

Economic Outlook

Presented to The Greater Vineland Chamber of Commerce

Vineland, NJ

September 29, 2010

Charles I. Plosser

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, David Kotok, Bob DeSanto, and Dawn Hunter for inviting me to speak this afternoon at the Greater Vineland Chamber of Commerce. I know David is proud of this part of South Jersey, and with this warm reception and turnout, I understand better why he feels that way. Today, I would like to offer my perspectives on the economic recovery in the U.S. and in the region, and the challenges that monetary policymakers face in this economic environment. Before continuing, I should note that my views are my own and not necessarily those of the Federal Reserve Board or my colleagues on the Federal Open Market Committee.

My basic message is this: I believe we are in the midst of an economic recovery – a modest one, but a recovery nonetheless. Over the last few months, we have experienced something like the summer doldrums. The tail winds that helped propel the economy earlier in the year have waned. Yet such a slowdown is not unusual in the early phases of recovery, and we should not overreact to data that can be volatile and may be revised over time. My assessment of the recent data leads me to expect that the recovery will continue at a moderate pace over the next several quarters.

That the pace of the recovery is modest is disappointing but not that surprising. We are emerging from one of the worst economic and financial crises in 70 years. Economists have been saying for over a year now that this recovery would be a modest one and that it would be a long climb out of a very deep hole. And as we are all painfully aware, the economy continues to face some real challenges. Most troubling is the unemployment rate, which remains high at 9.6 percent. Still, despite a downgrade in the outlook for the second half of this year, I expect we will avoid slipping back into recession. And with continued economic recovery, we will gradually return to healthier labor markets.

Overview of the Federal Reserve System

Before I elaborate on my views of the outlook, let me offer some background on the Federal Reserve. The financial crisis and the resulting regulatory reform have put the Fed in the spotlight. Yet many people still find our nation's central bank a mystery.

Congress created the Federal Reserve System in 1913 with 12 individual Reserve Banks rooted on Main Streets throughout our nation and overseen by a Board of Governors in Washington, D.C. Ours is a uniquely American form of a central bank, with checks and balances to protect and serve an economically and geographically diverse nation. As the central bank, the Fed is charged by Congress with providing the nation with a stable currency and supporting economic growth and employment. It seeks to achieve these objectives by influencing the cost and availability of credit through its decisions about interest rates and the supply of money. These decisions are the primary responsibility of the FOMC — the Federal Open Market Committee — the group within the Fed charged with setting monetary policy. The Fed also seeks to promote financial stability by providing oversight of key parts of the banking and payment systems and providing liquidity in times of crises.

The Fed has a unique public/private structure that operates independently within government, but not independent of it. The seven-member Board of Governors, appointed by the President and confirmed by the Senate, represents the public sector.¹ The 12 regional Reserve Banks, each independently chartered with their nine-member boards of directors drawn from citizens in their respective Districts, represent the private sector.² This structure imposes accountability while avoiding centralized governmental control of banking and monetary policy.

This structure also ensures that a diverse range of views is present in policy discussions and helps keep monetary policy decisions independent from short-term political pressures. The independence of monetary policy decision-making from the day-to-day political fray is an important governance principle. Good governance calls for a healthy degree of separation between policymakers who are responsible for spending the money and those policymakers responsible for printing it. History and economic theory teach us that it is far too tempting for governments to print money as a substitute for facing the hard choices of cutting spending or increasing taxes. The temptation is

¹ As of September 27, 2010, there are four Governors serving, with three more nominees awaiting Senate confirmation.

² Under the Dodd-Frank Act, only the six nonbank directors on each board may vote to recommend a Reserve Bank president, subject to the approval of the Board of Governors in Washington, D.C.

particularly acute in times when governments are running large budget deficits. The consequences of using the printing press to finance government spending are almost always bad – higher inflation, higher interest rates, a weaker currency, and often more economic instability. Congress also chose to insulate monetary policymaking from short-term political pressures by making the Fed self-funding. That is, it receives no government appropriations from Congress. In fact, the System turns over any excess earnings above the cost of its operations to the U.S. Treasury. In 2009, this amounted to about \$46 billion.

The individual Reserve Banks play an integral role in their region's economies. For example, the Philadelphia Fed provides currency and other basic payment services to banks and depository institutions in eastern Pennsylvania, southern New Jersey, and Delaware. We support community development activities. We help the U.S. Treasury manage its cash balances. We also supervise numerous banks and bank holding companies in our District under delegated authority of the Board of Governors.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 made many changes to the regulatory landscape. Under this new legislation, the Fed will continue to supervise many banks, a responsibility it shares with the OCC (Office of the Comptroller of the Currency), the FDIC (Federal Deposit Insurance Corporation), and state banking regulators. The Fed will also continue to be the sole supervisor of bank holding companies and now has the added responsibility of supervising thrift holding companies.

Here in the Third District, this means that the Philadelphia Fed will soon supervise 38 thrift holding companies in addition to retaining supervision of more than 100 bank holding companies and 22 state-chartered member banks. As bank supervisors, we also will retain a role in consumer protection compliance for firms with less than \$10 billion in assets. But the act requires the Board of Governors to transfer its responsibility for rule-making and enforcement for the largest banks and nonbanks to a new, independent Consumer Financial Protection Bureau.

Dodd-Frank is a massively complex piece of legislation, and many details remain to be worked out in the rule-writing underway to implement the act. It is also highly likely there will be many unintended consequences. It is too early to assess all of its ramifications or whether it can achieve all of the lofty goals that people have assigned to it. Only time will tell.

Economic Outlook

Now, let me turn to the national and regional economic outlook. As I suggested at the start of my remarks, I believe our nation's economic recovery continues on a sustainable path, with moderate growth and subdued inflation. All of us would like to see faster improvement in the job market. But the recession was very deep. Unfortunately, it will take some time to regain the ground the economy has lost. However, I believe the outlook remains positive.

The recovery officially began in June 2009 and is now in its second year. Yet, after averaging almost 3½ percent over the first three quarters of the recovery, growth slowed in the second quarter of this year to an estimated 1.6 percent.

Our monthly Philadelphia Fed Business Outlook Survey indicates that manufacturing activity weakened over the summer, and in August, the general activity index turned negative for the first time since July 2009. The September value increased but remained negative, just under zero. We should not read too much into monthly movements. The current activity index has, after all, dipped below zero in the midst of expansions before, notably in 2002 and 2003 as we were coming out of the last recession. On the national level, manufacturing continues to expand. However, the data suggest that the pace of activity remained sluggish over the course of the summer.

We saw the same kind of mixed signals in our quarterly South Jersey Business Survey. Overall, economic conditions have improved slightly in recent months, but many firms reported declines in employment.

And while firms responding to both our Business Outlook Survey and our South Jersey Business Survey remain optimistic about economic prospects six months from now, they are less optimistic than they were earlier this year.

Three temporary factors contributed to this slowdown. First, the temporary homebuyer tax credits pulled home sales forward into the spring and so what followed in the summer was a dramatic decline in home sales. Second, the U.S. Census Bureau hired hundreds of thousands of temporary workers but let them go in the latter part of the summer, which distorted the employment picture. Third, the sovereign debt crisis in Europe damaged the fragile confidence of financial markets. The lingering effects of these factors all contributed to our summer doldrums.

In reaction to the recent data, many forecasters have scaled back their growth forecast for the second half of the year. Yet they have made relatively minor changes in their outlook for 2011 and beyond. So, despite the media alarm, these professional forecasters see a soft patch in the economy but a relatively small probability of slipping back into recession. Still, the pace of this recovery is slow relative to recoveries after other deep recessions – resembling instead the so-called jobless recoveries of 2001 and the early 1990s.

I know many in your community feel the pains of high unemployment. Vineland, Atlantic City, and Ocean City share the unfortunate distinction of having the highest unemployment rates in our region. Vineland's unemployment rate is 13.5 percent, significantly higher than the 9.6 percent rate in both New Jersey and the nation.

Changes in the unemployment rate, however, are typically lagging indicators of economic activity. The reality is that businesses must be comfortable that the recovery will continue before they start hiring in earnest. I also hear from many business leaders that tax and regulatory uncertainty has dampened both their confidence and hiring plans. These concerns can be particularly detrimental to growth at this point in the cycle.

But other factors are also contributing to a tepid recovery. We entered this recession with an economy over-invested in residential housing and to a lesser degree commercial construction. We were also over-invested in the financial sector. In addition, many financial institutions and households were over-leveraged.

So when home prices collapsed, there was severe damage to household wealth. The typical response to such a decline in wealth is that households consume less and save more to strengthen their balance sheets. Given the oversupply of homes and the decline in home prices, it is unlikely that home values will provide a significant boost to household wealth any time soon. This suggests that consumption growth will remain modest compared to past recoveries and savings will be higher. Ultimately, the higher savings and investment will benefit the economy, even though the short-term adjustments are painful.

I also believe that construction activity will be a much smaller share of the economy going forward compared to the real estate boom years. Other sectors that are closely related to the residential construction industry, such as mortgage brokers, may also need to shrink. As a share of total employment, these sectors will likely be smaller than

they were before the recession. So many workers in these sectors will likely need to find jobs in other industries. Such adjustments are painful for workers and their families and they take time.

Other structural factors may also be weighing on the labor market and retarding the return to full employment. During this downturn, companies shed workers at an unusually rapid pace. Yet, companies also increased productivity, enabling them to produce more goods and services with fewer, but more highly skilled workers. As activity picks up, companies are likely to look for more highly skilled, perhaps specialized workers. This means there may be a skill mismatch between job opportunities and the current pool of the unemployed. This skill gap may further explain the sluggish job growth.

Some of the unemployed, who may have the skills to find a job in another state, may not be able to move because they cannot afford to take the financial losses associated with selling their current home. This limitation in geographic mobility is consistent with the observation that unemployment rates are typically above the national average in states where home prices have fallen the most.

Certainly not all of the 9.6 percent unemployment rate can be explained by these painful structural adjustments, but these factors do suggest that it will likely take some time for the labor market to heal.

Can monetary policy help speed up such adjustments? It may be tempting to think so, but monetary policy is not a magic elixir that can solve every economic ill. Doctors must diagnose the disease correctly if they are to prescribe the correct medicine. Otherwise, they could do the patient more harm than good.

While the Fed's actions can help encourage spending and borrowing, monetary policy is not designed to fine tune employment nor can it solve the sorts of geographic, sectoral, or skill mismatches I have just discussed. The Fed has already reduced the federal funds rate to near zero and provided \$1.7 trillion in added liquidity by buying mortgage-backed securities and agency debt. And recall that while we were dropping the federal funds rate by 5 percentage points to near zero, monetary policy was unable to stop the rise in the unemployment rate from 5 to 10 percent. This suggests that very precise management of unemployment rates over the short-term is simply not something for which monetary policy is particularly well suited.

Thus, it is difficult, in my view, to see how additional asset purchases by the Fed, even if they move interest rates on long-term bonds down by 10 or 20 basis points, will have much impact on the near-term outlook for employment. Sending a signal that monetary policymakers are taking actions in an attempt to directly affect the near-term path of the unemployment rate, and then for those actions to have no demonstrable effects, would hurt the Fed's credibility and possibly erode the effectiveness of our future actions to ensure price stability. It also risks leading the public to believe that the Fed is seeking to monetize the deficit and make it more difficult to return to normal policy when the time comes.

Inflation and Monetary Policy

On the inflation front, recent data indicate some deceleration, which has led some observers to voice concerns about sustained deflation – that is, a prolonged decline in the level of prices. In my view, inflation will remain subdued in the near term, but I do not see a significant risk of sustained deflation. I anticipate that inflation expectations will remain relatively stable and core inflation will run in the 1 to 1-1/2 percent range this year and accelerate toward 2 percent in 2011.

Inflation in this range is not a problem – indeed, low inflation is desirable. Most people forget, or are too young to know, that from 1953 to 1965, the average inflation rate measured by the consumer price index (CPI) was just 1.3 percent. For the last 15 years, Switzerland's average inflation rate has been less than 1 percent. In neither of these episodes did low inflation lead to economic stagnation or fears of deflation.

So I am not particularly concerned about low inflation per se, and brief periods of lower than desired inflation or even deflation are unlikely to materially affect economic outcomes. Yet it is important that monetary policymakers remain vigilant to ensure that neither disinflationary trends nor inflationary trends lead to an unanchoring of inflation expectations, which would undermine the return to price stability in the medium to long run. The stability of those expectations requires the public to believe that the Fed will act to keep inflation stable as the recovery continues.

Were deflationary expectations to materialize – and let me repeat, I do not see much risk of this – I would support appropriate steps to raise expectations of inflation, including, perhaps, aggressive asset purchases coupled with clear communication that our goal is to combat deflationary expectations. But for such a strategy to be successful, the public must believe that the Fed can and will act to combat those expectations. The Fed must be credible. Protecting that credibility is why, based on my current outlook, I

do not support further asset purchases of any size at this time. As I said earlier, asset purchases in our current economic environment can do little if anything to speed up the return to full employment. But if the public believes that they can and is disappointed, it may have less confidence that the Fed will act to raise inflationary expectations if needed. Because I see little gain at this point, and some costs, I would prefer not to engage in further asset purchases at this time.

Similarly, if the economic recovery unfolds as I expect, the Fed will need to begin normalizing monetary policy from its current very accommodative stance. That will mean selling assets to shrink the Fed's balance sheet and raising the level of short-term interest rates. The challenge for the Fed is recognizing the proper timing to ensure that the economy remains on a sustainable path toward price stability and full employment.

Conclusion

To conclude, after the worst financial and economic crisis that most of us have ever experienced, a slow but sustainable economic recovery is now underway in our region and in the nation. While the near-term outlook has softened a bit, I expect growth in the national economy to be around 3 to 3½ percent over the next two years, with stronger business spending on equipment and software, moderate growth of consumer spending, and gradual improvement in household balance sheets.

The unemployment rate continues to be one of the biggest challenges our economy faces. Although unemployment will begin to decline gradually, it will take some time for it to return to its long-run level. 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. But it may take even longer to address the sectoral, geographic, and skill imbalances that seem to plague the labor markets.

I expect inflation to remain subdued. As long as inflation expectations remain well anchored, I see little risk of a period of sustained deflation. Over time, I see the Fed conducting policy in a prudent fashion so that inflation gradually stabilizes in the 1.5 to 2.0 percent range.

This has been a painful episode in our nation's economic history, and many policy challenges remain to be faced. Yet, I believe that, over time, our economy can and will return to an environment of sustainable growth and low and stable inflation.