Economic Outlook

Presented at the Philadelphia 100 Signature Event

Hosted by the Entrepreneurs Forum of Greater Philadelphia

Federal Reserve Bank of Philadelphia

January 12, 2010

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FEDERAL RESERVE BANK
OF PHILADELPHIA

The views expressed today are my own and not necessarily
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Introduction

Good evening. Welcome to the Federal Reserve Bank of Philadelphia, and thank you for inviting me to help you launch the new year. For more than two decades, the Philadelphia Fed has hosted regular meetings of the Entrepreneurs Forum of Greater Philadelphia. Tonight we are delighted to host this special program tailored to current and past honorees of the Philly 100, the region's fastest growing, privately held firms. Whether you represent one of these firms or are one of their financial supporters, you are an integral part of entrepreneurial activity.

I believe that the entrepreneurial spirit is an essential element of the American economy and a key source of its vitality and resiliency. More than any governmental actions, your actions as entrepreneurs in the free marketplace help ensure that our economy remains vibrant and as productive as it can be.

The Importance of Entrepreneurship in the Economy

As we emerge from the recent financial crisis and the deep recession it generated, this entrepreneurial spirit will be important for a successful recovery. Small businesses have created 64 percent of the nation's new jobs in the past 15 years; employ about half of the nation's private-sector work force; and provide half of the nation's nonfarm, private real GDP.[1]

Entrepreneurs steadily recreate the economy, generating jobs and fostering innovation. Among small businesses, firms less than five years old account for a substantial amount of net job growth in the U.S.[2] Moreover, job creation from startups is much less sensitive to downturns than job creation in the overall economy.[3]

In fact, a number of the region's fastest-growing companies on the current Philly 100 list were founded during the recessions of 2001 and 1991. Indeed, many of today's renowned companies

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[1] U.S. Small Business Administration Office of Advocacy. September 2009. Data available at www.sba.gov/advo/stats/sbfaq.pdf.
[2] Robert E. Litan and Dane Stangler, *Where Will the Jobs Come From?* Ewing Marion Kauffman Foundation (November 2009).
[3] Dane Stangler, *The Economic Future Just Happened*. Ewing Marion Kauffman Foundation (June 2009).

were founded in recessions, depressions, or bear markets, including Microsoft, Disney, Genentech, McDonald's, Southwest Airlines, and Johnson & Johnson, to name a few. Furthermore, over half the companies on the 2009 Fortune 500 list were started during a recession or bear market.[4]

Entrepreneurial small businesses also drive innovation, producing 13 times more patents per employee than larger companies do.[5] Inventions often lead to innovations in technologies that can ultimately raise productivity growth. Economic research looking across countries and at different regions and industries within the U.S. has underscored the importance of innovation and invention in raising an economy's productivity.[6]

To a large extent, innovation is enhanced through the exchange of ideas among individuals, which economists call "knowledge spillovers." Meetings such as this one are one way to promote such exchanges of ideas in our region. Indeed, research by Philadelphia Fed economists has noted that cities such as Philadelphia serve as centers of creativity and innovation because they are well-disposed to exploit knowledge spillovers and thereby increase the productivity of local investments in R&D.[7] By increasing the rate of innovation, knowledge spillovers become an important driver of economic growth in the economy.

Clearly, entrepreneurs have the ability to recreate the economy and generate jobs in all sectors of our economy. Yet, even those with the hardiest entrepreneurial spirit might well have grown weary during the turmoil of the past two years. Starting in 2007, key financial markets began to falter. In the two years since then, the Federal Reserve has taken unprecedented actions in its role as lender of last resort as well as in monetary policy to mitigate the effects of this crisis and support a return to economic growth.

Small businesses have faced unique challenges in the financial crisis and recession. In Congressional testimony on November 30, Jon Greenlee, associate director of the Board of Governors' Division of Banking Supervision and Regulation, noted that small businesses rely on banks for 90 percent of their financing needs, compared to large businesses, which use banks for only 30 percent of their financing. He noted that 27 million small businesses nationally have approximately $1 trillion in debt outstanding, but that access to credit markets, in the current environment, remained a challenge. He also noted that demand for credit has remained weak, with inventory and capital spending levels at near historic lows.[8] I hear many anecdotal stories

[4] Stangler (June 2009)
[5] U.S. Small Business Administration Office of Advocacy. September 2009. Data available at www.sba.gov/advo/stats/sbfaq.pdf.
[6] D. Guellec and B. van Pottelsberghe de la Potterie, "R&D and Productivity Growth: Panel Data Analysis of 16 OECD Countries," OECD Science, Technology and Industry Working Papers 2001/3, OECD Publishing (2001).
[7] See Gerald Carlino, Satyajit Chatterjee, and Robert Hunt, "Urban Density and the Rate of Invention," *Journal of Urban Economics* (2007), pp. 389-419.
[8] See testimony by Jon Greenlee, associate director, Division of Banking Supervision and Regulation, Federal Reserve Board of Governors, before the Subcommittee on Oversight and Investigations, Committee on Financial Services, U.S. House of Representatives, November 30, 2009.

of small businesses having difficulty obtaining credit, and it is true that banks face their own set of challenges as they rebuild their balance sheets. Yet it is common for prospective borrowers to face greater scrutiny when the economy is soft and revenue prospects are uncertain. This cyclical pattern typically abates as firms' balance sheets and profits begin to strengthen. Credit, like unemployment rates, tends to be a lagging, not a leading indicator of a recovery.

The Fed has lent support to the flow of credit to businesses as well as households during the crisis. The Fed and Treasury's joint credit facility, the Term Asset-Backed Securities Loan Facility (TALF), has helped finance 480,000 loans to small businesses since it began in November 2008. In addition, the Federal Reserve is working with other banking agencies and Congress to encourage banks to deploy capital and liquidity in a responsible way that avoids past mistakes and does not create new ones.

Financial market conditions have improved significantly since this time last year, and so has the overall economy. Full recovery, however, will take time. So let me turn to how I see the outlook for the economy and inflation, as well as some of the uncertainties that will influence our policy choices in the year to come.

The Outlook for Growth and Employment

After a very sharp decline in economic growth in the first quarter of 2009 and a slight decline in the second quarter, real GDP grew moderately in the third quarter at a 2.2 percent annual rate. I expect that when we see the real GDP growth figure for the fourth quarter at the end of this month, it will be quite a bit stronger than in the third quarter. These data suggest that the recession is likely over and the economy is in recovery — perhaps not as strong a recovery as some in the past but one that I believe will be sustainable even as the fiscal and monetary stimulus programs eventually wind down.

The evidence for sustainability of the recovery is increasingly broad-based. Of particular note, the long decline in housing activity appears to have bottomed out, as home sales and housing starts have come off the lows they reached in the early part of last year. Home prices appear to have stabilized and have even started to rise in some areas.

In addition, a number of indicators point to increased activity in the manufacturing sector. Industrial production has risen since last June, and the Institute for Supply Management's index of manufacturing activity ended 2009 at its highest level since April 2006. The monthly Philadelphia Fed Business Outlook Survey's index of manufacturing activity has been in positive territory since last August and rose in December to its highest level since April 2005. Even our manufacturing employment index increased in December and has now returned to positive territory.

Consumer spending, while far from robust, seems to be holding its own in the face of slow growth in personal income. The monthly figures on consumer spending in 2009 were distorted by the “cash-for-clunkers” program, which moved some spending on autos into the summer months and probably diverted some spending away from other goods and services that households may have been planning to buy. The monthly consumer spending figures have also been affected by swings in gasoline prices. With all of this noise and government-induced reallocation of spending, it is difficult to get a very accurate reading on the underlying trend in consumption.

Even so, recent monthly data have shown some increases in consumer spending outside of autos and gasoline, which is encouraging. Excluding gasoline and autos, the year-over-year change in retail sales has returned to positive territory. In addition, the holiday season showed some promise. Early reports from retailers suggest an improvement from last year’s dismal holiday shopping season. However, I am not expecting very strong growth in consumer spending in the coming quarters, since unemployment will remain elevated for some time and will continue to restrain income growth.

Other elements that support an ongoing recovery include the prospect of a rebound in inventory accumulation following the very sharp contraction during the first part of the year and the improvement in growth in other parts of the world that is resulting in a significant expansion in our exports.

The improved outlook is also supported by the steady improvement in financial conditions. Interest rates on commercial paper and corporate borrowing have fallen and their spreads over Treasury securities have narrowed significantly since the first of the year. Banks have raised capital and are continuing to strengthen their balance sheets. Yet, as I noted earlier, the recovery of financial markets is not complete.

I believe we will not be able to determine how well the financial system has healed until the Federal Reserve withdraws more of the extraordinary amount of support it has provided. By design, many of the Fed’s liquidity facilities were priced so that they would be less attractive as markets improved. So I have been encouraged as banks and other borrowers have relied less on the Fed's lending facilities and have relied more on financial market funding.

In addition to the liquidity facilities, the Fed has been attempting to support the mortgage market through its purchases of mortgage-backed securities, or MBS. Indeed, we have been a very large participant, perhaps crowding out many private purchasers. We have indicated that we will complete our planned $1.25 trillion of purchases during this quarter. I believe it is important that we do so and reduce our participation in this market, so the private market can once again resume a significant role. It cannot do so as long as the Fed is the dominant player and we would

risk delaying the return to normal market functioning rather than promoting that return were our sizable purchases to continue.

There remain uncertainties and risks to the recovery. The commercial real estate market has not turned the corner and poses some risk to small- and medium-sized banks whose portfolios are heavily concentrated in this sector. This does pose some risks in the near term, but I believe that these risks will lessen as the economy recovers. As consumer spending recovers and unemployment declines, commercial real estate values should begin to stabilize.

The current rate of unemployment is now 10 percent. This continues to be a major concern for all of us. I would not be surprised if it edged slightly higher before beginning a gradual decline. As we track this metric in the coming months, we all need to keep in mind that changes in the unemployment rate and employment growth, like credit, typically lag output growth. Businesses need to recover before they start hiring again. So even with better real GDP growth over the next few quarters, the unemployment rate and payroll employment will take a little longer to show significant improvement. So far, the most encouraging sign from the labor market is that the pace of job losses has slowed substantially during the latter part of 2009. I am optimistic that unemployment rates will fall by the end of this year. However, we also need to realize that it will likely be some time before we see the unemployment rate return to more acceptable levels.

Given these developments, I expect real GDP growth from fourth quarter to fourth quarter to be between 3 and 3½ percent this year and in 2011. These rates of growth are slightly above what I believe is the underlying trend growth rate of the economy of about 2¾ percent.

There is another challenge that I believe is acting to inhibit growth. Large fiscal deficits and the prospects for significantly higher taxes to fund new federal programs have made many businesses reluctant to undertake new investments or to rehire workers. This hesitancy may continue to dampen the recovery until Congress and the administration make clear their plans for fiscal policy. More important, what fiscal policy choices they make may affect longer-term prospects for the economy, which I will return to in a moment.

The Outlook for Inflation

While the outlook for economic growth is becoming clearer, the outlook for inflation continues to be harder to read. Keep in mind that a year ago, many people were concerned about deflation, or falling prices, rather than rising prices. After all, the headline consumer price index (CPI) fell at an 8 percent annual rate in the fourth quarter of 2008 and at about a 2.5 percent annual rate in the first quarter of 2009.

For the second and third quarters of 2009, though, headline CPI inflation averaged about 2.5 percent at an annual rate — a big difference from the over 5 percent *deflation* of the previous two quarters. Core CPI, or CPI excluding food and energy, exhibited a similar but less dramatic pattern. Core CPI inflation averaged just 1 percent over the last quarter of 2008 and the first quarter of 2009, but in the second and third quarters of 2009, core CPI inflation averaged about 2 percent. On a year-over-year basis, it has remained close to 1.5 percent since last summer.

Looking back at the data, I believe the deflationary fears were just that — fears, driven mostly by falling oil and commodity prices in late 2008 and early 2009. As those commodity prices stabilized, and as policymakers made clear their commitment to keep the overall price level stable and prevent deflation, fears of a sustained deflationary trend faded away. My view is consistent with various consumer and market measures of expected inflation, which fell noticeably in the early part of the year, but have risen since then.

Yet, there appears to be considerable uncertainty about the prospects for inflation over the next two to five years. Inflation is a monetary phenomenon, and the stance of monetary policy has been very accommodative during the last 18 months. An appropriate exit strategy to withdraw or restrict the massive amount of liquidity that we have made available to the economy will have to be put into action to keep the inflation rate from rising to unacceptable levels. On the other hand, some believe that the high unemployment rate or economic slack will help keep inflation low, or perhaps even falling, for some time to come, thus obviating the need for an exit any time soon. These divergent forecasts will ultimately need to be reconciled.

While monetary policy has faced many challenges during the financial crisis, the challenges do not go away with the normalization in the financial markets. I believe that one of the Fed’s toughest challenges will be executing an appropriate exit strategy. How and when will we move to normalize policy, shrink our balance sheet, and return interest rates to a more normal level consistent with our longer-term objectives?

In timing this exit strategy, policymakers must keep in mind the important role that inflationary expectations play in the dynamics of inflation. The Fed's credible commitment to keep inflation low and stable is critical to anchoring those expectations. So the Fed must be free to act in a way that assures the markets and the public that it will take the necessary steps to keep inflation in check. Otherwise, expectations can become unanchored, and inflation will rise regardless of the amount of unemployment in the economy. In fact, anyone who remembers the 1970s can recall a time when the U.S. had some of the highest inflation rates in the post-World War II era while we also had high rates of unemployment and low resource utilization. Thus, economic slack is neither a necessary nor a sufficient condition to ensure low inflation.

Fortunately, so far, inflation expectations, especially longer-term expectations, continue to be well anchored. To ensure that the public does not lose confidence in the Fed's commitment to keep inflation low and stable, I believe the Fed will need to withdraw the extraordinary amount of liquidity it has provided to the economy and begin to raise interest rates as the economy continues to improve and financial markets return to more normal operation. If it fails to do so, rising inflation expectations could prompt workers to demand higher wages and firms to demand higher prices to head off the expectation of higher costs, thus setting off a burst of inflation.

Monetary policy's effect on the real economy and on inflation works with a lag. Therefore, policymakers need to think about how the economy will be performing and what the inflation outlook will be next year and beyond. While policymakers may have different outlooks for the economy and inflation over the next couple of years, we share the common objectives of sustainable growth and price stability.

The Outlook for Monetary Policy

As I mentioned, my projection is for economic growth to be between 3 and 3½ percent over the next two years. Stronger economic growth means stronger demand for credit, which in turn means upward pressure on real, or inflation-adjusted, interest rates. As long as inflation is near its desired level and inflation expectations are well-anchored, the targeted federal funds rate should increase as well. This increase in rates must occur well before the unemployment rate or other measures of resource slack have diminished to acceptable levels. If we fail to do so, we run the risk of keeping real interest rates too low for too long and injecting liquidity into a growing economy at a pace that will create inflation above desirable levels later in the business cycle. That could potentially distort asset prices and sow the seeds of another crisis. If this were to happen, the Fed would lose its credibility to preserve low and stable inflation.

Taking such forward-looking policy actions is not an easy task. Neither the public nor policymakers can easily observe real interest rates; yet they do change with changes in economic conditions. So judging the appropriate response of monetary policy at any point in time can be quite challenging. We must assess what the current data and market interest rates are telling us about the future, and we will need to be prepared to act depending on the current and prospective state of the economy and inflation.

Before I close, I would like to return briefly to the implications of continuing large fiscal deficits. The Congressional Budget Office has projected that spending by the government is likely to lead to a growing ratio of debt to GDP for the country into the foreseeable future. That is neither desirable nor sustainable. We will at some point have to either raise taxes or cut spending. However, that will require difficult choices. The only other alternative is to print money, which creates inflation — a form of tax on money. In country after country when governments use the

printing press to finance large government deficits, the result is high and volatile inflation, accompanied by higher interest rates, a weaker currency, and a general loss of confidence in the government. This is the fundamental reason that most governments have chosen to grant their central banks independence from the short-term political process — that is, to separate the spending decisions from the decision to print money. It is a way to prevent governments from using the printing press in lieu of more difficult taxing and spending choices. It is also an important part of our government's structure of checks and balances. Allowing the political process to unduly influence, or even to *appear* to influence, the setting of monetary policy can be costly to a nation. Thus, it is extremely important that the Fed, especially in times of large fiscal deficits, not become politicized or lose its ability to conduct independent monetary policy.

Conclusion

In conclusion, the economy is emerging from a severe recession with moderate growth of economic activity and a low rate of inflation. Unemployment rates will begin to decline by the end of 2010 but will lag the rest of the economy, as is typical for this indicator. Conditions in financial markets have been improving, and as the need for the extraordinary provision of liquidity continues to wane, the Fed will further unwind its lending programs. Withdrawing that liquidity in a timely manner will be important in keeping the outlook for inflation and inflation expectations low and stable. This is the key contribution that monetary policy can make in creating an economic environment that is beneficial to small businesses and entrepreneurs.