Presentation to Portland Community Leaders
Portland, Oregon
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The Economic Outlook, Unemployment, and Monetary Policy[1]

Thank you. This is the third time I've spoken in Portland in the past 14 months, and it's always a pleasure to be here. But, I have to tell you, if I come here any more often, I may have to buy Timbers season tickets and climb Mt. Hood. And that's something I need to think about.

Of course, you don't need to hear about local culture from me. So I'll segue to my reason for being here today, which is to talk about the U.S. economy and what the Federal Reserve is doing to support the recovery. I'll start with a look at the national economy, which continues to make forward progress, despite a number of strong crosscurrents. I'll then offer my forecasts for growth, unemployment, and inflation. And I'll wind up by discussing how the Fed is pursuing the goals Congress has set for us of maximum employment and stable prices.

In that regard, the question I get asked constantly these days is, when will the Fed begin cutting back on our current program of large-scale purchases of Treasury and mortgage securities? Later in my talk, I'll lay out for you my perspective on this important question. But, before I do, I should stress that my remarks represent my own views and not necessarily those of others in the Federal Reserve System.

More than four years have passed since the end of an unusually severe recession, and the economy still presents us with a jumble of good news and bad news. Growth has been choppy and, during much of the recovery, it's been slower than we hoped. Nonetheless, job gains over

[1] I want to thank Reuven Glick and Sam Zuckerman for their assistance in preparing these remarks.

the past year have been solid. We've been adding close to 200,000 jobs per month and have regained more than 6½ million jobs lost during the downturn. The unemployment rate was 7.4 percent in July, down from a peak of 10 percent.

I want to point out that the Federal Reserve has been working hard to support this economic rebound. We acted to push short- and long-term interest rates down to record low levels. Those low rates lit a fire under interest-sensitive sectors of the economy, like autos and housing, the ones where people typically borrow to make a purchase. In housing, the result has been dramatic. Across the country, home construction and sales have risen over the past year, and home prices are up more than 10 percent. This is just the medicine the economy needs. Homebuyers often need new appliances, furniture, and the like, so increased home purchases ripple throughout the economy. Recently, longer-term rates have risen as investors prepare for the eventual normalization of monetary policy. But they are still quite low by historical standards.

Meanwhile, the stock market has also been on the rise, with prices up about 15 percent from a year ago. With real estate and stock prices both higher over the past year, household wealth soared to a record $70 trillion in the first quarter of 2013, almost $20 trillion above its recession low. That rising wealth helps give people confidence to open their wallets, which has underpinned steady gains in consumer spending.

For their part, businesses appear to be more willing to invest in plants, equipment, and services, especially in information technology. I've been encouraged by the greater optimism I'm hearing from a broad range of business contacts—people in everything from tourism to commercial real estate—not just the pockets of strength we've seen in the past year or so.

All in all, the private side of the economy has been forging ahead with considerable momentum. But we're seeing just the opposite with the public sector. Fiscal policy at the federal level has become a major factor holding back the recovery. During the recession and early in the recovery, federal tax and spending policy provided a big boost to the economy. In 2009, Congress and the White House pushed through an $800 billion stimulus package that put money into the hands of households and businesses, pumping up spending.

More recently though, federal budget policy has shifted to austerity. Spending is down sharply and taxes have increased. The sequestration process has forced wholesale cuts in federal outlays. This budget tightening is having a big effect on the economy. This year, the drag from federal spending and taxes is estimated to subtract about 1½ percentage points from growth of gross domestic product, which measures the total output of goods and services and is considered the broadest gauge of economic activity.[2] It's as if the economy were trying to run while carrying a bag of rocks on its back. The fact that it's still moving forward is a testament to the underlying strength of the private-sector recovery.

Where will we go from here? GDP adjusted for inflation grew at a modest rate just above 1½ percent over the past year. However, I expect growth to pick up in the second half of 2013 as the drag from the federal budget wanes and momentum in the private sector continues to gather steam. For this year as a whole, I see inflation-adjusted GDP growing about 2 percent, and then rising to about 3 percent in 2014. With the economy continuing to grow and add jobs, I expect the unemployment rate to decline gradually over the next few years.

Price stability is the second part of the Fed's mandate, and of course what's happening with inflation is vitally important to us. We've set a 2 percent inflation rate as our longer-run target because that level seems most consistent with both our maximum employment and price

[2] See Lucking and Wilson (2013).

stability goals. We all know that inflation can get too high. The fact is, though, that inflation can also fall too low. Indeed, inflation has been running well below our target for some time, and earlier this year it slowed further. Over the past year, our preferred inflation measure rose at a 1.4 percent rate, well below our 2 percent target. I am encouraged, though, by recent data that suggest the declines in inflation over the past year will prove temporary. With the economy continuing to improve, I expect inflation will gradually climb back towards our 2 percent longer-run target over the next few years.

I'll turn now to Federal Reserve monetary policy. As you know, when the financial crisis hit in 2008, the Fed responded aggressively to keep the financial system from collapsing and thereby help save the economy from a recession even worse than the one we actually went through. Among other measures, our policy committee, the Federal Open Market Committee, or FOMC, pushed short-term interest rates down close to zero. Still, at the end of 2008, the economy was shrinking and jobs were disappearing. In November and December of 2008 alone, payrolls shriveled by almost 1½ million jobs.

With this kind of emergency, we had to do more. We had already maxed out our traditional policy lever by cutting short-term interest rates as far as they could go. So, to provide additional support to the economy, we put in place unconventional monetary stimulus programs. Those programs were designed to lower longer-term interest rates at the same time our conventional policies were working on short-term rates—a one-two punch to fight the recession.

Our unconventional programs were real innovations and they came in two forms.[3] One is known in central banking jargon as forward guidance. In our case, forward guidance means that the FOMC communicates to the public what Fed policy is likely to be in the future.

[3] See Williams (2012).

Let me explain how we are using forward guidance now. We have publicly stated that what we do with our benchmark short-term interest rate—the federal funds rate—depends on how the economy performs. Specifically, we've said that we would keep the federal funds rate near zero at least until three conditions apply: one, the unemployment rate falls to 6½ percent; two, inflation one to two years out is forecast to be no more than half a percentage point above our 2 percent target; and three, the public's inflation expectations remain in check. This lets people know that short-term interest rates will probably stay low for a long time. That makes them willing to pay more for longer-term securities, and that in turn pushes down longer-term interest rates.

Our second kind of unconventional program involves large-scale purchases of longer-term U.S. Treasury and mortgage-related securities. Currently, we are purchasing $85 billion in securities each month. These purchases increase demand for these securities, pushing up their prices and driving down their yields. Just like with forward guidance, lower yields on these securities push down other longer-term interest rates.

Our forward guidance and securities purchases have given a shot in the arm to the economy by significantly reducing longer-term interest rates. Today, despite the recent run-up in interest costs, mortgage rates are still quite low. And low mortgage rates have been a major reason for the rebound in the housing market. Low financing costs have also perked up motor vehicle sales to levels not seen in more than five years. Manufacturing of big-ticket items such as autos has risen significantly, regaining all the recession losses. By contrast, production of nondurable goods, which doesn't benefit as much from low interest rates, is still nearly 10 percent below its peak.

We are not the only ones who recognize that these policies are effective. Around the world, unconventional policy is quickly becoming downright conventional. Both the Bank of England and the Bank of Japan have carried out large-scale asset purchases. And these two central banks and the European Central Bank are now using forward guidance as well.

The improving economy here in the United States raises several questions about our policies. How long should we keep carrying out large-scale asset purchases? And how long should we keep our benchmark short-term interest rate near zero? These are two separate questions, but we've said the answers to both of them depend importantly on conditions in the labor market. And a key barometer of the health of the labor market is the unemployment rate.

As I noted, our forward guidance on our key policy short-term interest rate, the federal funds rate, is explicitly linked to the unemployment rate. The FOMC has stated that it will not begin raising the fed funds rate at least until unemployment falls below 6½ percent. In addition, the FOMC has said it will keep adding to our holdings of securities "until the outlook for the labor market has improved substantially in a context of price stability." In June, Fed Chairman Ben Bernanke clarified what we mean by "substantial improvement" in the outlook for the labor market. He said that, if the economy develops as expected, it would be appropriate to reduce the monthly pace of purchases beginning later this year and eventually end the current asset purchase program around the middle of next year, at which time the unemployment rate is expected to be about 7 percent.[4]

Clearly, the unemployment rate plays an important role in our thinking and communication about future policy. Therefore, an important issue is whether it is giving an accurate read on where things stand relative to our maximum employment mandate. The unemployment rate measures the percent of the labor force that is out of work and looking for a

[4] Bernanke (2013).

job. It has a number of advantages as a measure for summarizing the state of the labor market. For one thing, over time it has proven to be a reasonably stable and predictable barometer of whether labor market conditions are too hot, too cold, or just right in terms of creating inflationary pressures. Although structural changes in the labor market affect the unemployment rate, most of the variation in unemployment over time reflects cyclical factors, that is, whether the economy is too hot or too cold. And, second, the rate closely tracks other indicators of how much slack there is in the labor market, such as data from surveys on the share of households that finds jobs hard to get and the share of businesses that say it's hard to fill openings. This adds to our confidence in its reliability.

All the same, there are reasons to worry that the unemployment rate could now be understating just how weak the labor market is.[5] In particular, during the recovery, the share of the working-age population that is employed has increased very little, even as the unemployment rate has fallen. Taken at face value, the very low ratio of employment to population suggests that the labor market has improved far less than what's implied by the decline in the unemployment rate.

So should we stop using the unemployment rate as our primary yardstick of the state of the labor market in favor of the employment-to-population ratio? My answer is no. Although the unemployment rate is by no means a perfect measure of labor market conditions, the employment-to-population ratio blurs structural and cyclical influences. That makes it a problematic gauge of the state of the labor market for monetary policy purposes. To understand why, let's look at the behavior of labor force participation, which is the percentage of the working-age population in the labor force, and the source of the difference in the employment and unemployment numbers.

[5] Erceg and Levin (2013).

Over the past few years, labor force participation has plunged below 64 percent, a level not seen in almost 30 years. This drop in labor force participation explains how the unemployment rate can be falling while the employment-to-population ratio has been roughly stagnant. The overall ranks of the unemployed have been declining because many people are leaving the labor force, rather than finding jobs. But, it's important to remember that much of this decline in labor force participation reflects long-running demographic trends, such as retiring baby boomers leaving the workforce.[6] In addition, in recent years there has been a big exodus of young people and so-called prime-age adults. Again, some of this is related to ongoing trends, such as an increasing share of young adults enrolling in school, and workers moving onto disability rolls.

Nonetheless, a portion of the exodus from the labor market is due to the recession and slow recovery. It appears that unprecedented numbers of young and prime-age workers have been bailing out of the labor force because the job market has looked dismal. Many of these prime-age workers who have left the labor force say they want jobs and are available to work. But they don't think they can find work, so they've given up looking and therefore they're not counted as unemployed. Many of these people will probably return to the job market as conditions improve.[7]

All this gets quite complex. On the one hand, we have structural trends, like the aging of the workforce and young people spending more time in school. On the other hand, we have the effects of a weak economy, which discourages people from looking for work. From the standpoint of gauging the state of the labor market for monetary policy, it is crucial that we distinguish between structural developments in the labor market and the effects of a weak

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[6] Toossi (2012a, b).
[7] Bengali, Daly, and Valletta (2013).

economy. Recent estimates by the U.S. Bureau of Labor Statistics and others suggest that structural factors account for most of the decline in participation over the past several years.[8] According to this research, structural factors reducing labor supply are the main reason that the employment-to-population ratio has stayed so low while unemployment has declined. Therefore, the employment-to-population ratio is sending a much too pessimistic signal regarding the amount of slack in the labor market. On the other hand, this evidence also suggests that the unemployment rate probably is overstating somewhat the extent of improvement in the labor market. However, over time, as discouraged workers rejoin the labor force, this problem should go away.

As this discussion demonstrates, it's devilishly hard to distinguish between people who have left the labor force because of ongoing trends and those who left because the job market has been hurting. There's just a huge amount of uncertainty about what causes people to enter and exit the labor force for us to have much confidence in the employment-to-population ratio as a gauge of how close we are to maximum employment. Of course, we will continue to look at a wide range of indicators when we evaluate labor market conditions. But the preponderance of evidence indicates that the unemployment rate remains the best overall summary statistic.

What does that mean for monetary policy? First, the unemployment rate and a number of other labor market indicators, such as payroll job gains, point to continued progress in the labor market. Clearly, we are getting closer to meeting our test of substantial improvement in the labor market.

Second, any changes in policy will depend not only on labor market conditions, but also on inflation. In our July statement, the FOMC noted that inflation persistently below 2 percent could pose risks to economic performance. That means we will also take into consideration

[8] Toossi (2012a, b).

whether inflation is moving closer to our target. Third, any adjustments to our purchases are likely to be part of a multistep gradual process, reflecting the pace of improvement in the economy.

As I noted earlier, Chairman Bernanke has laid out a timetable for our securities purchases, which includes reducing them later this year and ending them around the middle of next year, assuming our forecasts for the economy hold true. I haven't significantly changed my forecast since then, and I view Chairman Bernanke's timetable to still be the best course forward. However, I can't emphasize enough that when and how we adjust our purchases will depend crucially on what the incoming data tell us about the outlooks for the pace of improvement in the labor market and movement towards our inflation goal.

I should also stress that cutting back our purchases does not mean the Fed will be tightening monetary policy. As long as we are increasing our asset holdings, we are adding stimulus to the economy. And there's another critical point: Even when we eventually halt asset purchases, we will continue to maintain the current very low level of the fed funds rate for at least as long as the unemployment rate is above 6½ percent and the conditions regarding inflation and inflation expectations are met. Based on my current forecast, I don't expect the economy to reach 6½ percent unemployment until the first half of 2015, and I don't expect the FOMC to raise rates until later that year. So monetary policy will continue to be extraordinarily stimulative for quite some time.

I am convinced that our policies have been instrumental in reviving the economy and avoiding what could have been an economic meltdown. But the time is approaching when our economy will have enough momentum on its own without the need for additional monetary stimulus. This is undeniably welcome news. Although the road ahead will likely be bumpy at times, with some twists and turns, I am confident that we will be able to navigate successfully the eventual normalization of monetary policy and achieve our goals of maximum employment and price stability. Thank you very much.

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