Presentation to the Money Marketeers of New York University
New York, New York
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For delivery on February 19, 2014

Economic Conditions and Monetary Policy: A Transitional Phase

Introduction

Thank you, William, and good evening everyone. I'd like to talk to you today about the outlook for the economy and its implications for monetary policy. We're heading into a transitional phase, and many people have questions about what the coming year will bring—questions about the economy's trajectory, questions about the labor market, and questions about the effects of the future path of monetary policy—and how the Fed will steer the ship during this time of change.

As always, let me add the caveat that the views expressed here are mine alone, and do not necessarily reflect those of others in the Federal Reserve System.

An Improving Economy

It's nice to start off by saying that things are looking up. The recent economic data have, overall, been positive: GDP is on the rise, the labor market is improving and we've seen an easing—and in some cases, a reversal—of some of the headwinds we've been fighting.

Real GDP growth picked up in the second half of 2013, to a more than 3 percent annual rate. Although some of that increase reflected inventory building, solid gains in real final sales were particularly encouraging, increasing much faster in the second half of 2013 than in the first. This pickup in aggregate demand underscores the economy's improving momentum as we enter 2014.

There has also been sustained improvement in labor market conditions. The unemployment rate has steadily declined, with a drop of 0.6 of a percentage point over the past three months. We also averaged nearly 180,000 new jobs a month over the past six months. Job growth in December and January came in below that average, partly due to the effects of bad weather in December, but the overall pace remains strong enough to keep bringing the unemployment rate down. Other indicators of labor market health are encouraging as well, such as workers' perception of job availability and their willingness to quit their current jobs.

What I'm hearing from the business community is also increasingly upbeat. Most of the San Francisco Fed's contacts have a positive outlook, and are planning to increase hiring this year. This is consistent with a broadly optimistic view we've seen on a national level, in surveys of executives.

So, the economic recovery appears to have shifted to a healthy, stronger path.

This newfound strength comes in large part from the easing of headwinds that had been holding back the recovery, the two most important of those being housing and fiscal policy. The reversal in the housing market has been propelled in part by the effects of very accommodative monetary policy, which pushed mortgage rates to historical lows. Both the pace of sales and house prices have increased rapidly over the past few years. This, in turn, has led to an increase in construction. In fact, residential construction contributed roughly a third of a percentage point to GDP growth in 2012–2013. While the increase in mortgage rates last year reined in the pace of the housing recovery somewhat, the housing market overall continues to expand.

The rebound in the housing sector has broader implications for the economy, positioning it to become a tailwind. It bolsters consumer spending by improving household wealth and balance sheets, and has had distinct benefits for the small business sector. The drop in house

prices and net wealth during the housing bust made it difficult to finance new businesses. As a result, new, small firms struggled during the recession and showed tepid employment growth during the early stages of the recovery.[1] Because those types of businesses usually account for a substantial share of employment gains during recoveries, investment and job growth were affected. Now that house prices and net wealth are rising again, financial conditions for small business owners are improving. This should foster new businesses and turn into a tailwind for growth down the line.

The second is fiscal policy. Over the past few years, federal fiscal policy has been a significant source of drag to the economy. In addition to tax increases and spending cuts, which directly impinge on GDP growth, fiscal policy has been surrounded by a cloud of uncertainty and brinkmanship. Heightened uncertainty about the future makes people more cautious and less willing to take on new commitments. People tend not to make potentially irreversible economic decisions if they're unsure whether they'll have a job in six months' time, meaning they stop spending on all but the necessities.

Economists at the Federal Reserve Bank of San Francisco estimate that the rise in policy uncertainty over the past several years increased the unemployment rate by as much as 1¼ percent, as of late 2012.[2] That translates into nearly 2 million lost jobs.

The good news is that confidence can recover. Since the government shutdown was resolved late last year, economic policy uncertainty has come back down and consumer confidence has rebounded. In December, the Federal Reserve did its part by laying out a clear plan to gradually reduce our asset purchases over this year, giving a level of assurance about the future course of monetary policy. And by avoiding a replay of the brinkmanship over federal

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[1] Laderman (2013).
[2] Leduc and Liu (2013).

fiscal policy, Congress averted what could have been a serious blow to the economy. Federal fiscal policy is likely to exert less of a drag this year, and hopefully policy uncertainty won't surge again, which together mean fewer headwinds than in prior years.

Collectively, these improvements mean that the economy is entering 2014 with good momentum. Real GDP grew just over 2½ percent last year, and I see a modest pickup to around 3 percent growth on average this year and next. This is significantly above the underlying trend growth rate, or potential GDP growth, which economists at the San Francisco Fed peg at about 2 percent a year.

Challenges for the Fed's Dual Mandate

The sustained improvement in the economy is a very welcome development. However, it has presented some challenges to the FOMC's communication of our views on the future course of monetary policy.

Let me start with our guidance related to employment. As an indicator of overall health in the labor market, economists typically compare the unemployment rate to its long-term equilibrium level, the so-called "natural rate of unemployment." While the unemployment rate has fallen substantially, especially in recent months, it remains well above typical estimates of its natural rate, which I peg at around 5½ percent.

Although the decline in the unemployment rate in part reflects an increase in employment over the past few years, it can also be traced to an unusually large drop in the labor force participation rate. Now, the majority of that decline over the past six years is due to structural factors, rather than cyclical. These include the first wave of baby-boomers entering retirement and the growing number of disability claimants among the working-age population.

There is, however, some non-participation in the labor market that appears to be cyclical. For example, the number of people in school and not in the labor force rose considerably over

the past several years. We also see a large number of people who have dropped out of the labor force but still say they want a job. Combined, these groups account for a good part of the increase in non-participation not related to retirement. It's likely that many of these people will come back to the labor force as job-seekers as the market improves. We can therefore think of them as a source of labor market slack that is not reflected in the official unemployment rate, though I'd stress that we can't say precisely to what extent.

Turning to inflation: It has been running below the FOMC's longer-term goal of 2 percent for well over a year now. That goal is based on the PCE price index, which provides a comprehensive measure of prices. There are three key factors holding down inflation. First, and most important, is domestic economic slack. The U.S. economy continues to operate below capacity, as we see in the still-high unemployment rate and still-low GDP relative to its potential.

Second is global economic conditions that have led to an appreciation of the U.S. dollar and lower import prices. Many other countries are struggling with slack as well. Downward pressure on inflation in those countries also tends to hold down import price inflation in the United States. For example, import prices fell by over 1 percent last year.

The third factor is the unusually slow growth in the cost of health care over the past year. Health care prices have typically increased faster than other prices, but last year they increased only 1.2 percent, the lowest rate of inflation since the early 1960s. This extraordinarily low rate of price increases is due in part to mandated reductions in Medicare reimbursement rates, and is unlikely to be sustained.

Looking ahead, I expect unemployment to continue to come down and slack in the labor market to dissipate; foreign markets to continue to strengthen, with less downward pressure from import prices; and for special factors, like health-care costs, to ebb. Assuming this transpires,

inflation will gradually come back up towards our 2 percent longer-run target over the next few years.

There is a chance that inflation will increase more quickly than that forecast. We generally look at the overall unemployment rate as a good yardstick of labor market slack and inflation pressures. However, its usefulness may be compromised today by the extraordinary number of long-term unemployed—defined as those out of the workforce for six months or longer. During the recent recession and its aftermath, the level of long-term unemployment rose well above its previous highs in records dating back to the late 1940s.

Standard models of inflation typically do not distinguish between the short- and long-term unemployed, because they're assumed to affect wage and price inflation in the same way. However, recent research suggests that the level of long-term unemployment may not influence inflation pressures to the same degree as short-term unemployment.[3] This view takes into account the unfortunate fact that the longer someone is unemployed, the more difficult it becomes to find a job. The long-term unemployed may be chronically disadvantaged—meaning they're not competing directly with the short-term unemployed for jobs. The continued severity of this situation could make the United States more like Europe, where long-term unemployment is more prevalent and exerts relatively little influence on wage and price determination.[4]

So if the long-term unemployed exert less downward pressure on wages than the short-term unemployed, the overall unemployment rate may be less useful for forecasting inflation now than it normally is. In fact, the short-term unemployment rate—the ratio of those unemployed less than six months divided by the labor force—is currently at the relatively low level of 4.2 percent. This is well below its longer-run historical average. Accordingly, it could

[3] Gordon (2013) and Watson (2014).
[4] Lindbeck and Snower (2001).

be that slack in labor markets is much less than assumed. As a result, with the unemployment rate continuing to come down, the inflation rate could rise more quickly than expected.

I currently see this as a risk to the inflation outlook. For now, measures of wage and price inflation remain muted.

Monetary Policy Options and Tools

In light of elevated unemployment and low inflation, monetary policy needs to remain highly accommodative. As you know, our primary conventional policy tool is the federal funds rate, which also serves as a benchmark for short-term market interest rates. As the financial crisis and recession intensified, we lowered the funds rate to near zero and have kept it there since December 2008. To ensure that this translated into longer-term interest rates, we started providing forward guidance about the likely future trajectory of the fed funds rate. We also started the large-scale asset purchase program, or "quantitative easing," in late 2008. The latest round started in September of 2012, and at its height purchased $85 billion of combined long-term Treasury and mortgage-backed securities each month.

In December of 2013, the FOMC announced the first step in scaling back those purchases from $85 billion to $75 billion per month. We set in motion a second step-down in purchases to $65 billion per month at our meeting last month. Assuming the economy evolves more or less in line with our expectations—and, like the saying goes, it's difficult to make predictions, especially about the future—the gradual tapering in the pace of asset purchases will continue. It is not locked in, but the bar for altering the path is high. In particular, it's important for monetary policy to keep focused on the medium-term outlook for the economy and not overreact to month-to-month movements in the data.

These reductions in the pace of asset purchases do not represent a tightening of monetary policy. Instead, they represent the first steps in ending the process of adding monetary accommodation in support of the economy. Once the asset purchase program is completed, the next step will be to start the process of eventually bringing monetary policy back to a more normal stance. In the December 2012 meeting, the FOMC also outlined plans to keep the funds rate at the zero lower bound at least until the unemployment rate reached 6½ percent, again in the context of price stability. The sizable subsequent improvement in economic conditions, and especially the decline in the unemployment rate below 7 percent, has necessitated updating and expanding this guidance. In particular, the guidance as of this past December is that the fed funds rate will likely remain near zero "well past the time that the unemployment rate declines below 6½ percent."[5]

Now that the unemployment rate is near 6½ percent, we will need to modify this guidance further. The FOMC will discuss this in detail and I don't want to speculate on the decision that will be made. But let me frame the issue as follows. Back in 2011, when we first introduced specific quantitative forward guidance on the future path of the funds rate, the public's expectations about our policy plans differed sharply from our own. In particular, private expectations were for the first funds rate increase to occur much earlier than we thought appropriate at the time.[6]

Quantitative forward guidance proved to be a very powerful, albeit blunt, tool for bringing public expectations of when we will raise interest rates in closer alignment with our own views.

[5] Board of Governors (2013).
[6] Swanson and Williams (2013) and Williams (2014).

The situation is very different now. Public expectations of future monetary policy appear to be reasonably aligned with our own, so there is no problem to "fix." Instead, our forward guidance should be aimed at providing the public with a good understanding of the key drivers of our policy decisions. This is best done by trying to explain how we are likely to react to economic developments, rather than putting down specific, quantitative markers for future policy decisions. Qualitative guidance of this type, complemented by our economic projections, speeches, and testimony, is better suited for the current situation. It avoids the problem of oversimplifying policy decisions down to one or two indicators and appropriately highlights the various economic factors that influence monetary policy.

When we do eventually increase the funds rate, and start the process of normalizing monetary policy, clarity and transparency will be key. We'll do our best to be clear, both in advance and as it's happening…we don't want to give anyone an excuse to pretend they didn't see it coming. We saw in December, with the taper announcement, that this can be achieved: the Fed can be clear and markets can take what we're saying at face value.

Looking further ahead, there are questions about normalizing monetary policy when we have this huge quantity of excess reserves, which were created to fight the financial crisis and recession. The Fed's balance sheet has expanded to over $4 trillion, an unprecedented level.

The Fed has been devoting a lot of thought and research to making sure that we can successfully conduct monetary policy and influence interest rates even with a large balance sheet. We have three main tools at our disposal to manage bank reserves while we normalize policy.[7]

The first is paying interest on reserves. The IOER rate lets banks earn a risk-free return on their reserves held at the Fed, instead of lending them to other banks overnight. This helps

[7] For additional details, see Potter (2013).

put a floor on the funds rate and other money market rates. The second and third tools the Federal Reserve has been testing as ways to drain reserves. One is the Term Deposit Facility, or TDF, whereby financial institutions can deposit excess reserves in interest-bearing deposits for a fixed period of time, similar to a CD. The other is "reverse repos." The IOER rate and TDF are only available to depository institutions; reverse repos are also available to non-bank financial institutions. The Fed has been developing and testing a program of reverse repos, with a range of trading partners, with the goal of providing even tighter control over short-term interest rates. All these tools will be available to help us control short-term interest rates.

Conclusion

To sum up: Things are definitely looking better. We're entering 2014 with solid momentum. The FOMC's taking the first steps towards reducing the pace of additional monetary accommodation is a reflection of that improvement. Let me stress that the normalization of monetary policy is likely to be a gradual process, and I expect the fed funds rate will stay near zero until well into next year.

Of course, there will also be challenges along the way. But we are prepared for the inevitable bumps in the road. And that road we're on is, finally, the one on the way to normal.

Thank you.

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