Economic Outlook, December 2012

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Good afternoon. I am pleased to be with you again to discuss the economic outlook, although I must say that the recent passing of Henry Faison makes this a bittersweet occasion. Henry served on the Board of Directors of the Federal Reserve Bank of Richmond from 1990 to 1995, the last two years of which he served as chairman. We knew Henry as a man of drive and determination, but also principle and generosity. In addition to being an exceptionally successful entrepreneur and an outstanding Charlottean, he was also a staunch supporter of the Federal Reserve and our quest for price stability. It's hard to picture this wonderful annual event without Henry's charm and grace and his annual appraisal of the Fed's inflation performance. I know I will miss him greatly.

The economic outlook is the main order of business today, though, and before I begin, I should emphasize that the views expressed are my own and should not be attributed to anyone else in the Federal Reserve System.[1] I will begin with the outlook for inflation. Over the last 20 years inflation has averaged 2.05 percent per year. There have been year-to-year fluctuations, to be sure. But these temporary swings have evened out over time, and inflation has tended to return to around 2 percent. In fact, since the Great Recession, inflation has averaged 2.01 percent. Although inflation was running at elevated rates a few months ago, driven up by a bulge in retail gasoline prices, energy prices have subsided of late. With futures markets forecasting flat or declining energy prices, most economists expect headline inflation to average a little less than 2 percent next year. I agree with that outlook.

I began with inflation to emphasize that the behavior of inflation is fundamentally attributable to the actions of the central bank. In contrast to inflation, real economic growth and labor market conditions are affected by a wide range of factors outside the central bank's control. In fact, the effects of monetary stimulus on real output and employment, are less than is widely thought; they consist largely of the transitory byproducts of frictions that delay the timely adjustment of prices. Attempts to overstimulate real economic activity via monetary policy can instead run the risk of raising inflation. Indeed, for reasons I will discuss later on, I see material upside risks to inflation in 2014 and beyond, given the current trajectory for monetary policy, though my baseline outlook is for inflation to move toward the Fed's long-run goal of 2 percent in coming years.

Turning to the outlook for growth, the expansion in economic activity since the Great Recession officially bottomed out at the end of the second quarter of 2009 has been disappointing. Real gross domestic product, for example, has risen at an average annual rate of 2.2 percent during this recovery, and job growth has averaged about 140,000 per month.

Several factors appear to be impeding a more rapid recovery in the U.S. economy. First, the housing boom created a substantial oversupply of new homes, and while significant progress is evident, we have not completely worked through that oversupply. New construction activity has been gradually improving, however, and home prices in many markets have bottomed out and are on the rise. Still, we should not expect the rapid rebound in housing that we have often seen in past recoveries.

A second, and related, factor behind the slow recovery was the significant shift in economic activity away from industries related to residential construction. 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 and an adverse shift in the average skill level of the unemployed. This effect is typical in a recession, but is larger now because of the magnitude of this recession. The need for capital investment and retraining as workers shift to new sectors has been slowing down recovery in the labor market.

Third, the Great Recession appears to have made many consumers more cautious and less willing to spend, relative to their income and wealth. Households have become more apprehensive about their future income prospects and more interested in paying down financial obligations. 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 Fifth District business contacts have long been emphasizing that uncertainty has caused them to delay hiring and investment commitments. The uncertainty that is most on everyone's mind at the moment concerns the looming year-end fiscal cliff. The total size of the spending cuts and tax increases slated to take effect is large enough to be at least temporarily disruptive to economic activity. But even if Congress and the administration get us past the fiscal cliff and the debt ceiling, significant uncertainty will remain about the longer-run tax and spending paths, the broad regulatory realignments that are currently in train and the uncertain prospects for European economies.

In short, much of the recent sluggishness is understandable. In fact, if you look back at how other advanced economies have typically behaved following recessions associated with housing slumps, you will find that the current U.S. recovery is actually not out of the ordinary.[2]

My best guess is that growth will continue into next year at an annual rate of 2 percent and that beyond 2013 we should see growth begin to firm. Several important suppositions lie behind this forecast. First, I expect to see meaningful progress on federal budget issues — both short-run and long-run — now that the election is behind us. Second, I expect risks emanating from Europe to continue to diminish next year as they make progress toward new institutional arrangements and emerge from recession. Third, my outlook is predicated on gradual gains in household confidence. Improvements in labor market effectiveness and modest growth in home prices should combine to reduce consumer apprehension about downside risks and thereby bolster spending.

This outlook is not without risks. Significant energy price increases or an unexpected downturn in some major trading partners could temporarily reduce overall U.S growth. On the other hand, a stronger-than-expected resurgence in confidence is not inconceivable; rapid and convincing progress toward fiscal sustainability, for example, might release a rush of pent-up spending.

Even though growth has been below our long-run trend rate since the recession, I believe that the fundamental prospects for longer-term U.S. growth remain quite strong. The flexibility and resilience of our markets, along with a relatively well-educated population, make this an advantageous place to implement innovations. Our major challenge over the longer haul is to find effective ways to deepen the knowledge and skills of our people because expanding our human capital is fundamental to improving our standards of living.

What role does monetary policy play in this outlook? Our primary responsibility at the Federal Reserve is to keep inflation low and stable; this allows businesses and consumers to make economic decisions without needing to worry about inflation. The Federal Open Market Committee, or FOMC (the body that determines monetary policy), took an important step to solidify confidence in its commitment to price stability with its January statement on "Longer-Run Goals and Policy Strategy."[3] That document identified 2 percent inflation, as measured by the annual change in the price index for personal consumption expenditures, as most consistent over the longer run with the its statutory mandate.

Beyond satisfying our inflation mandate, however, it's not clear that monetary policy, by itself, can bring about any material improvement in economic growth. At its meeting last week, the FOMC decided to continue the monthly purchases of $40 billion in agency mortgage-backed securities and $45 billion in long-term U.S Treasury securities.

In my view, the supply of bank reserves is already large enough to support the economic recovery, and the benefits of further asset purchases are unlikely to be sizeable. The effects on longer-term interest rates are uncertain and likely quite small, and the potential to boost job creation seems quite limited, given the fundamental impediments that appear to be restraining growth now. At the same time, it's important to recognize the potential costs of additional asset purchases. A larger Fed balance sheet will increase the risks associated with the timely and appropriate withdrawing of monetary stimulus by raising interest rates and selling assets.

My assessment was that the costs associated with additional asset purchases outweighed the expected benefits, and thus, I dissented. In its statement following last week's meeting, the FOMC said that "[i]n determining the size, pace, and composition of its asset purchases, [it] will, as always, take appropriate account of the likely efficacy and costs of such purchases." At the press conference following the meeting Chairman Bernanke noted that "[i]f future evidence suggests that the program's effectiveness has declined or if potential unintended side effects or risks become apparent as the balance sheet grows, we will modify the program as appropriate." I anticipate that the Committee will regularly reassess the benefits and costs of the asset purchases and make adjustments to the program as warranted.

The Committee also altered its description of its expectations regarding future interest rate changes, replacing its previous date-based forward guidance with guidance based on numerical thresholds. Specifically, the Committee said it anticipates the current "exceptionally low" target range for the federal funds is likely to remain appropriate "at least as long as the unemployment rate remains above 6.5 percent, the inflation rate over the next one to two years is projected to be no more than half a percentage point above its 2 percent longer-run goal, and longer-term inflation expectations continue to be well anchored." I had dissented previously against the use of a date-based forward guidance, so I supported the decision to drop such language at the December meeting.

I agree that it's useful for the Committee to describe how its future actions are likely to depend on the evolving state of the economy. However, a single indicator cannot provide a complete picture of labor market conditions. More broadly, monetary policy has only a limited ability to improve the path of unemployment, and such effects are transient and generally short-lived.

For these reasons I believe that tying the federal funds rate to a specific numerical threshold for unemployment is inconsistent with a balanced approach to the FOMC's price stability and maximum employment mandates. I would have preferred to describe in qualitative terms the economic conditions under which our monetary policy stance is likely to change.[4] It's true that the Committee's forward guidance contains a safeguard with respect to inflation, in that keeping rates low requires that inflation is projected to remain close to our 2 percent objective and that inflation expectations remain well anchored. Nevertheless, this sets up a potentially problematic tension between two competing commitments — one to price stability and the other to an unemployment rate threshold. These two commitments could well conflict because inflationary pressures can arise without triggering the inflation safety clause. In the past, we've had to act pre-emptively to head off incipient inflation pressures because re-establishing credibility after it has eroded is costly and economically damaging.

The broader issue is that disappointing labor market outcomes have motivated a search for how much stimulus can be provided — or promised for the future — without diminishing the Fed's credibility for price stability. Inflation has averaged quite close to our 2 percent objective in recent years, but continuation of that record of success should not be taken for granted. We do not really know whether monetary policy can make a sustainable difference in labor market outcomes, and we may be attempting to achieve more rapid improvement than is feasible. We need to be careful that in our zeal to promise future stimulus, we do not constrain ourselves in ways that endanger the price stability on which we've come to depend.

[1] I am grateful to Roy Webb and John Weinberg for assistance in preparing these remarks.
[2] Board of Governors of the Federal Reserve System, "Are Recoveries from Banking and Financial Crises Really So Different?" International Finance Discussion Papers, no. 1037, November 2011. See in particular Figure 12, page 24. The current recovery is within one standard error of the average advanced economy recovery from recessions that occur during housing slumps.
[3] Board of Governors of the Federal Reserve System, "Longer-Run Goals and Policy Strategy." News and Events, Monetary Policy Press Release, January 25, 2012.
[4] Jeffrey M. Lacker, "Perspectives on Monetary and Credit Policy." Speech at the Shadow Open Market Committee Symposium, New York, November 20, 2012.