Economic Outlook

Rotary Club of Wilmington

Wilmington, Delaware

March 29, 2012

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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 the Rotary Club of Wilmington. In planning for today, I learned that Wilmington's business and community leaders have been gathering under your auspices at this location since 1914, longer than any other Rotary Club in the world. From one organization that is almost a century old to another, that is quite an achievement.

Since the Federal Reserve is nearing its centennial in December 2013, I thought I would give you a little background on our nation's central bank before I talk about my economic outlook. While many Americans hear about the Fed in the news every day, not everyone knows how we work or how we are structured.

Congress created the Federal Reserve System in 1913. To balance political, economic, and geographic interests, the System was designed with 12 independently chartered regional Reserve Banks throughout the country, overseen by a Board of Governors in Washington, D.C. The Federal Reserve Bank of Philadelphia serves the Third District, which includes Delaware, the southern half of New Jersey, and the eastern two-thirds of Pennsylvania. The Reserve Banks distribute currency, act as a banker's bank, and generally perform the functions of a central bank, including serving as the federal government's fiscal agent.

A central bank also guides the country's monetary policy. In the U.S., the body within the Federal Reserve that makes monetary policy decisions is the Federal Open Market Committee, or the FOMC. The Committee includes the seven members of the Board of Governors in Washington – there are currently two open posts – and five of the 12 Reserve Bank presidents: the president of the New York Fed and four other presidents, who serve one-year terms on a rotating basis. This structure ensures that our national monetary policy has its roots not just in Washington or on Wall Street, but also on Main Street and across our diverse nation.

Whether we vote or not, all Reserve Bank presidents attend the FOMC meetings, participate in the discussions, and contribute to the Committee's assessment of the economy and policy options. 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 business leaders, as well as briefings on economic conditions by our Research staffs. All this helps contribute to a rich and comprehensive mosaic of the national economy.

In this way, we are able to make the best informed decisions possible to achieve the goals of monetary policy that Congress has set for us in the Federal Reserve Act. Specifically, Congress mandates 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, it is often said that Congress has given the Fed a dual mandate.

I believe the diversity of opinion around the FOMC table is one of its great strengths and serves to improve the quality of our decision-making. As the famous American journalist Walter Lippmann once said, “Where all men think alike, no one thinks very much.” But that diversity of views also requires me to note that I speak for myself and not the Federal Reserve Board or my colleagues on the Federal Open Market Committee.

Economic Outlook

Now let me turn to the state of our economy. We have now seen 10 quarters of real GDP growth since mid 2009, when the Great Recession officially ended. However, growth has not been particularly robust or smooth. To many, it occasionally feels like we take two steps forward only to take one step back. We finished 2011 with real GDP at 1.6 percent, compared to 3.1 percent in the prior year. There were some perfectly understandable reasons for the weakness last year, given the unexpected shocks we experienced early in the year. Yet, the economy persevered. We saw growth accelerate across each of the four quarters, from less than half of a percent in the first quarter to 3 percent in the fourth quarter.

I anticipate that we will continue to see moderate growth of around 3 percent in 2012 and 2013. That outlook puts me in a slightly more optimistic camp than some forecasters. For instance, the Philadelphia Fed’s first-quarter Survey of Professional Forecasters reported average estimates of real GDP growing 2.3 percent in 2012 and 2.7 percent in 2013.

Business spending, especially investment in equipment and software, remained relatively healthy last year, buoyed by solid growth in corporate earnings.

Results from the Philadelphia Fed’s monthly Business Outlook Survey of manufacturers, which are widely viewed as a useful barometer of national trends in manufacturing, have continued to improve since last summer’s lull. In March, regional manufacturers reported that their current activity continued to expand at a moderate pace, the sixth consecutive month of positive numbers. The survey’s indicators of general activity, new orders, shipments, and employment all remained positive. The survey’s measures of future activity showed that our respondents expect activity to continue to pick up over the next six months.

Consumer spending, which accounts for about 70 percent of the nation's GDP, also continues to improve. While personal consumer expenditures were steady through January, retail sales in February grew 1.1 percent. While not exactly robust growth, retail sales are more than 6 percent higher than a year ago.

On the housing front, I expect to see stabilization and maybe some slight improvement in 2012. We entered the Great Recession over-invested in residential real estate, and we are not likely to see a strong housing recovery until the surplus inventory of foreclosed and distressed properties declines.

Even as the economy rebalances, housing and related sectors are not likely to return to those pre-recession highs, nor should we expect them to do so. 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.

Nevertheless, households and businesses continue to make progress on restoring the health of their balance sheets by paying down debt and increasing savings. That is a healthy trend, and most economists, including me, believe that this trend will continue into 2012.

On the labor front, I continue to be encouraged by recent employment reports, although everyone would agree that there are still too many people unemployed in our region and in the nation. The February employment report showed a net gain of 227,000 jobs, giving us the third month in a row with job growth of more than 200,000. We also continued to see a trend of upward revisions in prior months, adding another 60,000 jobs to payrolls.

The unemployment rate was 8.3 percent in February, as it was in January, but the unemployment rate has been moving down steadily for six months, and it is now at its lowest levels in three years. As growth continues and strengthens, I expect further gradual declines in the unemployment rate, with the rate falling below 8 percent by the end of 2012.

At the regional level, the latest unemployment rates for January also showed improvement. New Jersey's rate, at about 9 percent, was still higher than the national average, but Delaware's rate of 7.0 percent and Pennsylvania's rate of 7.6 percent were below the national average. Our Research Department is forecasting no change in the unemployment rates for Pennsylvania and New Jersey and a decline in Delaware's unemployment rate in February. The data are scheduled for release tomorrow.

We are also seeing continued improvement in the employment index in our monthly survey of manufacturers, which suggests more employers are adding to payrolls than cutting back.

As we continue down the road to recovery, there will undoubtedly be some bumps and setbacks along the way, but I am generally optimistic. Of course, any forecast is subject to some risks. The most significant and identifiable risk on the horizon is the potential effects of the continuing sovereign debt crisis in Europe. In recent months, I have come to believe that the European governments and their economies will work through their challenges. Nonetheless, the economic slowdown in the euro zone will likely exert a small drag on U.S. exports. And while European financial institutions have so far endured through the financial market turmoil in Europe, we must continue to monitor events to ensure that these troubles do not spill over 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. Hopefully, some of that uncertainty is beginning to wane. Moreover, our own nation's fiscal challenges contribute additional uncertainty to the economic landscape.

Until the economic environment becomes clearer, firms and consumers are likely to exercise some restraint in their spending and hiring decisions, thus limiting the pace of recovery, even while economic fundamentals in the U.S. continue to improve.

On the inflation front, there are risks and we must monitor the trends with care. The rate of inflation, as measured by the consumer price index, was 2.9 percent for the 12 months through February. Another common measure called the personal consumption expenditures price index was 2.4 percent through January. Thus, inflation is higher than the Fed's long-term target of 2 percent. Some of the increased inflation over the past year was driven by sharp increases in energy prices. During the late summer, oil prices did decline somewhat, slowing price increases, but unfortunately, they have been rising again and crude oil prices are now over $100 a barrel and gasoline prices are rising.

Oil prices have added a great deal of volatility to the overall price index. At times, sharp spikes in oil prices raise overall inflation, which is then reversed when those prices increases moderate. Yet, since early 2009, when oil prices fell to about $60 a barrel, the trend has been upward. Moreover, inflation rates that remove the effects of energy and food have been drifting upward as well from their lows of 1 percent or less in late 2010 to about 2 percent or a little higher today, depending on the particular index. Thus, we must monitor these inflation trends with some care and be prepared to take appropriate actions as necessary.

The public has the right to expect the central bank to keep inflation near its target of 2 percent over the medium to longer term. 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 the lessons of the 1970s show that is not the case. As you may recall, we ended up with both high unemployment and high inflation, which became known as the misery index. That is not a place we want to find ourselves again.

Monetary Policy

Before discussing where monetary policy might go in relation to economic conditions, it might be helpful to review just how much accommodation we currently have in place. 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 Fed's balance sheet and changed its composition from short-term Treasuries to longer-term Treasuries and housing-related securities, mostly mortgage-backed securities.

Many of these actions were taken at the height of the financial crisis and the ensuing deep recession. Yet, since then, as I have indicated, the economy has been healing, if somewhat more slowly than we would like, and the financial crisis has substantially abated. Of course, problems remain, but things are not nearly as bad or as gloomy as they were in 2009 and early 2010. At its latest meeting in March, the Federal Open Market Committee continued to hold to its statement that economic conditions were "likely to warrant exceptionally low levels for the federal funds rate at least through late 2014." That follows a structure for forward guidance that the Committee first began last August, when it said conditions were likely to warrant exceptionally low rates through mid 2013. Then in January, it pushed back that calendar date another 18 months.

The FOMC has also announced that the Fed intends to continue the maturity extension program, or "operation twist," first launched last September and set to end in June. 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 long-term 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 then. After all, inflation was higher and unemployment was lower relative to the previous year, as we have been discussing. Monetary policy should be responsive to economic conditions, and since that time, unemployment has decreased, and inflation is above target. I believe monetary accommodation is still called for, but I do not believe it should be as accommodative or aggressive as it was at the height of the crisis, when unemployment was over 10 percent and inflation was just 1 percent. Now that unemployment is at 8.3 percent and falling and inflation is over 2 percent and drifting up, we should not anticipate additional accommodation. Indeed, in the absence of some shock that derails the recovery, we may well need to raise rates before the end of 2014.

Nevertheless, monetary policy should be responsive to economic conditions. In my view, current conditions do not warrant further accommodation. Yet, should economic conditions significantly deteriorate or the upside risks to inflation I have stressed fall and significant risk of deflation emerge, we should rethink our policy stance. But neither of these events seems likely to me at this juncture.

I believe further accommodation at this stage of the business cycle could lead us down a very treacherous path – one that would be ever more difficult for us to navigate and one that would increase the already substantial risk of higher inflation. Yet, 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 that could lead to more, not less, economic instability.

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 remain at moderate levels in the near term. However, with the very accommodative stance of monetary policy that has now been in place for more than three years, we must guard against the medium- and longer-term risks of inflation and further distortions such accommodation can create.

Monetary policy should be determined by economic conditions and not by a calendar date. And we should resist any notion that we can solve all of our economic challenges simply by an ever more accommodative monetary policy.