The Economic Outlook and Monetary Policy

Lehigh Valley Partnership and
Lehigh Valley Economic Development Corporation

Allentown, PA

October 16, 2014

Charles I. Plosser

President and CEO
Federal Reserve Bank of Philadelphia

FEDERAL RESERVE BANK
OF PHILADELPHIA

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Highlights

- President Charles Plosser gives his views on the regional and national economy and discusses why he remains optimistic about the economic prospects ahead.
- President Plosser shares some thoughts about the stance of monetary policy. He also explains why he departed from the majority view at the July and September Federal Open Market Committee (FOMC) meetings.
- While he is not suggesting that rates should necessarily be increased now, President Plosser believes that the FOMC's forward guidance should be adjusted to reflect economic realities and to give the Fed the flexibility to respond sooner and more gradually to the evolution of the economy.

Introduction

I want to thank Scott Fainor, the Lehigh Valley Partnership, and the Lehigh Valley Economic Development Corporation for sponsoring this breakfast. One month from today, on November 16, 2014, we will mark the 100th anniversary of the date when the 12 Federal Reserve Banks, each independently chartered by Congress, first opened their doors to begin serving our nation's economy. That opening day in Philadelphia and in the other 11 cities was the outcome of the Federal Reserve Act, which was signed into law by President Woodrow Wilson on December 23, 1913.

Wilson is credited with engineering a compromise that created our nation's decentralized central bank. To balance economic and geographic interests, Congress created a Federal Reserve System of regional Reserve Banks with oversight provided by a Board of Governors in Washington, D.C. This decentralized structure is one of our great strengths and mirrors the federalist framework of the nation. However, it requires that I begin by reminding you that the views I express this morning are my own and do not necessarily reflect those of the Federal Reserve System or my colleagues on the Federal Open Market Committee (FOMC).

Since we are so close to this centennial milestone, I thought I would begin with a little background about how the Fed works and how we are structured before I offer some thoughts on the economic outlook and monetary policy.

Exactly what are these nearly 100-year-old institutions? The Reserve Banks perform several roles. They distribute currency, act as a bankers' bank, and serve as the bank for the U.S. Treasury. They also play a critical role in supervising many banks and bank holding companies across the country. The 12 Reserve Banks also serve as the eyes and ears of our central bank in assessing the economic pulse of Main Street as it formulates and implements monetary policy.

Each Reserve Bank has a nine-member board of directors selected to represent a cross-section of banking, commercial, and community interests. These directors fulfill the traditional governance role, but they also provide valuable insights into economic and financial conditions, which contribute to our assessment of the economy.

The Reserve Banks seek to stay in touch with Main Street in other ways. Some have Branch offices with their own boards, and all have a variety of advisory councils.

The Federal Reserve Banks also collect and analyze data about economic activity. However, published data are generally looking backward at the last month or the last quarter. So, the viewpoints we gather through our boards and advisory councils, and our outreach to businesses and communities through events like this help us add a real-time perspective to the data and help us form a rich and detailed mosaic of our nation's economy.

Within the Federal Reserve, the body that considers this mosaic as it makes monetary policy decisions is the FOMC. Here again, Congress has designed the System with a number of checks and balances. Since 1935, the composition of the FOMC has included the seven Governors in Washington, D.C., who are appointed by the President of the United States and confirmed by the Senate, as well as the president of the New York Fed, and four other Reserve Bank presidents, who serve one-year terms as members on a rotating basis. Philadelphia votes this year, but 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 the policy options.

The FOMC has eight regularly scheduled meetings each year to set monetary policy. In normal times, the Committee votes to adjust short-term interest rates to achieve the goals of monetary policy that Congress has set for us. The goals for monetary policy are articulated in the Federal Reserve Act and specify that the FOMC "shall maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as 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, many have interpreted these instructions as being a dual mandate to promote maximum sustainable employment and price stability.

Economic Conditions

So, with that background, let me turn to an overview of the U.S. economy as we enter the fourth quarter of 2014. The economic expansion began more than five years ago in June 2009. While the pace has been sluggish and uneven, I believe progress is undeniable. In fact, I remain optimistic about the prospects ahead.

This year began with a harsh winter, which proved to be highly disruptive to the economy. Gross domestic product (GDP) declined at a 2.1 percent annual rate in the first quarter. But second-quarter GDP growth rebounded to 4.6 percent, according to the most recent estimates. In the second quarter, the strongest recoveries were in categories that were most directly affected by the first quarter's severe weather, including investment in equipment, residential structures, inventory accumulation, and exports.

Personal consumption, the largest spending sector of the economy, slowed during the first quarter to 1.2 percent. After all, it is hard to go shopping when snow and ice keep you from getting out of your house or driveway. In the second quarter, personal consumption growth roughly doubled to 2.5 percent. Purchases of durable goods, such as automobiles, advanced at an annualized rate of 14.1 percent.

I anticipate that consumer and business spending will help real GDP to grow at about 3 percent for the remainder of this year and next before reverting to trend, which I see as about 2.4 percent.

The Philadelphia Fed's *Manufacturing Business Outlook Survey* has proven to be a reliable indicator of national manufacturing trends in the U.S. We will get October's reading just after this meeting at 10 a.m., but September's reading was the seventh consecutive month in positive territory. The survey's future activity indexes remained at high readings, suggesting continued optimism about manufacturing growth. In late September, the Bank also officially launched a monthly *Nonmanufacturing Business Outlook Survey,* which we have been conducting since March 2011. The latest results from nonmanufacturing firms suggest continued expansion in the region.

The jobs report for September was also very strong, with employers adding 248,000 jobs in the month nationwide. Additionally, the initial low estimate for August was revised upward, as was the estimate for July. These revisions added 69,000 more jobs. In all, employers have added more than 2 million jobs thus far in 2014, at an average pace of 227,000 per month through September.

The unemployment rate fell to 5.9 percent, marking its lowest level since July 2008 and well below the 6.7 percent we experienced in December 2013. Even the broader U6 measure, which includes discouraged workers and involuntary part-time workers, dropped to 11.8 percent, its lowest since October 2008 and down from 13.1 percent in December 2013.

The unemployment rate continues to fall faster than many policymakers had been forecasting. For instance, in the Summary of Economic Projections (SEP) submitted in December 2013, the central tendency of FOMC participants was an unemployment rate of 6.3 to 6.6 percent at the end of 2014, and by the end of 2015, the central tendency was expected to be 5.8 to 6.1 percent. We have clearly exceeded these expectations. The unemployment rate is now below where the Committee thought it would be at the end of 2014 and is now within the range expected at the end of 2015. Thus, it is fair to say that we are at least a year ahead of where we thought we would be when we started to taper asset purchases. In fact, in September, the central tendency was lowered yet again to 5.9 from 6.0 percent for 2014 and to 5.4 from 5.6 percent by the end of 2015. We reached our year-end number for 2014 weeks later. How soon will we reach the year-end 2015 number?

In Pennsylvania, job growth has been positive as well. The state added more than 47,000 jobs over the past 12 months. The August unemployment rate in Pennsylvania was 5.8 percent, down 1.6 points from a year ago and down from a peak of 8.7 percent immediately following the recession.

This is not to claim that all is rosy in the labor markets. Many Americans remain frustrated and disappointed in their jobs and job prospects. For example, a large contingent of those working part time for economic reasons would like to be working full time. Nonetheless, we have to acknowledge that significant progress has been made.

Inflation remains somewhat below the FOMC's long-run goal of 2 percent, but it appears to be drifting upward. Headline inflation as measured by year-over-year change in the consumer price index, or CPI, was 1.7 in August, down from 2 percent in July. That broke a four-month streak of inflation at or above the 2 percent level. The Fed's preferred measure of inflation is the year-over-year change in the price index for personal consumption expenditures, or PCE inflation. In December 2013, inflation stood at 1.2 percent. The most recent reading for August 2014 was 1.5 percent. Compare that with the December 2013 SEP estimates for 2014, and you will find that we are currently in line with the FOMC's central tendency of 1.4 to 1.6 percent for PCE inflation.

In the September SEP, FOMC participants left their assessment of inflation unchanged with a central tendency for PCE inflation by the fourth quarter of 2014 to between 1.5 and 1.7 percent. The Philadelphia Fed's most recent *Survey of Professional Forecasters* also increased its average estimate of headline PCE inflation to 1.8 percent in 2014, up from 1.6 percent in the last survey. The survey also increased the estimate of PCE inflation to 2.0 percent in 2015, up 0.1 percentage point from the previous estimate. The FOMC has stated that it expects the inflation rate to gradually rise to the 2 percent target, and I agree with that assessment.

Since last year, the economy has moved closer to the Committee's goals and has done so more quickly than anticipated. Yet, the stance of policy and its projected path provided by the Committee have not changed.

Monetary Policy

So, let me turn to some thoughts on monetary policy, including why I departed from the majority view at the July and September FOMC meetings.

The Fed has taken extraordinary monetary policy actions, keeping the federal funds rate near zero for nearly six years and expanding its balance sheet to more than $4.5 trillion.

Yet, the recovery began over five years ago, and the unemployment rate has declined from 10 percent in October 2009 to 5.9 percent now. Whether you believe that the labor market has fully recovered or not, it is clear that we have made considerable progress toward full employment and price stability. We are no longer in the depths of a financial crisis nor is the labor market in the same dire straits it was five years ago.

In its July and September statements, the FOMC reaffirmed its highly accommodative stance. The statements noted that “in determining how long to maintain the current 0 to ¼ percent target range for the federal funds rate, the Committee will assess progress — both realized and expected — toward its objectives of maximum employment and 2 percent inflation.” In assessing this progress, the Committee reported that it will look at a wide range of information, including measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial developments.

The FOMC also noted, based on its assessment of these factors, “that it likely will be appropriate to keep its target federal funds rate near zero for a considerable time after the asset purchase program ends …”

I objected to this forward guidance regarding the expected timing for raising the funds rate because I believe this language is no longer appropriate or warranted. Appropriate monetary policy must respond to the data. I believe that by indicating that the FOMC continues to anticipate that it will be a “considerable time” after the end of asset purchases before it is likely that the Committee will raise interest rates does not reflect the significant progress made toward our goals. It also limits the Committee’s flexibility to take action going forward.

We have moved much closer to our goals since last December, and, accordingly, the stance of monetary policy should reflect such progress and begin to adjust gradually. That is the essence of being data dependent. In the current context, we must acknowledge and thus prepare the markets for the fact that interest rates may begin to increase sooner than previously anticipated. I felt that adjusting our language was the appropriate first step in responding to better-than-anticipated economic conditions.

My view is informed, as I have indicated, by realized and projected economic progress toward our goals. But it is also influenced by guidance gained from the historical conduct of past monetary policy. In particular, my views on the appropriate funds rate setting are — and continue to be — informed by Taylor-type monetary policy rules that depict the past behavior of monetary policy in response to deviation from its desired inflation target and economic activity from its natural or efficient level. I find such rules useful for benchmarking my policy prescriptions. These rules have been widely investigated and have been shown to be robust in that they deliver good results in a wide variety of models and circumstances.

The guidance I take from such robust rules is that we should no longer consider monetary policy as being constrained by the zero lower bound. A variety of these rules, which I discussed in a speech earlier this summer, indicates that given the current inflation rate of just under our target of 2 percent and the current unemployment rate of 5.9 percent, the funds rate should be above zero or should be lifting off in the very near future.[1] In fact, maintaining a funds rate target near zero is unprecedented under such circumstances and as such could pose risks to the economy in the years ahead, including higher inflation and financial instability.

I am not suggesting that rates should necessarily be increased now. Our first task is to change the language in a way that allows for liftoff sooner than many now anticipate and sooner than suggested by our current guidance. Raising rates sooner rather than later also reduces the chance that inflation will accelerate and require policy to become fairly aggressive with perhaps unsettling consequences. Thus, I believe that our forward guidance should be adjusted to reflect economic realities and to give us the flexibility to respond sooner and more gradually to the evolution of the economy.

There is a point of view that rates cannot be raised because the labor market has not completely healed. That is, we must wait, maintaining our current stance of policy until we have achieved our goals. I think this is a risky strategy for three reasons.

First, we do not know how to confidently determine whether the labor market is fully healed or when we have reached full employment. In January 2012, the FOMC affirmed in its statement of longer run goals and strategies that, “The maximum level of employment is largely determined by nonmonetary factors that affect the structure and dynamics of the labor market. These factors, such as demographics or advancements in technology, may change over time and may not be directly measurable.” Chair Yellen gave an excellent speech at the Jackson Hole conference in August that highlighted some of the structural and nonmonetary factors affecting the labor market. Economists don’t fully understand how these factors may be influencing our efforts to assess the meaning and measurement of full employment.

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[1] Charles I. Plosser, “Systematic Monetary Policy and Communication,” remarks to the Economic Club of New York, New York, NY, June 24, 2014.

Second, if we wait until we are certain that the labor market has fully recovered before beginning to raise rates, policy will be far behind the curve. One risk of waiting is that the Committee may be forced to raise rates very quickly to prevent an increase in inflation. In so doing, this may create unnecessary volatility and a rapid tightening of financial conditions — either of which could be disruptive to the economy.

This would represent a return of the so-called "go-stop" policies of the past. Such language was used to describe episodes when the Fed was aggressively providing monetary accommodation to stimulate employment and the economy — the go phase — only to find itself forced to apply the brakes abruptly to prevent a rapid uptick in inflation — the stop phase. This approach to policy led to more volatility and was more disruptive than many found desirable.

A third risk to waiting is that the zero interest rate policy has generated a very aggressive reach for yield as investors take on either credit or duration risk to earn higher returns. While the Fed is attempting to monitor such behavior, it is difficult to know how or where the consequences of such actions may show up. It seems to me that the law of unintended consequences looms large in this arena.

For these reasons, I would prefer that we start to raise rates sooner rather than later. This may allow us to increase rates more gradually as the data improve rather than face the prospect of a more abrupt increase in rates to catch up with market forces, which could be the outcome of a prolonged delay in our willingness to act.

Conclusion

In conclusion, I remain positive about the economic outlook. Second quarter growth has rebounded after the disappointing first quarter caused by the harsh winter. At the end of this month, we will get the first look at the third quarter, which I expect will help us reach an average of about 3 percent for the remainder of this year and in 2015, before settling back down to long-term growth levels of about 2.4 percent.

The unemployment rate continues to improve more quickly than many had expected. We are now approaching the rate that many policymakers view as a long-run sustainable value. Inflation appears to be drifting up toward our 2 percent goal.

Raising rates sooner rather than later reduces the chance that inflation will accelerate and, in so doing, require policy to become fairly aggressive with perhaps unsettling consequences. Waiting too long to begin raising rates — especially waiting until we have fully met our goals for maximum employment — is risky because we cannot know when we have arrived. That could also put monetary policy behind the curve and could lead to a return to abrupt go-stop policies that in the past have led to unwelcome volatility. Finally, delay is likely to increase the risk of overstaying our welcome at the zero bound, thus fostering unintended consequences for financial stability.

If monetary policy is to be truly data dependent, then our stance of policy must begin to change. I'm not suggesting a rate increase now, but changing the forward guidance would at least afford us the flexibility to gradually raise rates beginning earlier than currently anticipated.