The Economic Outlook, Oil Prices, and Monetary Policy

Introduction
Pittsburgh is an important part of my District, and I always look forward to visiting here. Over the past couple of years, I have been using Pittsburgh as an example of a city in my District that has revitalized itself. Currently, the Pittsburgh economy is performing better than the nation in terms of job creation and unemployment.

I am not alone in singing your praises. As you may know, Pittsburgh has been recognized by both The Economist and Forbes as the most livable city in America. It has also been cited as the “best city to relocate to” and is currently among the top 10 “best cities to find a job.” Great people live here already, and great people want to move here because of the energy and enthusiasm this city offers.

Your conference here today, with its focus on working across disciplines to expand corporate growth and finance, is another example of that Pittsburgh energy and enthusiasm. I am sure you have a lot of new information to take back with you, and I applaud your efforts.

One important part of my job as a Reserve Bank president is to represent Pittsburgh and this region at the FOMC, or Federal Open Market Committee, meetings in Washington. The FOMC is the Federal Reserve’s policymaking body. The Committee decides on critical monetary policy issues, such as targets for short-term interest rates. Our objectives are to promote price stability and maximum employment. That is the dual mandate that the U.S. Congress has given the Federal Reserve.

Each of the 12 Reserve Bank presidents brings information about his or her region to the monetary policy process. While this regional input is important in understanding economic conditions, the Federal Reserve’s monetary policy is national in scope and responds to economic conditions in the entire country.

This afternoon, I will talk about national economic conditions. I will begin with my current outlook for the economic recovery and inflation, and describe some risks to that outlook. Then I will make some comments about the Federal Reserve’s monetary policy.

As always, the views I express today are mine alone and do not necessarily reflect those of my colleagues in the Federal Reserve System.

Economic Outlook—A Moderate Recovery
So let me begin with my outlook for the economy. Since the severe
The recession ended in June 2009, the economy has been recovering, but at a gradual and bumpy pace. Typically, our economy recovers with several quarters of strong growth following deep recessions, but in this recovery, the economy has been expanding only moderately.

More recently, though, the recovery appears to have established a firmer footing. The pace of hiring has picked up, and more industries have been adding workers. These are encouraging signs that we should see stronger job growth in the coming months. Also, consumer spending has shown more strength than most forecasters expected. These are good signs that the recovery is entering a virtuous cycle of growth. Rising employment, incomes, and profits are supporting growth in retail sales and business demand, which in turn should fuel further growth in employment, incomes, and profits.

Up to this point, the recovery has been supported primarily by strong growth in exports, manufacturing, and business investment in equipment and software. In the past year and a half, both exports and investment in equipment and software have grown at double-digit rates. Over the same period, manufacturing production has grown at a robust annual average rate of 8 percent. Looking ahead, I expect these sectors to continue to expand at strong rates and help sustain a solid pace of recovery.

So with this good news, why isn't everyone cheering? Well, there are many Americans who still don't have all that much to cheer about. Even though some economic sectors such as manufacturing have expanded at strong rates, the housing sector and labor markets are still lagging behind.

To many Americans, one of the most unforgiving aspects of the recession has been the continued problems in the housing sector. Over the past two years, housing values have not rebounded and this sector has been unable to provide the economy any lift. Even today, a large number of excess properties remain available for sale, and many homes are still in the foreclosure pipeline. At current rates of foreclosure resolution, we are looking at well over a year before the number of bank-owned properties begins to decline significantly.1

Under these conditions, many households lack the confidence to buy a home, and many builders see new construction as too speculative. I see these problems acting as a drag on economic growth. Historically, investments in new home construction and improvements to existing homes help the economy to snap back quickly from recessions and help to spur GDP growth. However, in the past six quarters, instead of helping to support the recovery, housing investment has fallen by more than 2 percent.

Another important and lingering problem is the loss of nearly 9 million jobs during the recession. While output has grown and the rate of job growth is finally picking up, we've still added back only 1.3 million jobs. Reflecting these labor market conditions, average household income excluding government benefits is still down nearly 7 percent from its level in 2007. And with incomes remaining weak, many households have not been able to rebuild much of the wealth they lost during the recession as their home values declined and the value of their financial investments fell sharply. In fact, a survey run by The Ohio State University indicates that the median household's net worth in 2010 was still down about 35 percent from 2007.2 Recouping these losses will take some time.

Despite the challenges we face in both housing and labor markets, I still expect the economy to continue to expand at a moderate rate, a bit above the average growth rate of 3 percent per year. That said, as a policymaker, I must consider the risks facing the economy. Rising...
energy and commodity prices pose one potential risk to the outlook. For example, increases in energy prices would effectively tax consumers, reducing their purchasing power, and in turn would modestly slow the pace of GDP growth. But perhaps even more importantly, if energy and commodity prices continue to increase sharply, people could start to worry about the consequences for inflation.

The Inflation Outlook—Moderate Underlying Inflation

So let me turn to my outlook for inflation. Americans have been hit with sharply higher prices for food and energy, causing a lot of pain at the grocery store and the gas pump. These price increases have been especially hard on lower-income households. Households in the bottom 20 percent of the income distribution, on average, spend 44 percent of their after-tax income on food and energy.

These higher food and energy prices have caused short-term inflation measures to rise. The natural question in these times is whether these higher prices will be enough of a driving force to cause a lasting increase in the rate of inflation. At this point, I don’t think they will, and let me explain why.

Large increases in food or energy prices tend to be temporary. History shows that they are often followed by sharp declines. For example, in 2006, oil prices rose significantly over the first eight months of the year but then dropped in the remainder of the year. While periods of rising food and energy prices cause inflation to rise temporarily, the subsequent periods of falling food and energy prices cause inflation to fall, also temporarily. To cause a lasting rise in inflation, these price increases have to be large enough and persist long enough that they spill over and cause sustained increases in a wide array of other consumer prices. At this point, there is no evidence of broad spillover, but as a central banker, I keep a close eye on this.

To assess the underlying trends in a broad array of consumer prices, my staff at the Federal Reserve Bank of Cleveland calculates and publishes an indicator known as the median CPI. This index is designed to provide a reliable measure of the average increase in a wide set of consumer prices. Research at the Bank has shown the median CPI to be a superior predictor of future inflation rates. To this point, inflation in the median CPI remains very low: just 1 percent over the past year. Based on the behavior of the median CPI, I don’t expect recent rises in food and energy prices to cause a broad spillover into a wide array of consumer prices, or in other words, a lasting increase in inflation.

In my view, several important factors will keep inflation in check. One of these factors is the continuing slow growth in wages, which helps determine the cost of producing goods and services and, in turn, the prices set by firms. Another factor is retailers’ reluctance to raise prices in the face of strong competition and soft business conditions. Our economy still has a way to go to more fully recover from the steep recession, which will restrain growth in wages and retail prices.

Another important factor in my outlook for inflation is the public’s expectation that the Federal Reserve will keep inflation contained. Despite the recent surge in food and energy prices, measures of longer-run inflation expectations remain below 2 percent. These measures come from bond yields and surveys of economic forecasters. While it may sound like a self-fulfilling prophecy to say that we will have low inflation because we collectively expect low
inflation, the relationship between actual and expected inflation has been borne out over history. One reason is that expectations of inflation play a crucial role in the price-setting decisions of firms. When firms expect lower inflation, they raise prices more slowly.

Based on this evidence, I expect the underlying trend in broad consumer prices, which is currently quite low, to rise only gradually toward 2 percent by 2013. Of course, just as I consider the risks to economic growth, I also need to consider the risks to my inflation outlook. Today I would like to talk through one potential risk: that is, continued sharp increases in energy and other commodity prices.

My inflation forecast is built on the assumption that energy and commodity prices will remain near current levels. But suppose these prices continue to surge for a sustained period of time. To assess the implications of such a possibility, my staff constructed an alternative forecast scenario, one in which energy and commodity prices accelerate sharply.

In this scenario, we assumed the same percentage increase in prices that we saw in 2007 and 2008. For example, the price of oil would rise above $140 per barrel by next year and would spike to about $170 per barrel by the end of 2013. Oil prices directly boost gasoline prices, so in this scenario households would see gasoline prices move above $5.00 a gallon. As a consequence, the overall inflation rate would temporarily rise by about a percentage point, and then gradually decline back to the underlying inflation trend.

But what happens to the underlying inflation rate in this forecast scenario? Using history as a guide, we can see that energy and commodity shocks don’t fully pass through to other prices. We would expect households and businesses to conserve energy and cut back on some other purchases. The overall economy would be expected to slow down as well. Both of these reactions would help to offset some of the pricing pressure that the shocks are producing. In this severe case, the sustained surge in energy and commodity prices would be expected to spill over to broader consumer prices, but the effects would be small and fairly gradual.

Let me remind you that the conditions in this scenario, while not impossible, are highly unlikely. In my judgment, the most likely outcome is that despite the recent spike in energy and commodity prices, we will see a continued moderate rate of underlying inflation, as I indicated earlier, gradually rising from its current level of about 1 percent but staying below 2 percent through 2013.

The Benefits of an Explicit Inflation Objective

So, with my outlook for a moderate recovery and underlying inflation gradually moving toward 2 percent, I’d like to turn to the implications of the outlook for monetary policy. The Federal Reserve sets the course of monetary policy to achieve our dual mandate of price stability and maximum employment.

Based on the outlook for the economy and inflation, the FOMC has kept monetary policy highly accommodative. Short-term interest rates have remained close to zero since the end of 2008, and the Federal Reserve has pursued a program of buying nearly $2 trillion of long-term securities to lend further support to the economic recovery.

The question the FOMC will eventually face is when to begin removing that policy accommodation. In preparing for FOMC meetings, I look closely at the outlook for GDP growth, employment, and inflation. I want to emphasize that it is the outlook that is critical in pursuing our policy objectives, not current economic...
conditions. FOMC members focus on the outlook because there is a significant delay between policy actions and when those policy actions affect the economy. At the same time, the FOMC must also consider various risks to its outlook and be prepared to adjust policy to stay on course.

As the FOMC’s most recent statement indicated, the Committee is watching carefully for any signs of an unanticipated spillover from oil and other commodity prices into underlying inflation measures. A key to preventing this spillover is to keep long-run inflation expectations anchored because, as I mentioned earlier, inflation expectations are an important determinant of inflation. The current stability in inflation expectations was not achieved just by good fortune. The public’s expectation that inflation will remain low and stable over the long run comes from their expectation that the Federal Reserve’s monetary policy will deliver low and stable inflation over the long run. As a participant on the FOMC, I believe that it is my responsibility to do everything I can to underscore confidence in our commitment to maintain price stability. But I understand that price stability can mean different things to different people. Today, the concept is vague and the FOMC has not established a formal inflation objective.

With the potential for inflation expectations to be more volatile in the face of energy and commodity price shocks, I think it could be an opportune time for the FOMC to be more specific and publicly announce an explicit numerical inflation objective. Establishing an explicit inflation objective would clearly communicate our policy intentions and affirm our resolve to achieve price stability. It would also help the public to better evaluate the effectiveness of our actions as events unfold.

Adopting an explicit numerical objective would have to be the decision of the whole FOMC. My own preference is 2 percent over the medium term, an inflation objective that is quite similar to the targets of many central banks around the world.

Although I remain committed to fulfilling both aspects of our dual mandate for price stability and maximum employment, I think it would be unwise for the Federal Reserve to establish a corresponding numerical objective for unemployment. The long-run sustainable rate of unemployment can move around for a variety of reasons, such as the demographic makeup of the population and changes in how labor markets function. Since the Federal Reserve cannot know what the sustainable level of unemployment is, or how it will evolve over time, it should not set a numerical objective for unemployment.

From my perspective, establishing an explicit inflation objective need not imply any material change in the current conduct of monetary policy. It should be clear from my remarks today that I fully support the FOMC’s most recent decision to continue our asset purchase program as originally scheduled, and its assessment that economic conditions are likely to warrant exceptionally low levels of the federal funds rate for an extended period.

Conclusion
These are challenging times for our economy, and they are complicated by the unrest we are seeing in the Middle East and North Africa, and the devastating human tragedy in Japan. In these times, it is important not only to develop a view of the most probable path for the economy, but also to consider potential risks to the economy and to be prepared to respond to them. For my part, I will continue to study the financial and economic situation to determine the right policy actions to fulfill the Federal Reserve’s dual mandate of price stability and maximum employment.