Economic Prospects and Monetary Policy for the New Year

33rd Annual Economic Seminar

Rochester, New York

January 11, 2012

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President and CEO
Federal Reserve Bank of Philadelphia

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Introduction

Thank you for inviting me back to participate in this 33rd annual economic seminar. The Simon School began holding this event soon after I began teaching here, and it is a pleasure to return and share my thoughts about the economy. Providing an economic outlook for the same event for the past 33 years is both an honor and a challenge. As I have noted on many occasions, forecasting can be a humbling exercise in the best of times. For better or worse, my speeches at this event allow for a longitudinal study of the accuracy of my forecasts. I am not going to bore you with the results of that study, except to say that they do underscore the need for humility when forecasting.

Despite the challenges, policymakers, like business leaders, really have very little alternative than to continue to forecast. By its nature, monetary policy must be forward-looking, since the actions taken today may not have their full effects for a year or more into the future. Monetary policymakers provide forecasts as a context for how they set monetary policy.

So, today, I will venture forth once again to offer my perspective on the outlook for the economy. I will also provide some thoughts about the ways policymakers can improve their communications about monetary policy.

Of course, 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.

Economic Outlook

Despite past challenges, I remain optimistic about the economy's future. In part, my optimism arises from my belief in the fundamental resiliency of our market economy. Although I'm optimistic, I'm also realistic. I know that in the past year, the U.S. economy has failed to live up to the expectations of growth that I and many economists had at the beginning of 2011. A year ago most economists were forecasting that economic growth would be 3 percent or a bit more in 2011. Instead, growth is likely to turn out to be less than 2 percent.

Some of this weakness is perfectly understandable given the shocks we experienced. Shortly after the start of 2011, we had severe snowstorms in the East, then the earthquake and ensuing disasters in Japan, followed by the unrest in the Middle East and North Africa that led to a run-up in oil prices. In addition, there were renewed concerns about European sovereign debt, and our own fracas in Washington over fiscal policy and the debt ceiling. All of these events weighed heavily on growth, as well as on business and consumer confidence.

Nonetheless, neither I nor other forecasters see much chance that the U.S. economy will slip into another recession in the coming year. Real GDP in the U.S. has been growing — albeit modestly — for nine straight quarters. I anticipate that we will continue to see modest growth of around 3 percent for 2012 and 2013.

Realistically, though, downside risks certainly remain. The largest of these are the ramifications for the U.S. economy of the continuing sovereign debt crisis in Europe. An economic slowdown in the euro zone will likely restrain export growth in the U.S. And while strains in financial markets have been limited to European institutions so far, the situation bears watching to ensure that there are no adverse spillovers to U.S. financial institutions. Of course, regardless of how the European situation plays out, it has already imposed additional uncertainty on growth prospects for the global economy.

That uncertainty has been compounded by our own nation's inability to establish a clear plan to put our fiscal policy on a sustainable path. Until the economic environment becomes clearer, firms and consumers are likely to postpone significant spending and hiring decisions -- posing a drag on the recovery, even as economic developments in the U.S. continue to improve.

In addition to the effects of uncertainty, consumers face the ongoing work of restoring the health of their balance sheets. The fall in both home prices and the stock market markedly reduced household wealth. The natural response to such a decrease is for families to reduce consumption and increase saving, and that is exactly what we are seeing. Most economists believe that this process will take a while longer before consumers resume more normal spending and saving patterns.

Businesses, on the other hand, seem further along in improving their balance sheets' health and improving productivity. Business investment on equipment and software has been relatively strong, buoyed by solid growth in corporate earnings. The Philadelphia Fed's Business Outlook Survey and other regional measures of manufacturing activity have improved since late summer, and the forward-looking components of these surveys suggest continuing growth into 2012.

On the housing front, I expect to see stabilization but not much improvement in 2012. We entered the Great Recession over-invested in residential real estate, and we are not likely to see a housing recovery until the surplus inventory of foreclosed and distressed properties declines. As the economy rebalances, we may not see housing and related sectors return to those pre-recession highs, nor should we necessarily seek or expect them to do so.

The health of the labor market continues to be a major concern. Unemployment remains uncomfortably high, putting strains on millions of families and individuals. While there is a long way to go in restoring a vibrant labor market, I am encouraged by the employment reports released over the past several months.

Last Friday's report showed a net gain of 200,000 jobs in December and another drop in the unemployment rate to 8.5 percent. This means that in 2011 the economy added over 1.6 million jobs and the unemployment rate fell nearly a full percentage point. While the road may not be a smooth one, it is encouraging that we are continuing to see a gradual improvement in labor market conditions.

As growth continues and strengthens, I expect further modest declines in the unemployment rate to around 8 percent or, in my more optimistic moments, maybe a little less, by the end of 2012.

Just as growth has been weaker than many forecasters had anticipated, inflation has been higher than many expected in 2011. When we last met a year ago, many were concerned about the risks of a sustained deflation. I was not among them. Instead, I thought we would see inflation at about 2 percent for the year.

It turns out we were all wrong. Total inflation, as measured by the CPI on a year-over-year basis, is nearly 3-1/2 percent, reflecting strong increases in energy and food prices in the past year. Core inflation, which excludes more volatile food and energy prices, is running at about 2.2 percent. I do anticipate that with many commodity prices now leveling off or falling, and inflation expectations relatively stable, inflation will moderate in the near term. Indeed, total inflation has moderated over the past several months.

But as a policymaker, my focus is less on the near term and more on the medium term. Looking further ahead, I believe we must monitor the inflation situation very carefully, particularly in this environment of very accommodative monetary policy. Inflation most often develops gradually, and if monetary policy waits too long to respond, it can be very costly to correct. Measures of slack such as the unemployment rate are often thought to prevent inflation from rising. But that did not turn out to be true in the 1970s. Thus, we need to proceed with caution as to the degree of monetary accommodation we supply to the economy. So let me review some of the policy actions the Fed has taken.

Monetary Policy

An environment of extraordinary monetary accommodation has supported the recovery, with the federal funds rate near zero for over three years. In the meantime, the Federal Reserve's balance sheet has more than tripled as the Fed enacted programs to improve liquidity in a weak economy and to shift its asset composition from short-term Treasuries to longer-term Treasuries, mortgage-backed securities (MBS), and agency debt.

Last August, the Federal Open Market Committee changed its guidance about its expectations for the future path of the federal funds rate, stating that economic conditions were "likely to warrant exceptionally low levels for the federal funds rate at least through mid-2013."

In September, the Committee announced its intention to purchase $400 billion of longer-term Treasuries and to sell an equal amount of shorter-term Treasuries in an effort to reduce yields from already historically low levels. This action, to be completed by June, will lengthen the maturity of the Fed's asset holdings. In addition, in an effort to help mortgage markets, the FOMC is reinvesting principal payments from its holdings of agency debt and MBS into MBS rather than Treasuries.

If you happen to follow the Fed's policy actions, you may know that I dissented from these decisions. Let me briefly explain why. Given the economic developments in August and September and the economic outlook, it was not clear to me that further monetary policy accommodation was appropriate. After all, inflation was higher and unemployment was lower relative to the previous year. Moreover, policy actions are never free; they need to be evaluated based on a thorough analysis of costs and benefits. I felt that the benefits of further monetary policy actions were small at best, since, in my view, they would do little to help resolve the challenges on the employment front. But further monetary policy accommodation carried potential costs. It could translate into a steady rise in inflation over the medium term even without much of a

drop in the unemployment rate. We saw such an environment of stagflation in the 1970s, and we must remain vigilant that we do not create such a situation again. In my assessment, the potential costs outweighed the potential benefits of further accommodation.

In addition, the August decision to change the forward policy guidance by saying economic conditions were likely to lead to low rates through mid-2013 raised particularly difficult communication challenges. First, given my outlook, I believe economic conditions may require the Fed to raise rates before mid-2013. Second, monetary policy should be contingent on the economic environment and not on the calendar. In my view, making a perceived commitment based on calendar time risks confusing the public about how policy is formed. If the Committee wishes to provide forward guidance, then a better way of conveying such information is necessary. My own view is that it would be better to provide more information about how policy responds to economic events, a sort of reaction function, than to make commitments based on the calendar that we may not keep.

Improving Communications

In fact, my FOMC colleagues and I have been discussing for some time how to improve communications about policymakers' views of current economic conditions, the economic outlook, and our framework for making monetary policy decisions. Early last summer, Chairman Bernanke asked Governor Yellen, Governor Raskin, President Evans, and me to serve on a communications subcommittee. As the minutes from the December FOMC meeting indicate, the Committee discussed two communications initiatives brought forward by the subcommittee. The first concerned improving our communications about FOMC participants' economic projections. The second concerned the development of a consensus statement on the FOMC's longer-run goals and monetary policy strategy.

Making longer-term goals transparent is important, not just for central banks but for any organization. As that master of the understatement Yogi Berra is said to have remarked:

"You've got to be careful if you don't know where you're going 'cause you might not get there!"

Improving the transparency of monetary policy has always been high on my list of things to do. The Fed is accountable to the public, so it needs to be clear about its goals and approach to making policy decisions. Moreover, when households, firms, and markets have a better understanding of what to expect from monetary policy, they can make better financial plans and spending decisions. Thus, greater clarity helps monetary policy become more effective at promoting its congressionally mandated goals of price stability, maximum employment, and moderate long-term interest rates.

The Fed, particularly during the tenure of Chairman Bernanke, has become increasingly transparent in its policies and actions. In 2007, the FOMC decided to release its Summary of Economic Projections, or SEP for short, four times a year. These projections provide information about the range of individual policymakers' forecasts for key economic variables, including output, inflation, and unemployment. But these forecasts differ from the kind made by private-sector economists who try to predict what the policy path will be. Instead, in making the SEP projections, each policymaker assumes a path for monetary policy that – based on current economic conditions — he or she believes will deliver the best outcomes for the economy. Yet, up to now, the SEP did not include any information on those policy projections. This lack of information makes it harder for the public to interpret the projections. For example, two FOMC participants might have considerably different growth forecasts. Is this because they have different views about the underlying dynamics of the economy? Or is it because they are assuming different policy paths? Alternatively, two participants may have similar forecasts, but they may believe that these forecasts will be achieved through different policy paths. Without any information about the assumed policy paths, it is

harder to judge the meaning of differences or similarities of forecasts across FOMC participants. So to help alleviate some of this uncertainty, starting in January, the SEP will provide information on participants' assessments about the appropriate path of monetary policy.

As I indicated in a speech last November, I fully support this move toward increased transparency. In my view, giving the public a sense of Committee participants' views on appropriate policy in the SEP conveys much more useful information about the likely future path of policy than using a calendar date, as we have been doing in our recent FOMC policy statements. Of course, the views of appropriate policy will vary across participants. But that diversity will help convey a sense of the confidence bands around the assessments, which I consider a plus as well.

These policy projections are not unconditional commitments of the Committee. The views of appropriate policy will evolve over time as economic and financial conditions change. As the policy assessments change, the relationship between current economic conditions, the economic outlook, and appropriate policy will become more transparent. This will give the public a better understanding of our policy reaction function – that is, about how we are likely to adjust policy in response to changes in economic conditions.

As the minutes of the December FOMC meeting indicate, FOMC participants continue to discuss ways to clarify the Fed's longer-run goals and monetary policy decision-making process. Let me explain what, in my view, are three essential elements in such a clarification. First, the FOMC should provide an explicit numerical inflation objective. Being explicit will enhance the credibility of our commitment to price stability, which will help anchor inflation expectations and foster price stability and moderate long-term interest rates. Moreover, a credible commitment to price stability affords the Fed more flexibility in the short run as it attempts to mitigate the fluctuations in output and employment in the face of significant economic disturbances.

Second, in my view a clarification of our monetary policy objectives and strategy should explain why the FOMC cannot set a fixed long-run numerical objective for the employment part of our mandate. Let me be very clear – this does not mean that I do not care about maximum employment or want to disregard or downgrade its importance. Rather, it reflects the economic differences between the inflation and employment parts of our mandate. Over the longer run, the economy's inflation rate is mainly determined by monetary policy. So, the FOMC is able to set a longer-run numerical goal for inflation and should be held accountable for achieving that goal.

In contrast, maximum employment is largely determined by factors that are beyond the direct control of monetary policy. These factors include such things as demographics, technological innovation, the structure of the labor market, and various governmental policies – all of which will vary over time. Policymakers consider a wide range of indicators in assessing employment, but estimates of maximum employment are subject to substantial uncertainty. I do not believe the FOMC should set a fixed numerical objective for something that it does not directly control and cannot accurately measure.

A third element the FOMC should clarify is that it takes a balanced approach to setting policy. By balanced approach I mean one that promotes all of our congressionally mandated objectives of maximum employment, stable prices, and moderate long-term interest rates. In particular, the Committee's policy judgments will seek to mitigate fluctuations in employment and inflation in the face of significant economic disturbances.

Conclusion

In summary, the U.S. economy is continuing to grow at a moderate pace. I expect annual growth to gradually accelerate to around 3 percent in 2012 and 2013.

Prospects for labor markets will continue to improve, with job growth strengthening and the unemployment rate falling gradually over time. I believe inflation expectations will be relatively stable and inflation will moderate in the near term. However, with the very

accommodative stance of monetary policy, the inflation situation is one that bears careful watching in order to ensure that inflation pressures remain contained over the medium run.

Uncertainty imposed by the fiscal situation in Europe and the longer-run fiscal issues in the U.S. pose risks to the forecast. However, despite these risks, my baseline forecast is for the U.S. recovery to continue.

On the monetary policy front, the Federal Reserve remains committed to enhancing the transparency of its policy actions and creating better public understanding of the rationale behind the FOMC's decisions. For this reason, later this month the FOMC will begin to include information about each participant's assessments for the target federal funds rate path in its Summary of Economic Projections. The FOMC is exploring further enhancements to increase transparency and the effectiveness of its communications, including ways to clarify its longer-run goals and monetary policy decision-making process.

Economic research over the past 30 years has shown that setting monetary policy in a systematic manner leads to better economic outcomes — lower and less volatile inflation and greater economic stability in general. But the benefit depends on the public's understanding of the policymaking framework. Transparency not only furthers the effectiveness of monetary policy by enhancing the credibility of the central bank but also raises the Fed's accountability to the public. Thus, I remain committed to working to raise the clarity of the Fed's public communications about current economic conditions, the economic outlook, and our policymaking framework.