Charles I Plosser: Outlook and a perspective on monetary policy

Text of the Farash Distinguished Lecture by Mr Charles I Plosser, President and Chief Executive Officer of the Federal Reserve Bank of Philadelphia, at the Zell/Lurie Real Estate Center Fall Members' Meeting, Wharton, 12 October 2011.

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Good afternoon. Thank you for the opportunity to be here at the Zell/Lurie Real Estate Center Fall Members' Meeting. Your founding director, Peter Linneman, and I were graduate students together at the University of Chicago – a long time ago – and so I am especially delighted to be part of your program today.

I am also honored to have the opportunity to deliver the Farash Distinguished Lecture. Max Farash, who died last year at age 95, was a Rochester-based real estate pioneer, and I had the honor of knowing Max over the years, especially when I served as dean of the Simon School of Business at the University of Rochester.

Today, I'd like to share with you some thoughts on the nation's economy. I will also discuss my views on monetary policy. As always, these are my views and do not necessarily represent the views of the Federal Reserve Board or my colleagues on the Federal Open Market Committee.

Economic outlook

The U.S. economy has not lived up to expectations this year. Indeed, in July we learned from the revisions to the government's economic data that the recession was deeper and the recovery was weaker than we had previously thought. Some of this weakness is perfectly understandable, given the unanticipated shocks we experienced. 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 that led to a run-up in oil prices, and a renewed concern about European sovereign debt. And all of that occurred before May.

Over the summer, the economy faced more challenges, with the further deterioration of the European sovereign debt crisis, as well as our own fracas in Washington over fiscal policy and the debt ceiling. These events weighed heavily on business and consumer confidence. While many of these factors are transitory, and each will wane in time, the cumulative effect has served to feed uncertainty and inhibit growth.

Indeed, growth in the first half of 2011 was less than 1 percent, reflecting a very weak first quarter, and while the second quarter improved, growth remained well below the longer-term trend. In light of this performance, most forecasters have revised down their forecasts for overall growth for the full year. I now expect GDP growth to be less than 2 percent in 2011, with an acceleration to around 3 percent in 2012.

Although the downside risks around this forecast are apparent, I do not believe we are on the verge of a 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 many news accounts would suggest. Perhaps the greatest uncertainty today surrounds the outcome of financial events in Europe. The sovereign debt crisis is not resolved. Financial markets seem very sensitive to news from Europe, even to the point of discounting positive news on the U.S. economy. Resolution or greater clarity on the path forward in Europe would be most helpful for the U.S. and world economic growth prospects.

Yet as our economy recovers, we must realize the financial crisis was a severe shock that affected many economies around the world and led to a recession of great depth and structural imbalances. Prior to the recession, some sectors, such as financial services and real estate, had grown to historically high shares of U.S. GDP. As the economy rebalances, they may not return to those pre-recession highs, nor should we necessarily seek or expect them to do so.

Consumer and business spending

Now, let me turn to consumer and business spending. One of the more striking aspects of this recession is the continued weakness in consumer spending relative to previous recoveries. There were modest increases last year, but spending decelerated over the first half of this year in the face of higher oil prices and the continued deleveraging of household balance sheets. Consumers continue to pay down debt and work to rebuild their net worth by 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 prospects, they will remain conservative in their spending patterns. Moreover, the more uncertain they are about their own future earning power, the more reluctant households will be to spend and the more they will feel the need to save to protect their families against unforeseen events.

A brighter spot has been business investment spending, which has been supported by solid growth in corporate earnings. Looking beyond the month-to-month volatility, spending on equipment and software has continued to expand. The new orders data suggest continued growth, although perhaps not at the same pace. Indications from some of the regional business surveys, like the Philadelphia Fed's Business Outlook Survey of manufacturers, suggest some weakness relative to earlier in the year.

Many commentators 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 took place in the midst of market volatility after Standard & Poor's downgrade of U.S. debt, and the September survey occurred just days after the hurricanes and the severe flooding in New Jersey and Pennsylvania. Measures of future activity, however, have remained positive, and September was stronger than August, suggesting that firms expect activity to pick up over the next six months.

Nevertheless, the volatility in the financial markets over the last few months has contributed to sharp declines in business and consumer sentiment. With many businesses and consumers uncertain about future taxes, regulations, and the financial ramifications of the European sovereign debt situation, it is no wonder that sentiment is flagging. This high degree of uncertainty dampens current growth and poses added risk to the forecast.

Labor markets

Conditions in labor markets remain a serious challenge. Given the weak growth in employment so far this year, we have not made even the modest progress on reducing unemployment rates that many forecasters had anticipated. The September employment report, including revisions to July and August, was a bit of positive news. Firms added 287,000 jobs to their payrolls in the third quarter, comparable to the second quarter. But this pace is below what is needed to make significant progress in reducing the unemployment rate, which has remained stubbornly high at 9.1 percent.

The challenges facing the employment situation are underscored by the fact that more than 40 percent of the unemployed, or some 6 million people, have been out of work for 27 weeks or longer. This suggests we should not expect an easy solution to the problems in the labor market. 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 or in other parts of the country. These sorts of adjustments will take time to resolve. Jobs and workers will need to be reallocated across the economy and across the country, which is likely to be 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 gradually 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 as the prices of oil and other commodities have come down. 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.

Our focus should not be so much on the near term as on the medium term. Looking further ahead, we must continue to monitor this situation very carefully, particularly in this environment of very accommodative monetary policy. Inflation most often develops gradually, and if monetary policy waits too long to respond, it can be very costly to correct. 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, inflation was falling and there were concerns about deflation – year over year, PCE inflation was running about 1.2 percent and core PCE inflation (excluding food and energy) was under 1 percent. Today, PCE inflation is 2.9 percent and core PCE is running nearly 1.7 percent. I would also note that unemployment was 9.8 percent last fall compared to 9.1 percent today. Thus, with inflation higher and unemployment lower, it is not so surprising that some might question the need for the additional accommodation the FOMC undertook in August and September – a point I will return to shortly.

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 United Kingdom 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 framework 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 kept the federal funds rate – the traditional instrument of monetary policy – 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. Moreover, the asset composition has shifted significantly from mostly short-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 late September meeting, 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 both of these decisions. As I noted earlier, given that inflation was notably higher and unemployment lower than it was last fall when we embarked on our second round of asset purchases, it wasn't clear that further accommodation was called for. In addition, I believe these actions will do little to improve the near-term prospects for economic growth or employment, but they do pose some real risks. Policy actions are not 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 from our actions in September 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 considerably less. Thus, I am skeptical that this will do much to spur businesses to hire or consumers to spend, given the ongoing adjustments occurring in the economy and the uncertainties posed by the fiscal challenges both here and abroad.

In addition to having little benefit, 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 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. Economic theory and historical experience tell us that a central bank's ability to maintain price stability and promote economic growth hinges on its credibility. Actions that undermine credibility can put at risk the effectiveness of a central bank's ability to achieve its objectives. In my view, the actions taken in August and September risk undermining 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 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, our credibility will be undermined. The loss of that credibility and the loss of the public's 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 the calendar could be misinterpreted by the public; it could suggest that monetary policy is no longer contingent on how the economic outlook evolves. This could 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 then. If such a move is required and we don't act, our credibility to control inflation would be severely damaged. Yet, if we do act, our credibility will also be damaged because we encouraged the public to believe we would not act before mid-2013.

Finally, the actions taken at our last meeting will make our exit from this period of extraordinary accommodation more complicated. Since we will have more long-term Treasury securities and mortgage-backed securities in our portfolio, the time it will take to unwind and get back to our stated goal of returning to an all-Treasuries portfolio and shrinking our balance sheet may need to be extended and may put at risk our ability to control inflation over the medium term.

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.

The past three years have proven to be challenging times for monetary policymakers both here and abroad. We are in unprecedented territory in terms of policy tools and actions employed. This creates difficulties not only for policymaking but also 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.

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. 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.

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 when some may view the fiscal situation as threatening the independence of the Federal Reserve and its ability to maintain price stability. And it will help in the future by keeping inflation expectations well anchored during the eventual exit from these extraordinarily accommodative measures.

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, undoubtedly too gradually for many of us.

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. And it is a credible commitment to price stability that provides the surest path for monetary policy to successfully promote economic growth and employment.