Charles I Plosser: Perspectives on the economy and monetary policy

Speech by Mr Charles I Plosser, President and Chief Executive Officer of the Federal Reserve Bank of Philadelphia, at The School of Business at La Salle University, Union League of Philadelphia Business Network, Philadelphia, Pennsylvania, 14 January 2014.

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

Introduction

I want to thank La Salle University and the Union League for inviting me to speak at this annual economic event. The new year always seems like a good time to reflect on the past and refresh our outlook for the future, and I will try to do a bit of both today.

This is a particularly noteworthy time in the history of the Federal Reserve. On December 23, 1913, President Woodrow Wilson signed into law the act that created the Federal Reserve System. Thus, the Fed's official 100th anniversary occurred just three weeks ago.

So, I thought I would begin by sharing a brief history of our nation's central bank with you before discussing my views on economic conditions 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

What better place to share a little history of our central bank than here in Philadelphia and in this historic venue of the Union League. Just a few blocks from where the Philadelphia Fed stands on Independence Mall, you will find vestiges of two earlier attempts to create a central bank for the United States, dating back to the time Philadelphia was the nation's major financial and political center.

The first institution was the brainchild of our first Treasury secretary, Alexander Hamilton. His efforts led to the creation of the First Bank of the United States, which was awarded a 20-year charter by Congress in 1791.

Although the First Bank's 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. It was also given a 20–year charter and operated from 1816 to 1836. However, its charter was not renewed – Congress could not override the veto of President Andrew Jackson, who led the opposition to the central bank. Public distrust of centralized power was an important factor in the demise of both banks. Both became entangled in politics, and both failed to gain the public's confidence and establish the independence necessary to serve our vast and diverse country of bakers and bankers, farmers and financiers, and manufacturers and merchants.

It took Congress nearly 80 years to try again to establish a central bank. This time Congress and President Wilson agreed upon a uniquely American governance structure – a decentralized, central bank.

To balance political, economic, and geographic interests, Congress created the Federal Reserve System made up of regional Reserve Banks with oversight provided by a Board of Governors in Washington, D.C.

This structure helped to overcome political and public opposition stemming from fears that a central bank would be dominated either by political interests in Washington or by financial interests on Wall Street.

The Federal Reserve Act formed a Reserve Bank Organization Committee to divide the country into no fewer than eight and no more than 12 Federal Reserve Districts.

Almost immediately after the law was enacted, the committee started receiving letters and telegrams from local business owners, bankers, farmers, and others, who were all making a case for where they wanted a Reserve Bank to be located.

The committee held meetings in 18 cities before submitting a report to Congress in April 1914, naming the final 12 cities and districts. The Federal Reserve Bank of Philadelphia was designated as the regional Reserve Bank for the Third District, an area that includes Delaware, the eastern two-thirds of Pennsylvania, and the southern half of New Jersey.

These Reserve Banks 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.

The 12 regional Reserve Banks are deeply rooted in our nation's communities, which ensure that the Federal Reserve stays in touch with Main Street. The Reserve Banks all have boards of directors, many also have Branch boards, and all have advisory councils and other mechanisms to keep abreast of conditions in their regional economies. This rich array of information and the diverse views from around the country contribute to a mosaic of the economy that is essential as we formulate national monetary policy.

Of course, most people associate the Fed with the determination of 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.

One important role of the independent regional Reserve Banks is to ensure that diverse views are represented. The Reserve Banks each have economic research departments to guarantee that a wide variety of perspectives are brought to the table. In this way, the institution avoids groupthink. By being open and transparent about these various perspectives, the decentralized model for the Federal Reserve helps strengthen public confidence and preserve its independence.

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. 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 price stability in the long run.

Economic conditions

In order to determine the appropriate monetary policy to promote these goals, the FOMC must monitor economic developments. So, let me turn to an assessment of our economy. As we enter 2014, I think the bottom line is that the economy is on firmer footing than it has been for the past several years.

Real output grew at a 4.1 percent annual pace in the third quarter of last year, the strongest gain in nearly two years and a marked acceleration from the first half of 2013. Some of this growth came in the form of inventory investment, which is volatile and is less likely to have contributed as much to growth in the fourth quarter. Still, personal consumption and fixed investment provided positive contributions, and economic prospects at the end of last year and the beginning of this year are positive.

Personal consumption, which accounts more than two-thirds of GDP, advanced at an annual rate of 2 percent in the third quarter. Some observers have lamented at the lack of stronger growth in consumption. But I would note that consumption growth has not fluctuated that much over the course of the recovery. I am encouraged by the U.S. consumers' persistence in the face of many challenges, including a payroll tax hike last January, a government shutdown, significant uncertainties about future tax policy, and the implications of health-care reform.

Consistent job growth has added to wage and salary growth, which has supported spending. The December employment report released last Friday, which showed payroll gains of 74,000 jobs, came in below many analysts' expectations. Yet, I caution you not to read too much into one month's number. 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, and, importantly, it is at a lower level than the FOMC anticipated it would be at this point when we started the current asset purchase program in September 2012. That is, the labor market has performed noticeably better than expected, according to the unemployment rate measure.

Some people, however, feel that the decline in the unemployment rate overstates the degree of progress being made in labor markets because it 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 mostly by demographic changes, including 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 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 perhaps moved their retirement decision forward after losing a job. Nevertheless, few of these former 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 these people. So while 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, I would not overinterpret the decline in participation as a lack of progress made in labor market conditions or as a problem that must be corrected.

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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.

There are fundamental changes in the structure of the labor market that are likely real and sustained.

The progress in the labor market has led to growth in household income. In addition to income growth, household balance sheets have strengthened as well. Overall household wealth, in nominal terms, advanced 11 percent year over year through the third quarter. The improving housing market has been an important contributor to that growth, with owners' equity in real estate surging 29 percent in 2013 over 2012. House prices are rising; the number of homeowners with underwater mortgages and the number of mortgage delinquencies are down. I expect these improvements will help to support consumer spending going forward.

Business balance sheets are also healthy. Industrial production was very encouraging in November, when it advanced 1.1 percent on gains in all major categories. That growth was the most rapid in 12 months and brought the overall index higher than its prerecession peak for the first time. The Philadelphia Fed's Business Outlook Survey of regional manufacturing, which is a reliable indicator of national manufacturing trends, has also been in positive territory for seven months, and our firms expect continued expansion in manufacturing activity over the next six months. 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.

Inflation has been running below the FOMC's long-run goal of 2 percent. The year-over-year change in the price index for personal consumption expenditures, or PCE inflation, is the Fed's preferred measure. It has drifted downward over the past year to about 0.9 percent in November. Core PCE, a measure that removes food and energy prices that tend to be volatile, was a bit higher at 1.1 percent. I believe we must defend our 2-percent inflation target from below and above. However, I believe inflation is likely to firm up as some of the factors that have held it down, such as the cut in payments to Medicare providers and generally weak medical costs, are likely to abate over time. I am encouraged that inflation expectations remain near their longer-term averages and consistent with our 2-percent target. So, 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 that there is some upside risk to inflation in the longer term.

I anticipate overall 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 had a central tendency of growth of 2.2 to 2.3 percent for 2013, and accelerating to 2.8 to 3.2 percent in 2014.

I believe this growth will continue to lead to declines in the unemployment rate over the next year and should result in an unemployment rate of about 6.2 percent by the end of 2014. 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.

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 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 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 its December statement, the FOMC indicated that it intends to leave the policy rate near zero well past the time that the unemployment rate falls below 6.5 percent, especially if projected inflation continues to run below the FOMC'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. The Fed has structured its latest round of asset purchases as a flow-based program, with the idea that policymakers could fine-tune the rate of purchases in response to the economy.

The FOMC decided in December to reduce the purchases from $85 billion to $75 billion per month. Thus, we are still adding monetary accommodation but at a slightly slower pace. Asset purchases are not on a preset course and will continue to be contingent on the FOMC's economic outlook. However, the FOMC did indicate in December that if economic conditions evolve as expected, with improved labor market conditions and inflation moving back toward its goal, then the FOMC will likely reduce the pace of asset purchases in measured steps at future meetings. 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. The December employment report has not changed my belief that the economy has already met the criteria of substantial improvement in labor market conditions. So my preference would be that we conclude the purchases sooner than this, but I am glad that we have taken the first step on the path to ending the program.

Eventually, monetary policy will be normalized, but the way in which that is done will depend on what operating framework we plan to use in the normalized environment. I believe that the exit strategy principles laid out by the FOMC in June 2011 still apply. More specifically, we need to return to an operating framework in which a market interest rate is our policy instrument. We also should shrink the size of our balance sheet, which is now about $4 trillion, and return to an all-Treasuries portfolio as part of the normalization process.

This sounds easy in principle, but I believe the size and composition of our balance sheet will make it challenging to execute smoothly.

There are now more than $2.4 trillion of excess reserves in the banking system. These reserves are not inflationary until they are converted to money and flow out into the economy.

But as market rates rise in an improving economy, banks will find it advantageous to begin to increase lending or acquire assets using their reserves. The challenge for the Fed is to control the flow of reserves so that we can successfully maintain our 2-percent inflation target. This may require raising interest rates more quickly than currently anticipated. We have the tools that would enable us to raise rates if we chose to do so. However, the Fed may be subject to political pressures or pushback from various interest-sensitive sectors that could result in a more measured response than required.

One of the consequences would be higher inflation. History suggests that the Fed tends to be behind the curve when it comes time to tighten monetary policy, and in the current environment, that delay could prove to be more costly than when reserves are in limited supply. Thus, it's a matter of our will rather than our ability.

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 gradually, and I expect the unemployment rate will continue its decline to 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, the reduction in asset purchases from $85 billion a month to $75 billion a month is a step in the right direction. 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 recovery. Even after the asset purchase program has ended, monetary policy will still be highly accommodative.

The work of the Fed, however, is far from over. Monetary policy still faces considerable challenges as we seek to normalize policy. The task should be to return to a framework in which a market rate is our primary policy tool, to reduce the size of our balance sheet, and to restore our portfolio to all Treasuries. The challenge will be to do so 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.