FRBSF ECONOMIC LETTER

2012-22 | July 23, 2012

The Outlook and Monetary Policy Challenges

BY JOHN C. WILLIAMS

The pace of economic growth has been frustratingly slow and the recovery has lost momentum in recent months. The economy is weighed down by the ongoing European sovereign debt crisis and fiscal tightening in our own country. In these circumstances, it is essential that the Federal Reserve provide sufficient monetary accommodation to keep our economy moving towards the central bank's maximum employment and price stability mandates. The following is adapted from a presentation by the president and CEO of the Federal Reserve Bank of San Francisco to the Idaho, Nevada, and Oregon Bankers Associations on July 9, 2012.

This morning, I'll outline how the economy is doing and where it appears to be heading. I'll explain some of the factors holding us back. And I'll discuss some of the major risks that threaten even my subdued outlook—especially the ongoing crisis in Europe. I'll also speak about what this challenging environment means for Federal Reserve policy, given our mandate to pursue maximum employment and price stability.

The backdrop is that we are still recovering from the most severe financial crisis and the deepest recession since the 1930s. Following the housing boom of the first half of the 2000s, home prices crashed, wiping out almost $6.5 trillion in household wealth. Rising mortgage delinquencies and plunging asset values pushed many financial institutions to the brink of insolvency, and some failed. Businesses of all sorts slashed employment. The recession ended three years ago, but the recovery has lacked the vigor of typical cyclical rebounds. Indeed, to many Americans, it seems very much like we're still in a recession.

Now, this is by no means the first financial crisis, and, around the world, it turns out that a subpar economic recovery is pretty typical following such an episode (see Reinhart and Rogoff 2009 and Jordà, Schularick, and Taylor 2011). In this occasion, lenders, households, and businesses came out of the recession in a defensive crouch, which left a legacy of tight credit and uncertainty (see Williams 2012a).

Still, it's important to stress that the economy continues to improve. By that, I mean that economic output has been expanding and private employers have added jobs every month for over two years. The unemployment rate has fallen from a cyclical high of 10% to its June reading of 8.2%. However, that rate is still much too high, and economic growth is far short of what's needed to keep bringing it down quickly. What's more, the economy has lost some momentum in recent months as gains in consumer and business spending have slowed. In addition, financial markets are once more under strain in response to the flare-up of the European crisis.

Fortunately, these developments have not brought our forward motion to a halt. Credit conditions overall are much improved from a few years ago. For many borrowers, interest rates remain at or near historic lows. Consumer and business demand pent up during the recession is still reviving, although at a slower pace than earlier in the year. For example, car sales collapsed during the downturn. Now, with auto financing rates at rock bottom, motor vehicle sales are climbing, up nearly 14% in the first six months of 2012 from the year-earlier period and more than 50% from their recession lows. Similarly, business investment in equipment and software rose over 8% during the past year, adjusted for inflation.

An encouraging sign is that housing has started to show signs of life. Although housing is still deeply depressed and recovery hopes have been dashed before, a number of indicators hint we may be turning a corner. Homebuilding is beginning to tick up. Sales are rising and inventories of unsold homes are coming down. The huge backlog of foreclosed properties is beginning to get worked off. Nationally, home prices no longer appear to be falling and, in some areas, they are increasing.

Of course, a healthy economy requires vibrant financial institutions. These days, the condition of the U.S. banking system is mixed, reflecting the economic picture I've described. Conditions have improved notably since the depths of the recession, but there's still a considerable way to go. I was encouraged by the stress tests of the nation's largest banking organizations completed earlier this year. They showed that capital levels at most of these banks would still be adequate, even if the economy fell into an extreme, and highly unlikely, downturn. Smaller banks are in better shape too. Here, in the western United States, many community banks have strengthened asset quality, liquidity, and capital levels.

Meanwhile, as the economy has improved, loan demand has begun to revive. Although many businesses remain cautious about taking on big capital projects, the volume of new commercial and industrial loans has been rising. That's a good sign for bank earnings.

At the Fed, of course, we want banks to make soundly underwritten loans. In the 12th District, financially healthy banks with solid balance sheets are generally extending credit in a way that's good for the economy. During the 12 months ending in March 2012, loans grew over 6% among the District's strongest banks—those with a regulatory rating of 1 or 2 on the 5-point CAMELS scale. By contrast, weaker banks with financial problems left over from the crisis can't readily expand lending.

Clearly, the financial system must continue to heal in order to support stronger economic growth. The reverse is true as well. The recovering economy has helped strengthen the banking industry, and a prolonged economic slowdown would be a setback.

Government budget squeeze weighs on economic growth

As I mentioned, the pace of growth has been frustratingly slow, and we've seen some loss of momentum in recent months. In part, this reflects two major developments weighing on the economy. The first is the budget squeeze at all levels of government. The federal government cut taxes and increased spending during the recession and the early stages of recovery. This was due partly to automatic increases in programs such as unemployment insurance, and partly to specific stimulus measures aimed at supporting the economy. Those programs gave the economy a badly needed boost, but they have been unwinding over the past year and a half. Meanwhile, state and local governments have been slashing employment and spending in the past few years as they struggle to balance budgets in the face of lower tax revenue. Overall, combined federal, state, and local government payrolls have dropped by more than 600,000 workers in the past three years. From stimulus early in the recovery, the government sector has turned into a significant drag on growth (see Lucking and Wilson 2012).

And there is no relief in sight. Two major federal programs are set to expire at the end of the year: the temporary payroll tax cut and extended unemployment benefits. In addition, caps on discretionary government spending will go into effect then. All this is something I've taken into account in my forecast. But there's a risk that federal cutbacks could be more dramatic than I expect. Unless Congress acts, a number of other large tax increases and spending cuts will start up automatically at the beginning of next year. A recent Congressional Budget Office report suggested these additional measures could knock about 1½ percentage points off economic growth in 2013, which would mean that the economy would barely expand next year. This prospect has been dubbed a "fiscal cliff."

I hope and expect an agreement will be reached to prevent such a damaging fall off the fiscal cliff. Nevertheless, federal budgetary policy is moving toward greater belt tightening, and this austerity will dampen growth next year. Moreover, the uncertainty surrounding the federal budget is affecting decisions right now. Some government contractors tell me they are already trimming employment and production because they don't want to get stuck with excess workers and inventory next year. More generally, my contacts say that concerns about the looming budget deadline make businesses reluctant to take on new projects.

European sovereign debt crisis restrains U.S. economy

The second development restraining the U.S. economy is the European sovereign debt crisis, which has led to renewed stresses in global financial markets. I won't go into detail about the origins of this dire situation. What's important to understand is that Greece's deep recession and large fiscal deficit has spiraled into a wider emergency that threatens economies and financial systems throughout the euro area—and even the very existence of a broad monetary union in Europe.

The current approach, based mainly on fiscal austerity, can't alone solve the problems plaguing Europe. The European rescue package for Greece demands thoroughgoing economic reforms and severe austerity. Many other countries are doing the same. Although fundamental economic and budgetary reforms are needed to ensure the long-run health of these economies, fiscal retrenchment has choked off economic growth. That makes it even harder to reduce government deficits in the next few years.

Meanwhile, the crisis keeps spreading. Most recently, Spain has found itself in the crosshairs. Spain's problems didn't originate with a fiscal crisis. Instead, like us, they went through an enormous housing boom and bust. That loaded the nation's banks with bad loans, requiring massive recapitalization. The Spanish government found itself facing an enormous bill to rescue its banks, and its borrowing costs soared to unsustainable levels. Recent announcements from Europe have been encouraging on this front. Spain's euro-area partners have agreed to use European rescue funds to recapitalize Spain's ailing banks. This is an important step in the right direction. That said, the terms have yet to be worked out. And the danger remains that uncertainty and fear will once again outrun the slow-motion responses of European governments.

Over and over again, European authorities have struggled to get a grip on the crisis. One basic problem is that they've taken a piecemeal approach by providing rescue packages to individual countries. These steps calm markets temporarily, but don't yield a credible, comprehensive solution to the underlying problems that Europe faces. Until such a solution is in place, I am afraid that Europe will remain vulnerable to new shocks.

We are tied to Europe on many levels, and we are already feeling Europe's pain. One transmission channel is trade. About a fifth of our exports go to countries in the European Union. Many countries in the region are already in recession, and that has slowed our export growth. A second, more important link is through financial markets. Global investors are fleeing to the safety of U.S. Treasury securities. This has supported extraordinarily low interest rates for high-quality U.S. borrowers. But, here in the United States, most of the financial effects of the European crisis work against growth. For example, the capital flowing into our markets has boosted the value of the dollar. That makes our goods and services less competitive overseas. And investors have become more wary of taking on risk, which pushed down the prices of all kinds of risky assets, including U.S. stocks and some corporate bonds.

Economic growth frustratingly slow

So where does the economy's good news, bad news story leave us? On balance, it makes for frustratingly slow growth. The slowdown in domestic demand and global strains in financial markets have led me to trim my forecast for growth somewhat. I now expect real gross domestic product to expand by a little less than 2% this year and about 2¼% next year.

Over the past year, the economy has added about 150,000 jobs per month, and the unemployment rate has fallen nearly a percentage point. The trend in job growth is probably lower now. I still anticipate gains above what we've seen recently, probably between 100,000 and 150,000 jobs per month. But such a pace of job gains is just a bit above the projected growth of the labor force. So I expect that the unemployment rate will remain at or above 8% until the second half of 2013. What that means is that progress on bringing down the unemployment rate has probably slowed to a snail's pace and perhaps even stalled.

Turning to inflation, I expect the inflation rate to come in below the Fed's 2% target both this year and next. This forecast reflects several factors. A sluggish labor market is keeping a lid on compensation costs. A stronger dollar is holding down import prices. And the global growth slowdown has pushed down the prices of crude oil and other commodities.

My forecast is based on what I consider the most likely scenario. However, I am much more uncertain than usual about this forecast. I've mentioned the threat of automatic large tax increases and spending cuts at the start of 2013. But the most important wild card for the U.S. economy is Europe.

My forecast assumes that Europe's distressed pattern of the past two years will continue, but that the situation won't spin out of control. However, it is impossible to predict with any certainty how these circumstances will play out. Europe's crisis could escalate much more than I expect. A development that might not be disastrous on its own, such as a Greek decision to abandon the euro, could touch off a panic. European credit markets could freeze up as ours did in 2008. If that were to happen, the U.S. economy could be severely damaged. Our exports to Europe would fall sharply. Although U.S. financial institutions have been paring their exposure to Europe, our financial markets would probably still be severely disrupted. For example, research at the San Francisco Fed finds that over the past few years, when European corporate debt spreads have widened, U.S. debt spreads have responded roughly two-thirds as much—a sizeable reaction that would affect economic growth here (Hale, Marks, and Nechio 2012).

If the spillover from Europe were severe enough, much of the progress made in our own financial system could be undone. We might find ourselves in a renewed credit crunch, which would take a terrible toll on the economy.

Progress toward Federal Reserve's goals

So far in my talk, I've described the economic and financial environments, presented my outlook, and outlined two serious risks we face. For the Federal Reserve, this is a sobering set of circumstances. Congress assigned the Fed a dual mandate to guide us in setting monetary policy: achieving maximum employment and price stability. Let me describe where we stand on these objectives.

Maximum employment is a moving target that depends on how efficient the labor market is at matching workers with jobs. It's not a number you can measure directly. Economists fiercely debate what it might be. Expressed in terms of the unemployment rate, I estimate that maximum employment is currently around 6¼% (see Daly et al. 2011 and Williams 2012b). The current unemployment rate is far above that level, which means we are far short of maximum employment by any reasonable measure. What's more, with the economy's recent loss of momentum, job creation will barely keep up with labor force growth. As a result, I expect little progress toward maximum employment over the next year or more.

The second part of the Fed's mandate is price stability. As I've noted, our policy body, the Federal Open Market Committee (FOMC), has specified that a 2% inflation rate is most consistent with maximum employment and price stability. Over the past year, prices rose 1.5%, according to the Fed's preferred measure of inflation. Falling commodity prices, a rising dollar, and subdued labor costs suggest that inflation will fall to around 1¼% this year and then rebound somewhat to about 1¾% next year.

What does this mean for the Fed? We are falling short on both our employment and price stability mandates, and I expect that we will make only very limited progress toward these goals over the next year. Moreover, strains in global financial markets raise the prospect that economic growth and progress on employment will be even slower than I anticipate. In these circumstances, it is essential that we provide sufficient monetary accommodation to keep our economy moving towards our employment and price stability mandates.

At our June FOMC meeting, we reiterated our intention to hold our benchmark short-term interest rate at exceptionally low levels at least through late 2014. In addition, we announced an extension of one of our unconventional monetary policy initiatives, a program that's been dubbed "Operation Twist." This is a program to increase our holdings of longer-term U.S. Treasury securities and decrease our holdings of shorter-term Treasuries by the same amount. The continuation of this program through the end of this year will put further downward pressure on longer-term interest rates, easing broader financial conditions. In truth though, the extension of this program will probably have a relatively modest impact on the economy. Therefore, the FOMC noted that it "is prepared to take further action as appropriate to promote a stronger economic recovery and sustained improvement in labor market conditions in a context of price stability" (Board of Governors 2012).

If further action is called for, the most effective tool would be additional purchases of longer-maturity securities, including agency mortgage-backed securities. These purchases have proven effective in lowering borrowing costs and improving financial conditions (see Williams 2011).

At the Fed, we take our dual mandate with the utmost seriousness. This is a period when extraordinary vigilance is demanded. We stand ready to do what is necessary to attain our goals of maximum employment and price stability.

John C. Williams is president and chief executive officer of the Federal Reserve Bank of San Francisco.

References

Board of Governors of the Federal Reserve System. 2012. "Press Release." June 20. http://www.federalreserve.gov/newsevents/press/monetary/20120620a.htm

Daly, Mary C., Bart Hobijn, Ayşegül Şahin, and Robert Valletta. 2011. "A Rising Natural Rate of Unemployment: Transitory or Permanent?" *Federal Reserve Bank of San Francisco Working Paper* 2011-05. http://www.frbsf.org/publications/economics/papers/2011/wp11-05bk.pdf

Hale, Galina B., Elliot Marks, and Fernanda Nechio. 2012. "Are U.S. Corporate Bonds Exposed to Europe?" *FRBSF Economic Letter* 2012-17 (June 4). http://www.frbsf.org/publications/economics/letter/2012/el2012-17.html

Jordà, Òscar, Moritz Schularick, and Alan M. Taylor. 2011. "Financial Crises, Credit Booms, and External Imbalances: 140 Years of Lessons." *IMF Economic Review* 59, pp. 340–378. http://www.palgrave-journals.com/imfer/journal/v59/n2/abs/imfer20118a.html

Lucking, Brian, and Dan Wilson. 2012. "U.S. Fiscal Policy: Headwind or Tailwind?" *FRBSF Economic Letter* 2012-20 (July 2). http://www.frbsf.org/publications/economics/letter/2012/el2012-20.html

Reinhart, Carmen M., and Kenneth S. Rogoff. 2009. "The Aftermath of Financial Crises." *NBER Working Paper* 14656 (January). http://www.nber.org/papers/w14656

Williams, John C. 2011. "Unconventional Monetary Policy: Lessons from the Past Three Years." *FRBSF Economic Letter* 2011-31 (October 3). http://www.frbsf.org/publications/economics/letter/2011/el2011-31.html

Williams, John C. 2012a. "The Federal Reserve and the Economic Recovery." Presentation to The Columbian's 2012 Economic Forecast Breakfast, Vancouver, WA, January 10. http://www.frbsf.org/news/speeches/2012/john-williams-0110.html

Williams, John C. 2012b. "Update of 'What Is the New Normal Unemployment Rate?'" May 8 update to *FRBSF Economic Letter* 2011-05. http://www.frbsf.org/publications/economics/letter/2011/el2011-05-update.pdf

Recent issues of *FRBSF Economic Letter* are available at

http://www.frbsf.org/publications/economics/letter/

2012-21	Monetary Policy, Money, and Inflation http://www.frbsf.org/publications/economics/letter/2012/el2012-21.html	Williams
2012-20	U.S. Fiscal Policy: Headwind or Tailwind? http://www.frbsf.org/publications/economics/letter/2012/el2012-20.html	Lucking / Wilson