

# The Progress of Recovery and Challenges for Policymakers

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Rotary Club of Birmingham

February 23, 2011

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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**

Thank you for inviting me to speak to you today. It is always a pleasure to play to a hometown crowd and Birmingham will always be home to me. The opportunity to see old friends and family is always welcome.

I grew up in Birmingham, but over the years, I have watched the city from afar as it grew, matured, and transformed itself into a vibrant and broadly diversified economy. Like so many communities and municipalities around the country these days, Birmingham faces many challenges. Yet, it has met challenges before and forged a path forward, so there is every reason to be confident and optimistic about the future.

I was relatively new to my role as president of the Federal Reserve Bank of Philadelphia when we last met here three years ago. Much has changed since then. In early 2008 we were on the precipice of the Great Recession. Now, we are in a moderate but, I believe, sustainable recovery.

Still, these are exceptionally challenging times for our economy. Unemployment rates remain stubbornly high and almost double what they were when I last addressed this audience. The economic recovery has been slow and uneven. In 2008, we were wondering when the housing market would bottom out. As I recall, it was supposed to be six months away — and it remained six months away for the next two years. Today, housing remains weak, with millions of people still at risk of foreclosure on their homes.

When I joined the Federal Reserve four-and-a-half years ago, I do not recall the phrase “managing financial crises” being anywhere in my job description. Yet, for me, as a long-time academic and educator, the experience has been challenging, fascinating, and sometimes frustrating. Yet, I have also been privileged to see first-hand the dedication of so many people working together to try to improve the situation.

So today I am honored and delighted to be here with you today. As always, I speak for myself, and my views are not necessarily those of the Federal Reserve Board or my colleagues on the FOMC.

## **Economic Outlook**

Today, I want to summarize my views on the nation's economy and my outlook for growth and inflation. I also want to share some thoughts on the upcoming challenges for monetary policymakers as the economy transitions from recession to expansion.

Our economy is emerging from the worst financial and economic crisis since the Great Depression. The recovery, which officially began in mid-2009, a little over 18 months ago, has proceeded in fits and starts. Real GDP grew at a fairly strong 3¾ percent pace in the first quarter of 2010, but slowed to 1¾ percent in the second quarter. Growth was dampened, in part, by the anticipated decline in housing sales as the homeowner tax credits ended, and also by the deleveraging underway in households and businesses as they struggled to restore order to their balance sheets. In addition, concerns over European sovereign debt caused the economy to lose momentum and led some to worry about a possible double-dip recession.

By the third quarter, though, the economy was emerging from the summer doldrums and by the end of the year had picked up momentum, with fourth-quarter growth estimated at 3.2 percent, and growth for 2010 as a whole at 2.8 percent. Consumer and business spending has strengthened. Financial markets have stabilized, and banks are becoming somewhat more willing to lend.

For this year and next, I expect growth will pick up to about 3½ percent annually. As with all forecasts, this one carries some risks, both to the upside and the downside, but I believe the improvement in household and business balance sheets and better labor market conditions will support moderate growth overall, with strength in some sectors more than offsetting weaknesses in others.

On the bright side, business spending on plant and equipment appears to be strengthening as businesses see continued improvement in demand. Firms have been rebuilding inventories and are becoming confident enough to undertake the capital spending that they had deferred during the recession.

Manufacturing activity, too, has picked up around the nation. Results from the Philadelphia Fed's Business Outlook Survey of manufacturers, which is widely viewed as a useful barometer of national trends in manufacturing, have steadily improved in recent months, showing significant gains in measures of general activity, orders, and shipments. Indeed, in February, the index of general activity increased to its highest level in seven years. The sustained positive readings we have seen in this survey over the past four months are part of the accumulating evidence that the economic recovery is on a sustainable path. In fact, the survey's measures of expected future activity indicate that businesses are also becoming more optimistic. Thus, I expect business spending to continue at a healthy pace.

Consumer spending, however, makes up about 70 percent of GDP in the U.S. And it too has picked up speed, expanding at an annual rate of more than 4 percent in the fourth quarter of last year. Households continue to pay down debt and are rebuilding some of the net worth that was destroyed during the recession due to falling house and stock values. As household net worth improves, consumer spending should support growth going forward.

But for the consumer to provide a stronger foundation for continued expansion, job growth needs to strengthen. The good news is that there are signs that labor market conditions are improving. Firms added nearly a million jobs in 2010. Although in January firms added fewer jobs than expected, the numbers were likely affected by the severe weather experienced across the country. The unemployment rate is still high, but it is moving in the right direction, having fallen nearly a half percentage point in each of the past two months. Initial claims for unemployment insurance have been trending down and are about 12 percent lower than a year ago, an indication that fewer people are being laid off. Continuing claims are about 20 percent below last year's levels and job postings are rising. The manufacturers who participate in the Business Outlook Survey have also reported improving labor conditions for several months. These are all positive signs. I expect that as the pace of hiring improves, the unemployment rate will gradually improve to about 8½ by the end of 2011 and somewhere between 7 and 8 percent by the end of 2012.

This forecast is more optimistic than some, but it still represents only a gradual pace of improvement given the depth of the recession. Unfortunately, I believe this is the most likely outcome because there are still significant adjustments that must occur in the labor market. Many workers may be forced to find jobs in new and unfamiliar industries, or update skills to find their next job. This will be particularly true for those

who have been out of work the longest, and this is a large group: nearly 44 percent of the unemployed have been looking for work for more than six months. Unfortunately, easing monetary policy does not eliminate the need for these difficult and time-intensive adjustments, even if we wish it could. Indeed, relying on monetary policy to solve so many of our economic challenges can be dangerous for our long-run economic well-being – a point I will return to shortly.

The housing sector remains weak but appears to have stabilized. We entered the recession greatly over-invested in residential real estate, and I expect high inventory levels will continue to restrain home prices and residential construction for a while longer. Commercial real estate markets remain weak as well, but here too, values seem to have stabilized. Nonresidential construction spending declined last year, and I see very modest near-term growth in this industry. However, as the economic expansion continues, the commercial real estate sector will improve. This sector typically responds with a lag to economic expansion and it should do so during this cycle as well. Despite the emphasis that is frequently placed on the real estate market, I do not believe the weakness in this sector will prevent a broader economic recovery.

### **Inflation Outlook**

When I last addressed this group in 2008, we were concerned about inflation risks. The overall or headline consumer price index was rising at about 4 percent per year and core CPI, which excludes food and energy prices, was rising at about 2.5 percent. These inflation rates were a source of growing concern.

Recently, inflation was been running slightly below the 1½ to 2 percent range most policymakers would prefer. Last year, the deceleration in inflation rates led some economists to believe there was a significant risk of a sustained deflation. I was not one of them. And now it appears that such fears have largely abated. In fact, the respondents to the Philadelphia Fed's quarterly Survey of Professional Forecasters see only a 4 percent chance of deflation in the core CPI this year.

My forecast is that inflation will accelerate toward 2 percent over the course of the next year. Indeed, we are beginning to see some increasing price pressures. The January CPI report, issued last week, showed an acceleration in both headline and core CPI inflation. The headline CPI rose 1.7 percent over the past year, while the core CPI rose just under 1 percent. Commodity prices have risen strongly.

The manufacturers in our Business Outlook Survey continue to report increases in their input costs, and they are more inclined to raise prices than they have been in some time. Over half of our respondents report they have already raised prices this year, and over half said they plan to raise prices again. These survey data are buttressed by anecdotal reports that some firms have been able to pass on higher prices to customers for the first time in three years. My sense is that as the recovery continues to pick up steam and firms become more convinced that demand increases will be sustained, they will feel more confident that they can put through price increases and have them stick.

Of course, by itself, the rise in commodity or other input prices does not directly cause more general sustained inflation. That “cost push” theory of inflation was discredited long ago. Instead, the cause of sustained inflation is reserved for monetary policy. Our experience in the 1970s is instructive. As the price of oil began to rapidly rise in the early part of that decade, monetary policy became more accommodative to support the economy and keep unemployment rates down. In effect, monetary policy ratified the large increase in oil prices through an accommodative stance that, in turn, allowed higher energy prices to be passed along in the form of a general increase in prices, or greater inflation. As this occurred, people and firms began to expect higher inflation and that expectation influenced their decisions, making it that much harder to reverse the rise. Thus, it was easy monetary policy in response to high oil prices that caused the steady rise in inflation, not the high oil prices per se. Moreover, easing monetary policy cannot eliminate the real adjustments the economy must make in the face of rising oil or commodity prices.

Today it is likely that much of the rise in global commodity prices is driven by increased global demand. Yet, if a country’s monetary policy remains very accommodative, it will ultimately permit the prices of other goods and services to rise along with commodity prices, resulting in higher inflation rates.

### **Monetary Policy Challenges**

In the U.S., monetary policy decisions are made by the Federal Open Market Committee, or the FOMC. The Committee is made up of 12 members — the seven members of the Board of Governors in Washington, the president of the Federal Reserve Bank of New York, and four of the remaining 11 Reserve Bank presidents, who serve one-year terms on a rotating basis. This ensures that our national monetary policy is guided by input from across our diverse nation.

This year happens to be one in which I am a voting member. My colleague Dennis Lockhart, from the Sixth Federal Reserve District, which includes Birmingham and is headquartered in Atlanta, will vote in 2012. However, whether we vote or not, all Reserve Bank presidents attend the meetings of the Committee, participate in the discussions, and contribute to the Committee's assessment of the economy and policy options. All of the Fed Governors and Reserve Bank presidents discuss how they see economic and financial conditions in their Districts, as well as their views on national economic conditions. I may comment on economic conditions in the Third District, which covers Delaware, southern New Jersey, and much of Pennsylvania, just as President Lockhart discusses conditions here in the Southeast.

Each of us prepares for the meetings by gathering information throughout our Districts, around the nation, and, in some cases, internationally. This occurs through meetings with our boards of directors and advisory councils, conversations with local and international businessmen and -women, as well as briefings on economic conditions by our Research Department staffs. All this helps contribute to a rich and comprehensive picture of the national economy. In this way, we are better able to select policies that best meet the needs of this geographically and economically diverse nation.

In the last couple of years, the FOMC has been forced to react swiftly to new economic and financial challenges and responded with new and creative policies in its effort to manage through the crisis. Now, we must step back from our focus on significant short-term fluctuations and crisis management and think more broadly about what monetary policy can and should do going forward.

Given the extraordinary economic environment and the extraordinary actions taken, we find ourselves operating outside the usual and comfortable policy framework, with less consensus among economists about the right actions to take to promote sustainable growth and price stability. As a result, it is not surprising that debates about policy have been robust, with bright and talented people on every side. Thus, it should not be surprising — indeed, it should be reassuring — that debates within the FOMC are similar to many that are carried out in more public forums.

I stumbled upon a quote by the not-so-well-known French essayist Joseph Joubert from two centuries ago, but since I liked the quote, I thought I'd share it with you even if he isn't a household name: "It is better to debate a question without settling it than to settle a question without debating it."

Debate serves to enhance the Fed's credibility and transparency as an institution. We should acknowledge the debate as a healthy process that analyzes the costs and benefits of various policy choices and ultimately leads to more informed and well-thought-out decisions. Communicating the thoroughness of those discussions is a vital part of the accountability we owe the public.

Last November, after considerable deliberation, the FOMC decided to purchase an additional \$600 billion of longer-term Treasury securities. This asset purchase program has been commonly referred to as QE2. Based on my reading of the economic outlook and challenges that the economy faces, I have expressed some doubts that the benefits outweigh the costs of this policy. However, I supported continuation of the policy in January because it is generally a good practice for a central bank to do what it says it is going to do unless circumstances significantly change. To do otherwise would undermine the institution's credibility.

When the asset purchase program was adopted, the Committee also said that it would review its planned purchase program on a regular basis, and I take that promise to review seriously. Policy, after all, must also be dependent on the evolution of the economy so when the outlook for the economy changes in an appreciable way, so should policy.

Should economic prospects continue to strengthen, I would not rule out changing the policy stance to bring QE2 to an early close. Thus, I will continue to look at the data and consider revising my forecast and preferred policy path as we gain more information on economic developments in the coming months. If the growth rates of employment and output begin to accelerate or if inflation or inflation expectations begin to rise, then it may be time to begin taking our foot off the accelerator.

Policymakers must also look down the road and understand the sort of choices they may face in the future as a consequence of the decisions they make today. In this regard, I think monetary policy faces some difficult choices in the not-too-distant future. In particular, there is no question that, at some point, we will need to begin to remove the extraordinary amount of accommodation we have provided.

Yet, history tells us that exiting from an accommodative policy is tricky, and it is likely to be especially so this time around. Not only have our policies kept the federal funds target near zero for more than two years, they have also greatly expanded the Fed's balance sheet from about \$800 billion to more than \$2.5 trillion.



Some people have questioned whether the Fed has the tools to exit from its extraordinary positions. The answer to that is an unequivocal yes. We can raise interest rates and we can sell assets or stop reinvesting the proceeds when securities mature. The question is not can we do it, but will we do it at the right time and at the right pace. Since monetary policy operates with a lag, the Fed will need to begin removing policy accommodation before unemployment has returned to acceptable levels. Will we have the fortitude to exit as aggressively as needed to prevent a spike in inflation and its undesirable consequences down the road?

Congress set the goals of monetary policy in the Federal Reserve Act, which states that the Fed should conduct policy to “promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates.”

I believe that monetary policy can best contribute to maximum employment and moderate long-term interest rates by ensuring price stability over the longer run. Price stability is also critical in promoting financial stability. Committing to a stated goal to keep inflation low and stable can help to reduce market uncertainty and enhance the credibility and transparency of our central bank. That is why I have long advocated that the Fed adopt an explicit inflation objective. It would commit the central bank to a clear and explicit monetary goal that would be well understood by the public and reduce uncertainty as to the ultimate path of policy.

## **Conclusion**

Looking ahead, a sustainable economic recovery is under way, and I expect annual growth to be about 3½ percent over the next two years. As the economy continues to gain strength and optimism grows among businesses, hiring will increase. The unemployment rate, however, will decline to acceptable levels only gradually. I expect a gradual decline in the unemployment rate over the next two years, with the rate falling to between 7 and 8 percent by the end of 2012. The shocks and dislocations we experienced from the financial crisis were significant, and it will take some time for the labor markets to adjust.

The Federal Reserve remains committed to its long-run statutory goals of promoting price stability and maximum employment. Yet, I believe that finding the right path to attaining these goals, given where we have been, will require thoughtful deliberation and some difficult choices. Healthy debate is vital to that process and adds to the transparency and credibility of Federal Reserve policy as we move forward.