Economic Outlook, October 2012

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It's a pleasure to be with you today to discuss the economic outlook and monetary policy. The Federal Reserve's monetary policy received a great deal of media attention last month — though perhaps not as much as the presidential election campaign or the performance of NFL referees. I'm OK with all of this attention because monetary policy plays an important role in fostering an environment in which people can work, save and invest to expand prosperity. But the role of monetary policy is often misunderstood, so in my remarks I will talk about what it can, and cannot, accomplish. I should emphasize that the views expressed in this talk are my own and should not be attributed to anyone else in the Federal Reserve System.[1]

What does monetary policy do? First things first: Over the long haul, monetary policy determines the purchasing power of money. The Fed has an effective monopoly on the supply of certain critically important monetary assets — namely, currency and bank reserves. That supply, together with the demand for such assets, determines their value. Excessive supply leads to excessive inflation — that is, a rise in the overall price level. Insufficient supply leads to deflation — that is, a fall in the overall price level. Excessive inflation — or deflation — therefore can legitimately be blamed on the central bank. Conversely, we deserve credit when inflation is low and stable.

So how have we been doing? Some of you in this room probably remember the 1970s, when inflation was fairly high on average and at times reached double-digit rates. We fought hard to bring inflation under control in the 1980s and 1990s, and over the last 20 years, inflation has averaged 2.05 percent per year.[2] To be sure, inflation has varied from year to year. But these temporary swings have evened out over time, and inflation has generally run around 2 percent. In fact, over the last three years, inflation has averaged precisely 2 percent.

The record of low and fairly stable inflation over the last two decades is a substantial improvement over previous decades, and it should be kept in mind whenever we think about monetary policy in recent years. The Federal Open Market Committee, or FOMC, which is responsible for monetary policy, issued an important statement in January of this year on its "Longer-Run Goals and Policy Strategy."[3] In that document, the Committee stated that inflation at the rate of 2 percent, as measured by the annual change in the price index for personal consumption expenditures, is most consistent over the longer run with the Fed's statutory mandate. This confirmed a long-held belief among Fed watchers that 2 percent constituted the FOMC's unofficial target for inflation.

Beginning an economic outlook talk with a discussion of inflation is not the usual approach, even among Fed officials, perhaps due to the stability of inflation over the last 20 years. I did so simply to emphasize that the behavior of inflation is fundamentally attributable to the actions of the central bank, while growth and labor market conditions are affected by a wide variety of factors outside the Fed's control. So let's talk about growth now.

The Great Recession officially bottomed out at the end of the second quarter of 2009, but the expansion in economic activity since then has been disappointing. Real gross domestic product (GDP), for example, has grown at an average annual rate of 2.2 percent during this recovery. Labor market conditions have been particularly disheartening. We lost over 8 million jobs in the recession and its immediate aftermath. Since bottoming out in early 2010, we've added 4 ¼ million new jobs, which leaves us far from a complete recovery. The rate of job growth has been quite uneven over time. Thus job growth averaged 226,000 jobs per month in the first quarter, fell to 67,000 jobs per month in the second quarter and rebounded to 146,000 jobs per month in the third quarter. The most recent rate of job growth is fairly close to the average for this recovery, suggesting that the slowdown in the second quarter was a transitory swing.

These labor markets indicators are especially noteworthy because Congress requires that monetary policy should "promote effectively the goals of maximum employment, stable prices and moderate long-term interest rates."[4] Some observers see these labor market conditions as prima facie evidence that the Fed is failing to promote effectively the goal of maximum employment. In particular, many people point to how high the unemployment rate is now by historical standards.

But assessing monetary policy is much more complicated than simply noting that certain indicators are far from historical averages. Modern economies are buffeted by unanticipated disturbances. Even at their best, economies take time to adjust to those shocks. The pace of that adjustment is, in turn, affected by a variety of frictions in an economy — frictions in the way firms determine the prices of their goods, frictions in the process of searching for the most promising opportunities to deploy available capital and labor resources, and frictions in the way workers and employers search for each other, among others. Monetary policy is simply unable to offset all of the ways in which various frictions impede the economy's adjustment to various shocks. The term "maximum employment" in our congressional mandate should therefore be thought of as the level of employment that currently can be achieved by a central bank, taking into account its long-run objectives and the very real impediments to a more rapid adjustment to recent economic shocks.

Consider the severe recession we just experienced. An unanticipated decline in residential construction resulted in an oversupply of labor and capital. Redeploying those resources productively has been difficult and time-consuming: Retraining is often required for workers to find employment in other sectors, and capital investments are required to absorb the newly available pool of labor in other sectors. In the absence of further shocks, the economy's best response is likely to have the unemployment rate decline gradually over time. *How* gradually is the critical question. It's unlikely that we would be able to restore the unemployment rate to its long-run level immediately — within a quarter or two, for example. At the same time, there are significant social costs associated with delaying the recovery in labor market conditions too long. The key point here is that simply observing a high unemployment rate does not imply that the Fed's monetary policy is failing to comply with its congressional mandate, nor does it necessarily mean that monetary policy needs to do more to achieve its goals.

The FOMC was clear about this point in its January statement that I mentioned earlier, and I'd like to quote from that statement:

> "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. Consequently, it would not be appropriate to specify a fixed goal for employment; rather, the Committee's policy decisions must be informed by assessments of the maximum level of employment, recognizing that such assessments are necessarily uncertain and subject to revision. The Committee considers a wide range of indicators in making these assessments."

I believe there are several factors impeding a more rapid recovery in labor market conditions right now. First, the housing market is still coping with the large inventory overhang that remains from the prerecession boom. This sector has begun to show some encouraging signs, with home prices and construction improving this year. But housing investment has shrunk to a much smaller part of the overall economy than had typically been the case, and given the inventory overhang, residential investment is likely to remain below prerecession levels for a considerable period.

Second, and related, was the significant shift in economic activity away from residential construction and related supply industries. The rapid loss of jobs in these industries, layered on top of ongoing longer-run sectoral shifts, resulted in large inflows into the ranks of the unemployed. The result has been an adverse shift in the skill profile of available workers, which has intensified the reallocation and skill mismatch frictions that hinder labor market clearing.

Third, the Great Recession appears to have made many consumers more cautious and less willing to spend, relative to their income and wealth. Prior to the recent recession, American households experienced a two-decade run with just two mild recessions in which job losses were relatively limited. In contrast, the declines in income and wealth during the recent recession were far greater. As a result, consumers have become more apprehensive about their future income prospects. So while consumer spending has grown during this recovery, the tempered pace of that growth has limited the overall pace of the expansion, relative to previous recoveries.

Finally, our business contacts frequently emphasize that uncertainty is at a crippling level and has caused them to delay hiring and investment commitments. While there may be multiple sources of uncertainty, including the situation in Europe, the most widely mentioned is the nation's fiscal policy. Here I'll mention two aspects of the federal fiscal situation. One is the fiscal cliff, the combination of spending cuts and tax increases that will automatically occur next year if Congress fails to act. The total size of these changes is such that, should they all take effect, the economy is likely to contract and move back into a recession. The second relevant aspect of the federal fiscal outlook is the long-run imbalance between taxes and spending. According to projections by the nonpartisan Congressional Budget Office, the deficit is likely to decline somewhat for a few years, but then move higher, both in dollar terms and as a fraction of GDP. This implies that the outstanding stock of federal debt will increase without bound as a ratio to GDP. This is not a feasible scenario and cannot persist indefinitely. At some point, Congress will have to align taxes and spending. The set of policy changes that are likely to be considered affect almost every American consumer or business in a meaningful way. Not knowing which of these policies will be adopted, a wide array of economic decision-makers is likely to be affected.

Uncertainty is likely to continue to dampen U.S. growth until there is greater clarity about legislation that Congress and the president are likely to adopt. But merely avoiding the fiscal cliff is not likely to be enough. Fiscal uncertainty will continue to restrain growth, I believe, until Washington adopts a long-run plan that restores fiscal balance.

In short, much of the recent sluggishness is understandable. Economies take time to recover from severe shocks. In fact, if you look back at how advanced economies typically behave after recessions associated with housing slumps, you will find that the current U.S. recovery is actually not out of the ordinary.[5] What is exceptional is the depth of the contraction phase of this recession.

So where do we go from here? My best guess is that growth will begin to firm later next year and continue to improve beyond that. While the recession in Europe poses risks for this outlook, I think those risks will likely dissipate next year as leaders work through the adjustments necessary for creating a new fiscal regime. As U.S. labor markets continue to heal, I expect household confidence to slowly firm and bolster consumer spending.

The fundamental prospects for longer-term U.S. growth remain quite promising, in my view, and are likely to reassert themselves in the years ahead. We have a proven ability to generate advances in scientific knowledge and commercial innovation. The flexibility and resilience of our markets, along with a relatively well-educated populace, make this an excellent market in which to implement innovations. Our major challenge over the long haul is to deepen the knowledge and skills of our people, because growing our human capital is fundamental to improving our standards of living.

What is the role of the Fed's monetary policy in this outlook? Our first responsibility is to keep inflation low and stable; this allows businesses and consumers to make economic decisions without worrying about inflation. The FOMC took an important step to solidify confidence in our commitment to price stability with its January statement on "Longer-Run Goals and Policy Strategy" formalizing a long-run goal for inflation of 2 percent.

I strongly supported my colleagues' decision to issue that statement, but I have dissented at all six FOMC meetings this year. Let me explain some of my reasoning. At each meeting this year, the FOMC has voted to leave the federal funds rate near zero, and in each case, I supported that decision. But the Committee also issued "forward guidance," that is, language stating that economic conditions are likely to warrant a federal funds rate near zero for at least several years. I have objected to that language because it's a highly imperfect way to communicate about future policy. It could be misinterpreted as meaning that the Committee believes the economy will be weaker than people had thought. By itself, that could have a dampening effect on current activity, which is not what was intended. On the other hand, it also could be misinterpreted as suggesting a diminished commitment to keeping inflation at 2 percent. I would vigorously oppose adopting such a stance, and I do not believe my colleagues on the FOMC intended that interpretation either.

In addition, at its September meeting, the FOMC decided to begin increasing the size of its balance sheet by purchasing agency mortgage-backed securities, or MBS. I believe that the benefits of that action are likely to be small, because it's unlikely to improve growth without also causing an unwelcome increase in inflation. At the same time, adding to our balance sheet increases the risk we will have to move quickly when the time comes to normalize monetary policy and begin raising rates.

Finally, if we are going to purchase more assets, it would be better to purchase Treasury securities rather than agency mortgage-backed securities. Buying MBS rather than Treasuries may reduce borrowing rates for conforming home mortgages, but if so, it will raise interest rates for other borrowers and thus distort credit flows. This is an inappropriate role for the Fed, a principle that was recognized in the Joint Statement of the Department of Treasury and the Federal Reserve on March 23, 2009: "Government decisions to influence the allocation of credit are the province of the fiscal authorities," that is, Congress and the administration.

To sum up, I am cautiously optimistic about the outlook for growth in output and employment. While I have objected to some specific monetary policy decisions, the fact that inflation has stayed around 2 percent is evidence that monetary policy has done reasonably well in recent years. Maintaining that record of success should be our focus in the years ahead.

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[1] I am grateful to Roy Webb and John Weinberg for assistance in preparing these remarks.

[2] For an account, see Marvin Goodfriend, "Monetary Policy Comes of Age: A Twentieth Century Odyssey." Federal Reserve Bank of Richmond Economic Quarterly, Winter 1997, vol. 83, no. 1. pp. 1-22.

[3] Board of Governors of the Federal Reserve System, "Longer-Run Goals and Policy Strategy." New and Events, Monetary Policy Press Release, January 25, 2012.

[4] For a review of the history of the Fed's mandate, see Aaron Steelman, "The Federal Reserve's 'Dual Mandate': The Evolution of an Idea," Federal Reserve Bank of Richmond Economic Brief, December 2011.

[5] Greg Howard, Robert Martin and Beth Anne Wilson, "Are Recoveries from Banking and Financial Crises Really So Different?," Board of Governors of the Federal Reserve System, International Finance Discussion Papers, no. 1037, November 2011. See in particular Figure 12 on page 24. The current U.S. recovery is within one standard error of the average advanced economy recovery from recessions that occur during housing slumps.