

# Economic Outlook

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Delaware State Chamber of Commerce

DuPont Country Club, Wilmington, Delaware

May 7, 2010

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Charles I. Plosser

President and CEO  
Federal Reserve Bank of Philadelphia



FEDERAL RESERVE BANK  
OF PHILADELPHIA

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

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**Introduction**

I want to thank the Delaware State Chamber of Commerce for organizing this special event. I welcome the opportunity to speak to your organization — an organization that represents so many of the diverse businesses in our region. And thank you, Ted Cecala, for that kind introduction. Many of you may know that Ted serves as one of three bankers on the Philadelphia Fed's nine-person board of directors. The mix of bankers, business people, and community leaders that serve on our board helps ensure that the Philadelphia Fed brings a Main Street perspective to the nation's central bank. Prior to joining our board in 2008, Ted was the Third District's representative on the Federal Advisory Council, a group of 12 bankers from around the nation who advise the Federal Reserve Board of Governors in Washington. So Ted has been involved with the Fed for a number of years and we thank him for his service.

Today I will discuss the state of the economy, which is finally emerging from the worst financial crisis since the 1930s and one of the deepest recessions on record. I believe the economic recovery began in the middle of last year, although the arbiters of such business cycle dates at the National Bureau of Economic Research have yet to make that call. I suspect many here in Delaware would be hard pressed to declare the recession over in this region. The national recovery is not expected to be as strong as typically seen after a deep recession. But notwithstanding yesterday's volatility, financial markets are working again, there have been encouraging developments in the labor market, and the recovery is becoming more broad-based. Given the depth of the hole we are trying to climb out of, full recovery will take time. On balance, I believe the recovery is on a sustainable path and will continue even as the effects of fiscal and monetary stimulus wane.

After sharing with you my perspectives on the U.S. and Delaware economies, I will discuss some of the financial regulatory changes now under consideration in Washington and how these reforms would affect the Federal Reserve and our economy. Before continuing, I should note that these are my views and not necessarily those of my colleagues on the Federal Open Market Committee.

## Economic Outlook

After declining sharply for a year, economic growth stabilized in the middle of last year and then turned positive, growing at an annual rate of nearly 4 percent in the second half of 2009. The data released last Friday estimate that growth expanded at a respectable 3.2 percent annual rate in the first quarter. I expect real GDP growth from fourth quarter to fourth quarter to be around 3½ percent this year and next, somewhat stronger than the underlying trend growth rate of the economy, which I believe to be about 2¾ percent.

Of course, no recovery is entirely smooth. There will be some ups and downs along the way. In the housing sector, we are certainly seeing a mix of both good and bad news. Many housing indicators appear to have stabilized, but at depressed levels, even with the support of low interest rates, federal stimulus programs, and lower housing prices. New and existing home sales have been bolstered recently by the homebuyer tax credits introduced last year. However, even with this program, we have yet to see a sustained upward trend in sales. Going forward, a large inventory of houses will likely limit the growth of housing starts and permits for some time. However, I am encouraged that some regional business contacts in home building report considerably stronger sales this year compared to last year, even among buyers who are not eligible for the tax credit.

During the recession, uncertainty about the depth and length of the downturn, very weak demand, and difficulties in getting credit caused businesses to hunker down, cut costs, and refrain from spending. Yet as firms have gradually become more convinced that a sustainable recovery is underway, and as financial conditions have strengthened, business sentiment has improved. With it, so has business spending, which appears to be on a solid upward trend. Businesses also began to rebuild inventories in the first quarter after sharp cuts last year. In fact, some of the big swings in GDP growth from sharply negative to positive in the past year reflect the roller-coaster movements in inventories from sharp cuts toward accumulation. Even if we exclude inventories, final sales have grown in the past four quarters.

Some firms, particularly small to medium-sized firms that are dependent on bank financing, still report having trouble obtaining credit. For example, about a quarter of manufacturers in our region responding to a special question in our Business Outlook Survey said they had some difficulty getting long-term financing for capital spending. A fifth of those surveyed reported trouble getting financing for short-term uses, such as meeting payrolls or acquiring inventory. One expects that firms would experience some tightening of credit terms during a recession. As the recovery gains momentum, credit conditions will ease further for firms of all sizes, which will support business spending.

Consumer spending, which makes up about 70 percent of GDP, has been stronger in recent months. Real consumer spending grew at almost a 3-3/4 percent annual rate in the first quarter. Some of this rise reflects the improvement in household balance sheets, as consumers have paid down debt. Household wealth has begun to rise with the rebound in equity prices over the past year and stabilization in house prices. The better consumption numbers also likely reflect some pent-up demand after the weakness we saw during the recession. Indeed, the fourth-quarter over fourth-quarter decline in real consumer spending in 2008 was only the third such annual decline since World War II, an indication of just how deep the recession was. Even so, I expect the growth in household spending will not be as strong as in many previous

recoveries because it will take some time for labor markets to come back and incomes to begin to grow more robustly.

Fortunately, we are finally starting to see positive job growth. Today's data show that U.S. nonfarm payrolls added 230,000 jobs in March and 290,000 jobs in April. Even adjusting for the temporary hiring for the U.S. Census, these are solid increases and welcome news after more than a year of job losses. Still, despite these job gains, the unemployment rate remains very elevated at 9.9 percent in April, up slightly from the 9.7 percent recorded in March as more people returned to the labor force. Even so, the unemployment rates in March and April are down slightly from the peak of 10.1 percent last October. You will recall that changes in the unemployment rate and employment growth typically lag output growth. Businesses need to be convinced that the recovery will be sustained before they start hiring in earnest. With improved real GDP growth over the next few quarters, I expect payroll growth will strengthen over the rest of this year and next. The unemployment rate will gradually decline, but it will take some time before it returns to a more acceptable level. We cannot forget that more than 14 million people are unemployed and more than 6 million people have been out of work for more than six months. The possibility that job growth is weak during this economic recovery is an uncomfortable aspect of the outlook.

We also need to watch the commercial real estate market, which continues to lag the rest of the economy, as is typical in recoveries. Weakness in this sector could pose problems to small and regional banks that hold commercial real estate loans in their portfolios. While regulators have urged lenders to make prudent decisions and to continue lending to creditworthy borrowers, strains on banks resulting from these exposures could adversely affect credit flows to local businesses and consumers. I expect these risks will lessen and commercial real estate values will stabilize as the economy recovers, but it will likely take some time before we see growth in this sector.

Another risk to the forecast is the recent developments in Greece, where concerns over unsustainable fiscal deficits have led to downgrades of Greek sovereign debt and potential contagion to other countries with similar deficit problems, such as Portugal, Spain, and perhaps others. Renewed financial market turmoil could retard the recovery in the U.S., and we are following developments in Europe closely.

I have discussed some of the downside risks to my growth forecast, but it is important to recognize that there are upside risks as well. In particular, almost all of the forecasts, including my own, are considerably weaker than what the historical evidence would suggest. In particular, deep recessions are most frequently followed by sharp rebounds, not modest ones. Thus, we could be overestimating the effects of headwinds in our baseline forecasts, in which case, growth could turn out to be higher than the 3-1/2 percent that I currently expect in 2010 and 2011.

Let me now turn to the economy here in the Third District and, more specifically, in Delaware. Our District did not experience as severe a downturn in residential construction and house prices as some other parts of the nation. The year-over-year declines in house prices in the Wilmington and Dover metro areas, for example, have been only slightly worse than in the nation as a whole. Nevertheless, the impact of the economic and financial crisis has been severe across our region. Some areas that had previously been relatively immune to national

economic recessions have this time experienced much sharper declines in business activity and rapid increases in unemployment. That has certainly been the case in Delaware.

Delaware's unemployment rate, which had run near 4 percent or lower in the decade before this recent recession, shot up to over 8 percent last year and continued to rise this year, reaching 9.2 percent in March. Like the nation, however, our District and Delaware have finally begun to see some job growth; indeed, Delaware payrolls showed a nice increase in March. After recent struggles, there are other positive developments in the state. Plans to resurrect an oil refinery are underway, as is production of a hybrid electric vehicle plant. Both of these facilities will help restore lost jobs and support industry in Delaware.

If asked to characterize the view among my regional business contacts, I would say they are cautiously optimistic, and my hope and expectation is that sentiment will continue to improve as the recovery gains momentum over the rest of the year.

### **Outlook for Inflation and the Normalization of Economic Policies**

Turning to inflation, I believe it will remain subdued in the near term. Headline CPI inflation rose at less than a 2.5 percent rate over the 12 months ending in March. Core CPI inflation, or CPI excluding food and energy, has decelerated from about 1-3/4 percent for the 12 months ending last December to about 1.2 percent in the 12 months ending in March. As the economic recovery strengthens, I expect inflation to be around 2 percent in 2010 and to accelerate to around 2-1/2 percent in 2011.

Despite the recent low numbers, I do not see much risk of deflation — that is, a sustained decline in the level of prices. Indeed, I believe that the risks to inflation in the medium to longer run are on the upside. In order to keep inflation expectations well anchored and prices stable, monetary policymakers will have to carefully communicate and implement an exit strategy from the very accommodative monetary policy now in place.

Some of the normalization of monetary policy is already taking place. As financial markets have begun to function well again, the Federal Reserve has closed most of its special lending facilities. The final program, the Term Asset-Backed Securities Loan Facility (TALF), will close on June 30. We have also taken steps to normalize regular discount window lending by reducing the terms to overnight and by returning to a larger spread between the discount rate that banks pay to borrow at the discount window and the federal funds rate they would pay on the open market. We have completed our purchases of mortgage-backed securities. Yet, the size of the Fed's balance sheet remains very large, and its composition is heavily weighted toward less-liquid, long-term assets, rather than the short-term Treasury securities we held before the crisis. Normalization will involve reducing the size of the Fed's balance sheet and returning to an all-Treasuries portfolio. To achieve this transformation, I favor using sales of agency mortgage-backed securities from our portfolio as an important tool in our exit strategy.

Another part of normalizing monetary policy involves the level of the federal funds rate, which the FOMC lowered to near zero during the worst of the crisis and where it remains today. As the economic recovery strengthens, the FOMC will need to withdraw monetary stimulus. As in past cycles, the decision about when to begin raising the federal funds rate is conditional on the evolution of the outlook for economic growth and inflation. Given the lags in the effects of

monetary policy on the economy, we will need to begin withdrawing stimulus well before the unemployment rate gets down to its long-run level. Our intent will be, as it always is, to set monetary policy consistent with achieving our long-run goals of price stability and maximum sustainable economic growth.

### **Reform and Independence**

Finally, I want to share some of my concerns with the financial regulatory reform proposals now being considered in Washington. I believe that the most important challenge that reform must address is the perception that some firms are too big to fail. In order to end too big to fail, we must have a way to credibly convince large financial firms, their investors, and their creditors that firms on the verge of failure will, in fact, be allowed to fail. If the resolution mechanism is either too vague or allows for too much discretion by regulators or Congress to rescue firms through subsidies or bailouts, then troubled firms will continue to appeal to the government that they must be bailed out for the sake of the rest of the economy. The presence of such opportunities for discretion invites firms to take on too much risk, thereby increasing the probability that they end up in trouble.

Therefore, successful financial reform must include a credible commitment by the government to not intervene or bail out firms. I believe the best approach to making such a credible commitment is amending the current bankruptcy code for nonbank financial firms and bank holding companies, rather than expanding the bank resolution process under the FDIC Improvement Act, as outlined in the Senate bill. Whatever the provisions of the final bill prove to be, they must be sufficient to curtail the belief that discretionary actions by regulators and policymakers would lead to bailouts or rescues that arbitrarily reward some stakeholders in the troubled firm at the expense of others. A bankruptcy mechanism that stipulates the rules for resolving a failing firm would be much more credible and thus would be more successful in ending too big to fail. Moreover, with a credible mechanism for ending too big to fail, there would be less need to rely on the Fed's emergency lending authority that it exercised during the crisis.

Another provision in the Senate Banking Committee bill would restrict the Federal Reserve's supervisory authority to about 50 of the largest financial firms with \$50 billion or more in assets. This would undermine the effort to end too big to fail, since the markets will likely interpret this provision as signaling that these firms are unique and will not be allowed to fail.

The provision is troubling for another reason: Such a move would shift the Federal Reserve's attention toward Wall Street and away from Main Street, altering the fundamental character of our decentralized central bank. Today, the Federal Reserve supervises about 5,000 bank holding companies and 850 state-chartered banks. In the Third District, the Philadelphia Fed supervises over 100 bank holding companies and 23 state-chartered member banks.

Losing direct supervision of all but the largest financial firms would dramatically reduce the Federal Reserve's abilities to monitor the economy and financial market developments, to act as an effective lender of last resort, and to identify risks to the financial system. Moreover, the Fed would lose an important source of information on regional economies, which Federal Reserve Bank presidents bring to the table at FOMC meetings to guide monetary policy. For these

reasons, I believe the Fed must retain supervision of bank holding companies of all sizes and of state member banks.

Some in Congress seek to politicize the Fed. This is a dangerous path to pursue as it undermines the ability of the Fed to implement appropriate monetary policy. Today, Federal Reserve Bank presidents are selected in a nonpolitical process by their boards of directors, subject to the approval of the Board of Governors in Washington. Changing the New York Fed position to a presidential appointee, as the Senate bill does, would greatly skew the center of power toward Wall Street and Washington and minimize the input from the rest of our country in formulating monetary policy.\*

Others have proposed an amendment, similar to one passed in the House, that would allow any legislator to demand that the Government Accountability Office “audit” the Fed’s monetary policy decisions, which is another attempt to apply political pressure. Make no mistake, these audits are not financial audits. The Fed’s financial statements are already subject to GAO audits as well as outside independent audits. Instead, the House bill proposes policy audits that would allow any individual legislator who disagreed with an FOMC monetary policy decision to call for a GAO audit of the decision. The fact that the minutes of FOMC meetings are released within weeks and verbatim transcripts and documents are available to the public after five years suggests that the objective of the audits is not transparency of policy per se, but to influence policy in real time.

The attempts to politicize the Fed by increasing the number of political appointments and by allowing political interference in monetary policy decisions will concentrate more and more authority in Washington and on Wall Street. It will encourage large organizations to lobby Congress for specific monetary policy or regulatory outcomes and thus invite increased political intrusion into the monetary and regulatory process. Good governance calls for a healthy degree of separation between those that spend the taxpayer’s money and those that print money. Let’s keep it that way.

In summary, the financial crisis has clearly demonstrated the need to reform our financial regulatory system. But we must avoid reforms that have unintended consequences. We must preserve the independence and regional nature of the Federal Reserve System. Proposals that threaten to politicize monetary policymaking or centralize power in Washington and on Wall Street, to the detriment of the many Main Streets throughout our nation, will harm the economy by jeopardizing the Fed’s ability to set monetary policy to meet its dual mandate of price stability and maximum sustainable economic growth.

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\* See the letter from President Plosser to Senators dated April 20, 2010.

## **Conclusion**

Let me conclude by saying that the economy is now emerging from the “Great Recession,” the worst financial and economic crisis that most of us have ever experienced. I believe that a sustainable economic recovery is now underway in the nation and in our region. As with all forecasts there are risks but as we move forward, I expect growth in the national economy of around 3½ percent this year and next, with stronger business spending on equipment and software, moderate growth of consumer spending, and gradual improvement in residential investment. As aggregate demand strengthens and firms become convinced that the recovery is sustainable, hiring will pick up over the rest of this year and in 2011. The unemployment rate will begin to decline gradually, but it will take some time for it to return to its long-run level.

As the economic recovery takes hold, we will need to begin to withdraw monetary stimulus to ensure that inflation stays low, inflation expectations remain well anchored, and our long-run goals of price stability and maximum sustainable economic growth are met. Federal Reserve policymakers take these goals seriously. We are carefully considering all aspects of our strategy for exiting this period of extraordinary policy accommodation as we monitor the evolution of the economic outlook.