

From Recession to Expansion: A Policymaker's Perspective

Harrisburg Regional Chamber & Capital Regional Economic Development Corporation

April 1, 2011

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President and CEO
Federal Reserve Bank of Philadelphia



FEDERAL RESERVE BANK
OF PHILADELPHIA

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Introduction

Thank you for inviting me to speak to you this morning. Organizations like yours make important contributions to the growth and development of the regional economy, so I am delighted to have this opportunity to speak to you about the economic outlook this morning.

I was interested to learn that the Harrisburg Regional Chamber received its formal charter as a Chamber of Commerce in 1913 — the same year Congress passed the Federal Reserve Act establishing the Federal Reserve System. In 1914, the Federal Reserve Bank of Philadelphia received its charter as a part of this nation's decentralized central bank. Both of our organizations have seen a great deal of economic development and economic challenges over the course of the last century.

This morning I would like to discuss our nation's economic recovery from recession to expansion and my outlook for growth and inflation. I will also discuss the challenges policymakers face in the current environment.

As always, I speak for myself, and my views do not necessarily reflect those of the Federal Reserve Board or my colleagues on the FOMC.

Economic Outlook

Our economy is on track for a sustained recovery from the worst financial and economic crisis since the Great Depression. The recovery, which officially began in mid-2009, is nearing the two-year mark, and we are now on a much firmer footing than we were last summer.

If you recall, the first half of last year had its twists and turns. While real gross domestic product (GDP) grew at a fairly strong pace of 3¼ percent in the first quarter of 2010, the economy slowed to growth of 1¼ percent in the second quarter. The strength in the first quarter reflected a strong contribution from inventories. After cutting their inventories over the prior two years as sales plummeted, firms began to rebuild

inventories in the first quarter of last year in anticipation of the strengthening economic recovery. We saw swings in housing sales in the first half of last year as the homeowner tax credits brought sales forward. But just as the economy was beginning to strengthen, concerns over European sovereign debt led some observers to worry about a possible double-dip recession.

These fears passed, and after emerging from what I've been calling the summer doldrums, the economy showed renewed vigor and, by the end of the year, had once again picked up momentum. According to the revised estimate issued last week, real GDP grew at a 3.1 percent annual rate in the fourth quarter, up from 2.6 percent in the third quarter. This meant that growth for the full year of 2010 was just under 3 percent.

For this year and next, I expect growth will pick up to about 3½ percent annually. I believe overall strength in some sectors will more than offset persistent weaknesses in others so that the recovery will be sustained and become more broad-based. Improvement in household and business balance sheets, spending on software and equipment, and better labor market conditions will all support moderate growth overall.

Perhaps the brightest spot in the economy is manufacturing. Results from the Philadelphia Fed's Business Outlook Survey of manufacturers, which is a useful barometer of national trends in manufacturing, have steadily improved in recent months. In fact, in March, the survey's broadest measure of manufacturing conditions increased to its highest reading since 1984. Survey indicators of new orders and shipments are also at high levels. Future activity, measured by how firms think business will be six months from now, also remains high. Thus, I expect business spending will continue to show strength.

Consumer spending, which makes up about 70 percent of GDP in the U.S., has also expanded. Households continue to pay down debt and rebuild some of the net worth that was destroyed during the recession due to falling house and stock values. However, for consumers to contribute more to the continued expansion of the economy, job growth needs to strengthen.

Labor Markets

The good news is that there are signs that labor market conditions are improving. While initial estimates of January job growth looked anemic, this may have had more to do with the terrible weather during the Bureau of Labor Statistics' survey period. In February payroll job growth improved substantially, with firms adding about 192,000 jobs. The January job numbers were also revised up somewhat. Taken together, the first two months of the year saw an increase of a quarter of a million jobs, a pickup from the pace of job growth in 2010.

Another sign of improvement is the decline in the unemployment rate over recent months. The unemployment rate fell to 8.9 percent in February. While this is still an elevated level, it is down nearly 1 percentage point since its peak in November and it is at its lowest level in nearly two years. I do not want to downplay the pain that many households are going through with family members out of work. But I take these declines in unemployment as a positive sign that conditions in the labor market are improving.

Employment growth in the Third District has not been as strong as in the nation as a whole, but the unemployment rate was also not as high. Pennsylvania job growth has been somewhat stronger than in the rest of the Third District. February numbers showed a net gain of nearly 24,000 jobs in the state, with an unemployment rate of 8.0 percent, compared to 8.9 percent for the U.S. The Harrisburg-Carlisle MSA, aided by public-sector employment, has an even lower unemployment rate. January numbers, our most up-to-date MSA numbers, showed an unemployment rate of 7.1 percent, nearly 1 percentage point lower than for the state as a whole and nearly 2 percentage points lower than for the nation.¹

We will get another read on national employment later this morning when the March numbers are released. As the economy strengthens this year, I expect that businesses will continue to add to their payrolls and that we will see modest declines in the unemployment rate, reaching 8½ percent by the end of this year, and in the 7 to 8 percent range by the end of 2012.

Residential and commercial real estate sectors remain weak, but I do not believe that weakness in these sectors will prevent a broader economic recovery. Indeed, the nonresidential real estate sector is likely to improve as the overall economy gains ground.

The tragic events in Japan and the potential for sharply higher oil prices given the turmoil in the Middle East and North Africa pose some risk to our recovery. Yet, I believe the risks are small and short term, assuming Japan is able to stabilize its nuclear reactors and political unrest in the Middle East does not dramatically disrupt Saudi Arabia, the region's largest oil producer.

Inflation Outlook

Just a few months ago, inflation had been running slightly below the 1½ to 2 percent range that most policymakers would prefer. In fact, a deceleration in inflation rates last year led some economists to believe there was a significant risk of a sustained deflation. I was not one of them. Such fears have now abated, and rather than deflation, 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/>.

economists have become concerned about accelerating inflation due to the rise in oil prices we have seen this year and the strong increase in other commodity prices we have experienced since the summer.

My forecast is that inflation will be about 2 percent over the course of the next year. Many people ask me which measures of inflation I watch. The fact is that I watch several measures, including the prices paid and prices received indexes in the Philadelphia Fed's own monthly Business Outlook Survey. In February, the prices paid and prices received indexes hit their highest levels in three years, and in March, prices received continue to move up and prices paid stay at a very high level. My sense is that as the recovery continues to pick up steam and firms become more convinced that increases in demand will be sustained, they will feel more confident that they can pass through price increases and have them stick.

The February consumer price index increased to 2.1 percent year over year. Core inflation, excluding food and energy, rose to 1.1 percent.

Some fear that the strong rise in commodity and energy prices will lead to a more general sustained inflation. Yet, at the end of the day, such price shocks don't create sustained inflation, monetary policy does. If we look back to the lessons of the 1970s, we see that it is not the price of oil that caused the Great Inflation, but a monetary policy stance that was too accommodative. In an attempt to cushion the economy from the effects of higher oil prices, accommodative policy allowed the large increase in oil prices to be passed along in the form of general increases in prices, or greater inflation. As people and firms lost confidence that the central bank would keep inflation low, they began to expect higher inflation and those expectations influenced their decisions, making it that much harder to reverse the rise. Thus, it was accommodative monetary policy in response to high oil prices that caused the rise in general inflation, not the high oil prices per se. As much as we may wish it to be so, easing monetary policy cannot eliminate the real adjustments that businesses and households must make in the face of rising oil or commodity prices. These are lessons that we cannot forget.

Price Stability

As you know, 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." Since moderate long-term interest rates generally result when prices are stable and the economy is operating at full employment, it is often said that Congress has given the Fed a dual mandate.

Many economists understand 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 make explicit its commitment to a numerical inflation objective. Numerical inflation objectives are fairly common among major central banks around the world, and many academics and students of central banking regard adopting such an objective as best practice.

Establishing and communicating an explicit numerical objective would be particularly valuable as we exit our current very accommodative monetary policy stance. An explicit commitment to a low and stable inflation rate should help reassure the public that we will exit in a way that is consistent with that goal. This should help keep expectations of inflation well anchored as we carefully choreograph an end to our accommodative monetary policy.

Monetary Policy Challenges

Speaking of removing monetary accommodation, I'd like to discuss some challenges we are facing in the realm of monetary policymaking. History tells us that exiting from an accommodative policy is very tricky. It is likely to be especially so this time around, given the nontraditional actions we have taken.

In the last couple of years, as we have endured a financial crisis and a severe recession, the FOMC was forced to adopt nontraditional policies in an attempt to stabilize financial markets and the real economy. These actions have taken us far from the traditional and well-understood operating framework for conducting monetary policy.

The federal funds rate -- the traditional instrument of monetary policy -- has been near zero for more than two years. The Fed's balance sheet has grown nearly three times, to more than \$2.6 trillion, with a composition heavily weighted toward long-term Treasuries and mortgage-related assets.

Because we find ourselves in unfamiliar territory, it is understandable that there is less of a consensus among economists about the right actions to take to promote sustainable growth and price stability. As a result, debates about policy have been robust, with bright and talented people on every side. And 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.

A few months ago, I came across a quotation by the not-so-well-known French essayist Joseph Joubert from two centuries ago. It captured my belief about the importance of this honest debate so well that I have begun to cite it -- even if Joubert is not a household name. He wrote: "It is better to debate a question without settling it than to settle a question without debating it." You may have also heard me quote the

American journalist Walter Lippmann, who said, “Where all men think alike, no one thinks very much.”

Healthy debate is necessary for better-informed decisions. These debates also serve to enhance the Fed’s credibility and transparency as an institution. We owe it to the public to communicate the thoroughness of those discussions.

Some people have questioned whether the Fed has the tools to exit from its extraordinary positions. The answer to that is an unequivocal “yes.” 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. It is imperative that we have the fortitude to exit as aggressively as necessary to prevent a spike in inflation and its undesirable consequences down the road.

Any exit plan will use several policy tools, including raising interest rates, shrinking the balance sheet, and altering the composition and maturity of the assets we hold. Some would start with raising interest rates; some would begin by shrinking the balance sheet; others would do both.

Last week, I outlined a proposal for a systematic rule-based approach that would involve the Fed’s selling assets from its portfolio as it increased its policy rate, with the pace of sales dependent on the state of the economy.

The plan would get us back to a “normal” operating environment in a timely manner, by which I mean one where the Fed’s balance sheet is of the size to allow the federal funds rate to be the primary policy rate again.

Yet, the most important element is not the formula or pace I proposed, but that it is a plan, one that can be clearly communicated to the markets and the public in a way that reduces uncertainty. A systematic plan will help define not only where we are headed, but also how we will get there.

As to when to begin exiting from accommodative policy, I will continue to look at the data on output and employment growth and on inflation and inflation expectations. Signs that inflation expectations are beginning to rise or that growth rates are accelerating significantly would suggest that it is time to begin taking our foot off the accelerator and start heading for the exit ramp. I would add that we should not be too sanguine in believing that such a time is a long way off or that the process will only be gradual. A stronger rebound in the economy or inflation than some now expect could require policy actions to be taken sooner and more aggressively than many observers seem to be anticipating. Allowing monetary policy to fall behind the curve can only result in greater inflation and more economic instability in the future.

Conclusion

In closing, I am optimistic that our economy is on a firmer footing. The recovery will continue at a moderate pace. I expect annual growth to be about 3½ percent over the next two years. Prospects in labor markets have improved in recent months. Over the course of this year and next, the rate of unemployment will gradually fall to somewhere between 7 and 8 percent by the end of 2012.

The Federal Reserve remains committed to its long-run statutory goals of promoting price stability and maximum employment. We must carefully watch for signals of inflation and altered expectations to ensure that monetary policy stays ahead of the curve. As we move forward in this time of change, we will do our best to communicate clearly our actions and the intended purpose of our policy.

I believe that the challenges the FOMC faces as it exits from the period of extraordinary accommodation and nontraditional policies can be reduced if we communicate a systematic plan that describes where we are headed and how we will get there. Such a plan would be strengthened if the FOMC adopted an explicit numerical objective for inflation, which would help ensure that inflation expectations remain well anchored.