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The Slow Recovery: Causes and Monetary Policy Implications

Thank you. It's a pleasure to participate in the 2012 Santa Barbara County Economic Summit. It's especially nice for my Fed colleagues from other parts of the country to experience firsthand the beautiful scenery and wonderful weather that we Californians get to enjoy every day. In my presentation today, I'm going to sketch out the key factors shaping the economic recovery. I'll then comment on the implications of these events for monetary policy. Before I get running, I should note that my remarks represent my own views and not those of others in the Federal Reserve System.

Our economy is still feeling the aftereffects of the worst financial crisis and economic downturn since the Great Depression. Economists have pointed out that recoveries from financial crises are typically very slow and drawn out.[1] This one has been no exception. We are now nearly three years into the recovery phase, as measured by the National Bureau of Economic Research. The economy is steadily improving and the outlook is for continued moderate growth. Nonetheless, we have nearly four-and-a-half million fewer jobs today than five years ago and the unemployment rate remains very high at 8.2 percent.

A number of forces are holding back the economy. The foremost is the massive fallout from the housing crash.[2] The scale of the housing meltdown is breathtaking. From their peak in

[1] Reinhart and Rogoff (2009) and Jorda, Schularick, and Taylor (2011). See Williams (2012a,b) for fuller discussions of recent economic developments.

[2] Feroli et al. (2012).

2006, house prices have fallen by about a third nationally. The destruction of net worth from housing equaled more than 40 percent of the value of annual U.S. production. About a quarter of borrowers found themselves under water, owing more than their homes were worth. Millions of families have lost their homes to foreclosure. And millions more are currently in foreclosure or are severely delinquent on their mortgages.

When a debt-fueled bubble bursts, the economic effects are severe. During the boom, higher house prices helped fuel consumption as people tapped home equity to buy cars, boats, vacations, and the like. When house prices did a U-turn, households—deep in debt and feeling much poorer—hunkered down. They cut spending and salted away more savings to rebuild lost wealth. And that wasn't the housing bust's only depressing effect. By early 2009, home construction had plunged by over 75 percent from its 2006 high. It's edged up somewhat since then, but remains at very depressed levels. That's kept millions of carpenters, plumbers, and others in construction and real estate out of work.

In addition to the collapse of housing, other powerful forces have kept us stuck in a slow growth pattern. I'll highlight three: tight credit, government contraction, and uncertainty.

Tight credit was clearly a by-product of the housing bust. But it took on a life of its own when the fallout from the mortgage meltdown nearly brought down the global financial system in 2008. The repercussions of those dramatic events remain with us today. Many banks are still feeling the effects of the huge housing-related losses they experienced. As a result, credit has been harder to come by for many. For example, to get a mortgage, a borrower must have a top-notch credit rating and the cash to make a substantial down payment.

Government cutbacks are a second obstacle to growth. Typically, state and local government spending increases during an economic recovery. This time around, the housing bust has cut into the revenue of state and local governments, forcing them to slash spending.[3] I don't see government spending turning around soon. Indeed, spending at the federal level is set to contract sharply at the end of this year as several temporary programs expire, and taxes are set to rise sharply. Some of those programs may be extended. But, overall, we can expect federal spending trends to weigh on near-term economic growth.

Uncertainty is a third factor holding back the recovery. Businesses, investors, and households remain skittish, even in the face of better economic news. Many of my business contacts say they remain cautious about expanding because they're unsure about future conditions. Ordinary Americans worry about job prospects and future income. The political environment remains highly charged. Among other things, that makes it harder to predict how abrupt future tax and spending changes will be. The financial turmoil in Europe has added another dimension to the unease here.

These forces explain why we have not seen a V-shaped recovery typical of past post-World War II deep recessions. Instead, the pattern is more reminiscent of recoveries from previous financial crises. The stubbornly slow recovery and high unemployment also explain why the Federal Reserve has instituted such aggressive and sustained monetary stimulus aimed at boosting economic growth and bringing down unemployment.

Congress assigned the Fed two goals in conducting monetary policy: maximum employment and price stability. Over the past few decades, we've done pretty well on our price

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[3] Feroli et al. (2012).

stability objective. Indeed, despite the turmoil of the past five years, inflation has averaged almost exactly the 2 percent rate that the Federal Open Market Committee designated as our medium-run target. However, we are still very far from our maximum employment mandate. Despite recent progress in the labor market, the unemployment rate remains far too high.

The events of the past several years have caused some to ask whether the forces holding back growth are primarily structural in nature, rather than cyclical. In a nutshell, they argue that the lackluster growth reflects fundamental forces in the supply side of the economy, not a shortfall in demand. If this conjecture is right, then monetary policy should not be used so aggressively to try to boost demand. Instead, it needs to be recalibrated to reflect the reality of this supposed "new normal" for the economy.

This debate is often couched in terms of the unemployment rate. Broadly speaking, economists fall into two camps. One group argues that changes in the structure of the economy are pushing up the unemployment rate. The other group maintains that high unemployment is the result of a severe downturn, which significantly cut demand for goods and services, rather than a shortage of supply.

Those who favor a structural explanation argue that many jobseekers lack the skills employers need. For example, computer industry employers are having a hard time finding qualified workers. But they're not likely to find such employees in the ranks of jobless construction workers. If such labor market mismatches are widespread, they could be boosting the unemployment rate.

To explore this further, I'm going to introduce the concept of the natural rate of unemployment. The natural rate is basically an equilibrium jobless rate that pushes inflation

neither up, nor down. Before the recession, most economists thought this rate was around 5 percent or a bit less. Today though, economists in the structural camp argue that the natural rate has risen substantially, largely because of the labor market mismatches I described. The idea is that a lot of people are unemployed not because jobs are lacking, but because those jobs require skills unemployed workers don't have. If this were correct, then our 8.2 percent unemployment rate might not be that far above the natural unemployment rate. In other words, we might not really be so far from the Fed's goal of maximum sustainable employment.

Unfortunately, there is no way to know exactly what the natural rate of unemployment is. It's not a number you can look up in a statistical table. In fact, the natural rate is the subject of intensive economic research and debate. Economists estimate it using a variety of economic and statistical models, and no two estimates agree. In addition, because it fluctuates over time due to changes in labor force demographics and other factors, economists must regularly refine these estimates as new data come in. In the final analysis, which camp is right is an empirical question.

A key finding of this research is that mismatch and other factors may have indeed boosted the natural rate of unemployment a bit. But this explains only a small portion of the rise in the unemployment rate during the recession and recovery. In particular, research by my colleagues across the Federal Reserve System suggests that job mismatches are relatively limited in scope.[4] The difficulty some Silicon Valley companies find hiring software engineers is not enough to fundamentally transform the labor market. Other factors besides skill mismatches may have helped push up the natural unemployment rate. One temporary factor may be the

[4] See Barnichon and Figura (2010, 2011), Valletta and Kuang (2010b), Barlevy (2011), and Neumark and Valletta (2012) for further discussion and analysis on the quantitative role of mismatch in increasing unemployment during the past few years.

extension of unemployment insurance payments from the usual 26 weeks to as long as 99 weeks.[5]

Based on this research, I conclude that mismatches and other labor market inefficiencies have raised the natural unemployment rate from about 5 percent before the recession to between 6 to 6½ percent today.[6] Most of these factors should recede over the next few years. The effects of the temporary extension of unemployment insurance benefits will fade. And mismatches should diminish as workers retrain, and construction and other hard-hit industries recover. Once these adjustments have occurred, I expect the natural rate of unemployment to settle at 5½ percent.

The important point is that today's unemployment rate is about 2 percentage points above my estimate of the natural rate. That is, the elevated rate of unemployment is primarily due to a shortage of demand, not to structural changes in the labor market. The factors I mentioned earlier—tight credit, government contraction, and uncertainty—all work to reduce desired spending by households, businesses, and government below the level consistent with full employment. My forecast is that the economy will continue on a path of moderate growth over the next few years. As a result, the unemployment rate will gradually decline, reaching about 7 percent at the end of 2014. Given this forecast, the unemployment rate will remain above the natural rate for several more years.

To reiterate, the nation remains far from the Fed's assigned goal of maximum sustainable employment. Under these circumstances, and with inflation close to our 2 percent target and

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[5] See Valletta and Kuang (2010a).

[6] For other estimates of the natural rate of unemployment, see Weidner and Williams (2011), Daly et al. (2011), and the Congressional Budget Office (2012).

well under control, it's essential that we keep strong monetary stimulus in place for quite some time. Thank you very much.

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