

[Home](#) > [For the Public](#) > [News and Media](#) > [Speeches](#) > 2011 > Perspectives on the Economic Outlook and Monetary...



Perspectives on the Economic Outlook and Monetary Policy

Introduction

Of course, the state of the economy is on everyone's minds these days. It seems that everywhere I go lately, people ask me about my economic outlook. They want to know if conditions are improving and if better days are ahead. This is understandable given that the economic crisis we went through was the worst in most of our lifetimes.

The economic outlook has become front and center for many of us. In fact, the economic outlook was the focus of a historic event that took place two weeks ago, when Federal Reserve Chairman Ben Bernanke held his very first press conference following the Federal Open Market Committee meeting in Washington. At that press conference, the chairman focused on the economic outlook, emphasizing the importance of the economic outlook in setting monetary policy.

The Federal Reserve releases its economic projections to the public four times a year. Until recently, those releases came a few weeks after our policy meetings along with the meeting minutes. Going forward, the chairman will hold press conferences immediately after these four meetings to present the Committee's economic outlook and to explain how the outlook is linked to monetary policy decisions. These press conferences will be another opportunity for Chairman Bernanke to help people better understand the Federal Reserve's thinking about how economic conditions are unfolding and perhaps inform the economic decisions that people make in their own lives.

Today, in my remarks, I want to elaborate on why the economic outlook is so important to the monetary policymaking process. Then I will talk about what goes into economic forecasting. Finally, I will share with you my economic outlook.

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

The Monetary Policy Process

To elaborate on the importance of the economic outlook to monetary policymaking, let me start with the basics of the monetary policy process. Monetary policy is the responsibility of the Federal Open Market Committee, better known as the FOMC. This Committee consists of the members of the Board of Governors in Washington plus the presidents of the 12 Federal Reserve Banks, who are members of the Committee on a rotating basis. The FOMC meets eight times a year in Washington to review economic and financial developments and then determines the appropriate stance of monetary policy. The

Additional Information

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goal of monetary policy is to achieve the dual mandate given to the Federal Reserve by Congress: price stability and maximum employment.

Each FOMC meeting begins with a review of conditions in financial markets since the time of our last meeting, and we get a sense of what financial market participants are thinking and expecting. Next comes a presentation from Committee staff on the economic outlook. Their outlook is actually sent to FOMC participants in the week prior to the meeting, and it serves as a very useful reference point for each participant. By determining where each of us agrees and disagrees with the staff's projections, the Committee can have a well-organized discussion about the economic outlook.

Following the staff presentation on the outlook, we have a go-round, where the 12 Reserve Bank presidents bring information gathered from our Districts, and then we give our outlooks for the national economy. The Federal Reserve Board members provide insights based on their area of expertise about the economy or financial markets. After this go-round, the staff presents some monetary policy options for the Committee to consider, and the group has another go-round where we share our views on monetary policy. At the end of each meeting, members vote on the policy action.

The Committee has always devoted a significant amount of time to discussing the economic outlook, and has provided some information about its outlook to the public since 1979. As part of its ongoing efforts to improve transparency, the Committee increased the frequency and content of its published economic projections in October 2007. Each FOMC participant now submits a multi-year projection for national output, unemployment, and inflation once each quarter. As I said earlier, a summary of those projections will be made public on a quarterly basis in a press conference after the meetings.

Economic Forecasting

The reason that the FOMC spends a considerable amount of time discussing the outlook for the national economy is because monetary policy is forward-looking, and unfortunately so much of the economic data we rely on are backward-looking. In other words, most of the economic data we get tells us what has already occurred. Monetary policy has to be forward-looking because the decisions the FOMC makes at a point in time don't affect economic growth and inflation for some time in the future. That's why economic forecasting is so important. The FOMC's economic projections help us learn not just how the economy might evolve in the future, but they also help us to understand how the decisions we make today will likely affect the economy and inflation in the future.

To be sure, economic forecasting is far from precise. A wise person once said, "A good forecaster is not smarter than everyone else, he merely has his ignorance better organized." So let me briefly explain how the forecasting process works in my Reserve Bank.

First, the economists at my Bank collect data on all of the major sectors of our economy. I think of data as the raw material of a forecast. The data help me consider how the economy has performed under similar circumstances in the past when the data looked roughly the same. This is just a starting point, though.

The second step is to use this data as inputs to economic models. These models capture the relationships in the data to paint a more complete picture of how economic conditions might evolve. For example, when energy prices are rising sharply, as they most certainly have been recently, I want to know how these changes are

likely to affect consumer spending. Then, by extension, I would like to know how the changes in consumer spending will affect business capital spending plans, industrial production, and so on.

Economic models help put these interrelationships into perspective to see how major economic forces are influencing the economy. Think of a composer who takes musical notes and combines them into a musical score. Just as the score provides a framework for the individual notes to make sense, a forecasting model provides a framework for economic data to make sense. But, like the economic data, models are just a step along the journey in forecasting. They are essentially an average of the economic relationships that existed in the past, and they assume that these relationships will hold in the future. Of course, no past experience occurs again in exactly the same way. The economy inevitably changes and evolves in ways that cannot be captured precisely with any mathematical model.

The third and possibly most important piece of the forecasting process is judgment. I think that one of the best ways to develop a good sense of judgment is to talk regularly with businesspeople on the ground, who are often able to see trends emerging far ahead of our economic data. I am in frequent contact with my Bank's boards of directors in Cleveland, Cincinnati and Pittsburgh. I also speak regularly with members of our many business advisory councils across the District. I make judgments about the outlook based on that information. Judgment helps me gauge just how closely conditions in the current marketplace are following historical trends or how far away they are drifting from those trends.

So the interplay of data, models and judgment about current events is vital in how my staff and I structure an economic forecast. Multiply this process many times over among the FOMC participants, and the result is that each person brings his or her own forecast to the meeting.

Now that you know more about the process, I don't think you would be surprised to hear that sometimes there are differing opinions about the outlook among the [current] 17 FOMC participants. I don't find these differences to be a cause for concern. In fact, the differences of opinion generally lead us to explore the issues more fully and help us formulate better monetary policy. Just because some FOMC participants may have different opinions about the economic outlook, and even the most appropriate course for monetary policy, does not mean that we are each seeking different monetary policy objectives. Each one of us is focused on achieving the FOMC's dual mandate of price stability and maximum employment.

At his press conference a couple of weeks ago, Chairman Bernanke released the FOMC's most recent projections, and he took some time to discuss what we call the central tendency of the Committee's views. This measure removes the three highest and three lowest among the 17 projections and conveys a sense of the majority view on the outlook. Using that yardstick, the FOMC's outlook calls for the economy to grow slightly above 3 percent this year and to rise to between 3-1/2 percent to slightly above 4 percent in 2012 and 2013. With this outlook for growth, the unemployment rate falls to roughly 8-1/2 percent at year's end and declines gradually to around 7 percent at the end of 2013. We expect inflation to be temporarily elevated this year due to developments in oil and commodity markets, registering about 2-1/2 percent for the year as a whole, but falling back below 2 percent in the next couple of years. Of course, these projections assume no further shocks to the economy.

My Economic Outlook

For the most part, my outlook falls within the Committee's central tendency, but let me go into more detail on my outlook for the economy. Following a very deep recession, historical patterns would suggest a stronger recovery. Unfortunately, historical patterns have not held true this time around. In fact, this recovery has moved along at a frustratingly slow pace.

So what are the factors that have been holding back growth? For the past two years, the economy has been recovering from the worst recession since the Great Depression. People have become cautious, and somewhat more reluctant to invest and spend. We are still struggling with weak labor and housing markets, and fiscal challenges at all levels of government. These factors are creating some stiff headwinds for the economy.

Nine million jobs were lost in the recession, and we have added back only 1.8 million of those jobs in the past two years, which means that we still have a long way to go before labor markets can be described as healthy. In April, the economy added 244,000 jobs, but the unemployment rate ticked back up to 9 percent. These numbers highlight the slow pace of improvement in the labor markets. Labor force participation is at low levels, which reflects a large number of discouraged workers who have simply given up on finding a job. I estimate that even at the end of 2013, the unemployment rate will be around 7 percent. This is still above my longer-run projection for the unemployment rate, which is around 5-1/2 to 6 percent.

Here in the Cincinnati region, economic conditions are pretty much similar to those in the nation. The unemployment rate in this region now sits at just above 9 percent. The Cincinnati region, along with the rest of Ohio, fared worse than the nation in terms of job losses. Little progress has been made in recovering those losses, but we have seen some job growth in the healthcare and education sectors.

Understandably, the massive loss of jobs we have experienced in our country has taken its toll on household incomes and consumer spending. Wage and salary increases in this expansion have been anemic, especially for lower-income households. In fact, when you exclude government benefit payments, average household income is still nearly 7 percent lower than it was in 2007.

Typically, we can count on the housing sector to help add fuel to an economic recovery, but again, this is not the case this time around. Home prices are still under pressure, inventories of existing homes are still very high, and foreclosures continue to be a problem. Under these conditions, many people lack the confidence to buy a home, and many builders see new construction as too speculative. Historically, investments in new home construction and improvements to existing homes help the economy snap back quickly from recessions and help to spur GDP growth. However, there is actually less investment in housing taking place in our economy today than there was at the bottom of the recession.

Compared to the rest of the nation, the Cincinnati region did not see a sharp run-up or decline in home prices. Still, that does not mean the Cincinnati area escaped all the problems that have been inflicted on the housing sector. Cincinnati's construction of new homes has fallen quite a bit. Between 2005 and 2010, building activity (as measured by the number of permits issued) declined by roughly 75 percent in this region. That weak pattern has continued in 2011, and it is similar to the decline experienced in Ohio and the nation. Moreover, the region is still dealing with significant numbers of homes in the delinquency and foreclosure process, and this is likely to affect housing markets for quite awhile.

Finally, fiscal pressures are weighing down both the national and

regional economy. Budgets at the municipal, county and state levels are under a lot of pressure and are facing funding gaps that will need to be addressed. The public sector has traditionally been a steady source of job growth even when the private sector is weak. But now, even as we are seeing jobs come back in the private sector, we see continued job layoffs in the public sector.

Overall, my current outlook calls for the economic recovery to continue at a gradual pace over the next few years, with annual growth at just above 3 percent a year. That is a fairly slow pace, considering how much ground we have to make up. For example, in my outlook, I expect it could take about five years for the unemployment rate to reach its longer-run sustainable rate of 5-1/2 to 6 percent.

I mentioned earlier that the FOMC has a mandate to promote both maximum employment and price stability, so now let me turn to my outlook for inflation. The recent run-up in oil and other commodity prices has boosted inflation to an annualized rate of nearly 6 percent during the first three months of the year, but, like most of my colleagues on the FOMC, I do not expect inflation to remain above 2 percent beyond this year.

For inflation to remain elevated on a sustained basis, commodity and oil prices would have to be high enough and persist long enough to spill over and cause sustained increases in a wide array of other consumer goods. So far, that has not happened. For example, if you strip food and energy prices out of the CPI, that 6 percent inflation rate I just quoted you drops to about 2 percent. History shows that commodity price increases seldom pass through into other prices on a sustained basis. In addition, consumers purchase more services than goods, and prices for services are affected more by labor costs, not oil and commodity prices. That means that with no pressure to raise wages, there is little pressure to raise prices for services. Still, I realize that high commodity and oil prices and weak income growth cause a lot of pain for households.

At the Federal Reserve, we also pay a lot of attention to how people are thinking about inflation. A critical measure we look at is the inflation expectations of consumers and businesses, because our research shows that inflation expectations greatly influence the actual path of inflation over time. If people come to expect a higher inflation rate into the future, they tend to make decisions about wage and price setting that actually push inflation in that direction. While inflation expectations have been stable, I am watching the situation closely because stable inflation expectations are necessary for maintaining price stability over time.

Over longer periods, monetary policy is the sole determinant of the average rate of inflation--but is only one of many factors affecting employment and long-term interest rates. Put another way (to paraphrase the late Milton Friedman), in the long run, inflation is a monetary phenomenon, while trends in employment depend on other forces such as growth of the labor force and technological advances. Monetary policy promotes the fastest sustainable rate of economic growth by promoting price stability.

Given my outlook, I think that the current stance of monetary policy, with short-term interest rates close to zero, is appropriate and supports the FOMC's dual mandate of price stability and maximum employment. In fact, my outlook for the economy that I have been discussing is based on the Committee keeping the federal funds rate close to zero for an extended period of time.

Nevertheless, monetary policy will eventually have to become less accommodative, and we have been developing the tools that we will

use to exit from our current policy stance. I am confident that we will be ready to use them when the time is right.

Conclusion

As a Federal Reserve policymaker, 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. I will continue to rely on data, models, and judgment to inform my economic outlook.

In the critical area of judgment, my staff and I will also continue to listen to the businesspeople in this District to hear the challenges you are facing and some of the signposts you are seeing on the horizon. Through the Federal Reserve Bank of Cleveland's Cincinnati Board of Directors, through our business advisory councils in Cincinnati, Dayton, and Lexington, and through opportunities such as this one today here at Xavier, we keep in close contact with the business community in this region.

I also encourage all of you here today to stay in touch with us as well. We are listening.