

September 14, 2012

Also available upon release at
www.frbsf.org/publications/economics/fedviews/index.php

Simon Kwan, vice president at the Federal Reserve Bank of San Francisco, states his views on the current economy and the outlook.

- Incoming data indicate that economic activity has continued to expand at a moderate pace in recent months. Nonfarm payrolls rose by only 96,000 in August, while gains in July and June were revised down by 41,000 jobs. That put June-through-August job growth at a meager 94,000 per month, a notable downshift from average job creation of over 200,000 per month over the first three months of the year.
- Amid slow job growth, the unemployment rate remains elevated at 8.1%, nearly unchanged since the beginning of the year and well above its longer-run normal level. Other indicators, including the rate of participation in the labor force, confirm pervasive labor market weakness. The recent stagnation of the labor market, if not reversed, could pose a serious threat to the economy's long-term health.
- While household spending has continued to advance, capital outlays have slowed. New orders for core capital goods have also dipped below shipments lately, pointing to potentially further slowing in business capital investment.
- During the current recovery, aggregate capital expenditures by nonfinancial corporations have consistently been below the funds these businesses have generated internally, which consists mainly of after-tax profits and noncash business expenses such as depreciation.
- The sluggish business investment seems even more striking given the strength of corporate balance sheets. Profit margins of nonfinancial corporations have been holding up well, and equity analysts are forecasting robust earnings growth in future quarters. Meanwhile, data suggest that nonfinancial firms are sitting on a lot of cash and other liquid assets, and have ample borrowing capacity.
- One crucial factor driving sluggish hiring and lackluster capital investment appears to be heightened uncertainty about the future. This uncertainty is fueled by several factors, including the halting recovery in sales and demand, the protracted European debt crisis, and a lack of clarity on what will happen with near-term and longer-term federal fiscal policy, including the "fiscal cliff."
- With excess capacity in the economy and below-trend growth, inflation has been subdued. The medium-term outlook is that inflation is likely to run at or below the 2% target that Federal Reserve policymakers consider most consistent with their maximum employment and price stability goals. Looking ahead, the odds appear to have risen that the Fed will continue to miss both its maximum employment and price stability mandates.

- Thus, the stage was set for the Fed's policy body, the Federal Open Market Committee (FOMC), to act boldly. At its September meeting, the FOMC moved to provide additional monetary stimulus, using both its balance sheet and its communication tools. The FOMC announced that the Fed will purchase additional agency mortgage-backed securities at a pace of \$40 billion per month. The Fed will also continue the Maturity Extension Program announced in June to increase holdings of longer-term Treasury securities and decrease holdings of short-term Treasuries. And the Fed will maintain its existing reinvestment policy to replace maturing securities. If the labor market outlook does not improve substantially, the Fed will continue purchases of agency mortgage-backed securities, carry out additional asset purchases, and employ other policy tools as appropriate until improvement is achieved in a context of price stability.
- The policy of open-ended purchases of securities is unprecedented for the Fed. The shift to a flow-based balance sheet policy instead of a fixed quantity of purchases provides greater flexibility for the Fed to respond to new information. As always, the Fed will monitor economic and financial developments to assess the efficacy and costs of asset purchases.
- The new policy initiatives have a critical communications component. In explicitly laying out the conditions for stopping the asset purchase program—a broad-based improvement in the labor market—the Fed is underscoring its resolve to support economic growth. Doing so should reduce the uncertainty about whether asset purchases will be enough to improve labor market conditions. And, by stressing that it will conduct asset purchases in a context of price stability, the Fed is reconfirming its commitment to its dual mandate.
- The FOMC also emphasized that it expects a highly accommodative stance of monetary policy to remain appropriate for a considerable time after the economic recovery strengthens. This reassures the public that the Fed will not tighten policy prematurely as the economy picks up. In particular, the FOMC extended its guidance on future policy by stating it anticipates exceptionally low levels for the Fed's benchmark federal funds rate are likely to be warranted at least through mid-2015.
- The additional monetary stimulus is expected to support a stronger recovery, boosting GDP growth to about 2.5% in 2013 and about 3.3% in 2014. At the same time, the unemployment rate is expected to come down a bit faster, to about 7.9% by the end of 2013 and about 7.3% by the end of 2014. Inflation as measured by the personal consumption expenditures price index is projected to be only slightly higher than without the stimulus—1.7% in 2013 and 1.8% in 2014.



