Charles I Plosser: The US economic outlook and the normalization of monetary policy

Speech by Mr Charles I Plosser, President and Chief Executive Officer of the Federal Reserve Bank of Philadelphia, at the Society of Business Economists Annual Conference, London, England, 9 June 2011.

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

Introduction

Good morning. Thank you for this opportunity to speak before your Society. As business economists, you are well aware of the extraordinary economic times in which we live. A financial crisis and arguably the worst global recession of the post-war era have challenged policymakers in the U.S. and abroad. In many nations, monetary and fiscal authorities undertook extraordinary actions to mitigate the damage, and for most of the hardest hit countries, the recession trough has passed and a moderate recovery is underway. Yet the actions taken leave a legacy of huge government budget deficits, short-term interest rates at record lows, and central bank balance sheets of unprecedented magnitudes.

Even as our economies recover, policymakers face some daunting challenges as we try to unwind these extraordinary actions and rebuild confidence and credibility in our monetary policy frameworks. Today I would like to discuss my outlook for the U.S. economy and some thoughts about ways to begin the normalization of U.S. monetary policy. I believe there are several steps the Federal Reserve can take to ensure a successful exit from this period of extraordinary accommodation, including taking a page out of the Bank of England's book by announcing an explicit numerical goal for inflation. 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. We are nearly two years into a moderate, sustained recovery from financial crisis and the worst economic downturn since the Great Depression. In the fourth quarter of last year, the level of real GDP finally passed its pre-recession peak, but it did so with some 7½ million fewer workers, a reflection of strong productivity growth.

This year's first-quarter GDP growth, at just below 2 percent, was somewhat disappointing. But I believe that this weakness will likely prove to be a temporary soft patch and that the underlying fundamentals remain in place for the economy to resume growing at a moderate pace in the second half of this year, and to strengthen a bit more next year. Such soft patches are not that uncommon. Indeed, last year we experienced just such a bump in the road. Yet, after what I described as the summer doldrums, the economy picked up momentum to give us just under 3 percent growth for the full year.

I think the slower growth in the early part of this year has similarly been influenced by a number of temporary factors. In particular, severe weather, uncertainty surrounding the aftermath of the disaster in Japan, political events in the Middle East and North Africa, and higher food and energy prices, all have weighed on growth. Oil and commodity price increases and supply chain disruptions from the devastation in Japan may have some carryover into the second quarter, but I believe any loss of momentum is likely to be transitory.

Of course, the drama being played out in Congress over debt and spending has provided yet another source of uncertainty for the economy. Progress in that arena would undoubtedly improve confidence going forward and reduce uncertainty. Monetary policy cannot and should not be viewed as a substitute for sound fiscal policies. As I have argued many times in the past, monetary policy is not the silver bullet that many would like to think it is. It cannot solve all of our economic ills, and attempting to do so can be quite dangerous for economic stability.[1]

I anticipate moderate but above-trend growth of around 3 to 3½ percent for the remainder of this year and next. The overall strength in some sectors will more than offset persistent weaknesses in others, so that the recovery will be sustained and more broad-based as it continues. Improvement in household balance sheets and better labor market conditions will support moderate growth in consumer spending. Solid growth in corporate earnings will support continued healthy advances in business spending on equipment and software. Housing, however, will likely remain a weak spot in the U.S. economy, with flat to slightly falling prices and little new construction.

Outside of recent supply disruptions in the auto industry, I anticipate that growth in manufacturing will remain a source for optimism. The Philadelphia Fed's Business Outlook Survey of manufacturers has proven over the years to be a useful barometer of national trends in manufacturing. In April and May, the measures of current activity saw some pull-back from the very high numbers of February and March, but the numbers show that activity in the manufacturing sector continues to expand. Moreover, the survey's indicators of future activity, a measure of firms' expectations for activity six months from now, also signal continued expansion.

Consumer spending, which makes up about 70 percent of GDP in the U.S., is also increasing. Like GDP, real consumption has surpassed its previous peak and appears to be growing at a moderate pace. Households continue to pay down debt and rebuild some of the net worth that was destroyed during the recession. Higher energy and food prices have been a drag on recent consumer spending. But more important than gas prices for the health of the economy and the strength of consumer spending is job growth. So let me turn to labor markets.

Labor markets

Overall, conditions in the labor markets continue to gradually improve. But the path has not been a smooth one nor has it been as robust as one might like. In May, nonfarm payrolls expanded by 54,000 jobs, after growing by 232,000 jobs in April and 194,000 in March. The U.S. economy has added over 780,000 jobs since the first of the year. The private sector has managed to increase payrolls by more than 900,000, but government employment has been shrinking, thus dragging net hiring down below 800,000. May's uptick in the unemployment rate to 9.1 percent was a bit disappointing, but even with that, the unemployment rate has fallen by 0.7 percent since last November.

Despite these modest improvements in labor market conditions, millions of Americans remain unemployed. So we have a long way to go. But as the economy strengthens this year, I expect that businesses will continue to add to their payrolls. With continued growth in employment, I expect to see modest declines in the unemployment rate, to about 8½ percent by the end of this year, and then to a range of 7 to 7½ percent by the end of 2012.

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[1] See Charles Plosser, "The Scope and Responsibilities of Monetary Policy," Federal Reserve Bank of Philadelphia Annual Report 2010.

Inflation

Inflation has risen in recent months as the prices of energy and other commodities have surged. These prices have been extremely volatile of late, and despite some recent retrenchment, they remain considerably above their levels of just over six months ago, when the Fed embarked on its plan to purchase $600 billion of long-term U.S. Treasuries. While headline inflation has risen markedly, there has been less of an increase in the so-called core measures of inflation, which exclude food and energy prices, but even they are up noticeably over the same period.

There are signs that firms are becoming better able to pass along some of their increased costs to their customers. For example, in response to a special question in our Business Outlook Survey in February, over 56 percent of manufacturers said they had already put through price increases. Nearly 60 percent of all respondents said they had planned to increase prices over the next three months. Our survey's prices paid index, an indicator of firms' input costs, has been at high levels for the past six months. And the prices received index, an indicator of the prices that firms are charging their customers, turned positive last fall and continues to suggest that firms are likely to be testing their pricing power. In the May survey, 20 percent reported higher prices for their own goods, while just 3 percent reported price reductions. As commodity prices stabilize, headline inflation should come back down. However, I see the inflation risks in the U.S. as being clearly to the upside.

In an environment with very accommodative monetary policy, a key to keeping commodity price increases from passing through to other goods and services and creating more general inflation is to ensure that longer-run inflation expectations stay anchored. So far, that seems to be mostly the case. But, of course, expectations are well-anchored until they are not. So it is somewhat troubling to me that expectations of inflation in the medium to longer term are moving up and down as much as they are. It suggests that the public and the markets may not have as much confidence in the Fed's ability, or willingness, to deliver on its price stability mandate.

When we think about oil prices and inflation, we must keep in mind that inflation is a monetary phenomenon. In looking back to the Great Inflation of the 1970s, we learned it was not high oil prices per se, but easy monetary policy in response to high oil prices that caused the rise in general inflation. Accommodative monetary policy allowed the large increase in oil prices to be passed along in the form of a general increase in prices. As that happened, people and firms began to expect higher inflation – they lost confidence that the central bank would keep inflation in check – and those expectations influenced their decisions, making it that much harder to reverse the rising tide of inflation.

Thus, a key lesson from the 1970s is that the credibility of the central bank's commitment to maintaining price stability must be preserved. Once that credibility is lost, it is very difficult to regain, and economic outcomes are worse as a result. My colleagues and I on the FOMC are committed to ensuring that does not happen again. Yet we must be willing to do more than just talk about our commitment. We must be willing act – that is, undertake the necessary and difficult policies to ensure that medium- to longer-run inflation expectations remain stable and our credibility remains intact. This includes taking the right actions at the right time to exit the extreme accommodative policy that is now in place.

Normalization of monetary policy

During the last three years, the Federal Reserve, like many other central banks around the world, has taken extraordinary actions to mitigate the impact of the financial crisis and support the return of economic growth. Our traditional instrument of monetary policy, the federal funds rate, has been near zero for about two and a half years. The Fed's balance sheet has grown more than threefold, from nearly $900 billion before the crisis to about $2.7 trillion today, and its asset composition has shifted significantly from mostly short- to medium-term Treasuries to longer-term Treasuries, mortgage-backed securities (MBS), and agency debt. As our economy recovers, we must normalize our monetary policy framework.

Some people have questioned whether the Federal Reserve has the tools to exit from its extraordinary positions. We do. But the question for the Fed and other central bankers is not can we do it, but will we do it at the right time and at the right pace. How central banks manage the exit from such extraordinary policies will be the key to preserving our credibility and the public's confidence in our institutions. Our success in coping with this challenge will be at least as difficult and perhaps as important for our future economic well-being as our actions during the crisis.

Of course, the exact way policy is normalized will vary from central bank to central bank. I will focus my discussion on the U.S. and the elements that I believe will be critical for the Fed. Yet the principles that guide my thinking on these matters are important and apply more broadly to a range of policy discussions. I want to stress three key elements to the normalization effort. The first is clearly defining what we mean by normalization of our policy framework. The second is developing a systematic and credible plan for how policy will be conducted to achieve this normalization. The third is effectively communicating to the markets and the public about our intended policy framework and our plan to get there. I believe, as part of its communications, the Federal Reserve would do well to adopt an explicit numerical inflation goal, just as the Bank of England and many other central banks do. This type of clarity will reduce uncertainty and limit discretion that may lead to greater instability.

Let me discuss each of these three elements of exit. For the U.S., I believe normalization should be a return to a framework in which the federal funds rate is the FOMC's primary policy instrument and the Fed's balance sheet is composed predominantly of short- to medium-term Treasury securities, as it was before the crisis. This means the Fed will need to sell assets from its balance sheet and shrink the volume of excess reserves to a level that allows the federal funds rate to trade above the interest rate the Fed pays on excess reserves and below the Fed's primary credit rate, the lending rate the Fed charges for discount window loans. This framework is generally referred to as a corridor system and is fairly common among central banks around the world, including the Bank of England and the ECB.

As I mentioned, the Fed's balance sheet is currently three times larger than it was before the crisis and is composed of longer-term Treasuries and longer-term mortgage-backed securities and housing agency debt. Normalization will require returning the composition of the Fed's portfolio to predominantly Treasuries with a significantly shorter duration. In my view, the central bank should not be in the business of allocating credit to specific sectors of the economy, such as housing. That credit allocation should rest with the markets and the fiscal authorities should they choose to intervene, not the central bank. By mingling monetary and fiscal policies, the Federal Reserve puts at risk the independence of its monetary policy and therefore the desirable economic outcomes it is capable of delivering.

We should make it clear to the public that normalization of monetary policy will mean a return to the federal funds rate as our primary policy instrument and that means a much smaller balance sheet, dominated by Treasury securities.

Policymakers should also develop and articulate a coherent and credible plan for normalization. In late March, I proposed a systematic, rule-based approach that would involve the Fed's selling assets from its portfolio as it increased its policy rate, with the pace of sales dependent on the state of the economy. The plan would get us back to a normal operating environment in a timely manner, with the Fed's balance sheet reduced to a size that would again allow the federal funds rate to be the primary policy instrument. An alternative plan might be to set the balance sheet on something like a pre-determined glide path that would shrink the balance sheet steadily over time. In general, changes to the path would face a high threshold.

Perhaps more important than the details of any approach to exit is the very establishment – and communication – of a systematic plan to do so. Of course, monetary policy will always be dependent on the evolution of the economy, but the more we can articulate how we will conduct policy during the transition to a more normal policy framework, the more we will reduce uncertainty and contribute to stability.

Indeed, transparency is always an important ingredient in sound monetary policymaking, but as we exit from the period of extraordinary policy, it is even more important. Given the large amount of liquidity present in the U.S. banking system, it is reasonable for the public to be concerned about inflation. As we normalize the policy framework, we, as policymakers, need to do all we can to ensure that the public's expectations of inflation remain stable.

The majority of monetary economists and central banks, including the Bank of England, now consider some form of inflation targeting a best practice. It is time for the Fed to adopt this practice, as I have advocated for nearly 20 years.

Some argue that because the Federal Reserve does not have a single mandate for price stability as other central banks do, it should not set an explicit inflation objective. I disagree. The U.S. Congress set the Fed's mandate to conduct monetary policy to "promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates." Adopting an inflation objective does not mean controlling inflation at the expense of economic stability. On the contrary, most economists, myself included, agree that focusing on price stability is the most effective way for monetary policy to promote *all* parts of its mandate.

Moreover, committing to a stated goal to keep inflation low and stable can help to reduce market uncertainty and enhance the credibility and accountability of our central bank. During the transition from a very accommodative policy stance to a more normal operating environment, it is especially important that the public have confidence in the Fed's commitment to do so in a manner that does not let inflation accelerate. Thus, in my view, this would be an opportune time for the Fed to commit to an explicit numerical inflation objective.

It is noteworthy that just within the last year or so, the public discussion in the U.S. has swung from concerns that the U.S. might face a period of sustained deflation to concerns that monetary policy and rising commodity prices could produce higher-than-desired inflation. These swings in public concern indicate how much uncertainty there is in the lookout for inflation. We should seek to ensure that this does not translate into a lack of confidence in the Fed to maintain price stability. As we work to exit from this period of extreme monetary accommodation in a way that neither leads to higher inflation nor risks undermining the recovery, the public's confidence in the Fed's commitment to price stability will be crucial. For this reason, it would be highly desirable for the Federal Reserve to publicly commit to a clear and explicit inflation objective. While an inflation target is not a panacea for all the challenges facing monetary policymakers, it is an important element in a credible program for monetary and economic stability.

Conclusion

In summary, my forecast is for the economy to continue to expand at a moderate pace and for inflation to move back down from its current level as oil prices stabilize. Despite weakness in the first quarter, I expect annual growth to be 3 to 3½ percent over the remainder of this year and next. As the economy strengthens, prospects for labor markets will continue to improve, with the unemployment rate descending to between 7 to 7½ percent by the end of 2012.

As the economy evolves, the Federal Reserve remains committed to its long-run statutory goals of price stability and maximum employment. We must carefully watch for signals of inflation and altered expectations to ensure that monetary policy stays ahead of the curve. As we move forward in this time of change, clear communications regarding our actions and objectives will be of the utmost importance.

I believe we can be most successful in exiting from this period of extraordinary accommodation and nontraditional policies if we communicate a systematic plan that describes where we are headed and how we will get there. Such a plan would be strengthened if the FOMC adopted an explicit numerical objective for inflation, which would help ensure that inflation expectations remain well anchored.