

The Outlook and the Hazards of Accelerationist Policy

Economic Forecast

The University of Delaware Center for Economic Education and Entrepreneurship

Newark, Delaware

February 14, 2012

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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 back again to the University of Delaware. It has been three years since I last spoke at this event and a lot has happened. Yet, as I will explain, we have come a long way on the road to recovery from the Great Recession. So, this morning I will share with you my take on the economic outlook. Then I want to discuss the hazards of trying to apply ever more monetary accommodation to speed up the recovery process.¹

Economic Outlook

We are now in the third year of a moderate economic recovery that has had more than a few bumps along the way. We finished 2011 with real GDP at 1.6 percent, compared to 3.1 percent in the prior year. Some of this weakness is perfectly understandable, given the unexpected shocks we experienced during the year. Yet, the economy persevered. Indeed, growth accelerated across each of the four quarters, from less than half of a percent in the first quarter to around 2-3/4 percent in the fourth quarter. I

¹ I should note the usual disclaimer that my views are my own and not necessarily those of the Federal Reserve Board or my colleagues on the Federal Open Market Committee.

anticipate that we will continue to see moderate growth of around 3 percent in 2012 and 2013, which is slightly above trend.

Business spending, especially investment in equipment and software, was relatively healthy last year, buoyed by solid growth in corporate earnings. In January, the Philadelphia Fed's Business Outlook Survey showed that regional manufacturing activity continued to expand at a moderate pace, the fourth consecutive monthly increase since a late summer lull. The survey's measures of future activity also indicated that our respondents expect activity to continue to pick up over the next six months. I take this as a sign that business sentiment is also improving.

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.

Even as the economy rebalances, we should not seek, nor should we expect, housing and related sectors to return to those pre-recession highs. Those highs were unsustainable, and the housing crash that ensued destroyed a great deal of wealth for consumers and the economy as a whole. The losses are real and the consequences severe for many individuals and many businesses. Moreover, monetary policy cannot paper over these losses, nor should it try to do so. Households and businesses, nevertheless, continue to make progress on restoring the health of their balance sheets by paying down debt and increasing savings. Most economists, including me, believe that this process will continue into 2012.

The labor market has grown stronger in recent months. Although there are still too many people unemployed in our region and the nation, I am encouraged by the most recent employment reports. The January employment report showed a net gain of 243,000 jobs, and revisions to November and December added another 60,000 jobs to the recovery. Some have downplayed the report, suggesting that one good data point

does not make a trend, and I wholeheartedly agree. But what we have seen is more than one data point. Net employment gains were 103,000 in October, 157,000 in November, 203,000 in December, and 243,000 in January – a clear positive trend.

The household survey also reported a significant decline in the unemployment rate. Here, too, the trend is encouraging – 8.9 percent in October, 8.7 in November, 8.5 in December, and 8.3 in January. That is the lowest level in nearly three years. As growth continues and strengthens, I expect further gradual declines in the unemployment rate, with the rate falling to 8 percent or less, by the end of 2012.

In our District, all three states ended 2011 with lower unemployment rates. New Jersey's rate, at about 9 percent, is still higher than the national average, but Delaware's and Pennsylvania's were below the national average, with rates of 7.4 and 7.6 percent, respectively.

As we continue down the road to recovery, I expect we will face further hiccups along the way. One significant risk is the potential effects of the continuing sovereign debt crisis in Europe. The economic slowdown in the euro zone will likely restrain U.S. exports. And while strains in financial markets have been limited to European institutions so far, we must continue to monitor events 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 considerable uncertainty on growth prospects for the global economy. Moreover, our own nation's inability to establish a clear plan to put our fiscal house in order contributes additional uncertainty to the economic landscape.

Until the economic environment becomes clearer, firms and consumers are likely to postpone significant spending and hiring decisions – imposing a drag on the recovery, even though economic developments in the U.S. continue to improve.

Inflation risks in the near term remain modest. However, I remain concerned that monetary policy has exposed us to substantial inflation risk over the medium to longer

term. Total inflation in 2011, as measured by the consumer price index on a year-over-year basis, was 3 percent, reflecting strong increases in energy and food prices, particularly in the early part of the year. The personal consumption expenditures price index rose 2.4 percent. While these inflation rates exceed our target, I anticipate that with many commodity prices now leveling off or falling, and inflation expectations relatively stable, inflation will remain moderate in the near term. My forecast is that inflation will settle around 2 percent in 2012.

Yet, inflation 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 and be circumspect 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

As you know, the Fed has kept the federal funds rate near zero for more than three years to support the recovery. We have also conducted two rounds of asset purchases that have more than tripled the size of the balance sheet and changed its composition from short-term Treasuries to longer-term Treasuries and housing-related securities, mostly mortgage-backed securities. Today, we are in a modest recovery from a deep recession and financial crisis. The financial crisis has passed, however, and monetary policy should not continue to act as if the crisis was still with us.

In January, the Federal Open Market Committee announced that economic conditions were “likely to warrant exceptionally low levels for the federal funds rate at least through late 2014” – that’s almost three years from now. And that is 18 months longer than the mid-2013 calendar date first signaled last August. In addition, the Committee announced that the Fed intends to continue the maturity extension program, or “operation twist,” first launched last September. In this program, the Fed is buying \$400

billion of longer-term Treasuries and selling an equal amount of shorter-term Treasuries, in an effort to reduce yields from already historically low levels. The FOMC is also continuing to reinvest principal payments from its holdings of agency debt and MBS into MBS in an effort to help mortgage markets.

You may know that I dissented from the FOMC decisions in August and September because 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.

In addition, I do not support the practice of offering forward policy guidance by saying economic conditions are likely to lead to low rates through some calendar date. Such statements are, in my mind, particularly problematic from a communications perspective. Monetary policy should be contingent on the economic environment and not on the calendar.

Thus, I was not supportive of the Committee's actions in January. I think that economic conditions, as they have evolved since late last year, do not call for further accommodation. In fact, the economy has actually improved. Moreover, I continue to oppose using calendar dates to communicate forward guidance.

Yet, despite the extraordinary steps taken to support the economy, many argue that monetary policy should do more. The argument is that while inflation may be close to our target, unemployment remains elevated, and thus, monetary policy must act more aggressively if it is to meet its mandated employment objective.

I disagree and believe that doing so would lead us down a very treacherous path – one that would be ever more difficult to navigate and one that would increase the already substantial risk of higher inflation. But the problem is not just inflation risk down the road. Prolonged efforts to hold interest rates near zero can lead to financial market distortions and the misallocation of resources.

Let me offer an analogy that might help you visualize the risks.

Imagine you're driving a car down the Delaware Turnpike on a rainy and foggy day on the way to a birthday party for your mother. Unfortunately, you can't see very far ahead because of the weather, and you don't know exactly how far you are from the exit. You are anxious because you don't want to miss the party. Your children are in the back seat, giddy with excitement about seeing their grandmother. So you decide to go a little faster. You accelerate.

After some time passes, you still think you are some distance from your exit. The children are now fidgeting in the back seat, and you don't want to be late, so you decide to step on the gas a little more. Now, you are speeding, hoping to get to your destination sooner. Eventually, though, as you are flying down the highway, you finally catch a glimpse of the exit through the fog and rain, only now you are going too fast to safely navigate the off ramp. You are faced with two very unattractive options.

One option is to slam on the brakes to make the exit. This strategy risks causing a multicar accident, as your abrupt efforts to slow down surprises drivers behind you who had expected you to continue at high speed. The result is an accident, perhaps injuries to innocent people, and maybe a severe traffic jam, diverting or delaying many others. The second option is to continue down the road to the next exit, turn around, and then backtrack to the right exit. This strategy means that you are late, you miss the party, you disappoint everyone, you pay extra for tolls and gas, and you incur numerous other costs in the process.

Monetary policy is sometimes criticized for such "go-stop" policies. Policymakers step on the accelerator aggressively, only to slam on the brakes in order to change course. Such an approach to policy can be highly destabilizing, creating added volatility for financial markets and the economy.

I would add that constant acceleration only makes these risks even more hazardous. Slamming on the brakes or abruptly changing course could disrupt the economy. Failing

to slow down and exit at the right time risks excessive inflation, which then has to be controlled. It also risks the misallocation of resources and capital, and perhaps even credit bubbles or other distortions that could pose problems for the economy.

Thus, in my mind, such an accelerationist approach to monetary policy is risky and the potential costs may be quite high. It is an approach most often driven by an excessive focus on the short run and perhaps some hubris that we will be able to successfully avert the risks such a strategy poses for the economy over the longer run.

Conclusion

In summary, the U.S. economy is continuing to grow at a moderate pace. I expect annual growth of 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, we must guard against the medium- and longer-term risks of inflation and the potential for distortions such accommodation can create.

Finally, I believe we must also guard against an accelerationist approach to policy – one that calls for monetary policy to do more and more in an attempt to get to our objectives that much faster. The risks to economic stability of such an approach over the medium term could be quite high and could jeopardize our ability to achieve our longer-terms goals.