A Perspective on the Economic Outlook

Presented to CFA Society of San Diego

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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 CFA Society of San Diego today. I have addressed chartered financial analysts in Philadelphia on a number of occasions, and I am pleased that travels to California this week afforded me the opportunity to accept your invitation to present my views on the economic outlook and monetary policy.

Last week, I attended the most recent meeting of the Federal Open Market Committee, or the FOMC, which is the body within the Federal Reserve responsible for determining monetary policy. As many of you know, according to the Committee's structure, there are 12 voting members on the FOMC — the seven members of the Board of Governors in Washington always have a vote; currently only five of the seven seats are filled. The other voters include five of the 12 Reserve Bank presidents: the president of the New York Fed, who is a permanent voting member, and four other presidents, who serve one-year terms on a rotating basis.

This year happens to be one in which my colleague John Williams, president of the Federal Reserve Bank of San Francisco, is a voting member, as I was last year.

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. The federated structure draws on the strong roots of decentralized government that our country was founded on and 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.

So conversations like the ones I've had with some of you today and with other individuals from business and community organizations help me gather and share timely information on the economy. This leads to more informed decisions as the Committee seeks to achieve the goals of monetary policy that Congress has set for us in the Federal Reserve Act. Specifically, Congress has mandated 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.

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. Yet, it requires me to note that I speak for myself and not the Federal Reserve System 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 11 consecutive quarters of expansion since mid-2009, when the recession officially ended. In the third quarter of 2011 we finally surpassed the previous peak in real GDP, which occurred in the fourth quarter of 2007. The expansion, as you read about every day and most likely experience in your businesses, has not been particularly robust. To many, it occasionally feels like we take two steps forward only to take one step back.

We finished 2011 with GDP growth of just 1.6 percent, compared to 3.1 percent in the prior year. Unexpected shocks early in the year, ranging from the disasters in Japan that led to supply chain disruptions in many industries, to flare-ups in the Middle East and North Africa that led to a steep rise in oil prices, and the re-emergence of the sovereign debt crisis in Europe held GDP growth to less than 1 percent in the first half of the year.

Yet, the economy persevered, even through our own debt-ceiling crisis, and grew at an annual rate of 2.4 percent in the second half of the year. In fact, growth accelerated across each of the four quarters, from less than half of a percent in the first quarter to 3 percent in the fourth quarter.

The first estimate of first-quarter GDP growth was reported last week as 2.2 percent. This number was slightly less than many forecasters anticipated, but it was in line with my forecast of moderate growth that will strengthen over time.

I anticipate that we will see moderate year-over-year growth of about 3 percent in 2012 and 2013. That outlook puts me in a slightly more optimistic camp than some forecasters. For example, my forecast is at the top of the central tendency of the FOMC participants' forecasts that were submitted last week. And 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. Our second-quarter survey won't be released until later this month; however, many private-sector forecasters have marked up their outlook slightly since the early part of the year based on the somewhat better than expected first-quarter performance, particularly on the consumption and employment fronts.

Growth in manufacturing has proven to be a bright spot for the economy over the last six to nine months, and it continues to be a reason for optimism going forward. The Philadelphia Fed's monthly Business Outlook Survey of manufacturers has been a useful barometer of national trends in manufacturing over many years. The survey's general activity index tracked with last year's summer lull, posting a few negative readings during the late spring and summer, but since then, the survey has reported seven months of positive numbers – indicating a moderate but steady expansion. Moreover, the survey's indicators of activity six months ahead have remained strong, suggesting that manufacturers are optimistic about the future.

Another upbeat indicator can be found in the Philadelphia Fed's coincident indexes for all 50 states. We produce these indexes monthly to create a state-by-state view of the economy. Our latest readings indicate growth in every state for the three months ending in March. A similar set of leading indicators also shows that growth is expected to continue over the next six months in nearly all states, including here in California.

Consumer spending, which accounts for about 70 percent of the nation's GDP, also continues to improve, as the drag from household deleveraging lessens. Despite modest wage growth, retail sales in March grew 0.8 percent from the previous month and 6.5 percent above March 2011. The Bureau of Economic Analysis also reported that first-quarter personal consumption expenditures (PCE) increased at a 2.9 percent annual rate in the first quarter – up from 2.1 percent in the fourth quarter and the most rapid rate of consumption growth since the last quarter of 2010.

On the housing front, I expect to see stabilization and maybe slight improvement in 2012. Yet, as the old real estate saying goes: "Location, location, location!" Whereas some regions saw a tremendous build-up in residential real estate, followed by a sharp decline, other areas, including many parts of my region back east, saw neither the dramatic boom nor the tragic bust. At a national level, though, we must acknowledge that we entered the 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.

Yet we must realize that even as the economy rebalances, housing and related sectors are not likely to return to those heady 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 does not create real wealth so it cannot eliminate or offset 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. This is a rational reaction and a healthy trend. Most economists, including me, believe that this trend will continue into 2012.

Conditions in the labor markets continue to improve modestly, though monthly numbers do bounce around a bit. For example, strong job growth from December through February may have partially reflected the effect of unseasonably mild weather this winter, and the modest pullback in March may represent some payback. Indeed, March's gain of 120,000 nonfarm jobs came after three months of solid growth of more than 200,000 a month. I prefer to average the quarter's monthly numbers to infer the underlying trend. Doing so, we see that average monthly gains in the first quarter outpaced those in the fourth quarter by nearly 50,000 jobs per month.

So, we continue to make slow, steady progress, as evidenced by an unemployment rate that fell to 8.2 percent in March, down almost a full percentage point from the 9.1 percent in August. I expect further gradual declines in the unemployment rate, with the rate falling to about 7.8 percent by the end of this year.

Despite this gradual improvement, we cannot ignore the fact that there are still too many people unemployed. The U.S. lost 8.8 million jobs from the peak of employment in January 2008 to the trough in employment in February 2010. We have gained back 3.5 million lost jobs, or 40 percent, but it will take some time before we, once again, see a truly vibrant labor market.

Any forecast is subject to some risks, and today I will discuss two risks on the horizon. The first is the potential effects of the continuing sovereign debt crisis in Europe, and the second is a lesser risk from rising energy costs.

Over the past year, U.S. financial markets have been roiled by worries about the European sovereign debt situation. We have often seen good news on the U.S. economy drowned out by the news from Europe. The crisis was a long time in the making and continues despite the efforts of European leaders. Many who thought that preventing sovereign default by a euro country would prevent the crisis from spreading have been proven wrong. A number of the peripheral countries in Europe are unquestionably on fiscal paths that are unsustainable and that must be addressed. I might add that the U.S. is also on an unsustainable fiscal path that must be addressed. Let me stress that these are fiscal issues, not monetary issues. Thus, we should look to the fiscal authorities for solutions, not our central banks. I have come to believe that the European governments and their economies will muddle through this near-term crisis but at significant cost to the taxpayers all across the euro zone. Nevertheless, the turmoil has resulted in an economic slowdown in the euro zone that will likely cause a small drag on U.S. exports.

The other risk facing the U.S. economy has been the rising cost of oil and gasoline. Oil prices have fallen from their recent highs, but they remain over $100 a barrel and gasoline is about $4 a gallon. However, unless the price of oil rises substantially from current levels, this is not likely to derail our recovery. I come to this assessment, in part, because the U.S. economy is less vulnerable to oil price shocks than it was in the 1970s and 1980s, in part because we use about half as much energy to make a dollar of real GDP than we used to in the 1970s.

In addition, while oil prices have risen, natural gas prices have been falling, and they are now at their lowest level since 1999. This is a result of both increased production in places like Pennsylvania's Marcellus Shale areas, as well as reduced demand because of the mild winter. Thus, while energy is still an important factor of production, our economy is less dependent on oil than it used to be.

The larger risk from higher energy prices is not to growth but to inflation and expectations of inflation. The Fed recently set its long-term inflation target at 2 percent, as measured by the year-over-year change in the personal consumption expenditures chain-weighted price index. By that measure, prices rose at a 2.3 percent annual rate over the year ended in the first quarter, which is above our target. While this may prove to be temporary as oil prices stabilize, there is a risk that the oil price increases we've seen so far this year will not reverse as anticipated, which could put additional pressure on prices and inflation expectations. Thus, we must continue to monitor these inflation trends with some care and be prepared to take appropriate action 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, and the sum of those two statistics became known as the misery index. More recently, I note that for nearly three years, the Bank of England has been forecasting that inflation will return to its 2 percent target, but it has failed to do so, even though England's economy has contracted over the past two quarters and many perceive the level of slack in the British economy as large and increasing. That is not a place we want to find ourselves.

Monetary Policy

Before discussing where monetary policy might go as economic conditions evolve in the coming quarters, 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 our balance sheet. We continue to implement our maturity extension program, which is lengthening the maturity of our holdings of Treasury securities and the composition of the portfolio has changed from mainly short-term Treasuries before the crisis to longer-term Treasuries and housing-related securities, mostly mortgage-backed securities, today.

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 April, 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 to late 2014.

The FOMC has also announced that the Fed intends to complete 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 increasing 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. Since that time, unemployment has decreased further, and inflation is above target. While I believe monetary accommodation is still called for, in the absence of some shock that derails the recovery, we may well need to begin to gradually scale back the level of accommodation well before the end of 2014.

Another reason I dissented last year was that I did not favor providing forward guidance in terms of a calendar date. Monetary policy should be responsive to economic conditions, and I believe that we should be providing information on the economic factors that will influence our monetary policy decisions rather than trying to forecast when that time will be.

In January, the Committee took a step to enhance the information it includes in its economic projections, which are summarized four times a year in the Survey of Economic Projections, or SEP. I believe such information will prove to be useful in conveying the relationship between changes in economic conditions and monetary policy decisions. In particular, the Committee now summarizes the monetary policy assessments that underlie the economic projections of output, inflation, and unemployment. These assessments are what the individual policymakers view as the policy path that is appropriate in achieving the Fed's longer-term goals.

This additional information has two benefits. First, having more information on the underlying paths should help the public better understand the projections. For example, they will have a better understanding of whether inflation is expected to return to the long-term goal as shocks work their way through the economy or whether policymakers anticipate that further monetary policy actions will be needed to achieve the Committee's objective.

Second, as views of appropriate policy evolve over time as economic and financial conditions change, the public will be able to draw better inferences about the relation between current economic conditions, the economic outlook, and appropriate policy. This then informs the public about how policy is likely to react in the future to changes in the economy. For example, in April, the SEP indicated that only four participants now expect the first increase in the federal funds rate will occur after 2014, compared to six in the January projections. These projections of the policy path have changed as the central tendencies of the 2012 projections of growth and inflation were revised up and projections of unemployment were revised down.

We know that when monetary policy is conducted in a systematic way — that is, with a systematic relationship between changes in economic conditions and the policy actions taken by the central bank — policy becomes more transparent and easier to communicate. And the better the public and the markets understand how policy is likely to be adjusted as the economy changes, the more predictable policy becomes, which promotes price stability and better economic outcomes. In addition, policy transparency can increase the public's ability to hold the central bank accountable for its policy decisions.

I believe, and have argued for some time, that the FOMC should strive to provide information about the factors that will influence our policy decisions. Some call this a policy rule or reaction function. This will not only enhance transparency but also impose an important discipline on policymaking. If policymakers choose to deviate from the guidelines, they are forced to explain why and when they anticipate returning to more normal operating practices. Requiring this type of transparency raises the bar policymakers face to engage in discretionary policies in the first place.

I suspect that the FOMC participants may not be quite ready to agree on a specific policy rule or reaction function because they use different models and have different loss functions. However, I do believe it will be possible to provide assessments of the evolution of the key variables influencing our policy choices and then communicate our policy decisions in terms of the changes in these key variables. If policy was changed, then we would explain that change in terms of how the variables in our response function changed. If we choose a consistent set of variables and systematically use them to describe our policy choices, the public will form more accurate judgments about the likely course of policy – reducing uncertainty and promoting stability.

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. I believe the FOMC should continue to work toward increasing the public's understanding of how policy will systematically react to changes in economic conditions. Improving the transparency of our monetary policy decision-making process will help to improve the effectiveness of monetary policy and the Fed's accountability with the public.