Charles I Plosser: Monetary policy and a brightening economy

Speech by Mr Charles I Plosser, President and Chief Executive Officer of the Federal Reserve Bank of Philadelphia, at Lyons Companies, the University of Delaware's Center for Economic Education and Entrepreneurship, and Alfred Lerner College of Business and Economics, Newark, DE, 11 February 2014.

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President Plosser presented similar remarks at the Simon Business School in Rochester, NY, on 5 February 2014.

The views expressed are my own and not necessarily those of the Federal Reserve System or the FOMC.

Highlights

- President Charles Plosser provides his economic outlook for 2014 and reports that the decision of the Federal Open Market Committee (FOMC) to reduce the pace of asset purchases was a step in the right direction.
- President Plosser expects growth of about 3 percent in 2014. He also expects the unemployment rate to continue its steady decline and to reach about 6.2 percent by the end of 2014. Inflation expectations will be relatively stable, and inflation will move up toward the FOMC target of 2 percent over the next year.
- Based on the economic progress that has been made and his economic outlook, President Plosser believes it is appropriate to end asset purchases, and he supported the FOMC's decision in January to continue to reduce the pace of purchases.
- A case can be made for ending the current asset purchase program sooner to reflect the improvement in the economic outlook and to lessen some of the communications problems the FOMC will face with its forward guidance.

Introduction

I am delighted to return once again to the University of Delaware to speak at this annual event. This is a great event for the region and I am pleased to see it grow year after year.

I would like to begin my remarks this morning with a bit of history. We are observing the 100th anniversary of the Federal Reserve and that gives me the opportunity, or the excuse, to offer a perspective on this important, but sometimes misunderstood, institution. I should note that my views are my own and do not necessarily reflect those of the Federal Reserve System or my colleagues on the Federal Open Market Committee.

On December 23, 1913, President Woodrow Wilson signed the act that created the Federal Reserve System, and the 12 Federal Reserve Banks opened their doors on November 16, 1914. I have often described the Federal Reserve as a uniquely American form of a central bank – a decentralized central bank. To understand why, we need to consider two earlier attempts at central banking in the United States. Just a few blocks from the Philadelphia Fed's present building on Independence Mall, you will find the vestiges of both institutions, dating back to the early years when Philadelphia was the major financial and political center of the country.

Alexander Hamilton, our first secretary of the Treasury, championed the First Bank of the United States to help our young nation manage its financial affairs. The First Bank received a 20-year charter from Congress and operated from 1791 to 1811. Although this charter was not renewed, the War of 1812 and the ensuing inflation and economic turmoil convinced Congress to establish the Second Bank of the United States, which operated from 1816 to

1836. However, Congress could not override the veto of President Andrew Jackson, and the Second Bank's charter also lapsed. Both institutions failed to overcome the public's mistrust of centralized power and special interests.

Nearly 80 years later, Congress tried again. To balance political, economic, and geographic interests, Congress created a Federal Reserve System of 12 regional Reserve Banks with oversight provided by a Board of Governors in Washington, D.C. This decentralized central bank was structured to overcome concerns that its actions would be dominated either by political interests in Washington or by financial interests on Wall Street.

These 12 Reserve Banks perform several roles. They distribute currency, act as a bankers' bank, and generally perform the functions of a central bank, which includes serving 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.

Each Reserve Bank has a nine-member board of directors selected in a nonpartisan way to represent a cross-section of banking, commercial, and community interests. Pat Harker, president of the University of Delaware, serves on our board. These directors fulfill the traditional governance role, but they also provide valuable insights into economic and financial conditions, which contributes to our assessment of the economy.

The Reserve Banks seek to stay in touch with Main Street in other ways. Some have Branch boards, and all have advisory councils. Reserve Banks also collect and analyze data and conduct surveys of economic activity. This rich array of information and the diverse views from across the country help policymakers paint a mosaic of the economy that is essential as we formulate national monetary policy.

Within the Federal Reserve, the body that makes monetary policy decisions is the Federal Open Market Committee, or 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, 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.

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. The FOMC has eight regularly scheduled meetings each year to set monetary policy. The first one in 2014 was held just two weeks ago. 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.

Congress spelled out the current set of monetary policy goals in 1978. The amended Federal Reserve Act specifies 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 and the economy is operating at full employment, many have interpreted these instructions as being a dual mandate to manage fluctuations in employment in the short run while preserving price stability in the long run.

Economic conditions

In order to determine the appropriate monetary policy to promote these goals, the FOMC must monitor and assess economic developments. So, let me turn to an assessment of our economy as we enter 2014.

In a nutshell, my view is that the economy is on firmer footing than it has been for the past several years. So let's look at some of the details of how last year ended and the implications for the coming year.

Real output grew at a 3.2 percent annual pace in the fourth quarter of last year, following a 4.1 percent growth rate in the third quarter. That means economic growth doubled in the second half of 2013 compared with the first half. Consumer spending and business investment in equipment ended the year with strong increases. Inventory investment and net exports also contributed to growth. On the other side of the ledger, a decline in residential investment and a sharp decrease in federal government spending subtracted from growth in the fourth quarter of the year. Going forward, I expect that there will be less fiscal drag in 2014 than we saw in 2013 and that housing will continue its recovery.

Personal consumption, which accounts for more than two-thirds of GDP, advanced at an annual rate of 3.3 percent in the fourth quarter, the highest personal consumption growth rate since fourth quarter 2010. Rising house prices and stock prices have helped improve consumer balance sheets, and steady job growth has added to wage and salary growth, all of which have supported spending.

On the job front, the January employment report showed payroll gains of 113,000 jobs, following an increase of 75,000 jobs in December, which was below many analysts' expectations. Yet, these numbers were affected by the unseasonably cold and snowy weather. Indeed, winter weather has continued to be unusually disruptive, and that is making it difficult to assess underlying economic trends. I suspect it may be another couple of months before we have a better read on the economy – hopefully the weather will turn better before that!

We have to remember that these employment numbers are subject to revisions, and such revisions can be significant. For instance, in the latest report the November jobs number was revised up by 33,000, from 241,000 to 274,000, while the December number was also revised up by 1,000 to 75,000.

Because of month-to-month volatility and data revisions, I prefer not to read too much into the most recent numbers but, instead, look at averages over several months. Here the news remains positive. Based on the latest revision, firms added an average of 194,000 jobs per month in 2013, somewhat better than the pace in 2012. This consistent pace of job growth was enough to drop the unemployment rate 1.2 percentage points last year. In January, it fell a bit further to 6.6 percent. This is noticeably lower than the FOMC anticipated in its Summary of Economic Projections in September 2012, when we started the current asset purchase program. That is, the labor market has performed better than expected, according to the unemployment rate measure.

Should we be sceptical of the unemployment rate as an indicator of labor market conditions? Some people are because the decline in the unemployment rate reflects not only increases in employment but declines in labor force participation as well. Declines in participation can include discouraged workers who have stopped looking for work because it is difficult to find a job. There is concern in some quarters that the unemployment rate will move back up significantly when these discouraged workers reenter the labor force. Based on research by my staff, I am less concerned about this possibility.[1]

First, it is important to realize that labor force participation rates can decline for reasons other than a rise in discouraged workers. Indeed, we have seen steadily declining participation rates since 2000 that reflect demographic changes, most notably the aging of the baby boomers. This trend is continuing and has long been expected to accelerate.

Second, detailed analysis of the Current Population Survey's micro data indicates that about three-quarters of the decline in participation since the start of the recession in December 2007 can be accounted for by increased retirements and movements into disability. Some of

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1 Shigeru Fujita, "On the Causes of Declines in the Labor Force Participation Rate," *Research Rap Special Report*, Federal Reserve Bank of Philadelphia, February 6, 2014.

these increases might have been driven by the state of the economy. For example, some baby boomers may have moved their retirement decision forward after losing a job. Nevertheless, few of these individuals are likely to reenter the labor force. So, while I do expect some discouraged workers to reenter the labor force as the economy improves, I still believe the overall unemployment rate remains a good summary statistic of labor market conditions.

The business sector is also entering the year on a positive note. At the national level, manufacturing activity accelerated over the final three months of 2013. The Philadelphia Fed's Business Outlook Survey of regional manufacturing, which is a reliable indicator of national manufacturing trends, also showed that manufacturing activity picked up in the second half of 2013. In January, the survey's general activity index posted its eighth consecutive positive number. Expectations for manufacturing activity six months ahead also remained positive. This gives me some hope that business fixed investment, which has been generally lackluster during the course of the recovery, will pick up somewhat this year. Indeed, we saw a nice rebound in equipment spending in the fourth quarter.

Inflation has been running below the FOMC's long-run goal of 2 percent. The Fed's preferred measure of inflation is the year-over-year change in the price index for personal consumption expenditures, or PCE inflation. It came in at 1.1 percent last year. It is important to defend our 2 percent inflation target from both below and above. But I believe inflation is likely to move up. Economic growth is firming, and some of the factors that have held inflation down, such as the one-time cut in payments to Medicare providers, are likely to abate over time.

An additional and important determinant of actual inflation is consumer and business expectations of inflation. I am encouraged that inflation expectations remain near their longer-term averages and consistent with our 2 percent target. Thus, I anticipate, as the FOMC indicated in its most recent statement, that inflation will move back toward our target over time. Indeed, given the large amount of monetary accommodation we have added and continue to add to the economy, I think there is some upside risk to inflation in the longer term.

Although growth in the first quarter is likely to be somewhat slower than the rapid pace we saw in the second half of last year, overall, I anticipate economic growth of around 3 percent this year, a pace that is slightly above trend. Everyone would like to see robust growth of 5 to 6 percent, but I don't see that happening. Nevertheless, I do see steady progress and an improving economy. This growth is sufficient to result in a continued decline in the unemployment rate, which should reach about 6.2 percent by the end of 2014.

Of course, with any forecast, there are risks. The current volatility in emerging market currencies could pose a risk if it were to spill over more broadly into other financial markets. But at this point, I do not consider it a significant risk to the U.S. economy. While there continues to be some downside risks, for the first time in a few years, I see a potential for some upside risks to the economic outlook. We need to consider this possibility as we calibrate monetary policy.

Monetary policy

The Federal Reserve has taken extraordinary policy actions to support the economic recovery. The Fed has lowered its policy rate – the federal funds rate – to essentially zero, where it has been for more than five years. Since the policy rate cannot go any lower, the Fed has attempted to provide additional accommodation through large-scale asset purchases. We are now in our third round of this quantitative easing, or, as it is commonly called, QE3. These purchases have greatly expanded the size and lengthened the maturity of the assets on the Fed's balance sheet.

The Fed is also using forward guidance as a policy tool, which is intended to inform the public about the way monetary policy is likely to evolve in the future. In this dimension, the

FOMC has indicated that it intends to leave the policy rate near zero well past the time that the unemployment rate falls below the 6.5 percent threshold. The FOMC had previously indicated this was the earliest point at which it would consider raising interest rates, especially if projected inflation continues to run below the Committee's 2 percent target. On asset purchases, the FOMC has indicated that it will continue the purchases until the outlook for the labor market has improved substantially in the context of price stability.

Yet, with the economy having improved substantially over the last year and the outlook brightening, the time has come for the FOMC to slow the pace at which it is adding monetary accommodation, which is to say, ease our foot off the accelerator.[2] My personal view is that the process should have started sooner and proceeded more expeditiously. Nevertheless, the FOMC did decide in December to take a very modest step by reducing asset purchases from $85 billion to $75 billion per month, and then reduced this by another $10 billion to $65 billion a month in January.

The FOMC indicated that if incoming information broadly supports the expectation of ongoing improvement in labor market conditions and inflation moving back toward its longer-run objective, then we'll likely reduce the pace of purchases further in measured steps at future meetings. Former Chairman Ben Bernanke indicated in his December press conference that if we are making progress in terms of inflation and continued job gains, then the program would be concluded late in 2014.

Notice that even though we are reducing the pace at which we are purchasing longer-term assets, we are still adding monetary policy accommodation. So, the foot is still on the accelerator. My preference would be that we conclude the purchases sooner rather than later.

I believe a good case can be made for speeding up the pace of our taper if the economic outlook plays out as I expect. As I noted earlier, the unemployment rate fell 1.2 percentage points last year, and again in January to 6.6 percent. This is a much sharper decline than anticipated when we started the purchase program in September 2012. We are now only one-tenth of a point from the 6.5 percent threshold in our forward guidance for interest rates.

The FOMC has indicated that it doesn't anticipate raising rates when the economy crosses that threshold. However, I do believe that we have a communications challenge. We have not described how policy will be conducted after the unemployment rate passes 6.5 percent. Last summer, it was thought that we would stop asset purchases by the time unemployment reached 7 percent. Well, that didn't happen. What is the argument for continuing to increase monetary policy accommodation when labor market conditions are improving more quickly than anticipated and inflation has stabilized and is projected to move back to goal? The longer we continue purchases in such an environment, the more likely we will fall behind the curve in reducing the extraordinary degree of monetary policy accommodation. With the economy awash in reserves, the costs of such a misfire could be considerably higher than usual, fomenting higher inflation and perhaps financial instability.

My preference was, and remains, to scale back our purchase program at a faster pace to reflect the strengthening economy. Given the falling unemployment rate, our communications should be focused on how economic conditions will determine the interest rate path. Continuing to buy assets is neither helpful nor essential.

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2 For more on the subject, see Charles I. Plosser, "The Outlook and the Hazards of Accelerationist Policy," remarks before The University of Delaware Center for Economic Education and Entrepreneurship, Newark, DE, February 14, 2012.

Conclusion

In summary, I believe that the economy is continuing to improve at a moderate pace. We are likely to see growth of around 3 percent in 2014. Prospects for labor markets will continue to improve, and I expect the unemployment rate will continue its decline, reaching 6.2 percent by the end of 2014. I also believe that inflation expectations will be relatively stable and that inflation will move up toward our goal of 2 percent over the next year.

On monetary policy, we must back away from increasing the degree of policy accommodation in a manner commensurate with an improving economy. Reducing the pace of asset purchases to $65 billion a month is moving in the right direction, but that may prove to be insufficient if the economy continues to play out according to the FOMC forecasts. I believe the economy has met the criteria for ending the asset purchases as there has been significant improvement in labor market conditions. I also believe that further increases in the balance sheet are unlikely to provide appreciable benefits for the recovery and may have unintended consequences. A case can be made for ending the current asset purchase program sooner to reflect the improvement in the economic outlook and to lessen some of the communications problems we will face with our forward guidance.

Even after the asset purchase program has ended, monetary policy will still be highly accommodative. As the expansion gains traction, the challenge will be to reduce accommodation and to normalize policy in a way that ensures that inflation remains close to our target, that the economy continues to grow, and that we avoid sowing the seeds of another financial crisis. This means the Fed still has considerable work to do.