

Charles I Plosser: The economic outlook and housing

Speech by Mr Charles I Plosser, President and Chief Executive Officer of the Federal Reserve Bank of Philadelphia, at the Women in Housing & Finance, Inc., Washington DC, 20 May 2014.

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

Highlights

- President Charles Plosser gives his views on the sustainable improvement in housing in the context of a broader economic recovery. He also discusses the Fed's monetary policy issues, including forward guidance.
- President Plosser is optimistic about the housing recovery. He believes that even though sales have leveled off recently, prices are still rising, and fundamentals remain sound, including stronger household formation, solid job growth, and consumers with stronger balance sheets.
- He thinks that the U.S. economy is on firmer footing today than it has been in several years. He expects continued progress in 2014. He adds that one of the more encouraging signs for the economy comes from the labor market.
- President Plosser believes reducing the pace of asset purchases in measured steps is moving in the right direction, but the time may come sooner than many expect when interest rates may have to rise if we are to avoid falling behind the curve.

Introduction

Thank you for inviting me here today. Women in Housing & Finance meetings have featured a number of Federal Reserve policymakers in recent years. A review of their speeches traces an arc through the turmoil in the U.S. housing market, which led to the worst financial crisis and economic downturn since World War II, the regulatory reform that followed, and the moderate but steady recovery over the past five years.

In January 2008, then-Chairman Ben Bernanke addressed your group a month after the Great Recession began, following sharp and dramatic declines in the U.S. housing market during 2007. Then, in June 2009, former Governor Elizabeth Duke described the actions that the Federal Reserve had taken to contain the financial crisis and promote economic recovery. In February 2011, former Kansas City Fed President Tom Hoenig asked whether the Dodd-Frank Act would actually improve the financial regulatory climate and solve the yet-unresolved issue of too-big-to-fail institutions.

Today, I am delighted to join you at a time when, despite the effects of the severe winter weather, the economy is on the firmest footing it has been on since the recovery began. But this does not mean that we are likely to see, nor should we seek to see, a return to the unsustainable levels of residential real estate activity that preceded the financial crisis. That did not end well.

Instead, the perspective I will offer today is one of sustainable improvement in housing in the context of a broader economic recovery. Then, I will close with some thoughts on monetary policy. Before I continue, though, I will note that my views are my own and not necessarily those of the Federal Reserve Board or my colleagues on the Federal Open Market Committee (FOMC).

Economic conditions

So, let me begin with an overview of the U.S. economy. We are almost five years into a recovery that began in June 2009. Growth accelerated in the second half of 2013 but faced some stiff winter headwinds in the first quarter of this year. Yet, I think most of us now view this as a temporary weather-related slowdown and not a risk to the underlying recovery.

Snowstorms and frigid temperatures affected every aspect of the economy, from sales and hours worked to logistics and supply chains during the first quarter of the year. You can't sell a house if buyers can't get in the front door. You can't sell a car if it is buried in snow. And even if your factory is producing goods, you can't deliver them to your customers as scheduled if trucks can't navigate the highways or if trains have to slow down to half their normal speed. My own view is that it will take another month or two before we can hope to see a somewhat clearer picture of the economy.

The first estimate of GDP growth for the first quarter of 2014 showed that the overall economy was essentially flat, expanding at an annualized rate of just 0.1 percent. The underlying details are more encouraging. Consumer spending increased 3 percent, marking the 19th consecutive quarter of growth. This growth is supported by the fact that households have reduced their debt and strengthened their balance sheets over the past few years. And as the values of equities and real estate have risen, consumer savings rates have fallen and consumption spending has increased.

The weakness in the overall GDP figure comes predominately from lackluster investment, both by businesses and homebuilders, as well as some pullback in exports and imports.

Our business contacts as well as our surveys confirm that economic activity was greatly hampered by the winter weather in the Northeast and in other parts of the country. The Philadelphia Fed's *Business Outlook Survey* of manufacturers in our region has been a reliable indicator of national manufacturing trends in the U.S. The survey results indicate that manufacturing activity has been expanding for 11 of the past 12 months. The only aberration was in February 2014, when respondents ascribed their declines to the severe weather. But the survey has since indicated positive growth in March, April, and May. The ISM manufacturing index, which measures nationwide activity, similarly dropped in the winter months and has since bounced back.

Thus, I continue to believe that the U.S. economy is on a firmer footing today than it has been in several years. This is a cause for some optimism for continued progress in 2014. My forecast has been for growth of about 3 percent in 2014, and while the weather-related softness in the first quarter may temper this full-year outlook somewhat, it hasn't led me to downgrade my outlook for the remainder of the year.

One of the most encouraging signs for the economy comes from the labor market, believe it or not. Employers added 288,000 jobs in April, the strongest gain since January 2012, and job growth in February and March were revised upward by a total of 36,000. The gains in April were broad-based across sectors, including 32,000 net new jobs in construction. Indeed, net job growth has exceeded 200,000 in five of the past seven months, with only the frozen months of December and January showing disappointing numbers. Even if we include those weak months, the economy has added more than 200,000 jobs per month on average over the past seven months.

The unemployment rate dropped to 6.3 percent in April, down more than a full percentage point from a year ago and the lowest rate recorded in more than five years. This month's decline was particularly sharp and was driven, in part, by a decline in labor force participation. I would note that the household survey, which gives us the unemployment rate, is more volatile than the establishment survey, which measures the number of new jobs added. I would not be surprised if the unemployment rate moved up a bit next month, but the downward trend continues, and we are making significant improvement. The number of those unemployed for more than 27 weeks dropped by 287,000 in April, and by 1.25 million

since January 2013. While this is an improvement in labor markets, everyone will readily agree that the long-term unemployed remain a serious concern.

I expect that the unemployment rate will fall below 6.2 by the end of 2014. If anything, this forecast may prove to be too pessimistic. Given the recent trends, an unemployment rate below 6 percent is certainly plausible.

Inflation remains benign. It is running somewhat 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. That figure came in at 1.2 percent last year and is running at about the same pace over the first two months of this year. It is important to defend our 2 percent inflation target both from below and above. Yet, I anticipate, as the FOMC indicated in its most recent statement, that inflation will move back toward our target over time. Indeed, we learned last week that the CPI moved up in April and is now running at 2 percent over the past year and at a 2.3 percent annual rate during the past three months.

I am encouraged that inflation expectations remain near their longer-term averages and consistent with our 2 percent target. Given the large amount of monetary accommodation that we have added and continue to add to the economy, I think there is some upside risk to inflation in the longer term.

There are risks with respect to my growth forecast as well. While there continues to be some downside risk to growth, for the first time in years, I see the potential for more upside risk to the economic outlook. So as the economy gradually moves toward our 2 percent inflation target and the labor market continues to improve, we will need to calibrate monetary policy to reflect the improvements.

Construction and housing markets

Let me offer some further observations on the housing market. Residential real estate is a focus of many economists because it was ground zero for the financial crisis and the ensuing Great Recession.

In the past, we tended to see housing lead the economy out of the recession, but for a number of reasons, that was not the case this time.

As we know, sales of existing homes plummeted from unsustainable peaks during the housing boom. Sales bottomed out at an annual rate of 3.5 million houses in July 2010 and then climbed steadily for three years to 5.4 million in July 2013. That was about the same annual rate that we averaged in the years preceding the boom. Sales have fallen somewhat since mid-2013, due in part to rising mortgage rates, but those rates remain low by historical standards. The fundamentals of the housing market remain sound, including stronger household formation, solid job growth, and consumers with stronger balance sheets.

Home prices are well below their peaks, but they continue to improve as the market recovers. Two national measures were up recently: The S&P Case Shiller Home Price Index was up 12.8 percent year over year in its latest February number, and the CoreLogic National House Price Index was up 11.1 percent in March.

Some have expressed concern over the housing recovery in recent months, but I am more optimistic. As I said, the fundamentals remain sound, and even though sales have leveled off recently, prices have continued to rise even over the past three months. That suggests that supply may be restricting sales more than weaker demand. But we will have to wait and see how the remainder of the spring and summer plays out.

The structure of housing finance in our country remains a topic of intense discussion as it was before, during, and after the crisis. As I have argued in the past, the government-sponsored enterprises, or GSEs, were permitted to operate for private profit but with an implicit guarantee from the government, and so they were able to take extraordinary risk at

the taxpayers' expense.¹ This was a classic case of moral hazard, and it must not be repeated.

There are many proposals for a new system of housing finance with varying levels of government support. There is no clear or easy answer to the degree of government involvement in the housing market; that is a decision we must make as a nation, carefully weighing the benefits of homeownership with the costs of the misallocation of scarce capital and the risks of unintended consequences.

The U.S. subsidizes homeownership, more than any other developed country. We do so by providing an interest deduction for home mortgages and by underwriting housing debt through an explicit taxpayer support for the GSEs, which is reflected in mortgage rates. There are debates about the quantitative effects of these subsidies. But we should not be afraid to ask hard questions. Most financial advisors would tell you to diversify your asset holdings, yet our housing policies incentivize families to do just the opposite: put your savings in your home. The policies encourage homeownership over other asset classes. The results for many families were devastating.

The GSEs were at the center of the housing storm and we have to date not addressed the fundamental reforms required. However, if as a nation we choose to continue the subsidies to homeownership, the government involvement and subsidies must be explicit, transparent, and well understood. Burying those subsidies in complex financial arrangements or in new semigovernment enterprises will be counterproductive. Markets work best when the risks and rewards of decisions are clearly defined so that prices can accurately reflect each transaction and the appropriate risk monitoring takes place.

Monetary policy

So let me turn to some issues for monetary policy. The Federal Reserve lowered its policy rate – the federal funds rate – to essentially zero more than five years ago. Since the policy rate cannot go any lower, the Fed has attempted to provide additional accommodation through large-scale asset purchases. We are now in our third round of this quantitative easing.

Since September 2012, the FOMC has added about \$1.4 trillion in long-term Treasuries and mortgage-backed securities to its balance sheet through this program, known as QE3. It is already twice the size of the last round of asset purchases, known as QE2.

In December 2013, the Committee announced that it would reduce the pace of purchases from \$85 billion to \$75 billion per month. It announced another \$10 billion reduction in January, March, and April and is now purchasing \$45 billion a month. If the FOMC continues this path of measured reductions, the purchase program will end sometime this fall. If the economy continues to improve, though, we could find ourselves still trying to increase accommodation in an environment in which history suggests that policy should perhaps be moving in the opposite direction.

In addition to asset purchases, the Fed is using forward guidance to try and inform the public about the way monetary policy is likely to evolve in the future. In the March and April statements, the FOMC reaffirmed its highly accommodative stance. The statement used qualitative language to describe the economic conditions that would lead to action. The Committee reported that it will look at a wide range of information, including measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial developments, to assess progress – both realized and expected – toward its objectives of maximum employment and 2 percent inflation.

¹ Charles I. Plosser, "Some Observations About Policy Lessons from the Crisis," remarks at the Philadelphia Fed Policy Forum, Philadelphia, PA, December 4, 2009.

The FOMC also noted, based on its assessment of these factors, that it likely will be appropriate to keep its target federal funds rate near zero for a considerable time after the asset purchase program ends, especially if projected inflation continues to run below the 2 percent goal and longer-term inflation expectations remain well anchored. My own view is that, as we continue to move closer to our 2 percent inflation goal and the labor market improves, we must be prepared to adjust policy appropriately. That may well require us to begin raising interest rates sooner rather than later.

Conclusion

In summary, I believe that the U.S. economy is continuing to improve at a moderate pace. We are likely to see growth return to around 3 percent through the rest of 2014. Prospects for labor markets will continue to improve, and I expect the unemployment rate will continue to decline, reaching 6.2 percent or lower 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.

I expect the housing and construction sectors will continue to recover. But we should not seek to return to the heady days of last decade's real estate boom.

On monetary policy, reducing the pace of asset purchases in measured steps is moving in the right direction, but the pace may leave us behind the curve if the economy continues to play out according to FOMC forecasts.

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 to 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.

Let me conclude with this thought. Over the past five years, the Fed and, dare I say, many other central banks have become much more interventionist. I do not think this is a particularly healthy state of affairs for central banks or our economies. The crisis in the U.S. has long passed. With a growing economy and the Fed's long-term asset purchases coming to an end, now is the time to contemplate restoring some semblance of normalcy to monetary policy.

In my view, the proper role for monetary policy is to work behind the scenes in limited and systematic ways to promote price stability and long-term growth. Since the onset of the financial crisis, central banks have become highly interventionist in their efforts to manipulate asset prices and financial markets in general as they attempt to fine-tune economic outcomes. This approach has continued well past the end of the financial crisis. While the motivations may be noble, we have created an environment in which "it is all about the Fed." Market participants focus entirely too much on how the central bank may tweak its policy, and central bankers have become too sensitive and desirous of managing prices in the financial world. I do not see this as a healthy symbiotic relationship for the long term.

If financial market participants believe that their success depends primarily on the next decisions of monetary policymakers rather than on economic fundamentals, our capital markets will not deliver the economic benefits they are capable of providing. And if central banks do not limit their interventionist strategies and focus on returning to more normal policymaking aimed at promoting price stability and long-term growth, then they will simply encourage the financial markets to ignore fundamentals and to focus instead on the next actions of the central bank.

I hope we can find a way to make monetary policy decision-making less interventionist, less discretionary, and more systematic. I believe our longer-term economic health will be the beneficiary.