Charles I Plosser: The economic outlook

Speech by Mr Charles I Plosser, President and Chief Executive Officer of the Federal Reserve Bank of Philadelphia, at the Pennsylvania Association of Community Bankers' 137th Annual Convention, Amelia Island, Florida, 6 September 2014.

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

Highlights

- President Charles Plosser gives his views on the economy and shares some thoughts about the stance of monetary policy.
- President Plosser believes that forward guidance should be adjusted to reflect economic realities and to give the FOMC the flexibility to respond gradually to the evolution of the economy.
- President Plosser counters the view that rates cannot be raised because the labor market has not "completely" healed. He discusses two major risks with this strategy. First, economists do not know what maximum employment is and cannot easily measure it. Second, waiting until we are completely confident the labor market has fully recovered risks that monetary policy will be behind the curve and could lead to a return to abrupt "go-stop" policies of the past that led to unwelcome volatility.
- While he is not suggesting that rates should necessarily be increased now, President Plosser sees that the first task is to change the language and to begin signaling that liftoff may occur sooner than many now anticipate and sooner than suggested by the current FOMC guidance.

Introduction

Good morning. Thank you for the opportunity to speak at this 137th annual convention of the Pennsylvania Association of Community Bankers. Community banks have a long and venerable history in our nation, and the 137 years of the PACB is a powerful testament to your roots as stalwarts in our financial system. I would note that the longevity of this convention means that your organization significantly predates the Federal Reserve System, which is observing its centennial this year. My suspicion is that there are a number of community bankers here today who can trace their corporate histories to firms that petitioned for the establishment of a Federal Reserve Bank in Philadelphia 100 years ago. I actually have two letters here. One from the New Tripoli National Bank dated December 27, 1913, and one from the First National Bank of Mifflintown dated December 26, 1913, both addressed to William McAdoo, Secretary of the Treasury, requesting the establishment of a Federal Reserve Bank in the City of Philadelphia.

Over the years, community banking organizations, whether they are state member banks or not, have provided important links between the Federal Reserve Banks and the businesses and communities your institutions serve. We have reached out and listened to community bankers through their representation on our boards of directors and advisory councils, as well as through our ongoing contacts with individual firms and the business organizations you serve.

The insights we gather from community bankers in our District help me as a policymaker bring Main Street perspectives to the national policy table each time the Federal Open Market Committee, or FOMC, meets in Washington. When such information from all the Districts comes together at our meetings, it forms a rich mosaic of our economy that helps shape our monetary policy decisions.

So, I want to thank Nick DiFrancesco, president and CEO of the PACB, and Dennis Cirucci, your chairman, for inviting me here today. I also want to publicly thank Dennis for serving so ably on our Bank's Community Depository Institutions Advisory Council, or CDIAC, and as our council's representative to the Board of Governors.

My last opportunity to address the PACB was in September 2007, a very different economic environment than we find ourselves in today. I used that speech seven years ago to discuss the Federal Reserve's initial responses to growing financial instability in the housing sector. I explained that the Fed's role in promoting financial stability rather than its monetary policy responsibilities had prompted the short-term injection of some $68 billion in liquidity through open market operations in early August 2007, a mere 12 months after I joined the Fed. That seems like a long time ago and much has transpired since then. At the time, the FOMC had yet to lower the federal funds rate from its target of 5.25 percent. Weeks later, though, the FOMC began to lower the federal funds rate target and then kept lowering it to essentially zero in December 2008, as the global financial crisis and the ensuing Great Recession enveloped economies around the world.

The rate has been near zero for nearly six years now, and the Fed has augmented its aggressive policy actions through large-scale asset purchases, now tallying in the trillions, rather than in the billions of dollars.

Today, I would like to give you my assessment of the U.S. economy and then share some thoughts about the stance of monetary policy.

I should note that my views are my own and not necessarily those of the Federal Reserve Board or my colleagues on the FOMC, which will shortly become apparent.

Economic conditions

So, let me begin with an overview of the U.S. economy. We are more than five years into a recovery that began in June 2009. While the pace has been sluggish and uneven, I believe the progress is undeniable. In fact, despite a winter cold spell in the first quarter, I remain mostly positive about the prospects ahead.

The severe winter led to a decline in gross domestic product (GDP) during the first quarter of the year, but second-quarter growth rebounded to 4.2 percent, according to the most recent estimate. This largely confirmed that the disappointing performance in the first quarter was mostly a temporary weather-related slowdown rather than a more persistent retrenchment in the ongoing recovery. In the second quarter, the strongest recoveries were in categories most directly affected by the first quarter's severe weather, including investment in equipment, residential structures, inventory accumulation, and exports. Exports declined sharply at an annual rate of 10.1 percent in the first quarter and then jumped 9.5 percent in the second. Total private domestic investment fell 6.9 percent in the first-quarter freeze but then grew 17.5 percent during the second-quarter thaw.

Personal consumption, the largest spending sector of the economy, slowed during the first quarter to 1.2 percent. In the second quarter, personal consumption growth approximately doubled to 2.5 percent. Durable goods, which advanced at an annualized rate of 14 percent, were the strongest component of personal consumption in the second quarter.

I believe consumer and business spending will help real GDP to grow at about 3 percent for the remainder of this year and next before reverting to trend, which I see as about 2.4 percent.

The Philadelphia Fed's Manufacturing Business Outlook Survey in our region has proven to be a reliable indicator of national manufacturing trends in the U.S. In August, the diffusion index of current activity increased for the third consecutive month and had its strongest reading since March 2011. The survey also indicated that expectations for manufacturing activity six months ahead remained strong. Underlying details of the report included strong results for new orders and shipments. The current indicators for labor conditions also suggested continued expansion in employment. The employment index has been positive for 14 months, and the workweek index was positive for the sixth month.

These data suggest continued improvement in U.S. labor market conditions, despite a somewhat softer August number yesterday, which showed that 142,000 jobs were added to nonfarm U.S. payrolls. However, I prefer to look at longer-term trends rather than monthly numbers that are still subject to revision. Year-to-date monthly average job growth has amounted to 215,000 jobs this year, compared with a monthly average of 194,000 jobs added last year.

Despite the slowdown in August, job creation has improved markedly this year. The economy has created 1.7 million jobs since the start of the year, nearly 10 percent more than the same period in 2013, 20 percent more than in 2012, and 30 percent more than in 2011.

The unemployment rate was 6.1 percent in August, down more than a full percentage point from a year ago. This means the unemployment rate continues to fall faster than many policymakers had been forecasting. For instance, in the Summary of Economic Projections (SEP) submitted in December 2013, the central tendency of FOMC participants was to end 2014 with an unemployment rate of 6.3 to 6.6 percent, and by the end of 2015, the central tendency was expected to be 5.8 to 6.1 percent. We have clearly exceeded expectations. The unemployment rate is below where the Committee thought it would be at the end of 2014 and is now within the range expected at the end of 2015. Thus, it is fair to say that we are at least a year ahead of where we thought we would be when we started to taper asset purchases.

In Pennsylvania, job growth has been positive as well. The state added more than 54,000 jobs over the past 12 months. July's unemployment rate in Pennsylvania was 5.7 percent, down from 7.5 percent a year ago and from a peak of 8.7 percent immediately following the recession.

It is not just that the unemployment rate has fallen, other measures of labor market conditions have improved as well. Long-term unemployment in the nation, those unemployed for more than 27 weeks, has dropped by about 1.3 million from a year ago; the duration of unemployment spells has declined; job openings have returned to prerecession levels; and the rate at which employees voluntarily leave their jobs, called the quit rate, has risen.

This is not to claim that all is rosy in the labor markets. Many Americans remain frustrated and disappointed in their jobs and job prospects. For example, there remains a large contingent of those working part time for reasons economists don't fully understand. Nonetheless, we have to acknowledge that significant progress has been made.

Inflation remains somewhat below the FOMC's long-run goal of 2 percent, but it appears to be drifting upward. Headline inflation as measured by year-over-year change in the consumer price index, or CPI, was 2 percent in July, the fourth month at or above that level. The Fed's preferred measure of inflation is the year-over-year change in the price index for personal consumption expenditures, or PCE inflation. In December of last year, that figure stood at 1.2 percent. The most recent reading for July 2014 was 1.6 percent. Compare that with December 2013 SEP estimates for 2014, and you will find that we are already at the top of the FOMC's central tendency of 1.4 to 1.6 percent for PCE inflation.

In the June SEP, FOMC participants modestly increased their assessment of inflation, raising the central tendency for PCE inflation by the fourth quarter of 2014 to between 1.5 and 1.7 percent. The Philadelphia Fed's most recent Survey of Professional Forecasters also increased its average estimate of headline PCE inflation to 1.8 percent in 2014, up from 1.6 percent in the last survey. The survey also increased the estimate of PCE inflation to 2.0 percent in 2015, up 0.1 percentage point from the previous estimate. All of these figures suggest that inflation appears to be gradually moving closer to our target of 2 percent and doing so more quickly than anticipated in December 2013.

Monetary policy

Let me turn to some thoughts on monetary policy, including why I departed from the majority view at the July FOMC meeting.

As I noted in the beginning of my remarks, the Fed has taken extraordinary monetary policy actions, keeping the federal funds rate near zero for nearly six years and expanding its balance sheet to more than $4 trillion. Indeed, the balance sheet continues to expand, so the Fed is still trying to increase accommodation even though the pace of purchases is slowing and is expected to end in October.

Yet, the recovery began over five years ago, and the unemployment rate has declined from 10 percent in October 2009, to 6.1 percent now. Whether you believe that the labor market has fully recovered or not, it is clear that we have made considerable progress toward full employment and price stability. We are no longer in the depths of a financial crisis nor is the labor market in the same dire straits it was five years ago.

In its July statement, the FOMC reaffirmed its highly accommodative stance. The statement noted that "in determining how long to maintain the current 0 to ¼ percent target range for the federal funds rate, the Committee will assess progress – both realized and expected – toward its objectives of maximum employment and 2 percent inflation." In assessing this progress, 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.

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 ..."

I objected to this forward guidance regarding the expected timing for raising the funds rate because I believe this language is no longer appropriate or warranted. Appropriate monetary policy must respond to the data. I believe that by indicating that the FOMC continues to anticipate that it will be a "considerable time" after the end of asset purchases before it is likely that the Committee will raise interest rates does not reflect the significant progress toward our goals. It also limits the Committee's flexibility to take action going forward.

We have moved much closer to our goals since last December, and, as we do so, the stance of monetary policy should reflect such progress and begin to gradually adjust. That is the essence of being data dependent. In the current context, we must acknowledge and thus prepare the markets for the fact that interest rates may begin to increase sooner than previously anticipated. I felt that adjusting our language was the appropriate first step in responding to better-than-anticipated economic conditions.

My view is informed, as I have indicated, by realized and projected economic progress toward our goals. But it is also influenced by guidance gained from the historical conduct of past monetary policy. In particular, my views on the appropriate funds rate setting are – and continue to be – informed by Taylor-type monetary policy rules that depict the past behavior of monetary policy. I find such rules useful for benchmarking my policy prescriptions. These rules have been widely investigated and have been shown to be robust, in that they deliver good results in a wide variety of models and circumstances.

The guidance I take from such robust rules is that we should no longer consider monetary policy as being constrained by the zero lower bound. A variety of these rules, which I discussed in a speech earlier this summer, indicates that under current conditions the funds rate should already be above zero or should be lifting off in the very near future.[1] I am not

[1] Charles I. Plosser, "Systematic Monetary Policy and Communication," remarks to the Economic Club of New York, New York, NY, June 24, 2014.

suggesting that rates should necessarily be increased now. Our first task is to change the language in a way that allows for liftoff sooner than many now anticipate and sooner than suggested by our current guidance. Raising rates sooner rather than later also reduces the chance that inflation will accelerate and, in so doing, require policy to become fairly aggressive with perhaps unsettling consequences. Thus, I believe that our forward guidance should be adjusted to reflect economic realities and to give us the flexibility to respond sooner and more gradually to the evolution of the economy.

There is a point of view that rates cannot be raised because the labor market has not completely healed. That is, we must wait, maintaining our current stance of policy until we have achieved our goals. I think this is a risky strategy for two reasons.

First, we do not know how to confidently determine whether the labor market is fully healed or when we have reached full employment. In January 2012, the FOMC affirmed in its statement of longer run goals and strategies that, "The maximum level of employment is largely determined by nonmonetary factors that affect the structure and dynamics of the labor market. These factors may change over time and may not be directly measurable." Chair Yellen gave an excellent speech at the Jackson Hole conference just a couple of weeks ago that highlighted some of the structural and nonmonetary factors affecting the labor market. Economists don't fully understand how these factors may be influencing our efforts to assess the meaning and measurement of full employment.

Second, if monetary policy waits until it is certain that the labor market has fully recovered before beginning to raise rates, policy will be far behind the curve. One risk of waiting is that the Committee may be forced to raise rates very quickly to prevent an increase in inflation. In so doing, this may create unnecessary volatility and a rapid tightening of financial conditions – either of which could be disruptive to the economy.

This would represent a return of the so-called "go-stop" policies of the past. Such language was used to describe episodes when the Fed was viewed as providing lots of accommodation to stimulate employment and the economy – the go phase – only to find itself forced to apply the brakes abruptly to prevent a rapid uptick in inflation – the stop phase. This approach to policy led to more volatility and was more disruptive than many found desirable.

For these reasons, I would prefer that we start to raise rates sooner rather than later. This may allow us to increase rates more gradually as the data improve rather than face the prospect of a more abrupt increase in rates to catch up with market forces, which could be the outcome of a prolonged delay in our willingness to act.

Conclusion

To summarize, my own forecast is positive. Second-quarter growth has rebounded, confirming that the disappointing performance in the first quarter was mostly weather related rather than a retrenchment to the ongoing recovery.

Unemployment continues to improve more quickly than many had expected, and inflation appears to be drifting up toward our 2 percent goal.

If monetary policy is to be truly data dependent, then our stance of policy must begin to change. I'm not suggesting a rate increase now, but changing the forward guidance would at least afford us the flexibility to gradually raise rates beginning earlier than currently anticipated.

Waiting too long to begin raising rates – especially waiting until we have fully met our goals for maximum employment – is risky because we cannot know when we have arrived. That could also put monetary policy behind the curve and could lead to a return to abrupt go-stop policies that in the past led to unwelcome volatility.