A Perspective on the U.S. Economic Outlook and Monetary Policy

Presented to the Market News International Seminar

Hong Kong, China

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I want to thank Steve Beckner for his kind introduction and Market News International for arranging this evening's event. It is nice, if a bit unusual, to see Steve on a different continent, and it's a pleasure to have this opportunity to share my views of the U.S. economy and monetary policy with all of you.

An audience that gathers here at the Hong Kong Bankers Club is well aware of the extraordinary economic times in which we live. In the last five years, we have seen a financial crisis that led to, arguably, the worst global recession since the Great Depression. Thankfully, many economies around the world are now in modest recoveries. Yet, this episode has made us much more aware of how interconnected the world economy has become. But this evening I am going to concentrate on the outlook for the U.S. economy, which is now nearing the fourth anniversary of an economic recovery that officially began in mid-2009. As I share my outlook, though, I must note that the views I express here are my own and not necessarily those of the Federal Reserve Board of Governors or my colleagues on the Federal Open Market Committee.

Economic Conditions

Let me start with a discussion of inflation, since in my view, preserving price stability is the most important function of a central bank. In our modern economy, monetary policy has ultimate responsibility for preserving the purchasing power of a nation's fiat currency. That is not to say that central bankers have always lived up to that responsibility. At times, the Federal Reserve has been successful, but at other times, it has failed, such as the period of rapid deflation during the early 1930s or the rapid inflation of the 1970s.

However, economists and central bankers have learned from the past, which has led to better results over the last 20 years. From 1972 to 1992, the average inflation rate, as measured by the personal consumption expenditure, or PCE, price index, was about 5.5 percent, largely reflecting the Great Inflation episode of the 1970s and the subsequent transition to lower inflation during the 1980s. But in the two decades since 1992, inflation has averaged around 2 percent per year. While these averages mask the ups and downs, I believe the numbers suggest that the Fed has done a better job of achieving its objective of stable inflation in recent decades.

In January 2012, the FOMC announced an explicit long-run inflation target of 2 percent a year for the PCE price index. Being explicit about our inflation objective enhances the credibility of our commitment to price stability, which helps anchor inflation expectations and foster price stability and moderate long-term interest rates.

In the past three years, average PCE inflation in the U.S. has been running about 1.8 percent. Although that is a bit below our 2 percent target, I expect inflation to remain close to our goal over the next year or two. Thus, I do not see inflation as a serious threat in the near term. However, I remain concerned that our extraordinary level of monetary accommodation will have to be scaled back, perhaps more aggressively than some think, to ensure that inflation over the medium term remains consistent with our target.

Let me turn now to other aspects of the U.S. economy, including the prospects for growth and employment. The economy grew just 1.7 percent in 2012, measured on a fourth-quarter-to-fourth-quarter basis. Growth in the fourth quarter was particularly weak, eking out just a 0.4 percent gain, compared to 3.1 percent real GDP in the third quarter. However, a number of temporary factors adversely affected performance in the fourth quarter, including a sharp reduction in private inventory investment, defense spending that declined at more than a 20 percent annual rate, and the effects of Hurricane Sandy in the Northeast. Recent data indicate that 2013 has gotten off to a good start as the effects of these temporary factors have waned.

Consumer spending, which accounts for about 70 percent of U.S. GDP, continues to grow at a moderate pace. So far, the increase in payroll taxes this year has proven to be less of a constraint on spending than many economists had feared. More generally, it is household deleveraging that has been a drag on growth over the course of the recovery. The housing collapse in the U.S. destroyed a lot of the equity that families had built up in their homes. Thus, a huge portion of their savings vanished. With that wealth gone, it is only natural for consumers to want to rebuild savings, and they are doing so. I anticipate that the effects of deleveraging on spending will continue to wane over time and spending will pick up as labor market conditions improve and house prices rise.

My forecast is that the pace of growth in the U.S. will pick up somewhat, to about 3 percent in 2013 and 2014 – a pace that is slightly above trend. Based on the Federal Open Market Committee's Summary of Economic Projections, my outlook for 2013 is a little higher than the central tendency of 2.3 to 2.8 percent. For 2014, I am near the lower end of the central tendency, which is 2.9 to 3.4 percent.

My forecast of 3 percent growth should allow for continued improvements in labor market conditions, including a gradual decline in the unemployment rate, similar to the trend we have seen over the past two years, which was a 0.7- to 0.8-percentage point decline per year. Continuing at such a pace would lead to an unemployment rate close to 7 percent at the end of 2013 and a rate below 6.5 percent by the end of 2014.

Let me now turn to the implications for monetary policy.

Monetary Policy

Over the last five years, the Federal Reserve and many other central banks have taken extraordinary actions to support the economic recovery. The Fed has lowered its policy rate – the federal funds rate – to essentially zero, where it has stayed for more than four years. Since the policy rate cannot go lower, the Fed has attempted to provide even more accommodation through large-scale asset purchases, or quantitative easing. These purchases have greatly expanded the size and lengthened the maturity of the assets on the Fed's balance sheet.

In addition, the Fed has provided "forward guidance" on the future path of interest rates. Specifically, it has indicated that so long as the outlook for inflation over the one- to two-year horizon does not move above 2.5 percent and inflation expectations remain well anchored, and so long as the unemployment rate is above 6.5 percent, the Committee expects to keep the federal funds rate at essentially zero. The Committee has also indicated that it anticipates that the highly accommodative stance of monetary policy will remain appropriate for a considerable time after the economic recovery strengthens.

Currently, the Fed is purchasing $40 billion of agency mortgage-backed securities and $45 billion of longer-term Treasury securities each month. The Committee has indicated that it anticipates it will continue to purchase these assets until there is substantial improvement in labor markets in a context of price stability. The Fed is also reinvesting the proceeds of maturing or prepaid mortgage-backed securities and is rolling over maturing Treasury securities at auction. As a result, the Fed's balance sheet, which includes about $3.2 trillion in assets, is growing at a pace of about $85 billion a month.

These purchases of longer-maturity assets are intended to put downward pressure on longer-term interest rates to encourage households and businesses to spend today rather than save. Whatever one's views of the benefits, these changes in the size and composition of the balance sheet pose challenges for the Fed's eventual exit from this period of extraordinary accommodation and for the normalization of monetary policy.

Of course, before the Fed can begin to implement any sort of exit from the massive volume of accommodation it has put in place, it must stop its attempts to increase accommodation through its ongoing asset purchase program. I was not in favor of the September and December decisions to further grow the balance sheet, as I believed that the costs exceeded the expected benefits. Nevertheless, the Committee chose to establish the current open-ended asset purchase program that would adapt to changing economic conditions, with particular attention to the labor market.

In my view, a case can be made that we have seen sufficient improvement to begin tapering our asset purchase program with the objective of bringing it to an end before year-end. Let's look at some of the data.

In the six months through September 2012, when the decision to initiate the latest open-ended asset purchase program was made, private nonfarm payrolls increased an average of 129,000 per month and the unemployment rate averaged 8.1 percent. In the six months beginning in October 2012 and running through March 2013, private nonfarm payrolls have increased on average 202,000 per month and the unemployment rate has averaged 7.8 percent over the same period and has now reached 7.6 percent.

Moreover, the average duration of unemployment has fallen; the share of long-term unemployment has dropped; and hours worked and earnings have risen. While further progress would certainly be desirable, I believe the evidence is consistent with a significantly improving labor market. Thus, it is appropriate to begin scaling back the pace of asset purchases. I want to emphasize that ending asset purchases is not the start of an exit strategy, nor would it indicate that an increase in the policy rate was imminent. It is a way to halt efforts to continuously expand the level of accommodation by increasing the size of the balance sheet. Given the improving economy, dialing back asset purchases is an appropriate response.

Many observers have noted that the March employment report, released last Friday, was a disappointment because job growth in private payrolls was only 95,000. But I would remind everyone that monthly employment numbers are highly volatile and fluctuate a great deal from month to month. Indeed, while the March reading was lower than expected, the February payroll increase was higher than expected, at 254,000. Such swings are not unusual. Moreover, the first release is only preliminary and is subject to revision, and recently the revisions have tended to be upward.

We must be cautious as policymakers not to overweight the short-term numbers, especially when they are often subject to substantial revision. Excessive focus on the short term is often a recipe for long-term problems.

In addition to gradually eliminating our asset purchases, two other steps might be taken prior to raising the policy rate. First, we should seek to normalize the spread between the Fed's discount rate on overnight loans to financial institutions and the funds rate target. During the crisis, the Fed reduced the spread from 100 basis points to 25 basis points to encourage borrowing at the discount window to ease financial stresses. In February 2010, after the crisis had passed, the Fed increased the discount rate by 25 basis points, thereby raising the spread to 50 basis points, where it currently stands. There is little reason to maintain this crisis-initiated policy, and so we could begin to restore the spread to more normal, or non-crisis, levels.

A second step that might be taken before beginning normalization is to rethink our reinvestment strategy. There are no longer any short-term Treasuries in the Fed's portfolio. Rather than reinvesting maturing and prepaid assets into longer-term assets, it might be prudent to reinvest into shorter-term assets. That would provide more flexibility in managing our balance sheet as we move forward.

So let me offer some thoughts about exit.

Reconsidering the Exit Strategy

In March 2011, I shared principles that I thought should guide the Fed's eventual exit from its highly accommodative policies.[1] I said at the time that an effective exit strategy had to begin by determining our destination – what monetary policy operating framework we will use after exit – and then articulating a systematic approach to get there.

My preference is that the Fed should seek to return to an operating framework in which the federal funds rate is the primary policy instrument. However, in my preferred policy framework, the federal funds rate target would be set in a corridor bounded below by the interest rate paid on reserves, which the Fed has been authorized to do since 2008, and bounded above by the primary credit rate – the rate at which banks can borrow at the Fed's discount window.[2] This corridor system is similar to the system that the Fed used before the crisis and is used by a number of central banks around the world.

But the ability to pay interest on reserves allows the FOMC to consider a different operating system. In particular, the Fed could use the interest rate on reserves as its policy rate, rather than the funds rate, to establish a floor for market rates. This framework implies that the size of the Fed's balance sheet is technically indeterminate and could expand to be very large without necessarily affecting the implementation of monetary policy. However, I am skeptical of such an approach and prefer the corridor system, in part because it constrains the size of the balance sheet.[3] A corridor system makes it less likely that the Fed's balance sheet could be used for purposes outside the purview of monetary policy. The fed funds rate is also more familiar to markets and

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[1] Charles I. Plosser, "Exit," Remarks to the Shadow Open Market Committee, March 25, 2011.

[2] The Fed is permitted to pay different interest rates on required reserves and excess reserves. When the rates differ, the rate paid on excess reserves establishes the lower bound in the corridor system, but we can ignore that complication here.

[3] See Charles I. Plosser, "A Credible Commitment to Normalization," Remarks at the Conference on Capital Markets in the Post-Crisis Environment, Global Interdependence Center and the Bank of Finland, Helsinki, Finland, June 6, 2011; and Charles I. Plosser, "Credible Commitments and Monetary Policy After the Crisis," Remarks at the Swiss National Bank Monetary Policy Conference, Zurich, Switzerland, September 24, 2010.

policymakers, and because it is a market rate, rather than an administered rate like the interest rate paid on reserves, it offers policymakers more feedback on market pressures when setting policy.

To ensure that the fed funds rate trades above the interest rate on reserves, normalization will require a significant reduction in the volume of reserves in the banking system, which will result in a much smaller balance sheet for the Fed. The extent of that reduction will depend on the amount of reserves in the system when we begin to tighten policy. Currently, reserves total more than $1.8 trillion and are growing. They were only about $25 billion before the crisis.

I also believe that normalization should include returning the composition of the Fed's portfolio to mostly short-term U.S. Treasury securities, as it was prior to the crisis. This means that the Fed would have to rid itself of the agency mortgage-backed securities it currently holds on its balance sheet.

The framework I proposed in March 2011 is largely consistent with the exit strategy principles that the Committee adopted a few months later in June 2011. The Committee also went a step further and provided some information on the sequence of steps it would likely use once normalization began.

The Committee indicated that the exit process would likely begin by ceasing to reinvest some or all of the payments of principal on the Fed's securities holdings. At the same time or sometime thereafter, the Committee would modify its forward guidance on the path of the fed funds rate and initiate reserve-draining operations to support future increases in the policy rate.

When economic conditions warrant, the next step would be to begin raising the target fed funds rate. The Committee's exit strategy acknowledged that for some time during normalization, adjustments to the interest rate on reserves and reserve levels will be used to bring the fed funds rate to its target until reserve balances have been substantially reduced.

Following increases in the fed funds rate and interest on reserves, the Committee would begin selling its agency securities. The pace of sales would be communicated to the public, and it would likely be gradual and steady, but it could be adjusted as economic conditions warranted.

An important aspect of the exit strategy is that the Fed's holdings of mortgage-related securities would be eliminated over time and the size of the portfolio would be normalized. The goal is to reduce bank reserves to the smallest levels consistent with the efficient implementation of a monetary policy framework in which the fed funds rate is the primary policy instrument.

A lot has changed since 2011 when the Fed adopted these exit principles. So it is entirely appropriate to consider whether the exit strategy needs to be modified, especially in lieu of changes to the size and composition of the balance sheet.

In my view, the exit principles adopted by the Committee two years ago still apply. In particular, we should seek to return to operating in a corridor system, where the fed funds rate is the primary policy instrument. The balance sheet should shrink in size to enable such a system to operate. And the composition of the Fed's balance sheet should return to all Treasuries. But the specific timing and sequence of the steps detailed in the exit strategy may require some adjustments in light of the larger, and still growing, size of our balance sheet.

If asset purchases continue at current levels, reserve balances could grow to $2.25 trillion or more. That may require the Fed to sell assets at a somewhat faster pace than contemplated in the principles adopted in 2011. This action would heighten the risk that the Fed would be selling longer-term assets at a loss, which would affect the Fed's remittances to the Treasury. There might even be negative remittances. That would not impair the Fed's ability to implement monetary policy or have any direct macroeconomic consequences. Yet, the situation will be noticed, especially at a time when the federal government and the public are keenly focused on the need to reduce deficits. This would also come at a time when the Fed is paying higher interest to banks on their reserve balances at the Fed.

The complexity of shrinking the balance sheet is nuanced. It involves interactions among the overall size and composition of the balance sheet, the pace at which interest rates may have to rise, the effectiveness of interest on reserves and other reserve-draining tools, and the sensitivities to the prospects of negative remittances to the U.S. Treasury. We are in uncharted territory in this regard and should be appropriately cautious in specifying too detailed a path that we may not be able to follow.

Conclusion

In summary, the U.S. economy continues to grow at a moderate pace, and I believe that the fundamentals continue to gradually improve, thus supporting my projection of annual growth of around 3 percent in 2013 and 2014.

Prospects for labor markets will continue to improve gradually, but I believe we may see rates near 7 percent by the end of this year and a rate below 6.5 percent by the end of 2014. I believe inflation expectations will be relatively stable and inflation will remain at moderate levels in the near term.

The extraordinary policy actions taken have greatly expanded the size of the Fed's balance sheet and significantly changed the composition of its asset holdings. Eventually, economic conditions will improve to the point at which the Fed will need to begin to exit from this period of extraordinary accommodation and normalize its framework for monetary policy. Although there have been significant changes in monetary policy and the balance sheet over the past two years, I generally subscribe to the exit strategy principles adopted by the FOMC in June 2011.

In particular, we should return to an operating framework in which the federal funds rate is our policy instrument, we should shrink the size of our balance sheet to a level consistent with this framework, and we should shorten the duration and return the composition of our portfolio to all Treasuries.

The exact steps taken and the timing to arrive at this destination may have to be adjusted, given the changes in our balance sheet since June 2011. But one thing is certain: A precursor to an exit must be to halt the continued expansion of the balance sheet. That would not necessarily indicate that increases in the policy rate were imminent, but it would be a step in bringing to a close efforts to increase accommodation. The FOMC's forward guidance is that asset purchases will continue until the outlook for the labor market has improved substantially in a context of price stability. Our ever-growing balance sheet entails costs and poses risks to economic outcomes in the longer term. Given these costs and risks, in my view, the data we have received since last September, and my outlook, are sufficient to indicate to me that it is appropriate to begin tapering the pace of purchases with the goal of ending them before the end of the year.