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The Outlook for the U.S. Economy and Role for Monetary Policy[1]

Thank you for giving me the opportunity to speak here today. I want especially to pay my respects to Admiral Biesel, whose remarks remind us what America is capable of when we face a challenge. I'm very glad to be in Seattle, a city known for its excellent quality of life, natural beauty, and rich cultural resources.

I'm here to speak about the nation's economy and what the Federal Reserve is doing to promote recovery. It's worth reminding ourselves that, after suffering the worst financial and economic crisis in several generations, we are now in the third year of economic recovery. In fact, I am hopeful that the pace of recovery will pick up over the next few years as the economy heals from the wounds of the housing crash and financial crisis. We should keep in mind that the fundamental drivers of long-run economic health—our highly skilled and educated workforce, our entrepreneurial spirit, and our cutting-edge technology—remain intact at present. As I will discuss in a few minutes, a critically important goal for policy is to ensure that the economic difficulties we face today do not create lasting scars that diminish our longer-term economic prospects. I should stress that my remarks represent my own views and not necessarily those of others in the Federal Reserve System.

Although I remain bullish on the American economy in the long run, the fact is that we face real difficulties right now. The recovery has lost much of the momentum gained early last

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year and the outlook for the economy over the next year has grown darker. The GDP numbers tell the story. Real gross domestic product—or GDP—is a broad measure of the goods and services Americans produce. It grew at nearly a 4 percent annual rate in the first half of 2010, before slowing to about a 2½ percent rate in the second half. Then, in the first half of 2011, the real GDP growth rate fell to a scant 0.7 percent. That's dangerously close to stall speed.

This slow growth explains why the economy is adding so few jobs these days. Last week we learned that payrolls outside the farm sector didn't increase at all in August. Indeed, over the past four months, we've added only 40,000 jobs per month on average. That's well below the pace needed to bring the unemployment rate down from its current level of 9.1 percent. And this number understates the degree of underemployment in the economy. When you count those who want to work but have given up looking and those who only work part time because that's all they can find, the underemployment rate exceeds 16 percent.

The recent slowdown was due in part to temporary factors. The weather was unusually bad in many parts of the country this past winter, the Japanese earthquake disrupted global supply chains, and, perhaps most importantly for U.S. economic growth, oil and other commodity prices surged. Higher prices at the pump staggered Americans and took a sizable bite out of consumer spending at a particularly sensitive moment for the economy.

The effects of these temporary brakes on growth have largely faded. But several more persistent trends are also impeding recovery. The news from the housing market has been particularly dismal. Past recoveries typically got a kick start from a rebound in home construction and spending on furniture, appliances, and other big-ticket items people needed for their new houses and apartments. This time, though, construction is stuck at post-World War II

low levels. A huge supply of homes is available for sale, which keeps prices down. Add to that what might be called a shadow inventory of some 4 million homes whose owners are seriously delinquent on their mortgages or in foreclosure. Despite great loan terms and low prices, buyers who qualify for credit are understandably nervous about jumping back into the housing market. And, of course, millions of other potential buyers are underwater on their current mortgages, making it hard for them to sell or refinance.

Meanwhile, the bounce in consumer spending often seen in the wake of recessions has been unusually tepid this time around. The combination of huge amounts of household debt, losses in the housing and stock markets, and high unemployment has clearly taken a toll on both the ability and willingness of households to spend. People are on edge waiting for the other shoe to drop. Consumer sentiment plunged last month, which was partly a reaction to the unnerving news about the federal debt ceiling debate in Washington, D.C., and the European debt crisis. In fact, the latest consumer sentiment readings are near the all-time lows recorded in late 2008 during the most terrifying moments of the financial crisis. Here is a telling statistic: Sixty-two percent of households expect their income to stay the same or decline over the next year, the worst reading in the over 30 years that this question has been asked. With consumer spending making up 70 percent of the economy, it’s hard to have a robust recovery when Americans are so dispirited.

Recent developments raise questions about the strength and durability of the recovery. Still, despite all the obstacles, the odds are that we will continue along the path of recovery and that the pace of growth will pick up modestly. The temporary shocks that I mentioned earlier have begun to fade. Manufacturing—automobile production in particular—is starting to recover from the effects of the Japanese earthquake. Oil prices have come down. Importantly, the

financial system's health has improved greatly over the past few years. Interest rates are at historic lows and corporations are flush with cash. Banks are slowly relaxing their grip on loans. These factors should lay the foundation for gradual economic improvement. My forecast calls for the economy to grow around 2 percent in the second half of 2011 and gain further strength next year. Unfortunately, that won't be anywhere near fast enough to bring down the jobless rate much. I expect unemployment to remain around 9 percent through the end of this year and to still be above 8½ percent at the end of next year.

This recovery is very different from most other postwar upturns, which tended to be relatively vigorous. We're in the third year of renewed growth and the unemployment rate is still higher than at almost any other time since World War II. Shockingly, the economy today has the same number of jobs as in February 2000, more than 11 years ago. And almost a third of the unemployed—nearly four-and-a-half million people—have been out of work for at least a year, a striking break from past downturns when unemployment spells were typically short. The longer it takes to get this economy back to full health, the greater the risk that the recession will leave permanent scars. Millions of workers have gone years without jobs. They are losing out on work experience and their attachment to the labor market is fraying. Many potentially productive people could become much more difficult to employ or drop out of the labor market altogether.

At the same time, we are vulnerable to negative shocks that could put the recovery at risk. That's why events in Europe are such a cause for concern. Fears that some nations in the euro zone will not be able to make payments on their debts have spread from smaller countries, such as Greece and Ireland, to larger economies, such as Spain and Italy. This is not something we can dismiss as somebody else's problem. A full-blown financial meltdown in Europe would hit

U.S. exports, which have been one of the economy's few bright spots. Perhaps more importantly, it could slam U.S. financial markets and deal a further blow to already fragile confidence. In other words, a downturn in Europe could knock the props out from under the U.S. recovery.

We've had our own shock right here at home in the form of the contentious debate over a long-term fix for the federal budget deficit. It's essential that we bring the budget under control. But, how this is accomplished is extremely important, both for our country's short- and long-run economic health. First, let's look at the long view. The budget decisions made today will affect our nation's future investments in job training and education, research and development, and public and private capital. These are the critical determinants of our long-term economic prospects and standard of living. In the near term, efforts at deficit reduction may reduce demand and further slow the already precarious recovery. In addition, the deficit controversy has added one more ingredient to the currents of economic anxiety that are roiling households and businesses. And, as I mentioned before, the short and the long run are connected. The longer it takes to get the unemployment rate back down, the greater the risk that there will be permanent scars to the economy.

Let me now say a few words about inflation. At the end of last year, 12-month inflation was a very low 1.4 percent, according to the Fed's preferred measure of household consumption prices. That had some people wondering whether we were at risk of sustained deflation, in which prices actually fall. Since then, spikes in oil and some other commodities have driven up inflation. Over the 12 months through July, prices increased 2¾ percent. But I don't expect this inflation bump to persist. The earlier rise in commodity prices was fueled by strong demand, especially in the rapidly expanding economies of the developing world. At the same time, the

prices of goods imported from China and other countries rose as producers there passed along their own higher costs. Recently though, prices for oil and many other commodities have declined, largely due to reduced expectations for global economic growth. In addition, the price hikes for imports have mostly passed through the system, like the proverbial pig in the python.

Looking ahead, I expect inflation to ease to about a 1½ percent annual pace next year. This is somewhat below the 2 percent level that I see as the appropriate medium-term goal. My expectation that inflation will fall reflects the fact that the economy is performing so far below its potential. Such economic slack tends to depress inflationary pressures. It means that workers have very limited ability to demand higher wages and businesses can't push through price increases that will stick. For example, the latest report showed that wages grew around 2 percent over the past year, hardly a prescription for high inflation. In addition, surveys show that expectations for inflation remain stable.

To sum up, the economy is improving, but at such a modest pace that it will be years before we see a substantial reduction in unemployment. At the same time, we face heightened risks that could cause growth to fall short of even these modest expectations or, even worse, send us back into negative territory. And inflation, which has been running higher than I'd like, is now moderating and likely to drop below preferred levels.

Let me turn to monetary policy and what the Federal Reserve is doing to promote economic recovery. Congress has mandated that the Fed pursue the twin goals of maximum employment and price stability. During the recession, the economy deteriorated sharply and inflation dropped to very low levels. In response, the Fed's policymaking body—the Federal Open Market Committee, or FOMC—took aggressive monetary action. It lowered the Fed's

benchmark short-term interest rate—known as the federal funds rate—close to zero in December 2008 and has left it there since. In addition, the FOMC carried out two rounds of purchases of Treasury, mortgage-backed, and government-sponsored-agency securities, bringing our holdings of these instruments to $2.65 trillion. These purchases have reduced longer-term interest rates, thereby improving financial conditions more generally and providing a boost to the economy. They also reduced the risk of slipping into sustained deflation.[2]

Despite these efforts, the recovery slowed to a crawl this year. But what does this mean for monetary policy? After all, monetary policy cannot cure all that ails our economy, which in large measure involves the aftereffects of the mortgage lending boom, the housing crash, and the resulting financial crisis. But, monetary policy can help limit the damage and provide support to other areas of the economy. A medical analogy is useful. Today's economy is like a patient who has suffered a number of injuries and needs time to heal. For the healing process to succeed, it is essential that the bleeding be stopped, the patient be properly hydrated, blood pressure and temperature properly regulated, and secondary infections avoided and treated. These treatments don't cure the injuries directly, but they reduce the risk of the patient getting worse and allow the natural healing process to take hold.

The monetary policy situation is similar. Like the hospital patient, the economy took a turn for the worse and faces heightened risks. In addition, inflation is expected to drift down. These circumstances called for additional monetary easing. At our August meeting, the FOMC took a step in that direction, issuing a statement that we are likely to keep the federal funds rate at exceptionally low levels at least through mid-2013. In one respect, this wasn't such big news. Even before the announcement, financial market participants generally didn't expect the Fed to

[2] See Chung et al. (2011).

raise rates much earlier than mid-2013. But it was news in the sense that it removed uncertainty and helped financial markets better understand our intentions. In response to the FOMC statement, financial market expectations of future interest rates and U.S. Treasury yields fell. Note also that we are not tying our hands by making this announcement. We haven't made a guarantee. We will alter our policy as appropriate if circumstances change.

Right now, though, the real threat is an economy that is at risk of stalling and the prospect of many years of very high unemployment, with potentially long-run negative consequences for our economy. There are a number of potential steps the Fed could take to ease financial conditions further and move us closer to our mandated goals of maximum employment and price stability.[3] Of course, these "treatments" won't make our economic problems go away and their costs and benefits must be carefully balanced. But they could offer a measure of protection against further deterioration in the patient's condition and perhaps help him get back on his feet. Thank you very much.

[3] See Bernanke (2011).

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