weak housing sector will weigh on the pace of recovery for some time to come.

Consumer and Business Spending

One of the more striking aspects of this recession is the continued weakness in consumer spending. While there were modest increases last year, spending decelerated notably over the first half of the year. Partly this reflects the effect of higher oil prices we saw earlier in the year. Partly it reflects the continued deleveraging of the household balance sheet, as consumers pay down debt and work to rebuild their net worth. Most observers agree that weak income growth and falling house prices are restraining spending and we are unlikely to see strong consumer spending as long as we face a depressed housing market and a weak labor market.

Another way to view weak consumption is to note that households are continuing to restructure their balance sheets – saving more and consuming less. This is a perfectly natural and rational reaction to events. Until these households perceive that they have restored a balance to their long-run consumption and saving patterns commensurate with their earnings profile, they will not increase spending. Moreover, the more uncertain they are about their own earning power, the more reluctant households will be to increase spending and the more they will feel the need to build up their savings.

A brighter spot has been business investment spending, which has been supported by solid growth in corporate earnings. Looking through the month-to-month volatility, spending on equipment and software has continued to expand.

Indicators from business surveys, including the Philadelphia Fed's Business Outlook Survey of manufacturers, suggest some weakening in conditions, although it is too soon to tell whether this will be persistent.

Many have taken note of the weakness in our monthly survey, since it has proven to be a useful gauge for national trends in manufacturing. In August and September, the measures of current activity were negative. But our polling in August coincided with market volatility in the aftermath of Standard & Poor's downgrade of U.S. debt. Measures of future activity have remained positive, and September was stronger than August, suggesting that firms expect activity to pick up over the next six months.

Recent volatility in financial markets has contributed to sharp declines in business and consumer sentiment. But with a high degree of uncertainty over future taxes, regulations, and the financial ramifications of the European sovereign debt situation, it is no wonder that sentiment is flagging and this decline poses added risk to the growth forecast.

Labor Markets

Conditions in labor markets remain a serious challenge. Given the weak growth so far this year, we have not made even the modest progress on reducing unemployment rates that forecasters anticipated. Most recently, nonfarm payroll employment was flat in August, and the unemployment rate remained at 9.1 percent. Private payrolls added just 17,000 jobs, far below what we will need to see just to keep pace with changes in the labor force. Ongoing budget pressures faced by state and local governments have led to cuts in public payrolls.

These numbers are troubling, especially when more than 40 percent of the unemployed, or some 6 million people, have been out of work for 27 weeks or longer. This underscores that we should not expect any easy solution. Millions of unemployed workers may take longer to find jobs because their skills have depreciated or they may need to seek employment in other sectors. These structural issues will take time to resolve. Jobs and workers will need to be reallocated across the economy, which is a long and slow process.

Thus, while I expect a moderate recovery to continue and to strengthen over time, I expect to see only modest declines in the unemployment rate, with probably little change over the rest of this year, and then falling to a range of 8 to 8½ percent by the end of 2012.

Inflation

Let me now turn to my outlook for inflation. Just as growth has been weaker this year than many forecasters had anticipated, inflation has been higher than expected. Monthly changes in inflation have moderated slightly from those seen earlier in the year when the prices of many commodities, including oil, were rising sharply. However, measured on a year-over-year basis, both total inflation and core inflation continue to advance. I do anticipate that with many commodity prices now leveling off or falling, and inflation expectations relatively stable, inflation will moderate in the near term.

However, we must continue to monitor this situation, particularly in this environment of very accommodative monetary policy. Indeed, it is good to remember that the current inflationary environment is quite different from the one we faced a year ago when we embarked on the so-called QE2 policy to purchase $600 billion of long-term U.S. Treasuries. At the time, there were concerns about deflation, whereas now inflation is running above our long-run goal. I would also note that unemployment was higher last fall than it is today. Thus, with inflation higher and unemployment lower, it is appropriate to ask what criteria we are using to justify further accommodation. In this environment, I think it is very important that we refrain from actions that risk fueling a steady rise in inflation or inflation expectations over the medium term. We must not become too sanguine that high unemployment will lead to low inflation. The lesson of the 1970s is clear – high unemployment or low resource utilization is not sufficient to prevent high rates of inflation. The current environment in the U.K. should also be a warning. The unemployment rate in Britain is near 8 percent, having risen sharply during its recession, yet inflation is now approaching 5 percent and has been steadily rising for nearly two years.

Monetary Policy

This brings me to a discussion of the recent policy actions the Fed has taken, why I dissented from these actions in August and September, and what I believe should be the long-term view of monetary policy.

As I noted at the beginning of my remarks, the economic conditions of the past few years have led to extraordinary monetary policy accommodation. To date, our actions have led to a level of the federal funds rate — the traditional instrument of monetary policy — that has been near zero for almost three years. The Fed's balance sheet has grown more than threefold, from nearly $900 billion before the crisis to about $2.9 trillion today, and its asset composition has shifted significantly from mostly short- to medium-term Treasuries to longer-term Treasuries, mortgage-backed securities, and agency debt. This extraordinary degree of monetary accommodation has played a role in supporting the recovery thus far, and it continues to do so.

In August, the FOMC changed its guidance about its expectations for the future path of the federal funds rate. In particular, it stated that economic conditions were "likely to warrant exceptionally low levels for the federal funds rate at least through mid-2013." At its meeting last week, the FOMC announced additional accommodative action. In an effort to reduce long-term Treasury yields from already historically low levels, the FOMC intends to purchase $400 billion of longer-term Treasury securities and to sell an equal amount of shorter-term Treasuries by the end of June 2012. This action will not increase the size of the Fed's balance sheet, but it will lengthen the maturity of the Fed's holdings. In addition, the FOMC will be reinvesting principal payments from its holdings of agency debt and agency mortgage-backed securities in mortgage-backed securities rather than Treasuries. This action was intended to help support mortgage markets.

I dissented from these decisions because I believe that they will do little to improve the near-term prospects for economic growth or employment and they do pose risks. Policy actions should never be considered free and should be evaluated based on the costs and benefits. Based on our experience with Operation Twist in the 1960s and with last year's QE2, the reduction in long-term rates is likely to be less than 20 basis points for the 10-year Treasury yield, which is currently only 2 percent. The pass-through to the rates at which consumers and businesses actually borrow is likely to be much less. Thus, I am skeptical that this will do much to spur businesses to hire or consumers to spend, given the ongoing structural adjustments occurring in the economy and the uncertainties posed by the fiscal challenges both here and abroad.

In addition to having little effect, the actions come with significant potential costs. We have provided a great deal of monetary accommodation to the economy, and given the stubbornness of the unemployment rate in responding to these efforts, we should be cautious and vigilant that our previous accommodative policies do not translate into a steady rise in inflation over the medium term even while the unemployment rate remains elevated. Creating an environment of stagflation, reminiscent of the 1970s, will not help businesses, the unemployed, or the consumer. It is an outcome we must carefully guard against.

We also need to ensure that Fed policy remains credible. In my view, the actions taken in August and September tend to undermine the Fed's credibility by giving the impression that we think such policies can have a major impact on the speed of the recovery. It is my assessment that they will not. We should not take certain actions simply because we can. To address our economic ills we must apply the appropriate remedies. A doctor who misdiagnoses a disease and prescribes the wrong medicine can make the patient worse. The ills we currently face are not readily resolved through ever more accommodative monetary policy. If we act as if the Fed has the ability to solve all our economic problems, the credibility of the institution is undermined. The loss of that credibility and confidence could be costly to the economy because it will make it much harder for the Fed to implement effective monetary policy in the future.

Credibility was also at the center of my opposition to changing the forward policy guidance in August. I was concerned that tying monetary policy to calendar time could be misinterpreted by the public as suggesting that monetary policy is no longer contingent on how the economic outlook evolves. This could also lead to a loss of credibility should economic conditions develop in a way that requires the federal funds rate to be adjusted prior to mid-2013. And in my view, given the outlook, economic conditions will likely warrant that the Fed begin to raise rates before that time.

Finally, the actions taken at our last meeting will make our exit from this period of extraordinary accommodation more complicated. We will have more long-term Treasury securities and more mortgage-backed securities in our portfolio, which may extend the time it will take to withdraw from allocating credit to particular sectors of the economy and return to our stated goal of an all-Treasuries portfolio.

This does not mean that I see no circumstances in which further monetary policy action should be taken. Should the developments in the euro area lead to significant financial market disruptions, the Fed would need to respond in its role of lender of last resort to support financial stability and the payments system. Or if deflationary fears were to become a real threat again and we saw signs that the economy was moving to a sustained disinflation with declining inflation rates and inflation expectations, then we would need to consider further action to stabilize inflation expectations. I do not see either of these scenarios in my forecast, so I do not anticipate that further accommodative monetary policy actions will need to be taken.

An Explicit Numerical Objective for Inflation

The past three years have proven to be challenging times for monetary policymakers. We entered unprecedented territory as we employed new policy tools to stem the financial crisis and limit the damage to the economy from the severe economic recession. There was no established framework for making policy decisions in such an environment, and that added to the difficulties in determining appropriate policy. It also created difficulties for the Fed's communications. In my view, a high priority for the Fed must be to strengthen our monetary policy framework and articulate that framework to the public so that they will better understand the basis for our decisions and be better able to formulate expectations of future policy actions.

An important first step in that direction is for the Federal Reserve to adopt an explicit numerical objective for inflation. The explicit inflation goal would help to anchor inflation expectations, raise policy transparency, and increase the central bank's accountability for its actions. There is considerable evidence that countries that have adopted such an objective as a cornerstone of their monetary policy decision-making have had more success at achieving price stability without any deterioration in the stability of real activity. In the United States, Congress has given the Fed a mandate to promote the goals of maximum employment, stable prices, and moderate long-term interest rates. Price stability is the most effective way for monetary policy to promote the other two goals. Thus, by helping the Fed achieve and maintain price stability, an explicit inflation objective would help the Fed promote <u>all three</u> of the goals set forth by Congress.

For nearly 20 years, I have advocated that the Fed make explicit its commitment to a numerical inflation objective in support of its full mandate. I believe that now is an opportune time to do so.

First, it will increase the credibility of our commitment to keeping prices stable even as we employ new, less familiar policy tools.

Second, we are confronting an environment where some may be questioning the ability or resolve of the government to address our long-run fiscal problems. In such an atmosphere of uncertainty, being explicit about our inflation goal will underscore the Fed's commitment not to succumb to external pressures to use inflation as a solution to the country's long-run deficit problem. This will help anchor inflation expectations, which is critical because an undesirable rise or fall in inflationary expectations can generate a self-fulfilling mechanism. Should inflation expectations become unhinged, it would be difficult and costly for the monetary authority to re-establish price stability.

Third, communicating an explicit inflation objective will clarify the Fed's intentions regarding the level of inflation it considers consistent with its mandate. Some economists have suggested that raising our inflation goal above 2 percent would be an effective tool for lowering real interest rates. I am very wary of such a strategy because I don't believe we can control inflation expectations that precisely. It is at least questionable whether we could credibly raise inflation expectations. And were we able to do so, how easily would we be able to bring them back down? Trying to manipulate the public's expectations may risk undermining the Fed's credibility and the public's confidence in the institution.

Fourth, we eventually will need to normalize our monetary policy and exit this period of extraordinary accommodation. Having an explicit inflation objective will help us maintain our commitment to price stability while we do that and increase the credibility of that commitment in the eyes of the public.

As business leaders, you understand the importance of credibility in your own institutions. An institution's reputation is built on its credibility for fulfilling its commitments. Once that foundation is compromised, it is very difficult to rebuild. The Fed must do all it can to preserve its hard-earned credibility. I believe an explicit inflation goal can help us do that.

Conclusion

In summary, the U.S. economic recovery will continue and gradually strengthen over time. I expect annual growth of less than 2 percent this year to gradually accelerate to around 3 percent next year. As the economy strengthens, prospects for labor markets will continue to improve and the unemployment rate will gradually decline.

As we move forward in this time of change, the Federal Reserve remains committed to its long-run statutory goals of price stability and maximum employment. We remain vigilant on inflation and committed to clear communication of our monetary policy. I believe that this communication, and our accountability to the public, could be greatly enhanced were the Fed to adopt an explicit numerical inflation goal. Having such an objective in place would prove particularly useful in the current environment in which the Fed is providing monetary stimulus using new tools that are not as familiar to the public and the markets. It will also help at a time when some may view the fiscal situation as threatening the independence of monetary policy. And it will help in the future, during the eventual exit from these extraordinarily accommodative measures.