

The U.S. Economic Outlook and Monetary Policy

UBS European Conference 2014

London, England

November 12, 2014

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President and CEO
Federal Reserve Bank of Philadelphia



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OF PHILADELPHIA

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Highlights

- President Charles Plosser gives his views on the U.S. economy and discusses why he remains positive about the economic prospects for the U.S.
- President Plosser shares some thoughts about the stance of monetary policy and the advantages of raising rates gradually and starting sooner instead of being forced to raise them abruptly later.
- President Plosser believes that the FOMC's forward guidance should be adjusted to provide more information about the reaction function and how policy will respond to economic data. This will give the Fed the flexibility to respond more gradually to the evolution of the economy.

Introduction

It is a pleasure to be with you this morning. I want to thank our host Axel Weber for that kind introduction and for inviting me to speak at this annual conference and to participate in the upcoming panel on monetary policy with fellow central bankers. I am looking forward to a lively and interesting discussion.

In a few days, on November 16, 2014, we will mark the 100th anniversary of the date when the 12 Federal Reserve Banks, each independently chartered with oversight by a Board of Governors in Washington, D.C, first opened their doors. Of course, among central banks, this makes the Fed the new kid on the block compared with the Bank of England; it also makes the Fed perhaps an older sibling to the ECB. I view the decentralized structure of the Federal Reserve as one of its great strengths. 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).

Economic Conditions

Let me begin with an update on the U.S. economy. The U.S. is now more than five years into a steady, if unremarkable, recovery that began in June 2009. The unemployment rate has gone from a peak of 10 percent in October 2009 to 5.8 percent in October of this year. Gross domestic product (GDP) declined to a 2.1 percent annual rate in the first quarter of 2014 due to a severe winter. However, second-quarter GDP growth rebounded to 4.6 percent. The advance estimate for the third-quarter GDP growth is a solid 3.5 percent.

Personal consumption, which accounts for more than two-thirds of U.S. GDP, has recovered from 1.2 percent growth in the first quarter, to average 2.2 percent over the second and third quarters.

I anticipate that consumer and business spending will help real GDP to grow at about 3 percent for the second half of this year and for 2015 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 manufacturing trends in the U.S. In October, manufacturers reported the eighth consecutive month in positive territory and well above its average nonrecession level. The survey's future activity indexes also remained at high levels, suggesting continued optimism about manufacturing growth. In addition, the Philadelphia Fed now releases a monthly *Nonmanufacturing Business Outlook Survey*, which showed that the region's service sectors continued to grow in October, with improvement in general activity, new orders, and sales or revenues. Nonmanufacturing firms also continue to be optimistic about activity during the next six months.

Last week's employment numbers showed employers adding 214,000 jobs in October. Revisions for September and August added 31,000 more jobs than originally estimated. Interestingly, what we once thought was a weak jobs report for August now shows we added 203,000 jobs, which means that we have had nine months of job growth above 200,000 for the first time in nearly 20 years. In all, employers have added more than 2.3 million jobs thus far in 2014, at an average pace of 229,000 per month through October.

The unemployment rate in October was 5.8 percent, well below the 6.7 percent we experienced in December 2013. Whereas the headline U3 measure fell 0.9 percentage points since December 2013, the broader U6 measure, which includes discouraged workers and involuntary part-time workers, dropped 1.6 points, from 13.1 percent to 11.5 percent, its lowest since September 2008.

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' projections for the unemployment rate at the end of 2014 was 6.3 to 6.6 percent, dropping to 5.8 to 6.1 percent at the end of 2015. We have clearly exceeded these expectations. At 5.8 percent, the unemployment rate is already notably below where the Committee thought it would be at the end of 2014 and is at the low point in 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.

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 has risen since last year. 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 October 2013, inflation stood at 0.9 percent. The most recent reading for September 2014 was 1.4 percent. Other measures of inflation have risen modestly as well. While inflation remains somewhat below the Fed's target, the gap seems to be gradually closing.

As noted by the FOMC in the October 2014 statement, the Committee believes it is unlikely that inflation will remain persistently below our long-term goal. The FOMC has stated that it expects the inflation rate to rise gradually to the 2 percent target, and I agree with that assessment. However, over the next quarter or two, headline inflation is likely to ease somewhat, reflecting the decline in the dollar price of oil and other temporary factors. But looking through such transitory changes in relative prices, the FOMC sees underlying inflation gradually moving toward its 2 percent target. Thus, since last year, the economy has moved closer to the Committee's goals and has done so more quickly than anticipated.

Monetary Policy

So, let me turn to some thoughts on monetary policy. 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 about \$4.5 trillion.

Yet, the recovery began over five years ago, and the unemployment rate has declined from 10 percent in October 2009 to 5.8 percent now. Whether you believe that the labor market has fully recovered or not, it is clear that the economy has 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. To me, that means we should no longer be conducting monetary policy as if we were still in the midst of a financial crisis or in the depths of a recession.

In its October statement, the FOMC reaffirmed its highly accommodative stance. In doing so, it acknowledged that the economy had made significant progress. Therefore, as widely anticipated, the Committee brought to a close its asset purchase program. However, the Committee indicated that it would continue its practice of reinvesting principal payments. This should maintain the size of the Fed's balance sheet at its current, and sizable, level.

The Committee also adjusted its language somewhat regarding the expected path of interest rates — the federal funds rate more specifically. In particular, the Committee reiterated its assessment that it would likely maintain the current target range of 0 to $\frac{1}{4}$ percent for the fed funds rate for a “considerable time” after the end of the purchases. As some of you may be aware, I objected to this forward guidance in both the July and September meetings because it conveyed a date-based approach to guidance rather than a data-based approach. I also objected to the fact that it failed to acknowledge the progress made during the last year toward full employment and price stability.

While the Committee retained the “considerable time” language, it added clarity by stressing the fact that the decision to lift the interest rate target would be driven by the data. The Committee explicitly noted that should the economy make faster progress than anticipated toward its goals, liftoff could occur earlier, and if progress was slower than anticipated, liftoff could be delayed. From my perspective, this is the operative language and it makes clear that the Committee intends for policy to be data-dependent. It provides a start, but we could offer greater clarity as I will explain in a moment.

As I said, we have moved much closer to our goals since last year, and, accordingly, the stance of monetary policy should reflect such progress and begin to adjust gradually.

That is the essence of being data dependent. Given the progress to date, 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.

More generally, how do I think about the stance of policy and how it should be adjusted as the economy evolves? My view is informed by realized and projected economic progress toward our goals. But it is also influenced by guidance gained from the conduct of past monetary policy — that is, historical experience. 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 5.8 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.

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

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 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 the degree to which these factors may be influencing our efforts to assess the meaning and measurement of full employment.

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. Of course, financial markets are not always patient, so some volatility will be unavoidable.

Of course, there are also risks of moving too soon as tightening financial conditions could stifle a fragile recovery, and some argue that this is the greater risk. However, it is important to recognize that rates always rise during a recovery — always. Thus, rising rates are not inconsistent with a continuing recovery. The inflation-adjusted or real federal funds rate in the U.S. is notably negative, and it has been for some time. A negative real rate is neither sustainable nor desirable when an economy is growing at 2 to 3 percent and is near full employment.

In addition, by referring to historical experience as captured in some of the rules I mentioned, we can determine, to a degree, the economic conditions that have been consistent with rising rates in the past. And as I discussed, these rules suggest that, given current conditions, we should begin raising rates in the near future. Moreover, it is important to recognize that these rule-like guidelines take into account the fact that inflation is running below our target. They do not tell us that we should keep rates at zero until inflation rises to 2 percent any more than they tell us to keep rates at zero until we reach full employment. They tell us that the stance of policy should be calibrated and adjusted based on how far the economy is from our goals. We are closer

to our goals than we have been in quite some time. The stance of monetary policy should reflect such progress.

Conclusion

In conclusion, I remain positive about the U.S. economic outlook. Growth in the second and third quarters has rebounded, demonstrating that the effects of the wintry first quarter were indeed transitory. Thus, I expect growth will average 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. Further, numerous labor market indicators continue to show broad improvement and inflation is not appreciably below our 2 percent goal.

Beginning to raise 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 or attained our inflation target of 2 percent — is risky because doing so could put monetary policy behind the curve. Such policies could lead to a return to abrupt go-stop policies, which in the past have led to unwelcome volatility. Finally, delay is likely to increase the risk of overstayng 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 change with the data. Changing the forward guidance to provide greater clarity about the policymakers' reaction function would strengthen accountability and afford us the flexibility to gradually adjust rates as the economy evolves.