Economic Outlook

Blair County Chamber of Commerce Breakfast Club

Altoona, PA

June 11, 2010

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President and CEO
Federal Reserve Bank of Philadelphia

FEDERAL RESERVE BANK
OF PHILADELPHIA

The views expressed today are my own and not necessarily
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Introduction

Thank you for inviting me to join you here this morning at the Blair County Chamber of Commerce's monthly Breakfast Club meeting. Last night, the Philadelphia Fed held the last of eight Field Meetings throughout the Third District. This was the 65th year that we have traveled around the District to meet face to face with banking leaders, which makes these outreach meetings one of the oldest, continuous series of this type in the Federal Reserve.

So I am delighted to have the opportunity, while I am in the western-most part of our District, to address your Chamber. Opportunities like this to talk with business leaders on Main Streets across the District help shape my contribution to national monetary policy. It does so by providing insights into the state of our diverse economy and how individuals and businesses are reacting to events and policies.

Today I will offer my perspectives on the state of the economy as we emerge from the worst financial crisis since the 1930s and one of the deepest recessions on record. I believe the economic recovery is on a sustainable path, and I expect further progress even as we unwind the accommodative monetary and fiscal stimulus put in place during the crisis. Although the recovery so far has been quite mild given the recession's severity, I believe that it is becoming more broad-based. Nonetheless, it will take some time before the severe effects of the recession are fully reversed.

After sharing my perspectives on the U.S. and regional economies, I will discuss some aspects of the financial regulatory changes under consideration in Washington. The crisis and the decisions being made in the corridors of Congress are affecting the Federal

Reserve and our economy. I should note that my views this morning are my own and not necessarily those of the Federal Reserve Board or my colleagues on the Federal Open Market Committee.

National Economic Outlook

Let's begin with the national economic outlook. I believe the economic recovery in the U.S. likely began in the middle of last year, when measures of economic activity stabilized and turned positive following a sharp, yearlong decline. In the first quarter of this year, growth expanded at a respectable 3 percent annual rate. I expect real GDP growth from fourth quarter to fourth quarter will 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. Like nearby Lakemont Park's historic wooden roller coaster, the course of our economy will have some ups and downs, but it will eventually come around.

In the housing sector, many indicators have stabilized, but at depressed levels. New and existing home sales were bolstered through April by the homebuyer tax credits. However, we have yet to see a sustained upward trend in sales. Going forward, the large inventory of unsold houses will likely limit growth of housing starts for some time.

Business investment spending appears to be trending upward. During the recession, most businesses cut costs and refrained from spending due to the uncertainty about the severity of the recession, weak demand, regulatory uncertainty, and credit difficulties. As firms have gradually gained confidence, business spending has returned. Firms slashed inventories dramatically in the first half of 2009, which was a large factor in the sharp decline in real GDP. However, in the second half of 2009 the inventory correction abated, and in the first quarter of 2010, firms began to rebuild inventories. It is not unusual to see such an inventory cycle associated with sharp swings in GDP growth. As financial conditions have strengthened, so too have business sentiment and final sales. I expect that as the recovery continues, credit conditions will continue to ease, supporting more business spending.

Consumer spending, which makes up about 70 percent of GDP, has also strengthened in recent months. The condition of household balance sheets has improved: consumers have paid down debt and household wealth has begun to rise with the rebound in

equity prices and stabilization in house prices. Nonetheless, recent data on household spending reinforce my view that growth in this sector will be modest relative to previous recoveries because the labor market weakness will likely restrain income growth and thus consumer purchases.

We are finally starting to see some positive job growth, although May's numbers, released last Friday, were somewhat disappointing. All but 41,000 of the 431,000 jobs added in May were government jobs, mostly reflecting the hiring of temporary census workers. This followed stronger gains of 290,000 nonfarm jobs in April and 208,000 in March. While May's report was less rosy than expected, I do not give one month's number that much weight. That said, we will need to watch developments closely in the coming months. As the recently hired temporary census workers are let go, we will likely see more big swings in the numbers before we get a more accurate picture of the underlying employment prospects.

The unemployment rate fell from 9.9 percent to 9.7 percent last month. Although this is down from the peak of 10.1 percent last October, we should not forget that about 15 million people are unemployed and more than 6 million people have been out of work for more than six months.

Changes in the unemployment rate typically lag output growth. While I believe the unemployment rate will gradually decline, it will take some time before it returns to a more acceptable level. Businesses must be comfortable with their prospects in the recovery 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.

Like unemployment, developments in the commercial real estate sector also typically lag the rest of the economy. Weakness in this sector could still pose problems to those banks that hold substantial amounts of commercial real estate loans in their portfolios. Strains on banks resulting from these exposures could adversely affect credit flows to local businesses and consumers, so we are keeping our eye on this sector. I expect these risks will lessen since commercial real estate values will stabilize as the economy recovers.

We are also watching the economic situation in Europe carefully. Concerns over unsustainable fiscal deficits have led to downgrades of Greek sovereign debt and worries that other countries face similar challenges. In financial markets, these

concerns have led to widening credit spreads on the debt of these countries and for some institutions that hold their debt. Some are concerned that renewed financial market turmoil could retard the recovery in the U.S. To minimize the risk that strains abroad could spread to U.S. markets and to improve liquidity in global money markets, the Fed has reopened temporary swap lines with the European Central Bank, the Bank of England, and the Swiss National Bank, making it easier for them to supply U.S. dollar funding to institutions in their areas.

The Economic Outlook for the Region

Let me turn to the economy here in the Third District and, more specifically, here in Blair County.

Our part of the country did not experience as severe a downturn in residential construction and house prices as some other parts of the nation. Even in the Third District, the largest declines in house prices and housing activity occurred in New Jersey, Delaware, and the eastern portion of Pennsylvania. The western parts of Pennsylvania, including Blair County, had smaller declines.

For example, according to the Federal Housing Finance Agency, or FHFA, house prices in the Altoona metropolitan statistical area (MSA), which is Blair County, were down 1.5 percent over the past year, through the first quarter, compared with a drop of more than 6.5 percent in the nation.

Blair County also has not had as sharp a rise in its unemployment rate as in the nation or the state as a whole. The unemployment rate here rose to 8.1 percent in April,[1] compared with 9.9 percent for the nation and 9 percent for Pennsylvania. So although job losses in this part of Pennsylvania have been substantial, it seems there are some factors at work that have helped Blair County weather the Great Recession a little better than many other parts of the state and nation.

Perhaps the reason for this performance is that over the past decade, business development along the I-99 corridor has boomed, attracting more business and creating new jobs. Altoona has also been working to revitalize its downtown area with a number of redevelopment projects for both Penn State Altoona and the Altoona Medical Health System — two of the region's largest employers. In fact, Altoona experienced some

[1] The Philadelphia Fed publishes seasonally adjusted county unemployment rates on its website at http://www.philadelphiafed.org/research-and-data/regional-economy/historical-data/.

growth in the health and education sectors during the recession, no doubt thanks to the health-care system and universities serving the area.

Outlook for Inflation

As for inflation, I believe it will remain subdued in the near term. That is a view shared by respondents to the Philadelphia Fed's Survey of Professional Forecasters, who see inflation remaining low and stable over the next year. 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. However, in the medium to longer run, I believe there are some upside risks to inflation. The key to keeping inflation expectations well anchored and prices stable is for monetary policymakers to carefully communicate and implement an exit strategy from the very accommodative monetary policy now in place.

The Normalization of Monetary Policy

What is our exit strategy? Some normalization of monetary policy is already taking place. 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 discount window lending by reducing the maturity of such loans to overnight and by returning to a larger spread between the discount rate that banks pay to borrow from the Fed and the rate they would pay on the open market. We have also completed our purchases of mortgage-backed securities and longer term government bonds. As a consequence of these actions, the Fed's balance sheet grew and remains very large. Moreover, it is heavily weighted toward less-liquid, long-term assets, rather than the short-term Treasury securities we held before the crisis. Combining these factors with an interest rate target close to zero means that monetary policy remains extraordinarily accommodative. If we do not exit from this strategy in a timely manner, we could be sowing the seeds of another round of uncomfortable and costly inflation in the intermediate term.

Executing an exit strategy and returning to a more normal monetary policy will involve reducing the Fed's balance sheet, in part by selling mortgage-backed securities, returning to an all-Treasuries portfolio, and raising the short-term interest rate toward a more normal level.

My own view is that we should begin to sell some of our non-Treasury assets sooner rather than later. Despite recent volatility in markets due to fiscal deficit problems in

Europe, financial markets are now functioning much better than they were during the height of the financial crisis, and I believe the Fed could begin to liquidate its positions gradually without market disruption.

Depending on the outlook for economic growth and inflation, the time will come when the FOMC will need to raise the federal funds rate target. Even if the target was increased to 1 percent, policy would remain very accommodative. Given the lags in the effects of monetary policy on the economy, we will need to begin withdrawing stimulus and raising interest rates well before the unemployment rate has fallen to acceptable levels. We need to be forward looking in setting monetary policy to achieve our long-run goals of price stability and maximum sustainable economic growth.

Reform and Independence

Finally, I want to share some of my thoughts on financial regulatory reform. As you know, bills have now passed both the House and the Senate. Lawmakers are in the process of reconciling these bills in a way acceptable to both houses of Congress.

I believe that one of the most important objectives of financial regulatory reform is to address the notion that some firms are too big to fail. The recent crisis and actions by policymakers have exacerbated moral hazard and expanded the safety net for failing firms. This is a huge problem that if not adequately addressed will sow the seeds of the next crisis. If a firm's creditors believe that the government will rescue them in the event of an impending failure, they will have little incentive to discourage the firm from taking excessive risk. Failure is the ultimate form of market discipline and an essential element of free enterprise. Individuals must have the freedom to reap the rewards of their success, but they must also be free to fail. As my friend and fellow economist Allan Meltzer has said, "Capitalism without failure is like religion without sin. It doesn't work."[2]

We must work to restore the prospect of failure. To do so, we must establish a credible commitment by the government to not intervene or bail out firms on the verge of bankruptcy. I believe the best approach is amending the bankruptcy code for nonbank financial firms and bank holding companies, rather than expanding the bank resolution process under the FDIC Improvement Act as both versions of the reform legislation appear to do. Resolution processes can be highly inefficient and arbitrary — granting far

[2] See Allan Meltzer, "Asian Problems and the IMF," *Cato Journal*, 17:3 (Winter 1998), pp. 267-74.

too much discretion to regulators or politicians to rescue some stakeholders and not others.

Other aspects of the proposed bills also concern me. Some provisions in both the House and the Senate bills seek to politicize the central bank by increasing political appointments and concentrating authority in Washington and on Wall Street. This could undermine 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. The Senate bill contains a provision that would make the New York Fed position a presidential appointee.

In addition, the House bill contains a provision 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, as well as the fact that the Fed Chairman delivers the Monetary Policy Report to Congress twice a year and can be called to testify at any time by the House or Senate banking committee, suggests that the objective of the proposed audits is not to ensure transparency of policy per se but to influence policy decisions 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 and minimize the input from the rest of the country in formulating monetary policy. Because monetary policy works on the economy with long lags, it's important for monetary policymakers to take the long view. The Fed is ultimately accountable to the Congress and the American people, and we must seek to be as transparent about our actions as possible. But good governance calls for a healthy degree of separation between those that spend the taxpayer's money and those that print it.

Conclusion

In summary, the economy is now emerging from the “Great Recession,” the worst financial and economic crisis that most of us have ever experienced — and hopefully ever will. I believe that a sustainable economic recovery is now underway in our region and the nation. 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 the economy 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 and inflation expectations remain well anchored.

Finally, as the work to reform our financial regulatory system proceeds, it is important that we recognize that rules and regulations can have unintended and often undesirable consequences. While the proposals now before Congress claim to have solved the too big to fail problem, I am less convinced. In addition, proposals that threaten to politicize monetary policymaking or centralize power in Washington or on Wall Street, to the detriment of the many Main Streets throughout our nation, will harm our country’s economy. That is why we should seek to protect and, if possible, strengthen the independence and decentralized, regional nature of the Federal Reserve System, not weaken it.