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

SNS (Center for Business and Policy Studies) and SIFR (The Institute for Financial Research)

Stockholm, Sweden

May 14, 2013

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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 those of the Federal Reserve System or the FOMC.

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Introduction

I am delighted to be here in Stockholm, so close to the world's oldest central bank. Later this year, the Federal Reserve System, the central bank of the United States, will observe its 100-year anniversary. The Federal Reserve Act was signed on December 23, 1913. In contrast, the Riksbank traces its roots back to 1668 and is now in its fourth century as a central bank.

Our concepts of central banking and the field of macroeconomics have matured over the centuries, and in many ways, the Riksbank has been at the forefront of advancing sound central banking practices.

Of course, despite the progress that has been made in the science of monetary policy, the recent financial crisis and the deep recession that followed have posed enormous challenges to central bankers and policymakers more generally. Fortunately, many economies around the world are now in modest recoveries. Yet no one is particularly satisfied, and growth prospects remain uncertain in many parts of the world. This morning, I am going to concentrate on the outlook for the U.S. economy, which has officially been in recovery since mid-2009 – almost four years. Before I begin, 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 (FOMC).

Economic Conditions

I will start with a discussion of inflation, since in my view, preserving price stability is the most important function of a central bank. In a world of fiat money, monetary policy has the ultimate responsibility for preserving the purchasing power of a nation's currency. That is not to say that central bankers have always lived up to that responsibility. Over the 100-year history of the Federal Reserve, for instance, its price stability record has been mixed. At times, the Federal Reserve has been successful, but at other times, it has not. Federal Reserve policy contributed to the dramatic deflation of the 1930s, and it stoked the rapid inflation of the 1970s.

However, economists and central bankers have learned from the past. The U.S. has seen better inflation outcomes over the past 20 years. From 1972 to 1992, the average inflation rate in the U.S., as measured by the personal consumption expenditure, or PCE, price index, was about 5.5 percent, largely reflecting the impact of 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 some variability, 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, for the first time, an explicit long-run inflation target of 2 percent a year for the PCE price index. I note that this was nearly 20 years after the Riksbank announced its inflation target – we seem to be slow learners! Being explicit about our inflation objective enhances the credibility of the Fed's commitment to price stability, which helps anchor inflation expectations and foster price stability and moderate long-term interest rates.

Over the past three years, average PCE inflation in the U.S. has been running about 1.8 percent, a bit below our 2 percent target. Although inflation has been running somewhat lower than this over the past four quarters, I expect it to return to our goal over the next year or two, as inflation expectations remain fairly well anchored near our goal. In fact, the participants in the Survey of Professional Forecasters released by the Philadelphia Fed just last week expected annual-average PCE inflation of 2 percent over the next 10 years. Should inflation expectations begin to fall, we might need to take action to defend our inflation goal, but at this point, I do not see inflation or deflation as a serious threat in the near term. However, I do believe 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.

According to the advance estimate of GDP for the first quarter of this year, U.S. economic growth rebounded to an annualized rate of 2.5 percent following a weak 0.4 percent growth rate in the fourth quarter of 2012, and the composition of that growth was encouraging. Consumer spending, which accounts for about 70 percent of the U.S. economy, made a solid contribution to growth, expanding at an annualized rate of 3.2 percent. This is the fastest rate of growth from consumers in two years and marks the fourth consecutive quarter of acceleration in spending growth. Some economists worried that the hike in the federal payroll tax at the beginning of 2013 would constrain consumer spending, but that has yet to materialize.

However, uncertainty over fiscal policy and doubts about the strength of the recovery appear to be dampening growth in business investment spending. This spending grew at less than a 4 percent annual rate in the first quarter, compared with over 7 percent last year. Home construction has been more encouraging. Private residential investment registered its third consecutive quarter of annualized double-digit growth. These growth rates may sound more impressive than they are – we have to remember that housing activity, including home sales and starts, remains relatively low by historical standards.

Nevertheless, housing does appear to be in a sustainable recovery, and house prices are rising. In the U.S., we follow several indexes for house prices. In February, both the Case-Shiller and Federal Housing Finance Agency home price indexes posted their highest year-over-year gains since mid-2006. Higher home prices will help strengthen the balance sheet of consumers, supporting consumption and new home construction. However, I do not believe we are going to see, nor should we seek to see, a return to the heady days of residential real estate activity that preceded the financial crisis.

Government spending, particularly in defense, has declined notably over the past three years. These declines reflect fiscal policy decisions and budgetary timelines, not business cycles. Netting out the decline in government spending, the private sector portions of GDP advanced at an annual rate of 3.3 percent in the first quarter.

Overall, the U.S. economy is growing at a pace that is close to trend. My forecast is that the pace of growth in the U.S. will pick up to slightly above trend and average close to 3 percent through 2014. Based on the Federal Open Market Committee's most recent Summary of Economic Projections, my outlook for 2013 is a little higher than the central tendency and on the lower end of the central tendency for 2014.

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 three 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.

Indeed, this year we have already seen the unemployment rate fall from 7.9 percent in January to 7.5 percent in April. Employers added 165,000 jobs in April, but the more positive news came in the revisions for February and March. The revised data indicate that firms added 332,000 jobs in February and 138,000 in March. The upward revisions for these two months added 114,000 jobs.

Let me now turn to the implications for monetary policy.

Monetary Policy

Over the past 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 as 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 as 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 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 $3.3 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 in the hope that households and businesses will choose 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 because 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.

The FOMC has provided forward guidance about its asset purchases. In particular, 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. But the most recent FOMC statement also made clear that the Committee is prepared to increase or reduce the pace of its purchases to maintain its assessment of appropriate policy accommodation as the outlook for the labor market or inflation changes. In addition, in determining the size, pace, and composition of its asset purchases, the Committee continues to weigh the likely efficacy and costs of such purchases, as well as the extent of progress toward its economic objectives.

Based on the stated views of the Committee regarding the flexibility in pace of purchases, I believe that labor market conditions warrant scaling back the pace of purchases as soon as our next meeting. Moreover, unless we see a significant reversal in current trends that jeopardizes my forecast of near 7 percent unemployment rate by the end of this year, then I anticipate that we could end the program 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, nonfarm payrolls had increased an average of 130,000 per month, and the unemployment rate had averaged 8.1 percent. In the most recent six months, from November 2012 through April 2013, nonfarm payrolls have increased on average 208,000 per month – a 60 percent increase – and the unemployment rate has averaged 7.7 percent. As I noted earlier, April's unemployment rate has now reached 7.5 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.

Indeed, in my view, were the FOMC to refrain from reducing the pace of its purchases in the face of this evidence of improving labor market conditions, it would undermine the credibility of the Committee's statement that the pace of purchases will respond to economic conditions. Similarly, if there were sufficient evidence that conditions in labor markets had deteriorated, I would expect the FOMC to consider increasing the pace of purchases. After all, this is the meaning of state-contingent monetary policymaking. But if we reach the point that markets only expect us to move in one direction – that is, toward more easing – and we become reluctant to dial back on purchases over concerns of disappointing or surprising markets, then we will find ourselves in a very difficult position going forward.

I want to emphasize that in this state-contingent framework, reducing the pace or even ending asset purchases need not be the start of an exit strategy or more aggressive tightening. Nor would it indicate that an increase in the policy rate was imminent. Instead, these actions would slow and then 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.

I think we should also consider rethinking 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

Last month, I recounted some principles that I first shared in March 2011, which I believe should guide the Fed's eventual exit from its highly accommodative policies.[1]

My preference is that the Fed should seek to return monetary policy to an operating framework in which the federal funds rate is the primary policy instrument. In my preferred policy framework, the federal funds rate target would be set in a corridor above the interest rate paid on excess reserves and below the discount rate (also called the primary credit rate). This corridor system is similar to the system that the Fed used before the crisis and is similar to corridor systems used by other central banks around the world. In fact, the Riksbank sets its policy overnight rate in an interest-rate corridor between the deposit rate and the lending rate.

An alternative framework would have the Fed use the interest rate on excess reserves as its policy rate to establish a floor for market rates. In this floor system, monetary policy could be implemented with no limit on the size of the Fed's balance sheet. I am skeptical of such an approach and prefer the corridor system, in part because it constrains the size of the balance sheet, thereby making it less likely that the Fed's balance sheet could be used for purposes outside the purview of monetary policy and because the fed funds rate is a market interest rate.

To ensure that the fed funds rate trades above the interest rate on excess 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

[1] See Charles I. Plosser, "Reconsidering EXIT," remarks at Tsinghua University, Beijing, China, April 16, 2013, and "Exit," Remarks to the Shadow Open Market Committee, March 25, 2011.

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 mortgage-backed securities on the Fed's balance sheet would have to be eliminated. They could be allowed to run off via maturity or prepayment, or the Fed could sell these assets.

The framework I first proposed in March 2011 is largely consistent with the exit strategy principles that the Committee announced a few months later in June 2011. And while a lot has changed since then, I believe these general principles 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 U.S. Treasuries.

The specific timing and sequence of the steps detailed in the FOMC's exit strategy announcement 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 2011. Faster sales of assets also would heighten the risk that the Fed would sell longer-term assets at a loss, which would affect the Fed's remittances to the Treasury. There might even be negative remittances. While that would not impair the Fed's ability to implement monetary policy, it would certainly 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.

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.

Yet the timing and pace of the exact steps 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 slow and then halt the continued expansion of the balance sheet. This would not necessarily indicate that increases in the policy rate were imminent. Rather, it would indicate that efforts to increase accommodation were coming to a close. The FOMC's forward guidance is that asset purchases will be increased or decreased based on the outlook for labor markets and inflation and that purchases will end when we have seen substantial improvement in the labor market conditions in a context of price stability.

In my view, labor market conditions have improved sufficiently for the Fed to reduce the pace of its asset purchases. Should labor market conditions and inflation continue to evolve as I project, then I would view ending the purchases by year-end as appropriate. In fact, I believe the FOMC would undermine the credibility of its own statement if it fails to adjust the pace of asset purchases in response to economic conditions.