Economic Outlook and Economic Choices

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Thank you for the generous introduction. It is great to be back in Wisconsin. I've been to many places in your great state as a tourist—Cornucopia, Prairie du Chien, Madison—just to name a few.

While I've been to Wisconsin many times, this is my first trip here as president of the Federal Reserve Bank of Minneapolis, and I'm delighted to have this opportunity to talk to you today. One of the parts of my job that I'm really enjoying is the ability to talk to people throughout the Ninth District. It's always important for us presidents to engage in this kind of public dialogue, but even more so now when people have so many questions about the Federal Reserve and its role in the economy. Today I want to discuss my economic outlook and then turn to three important issues facing the Federal Reserve. Before I go on, though, I must tell you that any views I share today are my own, and not necessarily those of others in the Federal Reserve System.

Let me first remind you of the role that I—and you—play in the making of monetary policy. The Minneapolis Fed is one of 12 regional Reserve banks that, along with the Board of Governors in Washington, D.C., make up the Federal Reserve System. Our bank represents the ninth of 12 Federal Reserve districts, which includes Montana, the Dakotas, Minnesota, northwestern Wisconsin, and the Upper Peninsula of Michigan.

Every six to eight weeks, the Federal Open Market Committee meets to vote on monetary policy. The committee consists of the Board of Governors of the Federal Reserve System, the president of the New York Fed, and four other presidents of the Federal Reserve Banks that rotate through on an annual basis. I'll be on the committee in 2011. Even though only five of the presidents vote, the other seven—including me—attend the committee's meetings and participate fully in its deliberations.

In this way, the structure of the FOMC mirrors the federalist structure of our government. Representatives from different regions of the country—the various presidents—have input into FOMC deliberations. The independent input from the presidents relies critically on information that they receive from their districts about local economic performance. We obtain this information through the work of our research staffs—but we also obtain it from business leaders like you. Members of our board of directors, like Mike O'Meara, as well as members of our advisory councils on agriculture, and small business and labor, keep us attuned to what is happening in the economy in real time. I thank them, and former members of those groups, for their hard work. Their diligence is what gives the residents of Main Street a voice in monetary policy.

At an FOMC meeting, the 17 attendees each present their current assessment of the state of the economy and its outlook. In the same vein, let me tell you about mine. GDP growth has been positive in each of the past three quarters and was 3.2 percent in the past quarter. I expect GDP growth to be near 3 percent again in the current quarter, and to average close to 3.5 percent over the next two years. The recovery is well under way.

At the same time, my projected recovery does not have the V shape that we would prefer to see. My forecast for GDP growth is pushed downward by uncertainty along several key dimensions. First, the increase in the public debt in the United States may well lead to an increase in future tax rates. These increases will retard investment and dampen GDP growth. Second, as of the first quarter, bank lending continued to decline, even though the overall economy grew relatively robustly. The decline has many sources, but it is certainly true that all banks are affected by ongoing regulatory uncertainty, and many are affected by ongoing asset quality concerns. Finally, the fiscal and financial situation in Europe may well lead European growth to continue to be restrained over the next year or two.

The news from the labor market is, at first glance, confusing. Last Friday, we learned that firms reported that the economy had created nearly 300,000 jobs last month. At the same time, the unemployment rate rose to 9.9 percent in April from 9.7 percent in March. How can both of these take place at the same time? To understand this, we have to get into the technicalities of how the unemployment rate is calculated. The government asks a large group of people: Are you working? Or, if you're not, have you looked for work in the past four weeks? The total number of people engaged in one of these two activities—working or looking for work—is called the labor force. The unemployment rate is the fraction of the labor force who don't have a job, but are looking for work.

So, what happened in April is that the growth rate of the labor force was actually faster than the growth rate of the employed. My own tentative interpretation is that both of these pieces of information—the increase in the number of jobs and the increase in the size of the labor force—actually indicate that the labor market is starting to function better. Of course, our eventual goal is to have the extra searchers also be able to find jobs. On that score, I believe that the recovery will be slower than we would like. I would be surprised if unemployment were to fall below 9 percent before the end of 2010 or below 8 percent by the end of 2011. There were many big surprises during the past recession, but I believe that the remarkable increase in labor productivity was one of the most important. The growth in productivity has allowed firms to expand production without commensurate increases in hiring.

The truly good news is about inflation. Over the first quarter of 2010, annualized PCE inflation was 1.5 percent. I expect it to remain at about this level during the rest of this year. We can get a market-based measure of inflation expectations over the next five years using TIPS yields. Those expectations are also under 2 percent.

After presenting our views on the economy, the participants in the FOMC each present their views of what should be done with monetary policy. What are the main issues that are currently confronting us? I think that there are three main ones: short-term interest rates, the Fed's large balance sheet, and fiscal uncertainties. The first two are under our control, but the last is not.

Let me talk first about short-term interest rates. The federal funds rate—the key short-term interest rate set by the FOMC—has been set at 0-25 basis points for the past 17 months. We can't set interest rates to be negative. This means that the question, "What's going to happen to interest rates?" is an even less interesting one to use at cocktail parties than usual.

But, it's my job and livelihood—and so, what is going to happen to interest rates? The FOMC's March statement contains the following key sentence:

"The Committee will maintain the target range for the federal funds rate at 0 to 1/4 percent and continues to anticipate that economic conditions, including low rates of resource utilization, subdued inflation trends, and stable inflation expectations, are likely to warrant exceptionally low levels of the federal funds rate for an extended period."

What do we learn from this sentence? Right now, the unemployment rate is 9.9 percent and measured inflation is low (below 2 percent last quarter). Inflationary expectations are also low; as I've discussed, expected inflation over the next five years is also less than 2 percent. In its statement, the FOMC is saying: We're keeping interest rates low to keep unemployment from going any higher, and we feel safe in doing so because there seems to be little threat of inflation.

I think that most or maybe even all of the members of the FOMC and the other presidents agree that current conditions necessitate interest rates near zero. However, the sentence goes on to forecast that these kinds of economic conditions are likely to continue for "an extended period." There has been some public disagreement about this forecast, and it is one reason given by the president of the Federal Reserve Bank of Kansas City for his dissenting from the statement at the last three meetings.

As for my own view, had I been a voter, I would have voted in favor of the FOMC statement in April. I do think that readers of the FOMC statement should pay very careful attention to its explicit conditionality. The statement says that the committee will raise interest rates if economic conditions change appropriately—whether that's in three weeks, three months, or three years.

Let me turn next to the issue of our balance sheet. The Federal Reserve has 2.3 trillion dollars of assets—over 2.5 times what it owned in September 2008. Over 2 trillion dollars of those assets are in Treasuries or in mortgage-backed securities issued by Fannie Mae and Freddie Mac. These MBSs are backed by the U.S. government—the Fed faces no credit risk in holding them. However, the MBSs do expose us to interest rate risk and prepayment risk.

In the January meetings, the FOMC unanimously expressed support for the proposition that it would like to return to a much smaller all-Treasury portfolio in the long run. This is a statement about both scale and composition. Why do we want the portfolio to be smaller? There are many reasons—but for my own part, I worry that a large balance sheet could trigger inflation. Why do we want to get out of MBSs? Again, there are many reasons for this view, but one is certainly that we don't want to be seen as a long-term prop for the housing sector.

But what does "long-term" mean? Many of the MBSs that we hold won't mature for 30 years! Now, prepayment will reduce the size of our portfolio. However, prepayment is slow—we've estimated in Minneapolis that even 20 years out, the Fed is likely to have something like 250 billion dollars of MBS holdings. This means that if we want to normalize our balance sheet sometime in the next two decades, we will need to sell some of our MBS holdings. Doing so is challenging—we want to be careful not to cause large jumps in long-term interest rates, and especially not in mortgage rates. But I believe that we can do so, as long as we commit to a sufficiently slow pace of sales. I'm optimistic that we can get MBSs off our balance sheet by 2020 at the very latest.

Finally, let me say a few words about fiscal policy and inflation. Almost all people think that inflation is the sole responsibility of the Fed. That's not true—Congress also plays a key role. Over the past two and a half years, the amount of federal debt in the hands of the private sector has increased by over 50 percent. This extra debt can only be paid in one of two ways. First, Congress can cut spending or raise taxes. Second, the Fed can print extra money to pay off extra obligations and thereby create inflation.

Logically, this means that if Congress does not raise taxes or cut spending, the Fed must create inflation. So, we rely on Congress to do its job and practice fiscal responsibility if we are to be able to do ours. So far, I would say that, despite grumbling in some circles, the public has faith in both Congress and the Fed. As I mentioned earlier, inflationary expectations—as measured by TIPS yields—remain low.

So, I've touched on three key issues in monetary policy today: short-term interest rates, the balance sheet, and fiscal policy uncertainties. Let me close by talking about the most recent decision of the FOMC: to create temporary swap lines with the Bank of Canada, the Bank of England, the Bank of Japan, the European Central Bank, and the Swiss National Bank. These lines allow these central banks (not private banks) to borrow dollars from the Fed. The loans are short term (under three months) and require the borrower to repay us in dollars. The loans are secured, because a borrower who borrows $10,000 gives us $10,000 worth of their home currency to hold as collateral.

I'm happy to talk about the economics of these arrangements, but they're pretty basic and compelling. We opened these lines to allow these central banks—especially the European ones—to ease funding pressure in dollar interbank lending markets. We didn't do so out of any special love for Europe – we're American policymakers, and we make decisions to keep the American economy strong. But the liquidity problems in European markets were showing signs of creating dangerous illiquidity problems in our own country's financial markets. We knew that the swap lines would be a useful step in heading off that process.

I think that the decision about swap lines is more interesting for an institutional reason. There has been a huge demand from the public and its elected representatives for more Fed transparency. Our communication around the swap lines has been highly responsive to this demand. On Tuesday, we released the exact contracts that are involved. The exact loan amounts on a bank-by-bank basis will be announced on a weekly basis.

I was happy to see this. It is often said, and it is true, that the Fed of 2010 is much more transparent than the Fed of 1980. Nonetheless, I believe that we should continue to do more on this dimension. It is critical to the economic health of this country that the Fed remains independent of short-term political pressures. But we do not need to be opaque to be independent.

Thank you for your attention. And now I'm happy to take your questions on these or other matters.