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By John C. Williams, President and CEO, Federal Reserve Bank of San Francisco
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Monetary Policy and the Recovery

Good afternoon, it's a pleasure to be back in Idaho. Yesterday, we toured the Simplot potato processing plant out in Caldwell, which is one of the most technologically advanced of its kind. This visit was an apt reminder of the importance of both agriculture and high-tech—not just to this state but to the country as a whole.

There's been increased discussion of monetary policy lately and why the Fed has taken the actions we have. So I'd like to talk to you today about just that—what the goals of monetary policy are, how we got to this point in economic history, and where we're going. Before I start, I need to give the usual Fed disclaimer that my remarks represent my own views and do not necessarily reflect the views of others in the Federal Reserve System. Now that's out of the way, let me begin.

The goals of monetary policy

The aims of the Federal Reserve's monetary policy are full employment and price stability. These goals are set down in law by Congress. In plain English, that means that there should be enough jobs for everyone and your paycheck should hold its value. These are laudable goals that I think everyone can support.

But there's a lot of noise around monetary policy and our intent can get lost in the ruckus. And when we don't explain what we're doing and why, I'm afraid the "MSU principle" can take over. That is, people will just "make stuff up." So we at the Fed have been making a concerted effort to bring greater clarity and transparency to the discussion.

Over the past several years, the Fed has undertaken unconventional monetary policies to achieve our goals.[1] In particular, we've engaged in large-scale asset purchases, which most people refer to as quantitative easing, or QE. In addition, we've increasingly used forward guidance, which seeks to bring more transparency and clarity about our views of the economy and intentions regarding future policy. Combined with near-zero short-term interest rates, these form the basis of our plan to get people back to work and keep inflation low and stable.

We took these steps after the country suffered the worst financial crisis and recession since the Great Depression. The Federal Open Market Committee, or FOMC—the Federal Reserve's monetary policy body—cut the federal funds rate to close to zero. That's the short-term interest rate that acts as our main conventional policy tool. We would've liked to have cut rates even further, but nominal interest rates can't fall much below zero. So, having reached the

[1] See Williams (2012, 2013).

limit of what we could do with the short-term interest rate, the Fed introduced alternative ways to ease financial conditions to stimulate economic growth and job creation.

The correlation between what the Fed is doing and how it achieves those ends isn't always clear. And we don't always make it easy, either. I got asked a great question at a talk I gave a while ago. He said, "Look, I understand that the Fed is lowering interest rates, and I understand that that may get some people to buy a car when they might otherwise wait. But why does that create jobs? And why does that reduce unemployment?"

I realized then that people don't always make the connection that if we're buying more cars, we're creating more jobs for car manufacturers. And if we're buying more cars, those companies need to compete for our business… so they don't just hire people to make the cars, they hire people to market and sell the cars. And with more employees on the assembly line and in the marketing and sales departments, they need more people in HR; they need more people in accounting; they need more people running the offices.

So now all those newly-employed autoworkers and marketing managers and accountants have more money in their pockets. They're doing things they couldn't do before, like going out to restaurants—which have to hire more waitstaff to serve more customers, and order more stock from Simplot to feed them—or going to the movies or even, yes, buying more cars. It's the multiplier effect—or cause and effect and effect and effect.

So those are the goals of monetary policy—full employment and price stability. But questions remain about why we still need such aggressive monetary stimulus, and for that we have to turn to the circumstances that brought us here.

Where we were—the financial crisis

This whole question of how we follow the line of cause and effect is important for thinking about where we are in the economic recovery and why. Because part of the reason the recovery hasn't been as strong as we'd like is the multiple factors that caused the financial crisis – and the events that have affected the recovery.

The fifth anniversary of Lehman Brothers' failing led to a lot of commentary and reflection on the crisis. Which was good, because time and distance can dull the memory of pain or let people oversimplify its causes. It's easy to forget how bad it was, and just how many elements came together in a perfect storm.

It all started in the early 2000s, as we were recovering from the dot-com crash. The housing market started to take off, which was great—it provided a much-needed boost to the economy. As house prices rose, people felt wealthier and started to spend more. Again, great. Buyers flooded into the market and everyone was sure that prices would continue to rise, which was not so great. It meant lenders felt comfortable taking risks. People who didn't actually have the income to make monthly payments could get a mortgage. But it didn't matter, because prices kept rising. All of a sudden, people who put little or no money down were sitting on five- and six-digit figures of home equity…which was easily converted into cash to buy SUVs or home entertainment systems or any number of things that had once been luxuries but now seemed within reach.

At the same time, financial instruments had gotten more and more complicated and lax regulation meant little or no oversight. Higher returns meant the people creating those instruments cared less about the exposure to risk, or the effects it could have down the line, and more about short-term gain. As mortgages became far more generous and easier to get, the risks increased. But that risk was chopped up, repackaged, and sold on…and on and on…to investors spanning the globe. It reached the point that people who owned the risk often had no clue what they had.

Then the bottom fell out. People fell behind on mortgage payments, housing values plummeted, and credit dried up. Financial institutions stopped lending—including to one another—choking off funds they depended on to finance day-to-day operations.

Think back to 2008: Fannie and Freddie insolvent; Lehman failed; WaMu; AIG. No one knew how big the problem was or how it would end. It seemed very possible that the financial system as we knew it would collapse entirely. The resulting fear and panic could easily have ushered in a major depression.

I want to stress that: as bad as it was, it could have been much, much worse. We could have fallen into the abyss. Historically, that's what has happened when widespread financial panics cut off the flow of credit. But we didn't. And that's in part because the Federal Reserve did what it's supposed to do: it moved quickly and decisively to safeguard the financial system. I would give the Fed a high grade for the actions we took. But I would probably give us a lower grade for explaining and building support for our emergency programs. When millions of Americans were losing their jobs and their homes, it may have seemed to many as if the Fed was more focused on saving financial institutions than on saving jobs.

But a collapsed financial system would've taken the finances of average Americans along with it. It would have resulted in a blow to jobs and the economy of cataclysmic proportions, on par with the Great Depression. However, that message got drowned out. And that meant not only confusion but misinformation. Among other things, some people thought we'd launched secret programs that put taxpayer money at significant risk and gave financial institutions below-market interest rates.

To be clear, that was simply not the case. Our lending programs were publicly announced and regularly reported on. The lending was backed by good collateral and nearly every penny has been repaid, with interest. In fact, Federal Reserve emergency lending programs generated some $20 billion in interest income. That income, like virtually all net income the Fed generates after expenses, went to the U.S. Treasury. And borrowers did not get below-market interest rates. In fact, many of our programs charged penalty rates—we wanted borrowers to go back to the private markets as soon as they opened up again.

That brings us to the recovery. It's a legitimate question to ask why we aren't further along in getting everyone back to work. Just as the crisis involved multiple factors that made its impact so devastating, a lot has come together to hinder the recovery. The financial crisis destroyed trillions of dollars of household wealth. It left the housing market in a deep depression. It made credit hard to get. In addition, the federal government's austerity is exerting a huge drag on economic growth. And all of these factors have converged to create tremendous uncertainty. Let me take those in order.

First, the collapse in housing prices caused a $6.5 trillion decline in U.S. household wealth. The stock market plummeted. People got scared, they scaled way back on their purchasing, and consumer spending virtually froze.

Second, there's the fact that past recoveries have generally gotten a push from home construction and spending on household goods. But this recession was caused in part by a burst housing bubble, which meant the usual source of a jump-start was still mired in brutal conditions.

Those two factors are tied to the third: tight credit. Unless they had perfect credit, almost no one could get a loan. Small businesses were particularly hard-hit. For one, real estate became less viable as collateral with lenders. For another, many banks they might otherwise rely on were too weak to extend much credit.

The fourth factor restraining growth today is federal fiscal policy. This year, income tax rates were raised on upper-income Americans, and the Social Security payroll tax cut was allowed to expire—eating into disposable income that could otherwise go towards consumer spending. On top of that, we have budget austerity and sequestration. While one can debate the longer-run costs and benefits of the resulting deficit reduction, the direct near-term result is a negative contribution by the government sector to GDP growth. This year, it's estimated that federal fiscal policy is subtracting 1½ percentage points from economic growth.[2]

While we can formulate monetary policy to chip away at some of these factors, we are less able to control the fifth, which is uncertainty. Business leaders are nervous about tax and regulatory policies. Households are worried about jobs and future income. And *everyone* is uncertain about Washington's ability to overcome gridlock, including many in Washington. None of this is bolstering anyone's confidence.

Where we are—the economy today

However, in spite of these multiple hurdles, the past four years have seen the U.S economy slowly but surely making progress. Job growth has been fairly steady and positive.

[2] See Lucking and Wilson (2013) and Congressional Budget Office (2013).

Over the 12-month period through August, the U.S. economy added 2.2 million jobs. I would like to report the jobs data through September, but the federal government shutdown means that data hasn't been released.

One puzzling issue we've seen with the labor market is that while job openings are increasing, we aren't seeing a similar increase in the number of people being hired. There's been speculation that this might be due to skills mismatch. That is, you can't hire a mortgage broker to work at Micron. But recent studies show that this isn't likely to be the main cause for the increase in openings.[3] It's more likely that it's still an employers' market—there's no real sense of urgency to fill an opening unless the rare perfect candidate emerges. I should add that this hesitance in the jobs market has a lot to do with that uncertainty I mentioned. Researchers at the San Francisco Fed find that uncertainty may have added as much as 1¼ percentage points to the unemployment rate by late 2012.[4]

I expect to see continued steady gains in jobs, with the unemployment rate edging down gradually over time.

Turning to inflation, both headline and core measures have stayed low and stable. Let me repeat that. Inflation is low and stable. That may seem surprising to those who have heard that the Fed's easy monetary policy is leading us to high inflation. In fact, since the start of the

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[3] See Daly et al. (2012).
[4] See Leduc and Liu (2013).

recession in December 2007, the inflation rate has averaged 1.5 percent, which is below our 2 percent longer-run goal.

Now, that doesn't mean that individual prices of goods and services never change. The price of gasoline, for instance, fluctuates depending on the price of oil. Oil is a global commodity; its price is influenced by myriad market factors beyond our control. But while prices of some goods are rising, prices of other goods might be falling. Therefore we look at inflation across a broad range of goods and services.

Where do I see inflation going in the near future? Over the past year, the Fed's preferred measure of consumer prices rose 1.2 percent. As the economy continues to improve and unemployment returns to more normal levels, I expect inflation to gradually rise over the next few years, closing in on our 2 percent longer-run inflation goal.

Where we're headed—the outlook

Putting all of this together, with monetary policy continuing to provide needed stimulus, I expect economic growth to pick up somewhat next year. As the economy continues to get better, the highly accommodative stance of monetary policy will need to be gradually adjusted back to normal. The first step will be to slow the pace of asset purchases over time, eventually ending them altogether. This won't be a slamming on the brakes, it will be an easing off the gas. And it will not be a fixed date on the calendar. Instead, it will be in response to economic developments and the progress we have made towards our dual goals of maximum employment and price stability.

Looking further ahead, the time will eventually come to raise short-term rates again and normalize the stance of monetary policy. Last December, we introduced a new form of forward guidance that explicitly tied the timing of the liftoff of the federal funds rate to economic events. Specifically, the FOMC said that it "currently anticipates that this exceptionally low range for the federal funds rate will be appropriate at least as long as the unemployment rate remains above 6½ percent…." This threshold for the unemployment rate is not an automatic trigger. The statement says "at least as long as." Once unemployment falls below that threshold, we'll evaluate how the recovery is progressing and decide on the appropriate course for the federal funds rate then. In my own projection, even though I expect the unemployment rate to fall below 6½ percent early in 2015, I don't currently expect that it will be appropriate to raise the federal funds rate until well after that, sometime in the second half of 2015.

Conclusion

So that's where we were, where we are, and where we're headed, and why the Federal Reserve has pursued the monetary policies we have. I hope I've addressed some of your questions and concerns about monetary policy and what the Fed's intentions are. I'm happy to answer any specific ones now, but first want to thank everyone for coming out today. As I said, it's always a pleasure to be in Boise.

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