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The Economic Outlook and Challenges to Monetary Policy[1]

Good afternoon. It's a pleasure to be here at the City Club. This beautiful building connects us with San Francisco's history as a center of commerce and finance, which makes it a great place to give a talk about the economy. My subject is how the U.S. economy is doing and where it's heading. I'll take a close look at why the recovery has so far been somewhat lackluster, and I'll go over measures we at the Federal Reserve recently announced aimed at boosting growth and getting us closer to our goals of maximum employment and price stability. As always, my remarks represent my own views and not those of others in the Federal Reserve System.

It's been several years since we passed through the worst financial crisis and deepest recession the nation has experienced since the Great Depression. The collapse of the housing market and the near meltdown of the financial system took an enormous toll. The past three years have been marked by sluggish growth, a severely depressed housing sector, and very high unemployment.

Still, as discouraging as the economic news has been at times, there's no doubt the economy is on the mend. Private-sector payrolls have climbed for 30 consecutive months, adding over 4½ million jobs. That's more than half what we lost in the recession. Despite these gains, economic growth has not been strong enough to bring the jobless rate down to normal levels. After reaching a peak of 10 percent in October 2009, the unemployment rate has declined

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

by nearly 2 percentage points to 8.1 percent. That's real progress. But we still have quite a way to go to get the economy back to where it should be.

It's not that surprising that the recovery has been sluggish. It can take quite some time to get over a financial crisis and a severe recession like we just lived through. But the healing process is well under way.[2] Credit conditions are much improved from a few years ago. For many borrowers, interest rates are at or near historic lows. And lenders seem more willing to extend credit. Consumer and business demand pent up during the recession is reviving. We can see that, for example, in car sales, which collapsed during the recession. Now, with auto financing rates at rock bottom and more people working, motor vehicle sales have climbed over 50 percent from their recession lows.

Another encouraging development is that housing is once more showing signs of life. With the economy improving, mortgage rates at historically low levels, and homes extraordinarily affordable, confidence is returning to the housing market. Home sales are rising, and inventories of unsold homes have come down. We've started working off the huge backlog of foreclosed properties. Nationally, home prices have stabilized and are starting to rise. Here in San Francisco, we can even say that the housing market is heating up.

The recovery in housing includes a rebound in home construction, something particularly important for the health of the overall economy. Housing starts simply collapsed during the downturn, plummeting from a seasonally adjusted annual pace of over 2 million new units during the boom to around half a million in the depths of the recession. It's clear that, as a country, we built too many homes during the housing bubble. But it's just as clear that the dearth of homebuilding over the past four years can't continue forever if we are going to have

[2] See Williams (2012a) for a discussion of the financial roots of the crisis and how they have affected the pace of recovery.

enough homes for the nation's growing population. The latest data show housing starts rising to an annual rate of 750,000 units. That's a big increase from three years ago, but still well short of the longer-run trend of about 1.5 million units. Over the next few years, an ongoing recovery in housing construction should be one of the key drivers of economic growth.

I've highlighted a few sectors—autos and housing—that were hard hit during the recession, but are on their way back. Why then are we unable to shift into a higher gear of growth? Three reasons stand out: the European debt crisis and recession, the budget squeeze at all levels of government in the United States, and a pervasive sense of uncertainty.

I'll start with the situation in Europe. The crisis there has been a dark cloud hanging over global financial markets and our own economy for the past two years. Greece has already defaulted on its sovereign debt. Several other countries in the euro area are under severe stress. The European Union and the International Monetary Fund have put in place emergency support programs for Ireland and Portugal, in addition to Greece. It's a story that is in many ways familiar to Americans—too much borrowing, creditors exposed to huge losses, and investors running for cover. But there are critical differences. In Europe's case, some national governments are now in danger of default. In Greece, the government simply borrowed too much. In other countries, governments made large commitments to aid failing financial institutions. In all these cases, the downturn strained budgets further. As fear spread, these governments found themselves paying ever-higher interest rates, which made their fiscal plight even worse.

What started as a financial problem has morphed into a general economic downturn—and the shock waves are hitting us. With Europe in recession, U.S. companies are seeing lower demand for their products. The same is true for other countries that sell to Europe, such as China, and they are experiencing slowdowns as a result.

European authorities have taken important steps to contain the crisis. Recently, the European Central Bank announced a bold plan to stabilize the markets for government debt of countries under stress. This plan should buy time for European governments to put in place more comprehensive solutions for their banking and sovereign debt problems. But it is far from certain that European leaders will succeed in doing so. One challenge is that, in exchange for aid, authorities have demanded austerity measures, including tax increases and deep spending cuts. In the longer term, these measures are needed to put the government budgets of these countries on sustainable paths. But, in the near term, austerity has held down economic growth further, prolonging economic downturns and making it even tougher to trim budget deficits.

Europe is by no means the only thing pressing on the U.S. economy now. In our country, tax cuts and spending increases gave the economy a badly needed boost in the depths of the recession and early in the recovery. But these stimulus measures have been unwinding. At the same time, states and localities have cut spending and raised taxes as they struggled to balance their budgets. As a result, fiscal policy in the United States has shifted from the accelerator to the brakes as far as growth is concerned.[3] The numbers tell the story. Government consumption expenditures and investment, adjusted for inflation, have declined 5.4 percent over the past two years. That's equivalent to more than a one percent reduction in gross domestic product. This shrinkage of the government sector can also be seen in employment at the state, local, and federal levels. Total government employment has fallen by 680,000 jobs, or 3 percent, over the past four years.

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[3] See Lucking and Wilson (2012).

The drag on the economy coming from shrinking government employment and lower spending could turn dramatically worse at the beginning of 2013. You may have heard the expression "fiscal cliff." It refers to large federal tax increases and spending cuts that will automatically take place under current legislation. These include ending the temporary payroll tax cut and extended unemployment benefits. Caps on some federal outlays and sharp cuts in others are also set to go into effect. In addition, the Bush-era tax cuts are scheduled to expire.

To be sure, I don't expect all these tax hikes and spending cuts to take place as scheduled. For example, it's likely that the Bush tax cuts will be extended temporarily and that some spending cuts will be deferred. Still, there's little doubt that a number of austerity measures will hit. I expect that to slow our economy's forward progress.

If my prediction is wrong though, and the entire range of fiscal cliff measures stays in place, the effects on the economy next year would be much more severe. The nonpartisan Congressional Budget Office estimates that the complete fiscal cliff package would knock 2¼ percentage points off growth in 2013 and push unemployment up a percentage point compared with the less draconian scenario I expect. If that happens, the economy could find itself teetering on the brink of recession.

This brings me to the third factor restraining growth: uncertainty. The crisis in Europe, the fiscal cliff, and, more generally, the tumultuous events of the past five years have unsettled consumers and businesses alike. In particular, they have fostered a high degree of uncertainty about the future and undermined the economic confidence that spurs spending and investment. Greater uncertainty causes households and businesses to save more out of fear over what lies ahead. With everyone hunkering down and preparing for the worst, businesses see a drop-off in demand for their goods and services. That in turn damps economic growth and drives up unemployment.[4] Just about everyone I talk with stresses that pervasive uncertainty is holding back hiring and investment. Indeed, uncertainty about the economy—including federal fiscal policy—appears to have all but paralyzed some businesses, prompting them to postpone capital spending and payroll expansions.

I'd like now to offer my economic outlook and talk about what the Federal Reserve is doing to help keep our economy on the road of recovery, while keeping inflation low. As a backdrop for this discussion, it's useful to say a few words about the goals of monetary policy. Congress assigned the Fed two goals in setting monetary policy: maximum employment and price stability. In considering what maximum employment is, economists look at the unemployment rate. We tend to think of maximum employment as the level of unemployment that pushes inflation neither up nor down. This is the so-called natural rate of unemployment. It is a moving target that depends on how efficient the labor market is at matching workers with jobs. Although we can't know exactly what the natural rate of unemployment is at any point in time, a reasonable estimate is that it is currently a little over 6 percent.[5] In other words, right now, an unemployment rate of about 6 percent would be consistent with the Fed's goal of maximum employment. In terms of the Fed's other statutory goal—price stability—our monetary policy body, the Federal Open Market Committee, or FOMC, has specified that a 2 percent inflation rate is most consistent with our dual mandate.

So, how are we doing on these goals? As I said earlier, the economy continues to grow and add jobs. However, the current 8.1 percent unemployment rate is well above the natural rate, and progress on reducing unemployment has nearly stalled over the past six months. If we hadn't taken additional monetary policy steps, the economy looked like it could get stuck in low

[4] See Bloom (2009) and Leduc and Liu (2012).
[5] See Daly et al. (2012) and Williams (2012b).

gear. That would have meant that, over the next few years, we would make relatively modest further progress on our maximum employment mandate. What's more, the job situation could get worse if the European crisis intensifies or we go over the fiscal cliff. Progress on our other mandate, price stability, might also have been threatened. Inflation, which has averaged 1.3 percent over the past year, could have gotten stuck below our 2 percent target.

For the FOMC, this was the sobering set of circumstances we were staring at during our most recent policy meeting. Faced with this situation, it was essential that we at the Fed provide the stimulus needed to keep our economy moving toward maximum employment and price stability. So, at our meeting, we took two strong measures aimed at achieving this goal.[6]

First, we announced a new program to purchase $40 billion of mortgage-backed securities every month. This is in addition to our ongoing program to expand our holdings of longer-term Treasury securities by $45 billion a month. Second, we announced that we expect to keep short-term interest rates low for a considerable time, even after the economy strengthens. Specifically, we expect exceptionally low levels of our benchmark federal funds rate at least through mid-2015.

These actions work the same way monetary policy always does—by lowering borrowing costs and improving broader financial conditions.[7] For example, low interest rates cut the cost of borrowing to buy a car, making people more willing to make the purchase. And, as car sales increase—thanks to low interest rates—automakers need to produce more cars and more parts, which leads them to hire additional factory workers. This is exactly the kind of virtuous circle that provides the oomph in a healthy economic recovery.

[6] See Board of Governors (2012b).
[7] See Williams (2011).

We have already seen some benefits of our ongoing stimulus programs in the notable improvements in the sectors of our economy that are especially sensitive to interest rates, such as autos and housing. In particular, purchases of mortgage-backed securities have been very effective at bringing down mortgage rates.[8] As I noted, the housing market remains depressed, but is now showing signs of life. Lower mortgage rates should provide another shot in the arm to the housing recovery at just the right time, just as it is beginning to generate some real forward momentum. Lower rates make owning a home more affordable, which increases demand for new housing. This increase in demand should put upward pressure on depressed house prices, making it easier for existing homeowners to refinance or sell their homes. The happy result could be a positive feedback loop of growing confidence and improving fundamentals in the housing market.

Thanks in part to the recent policy actions, I anticipate the economy will gain momentum over the next few years. I expect real gross domestic product to expand at a modest pace of about 1¾ percent this year, but to improve to 2½ percent growth next year and 3¼ percent in 2014. With economic growth trending upward, I see the unemployment rate gradually declining to about 7¼ percent by the end of 2014. Despite improvement in the job market, I expect inflation to remain slightly below 2 percent for the next few years as increases in labor costs remain subdued and public inflation expectations stay at low levels.

Of course, my projections, like any forecast, may turn out to be wrong. That's something we kept in mind when we designed our new policy measures. Specifically, an important new element is that our recently announced purchase program is intended to be flexible and adjust to changing circumstances. Unlike our past asset purchase programs, this one doesn't have a preset expiration date. Instead, it is explicitly linked to what happens with the economy. In particular,

[8] See Gagnon et al. (2011).

we will continue buying mortgage-backed securities until the job market looks substantially healthier. We said we might even expand our purchases to include other assets.

This approach serves as a kind of automatic stabilizer for the economy. If conditions improve faster than expected, we will end the program sooner, cutting back the degree of monetary stimulus. But, if the economy stumbles, we will keep the program in place as long as needed for the job market to improve substantially, in the context of price stability. Similarly, if we find that our policies aren't doing what we want or are causing significant problems for the economy, we will adjust or end them as appropriate.

Let me emphasize that these policy actions are designed to help us achieve both our goals of maximum employment and price stability. Inflation continues to be low and inflation expectations are low and stable—what we economists call well anchored. In fact, over the past four years, the inflation rate has averaged a mere 1.2 percent. That's the lowest rate recorded over a four-year period since the early 1960s. And longer-term inflation expectations are at about the same level they were five years ago, before the Fed began taking unconventional monetary policy actions. The Fed's recently announced actions should help move inflation up a bit closer to our 2 percent long-run goal.

Clearly, the bigger problem today is high unemployment. Much of the discussion about monetary policy focuses on that issue—as it should. But, I want to stress, in no way has our commitment to price stability wavered. Inflation is something we watch carefully, and we remain determined to work toward our price stability objective.

Monetary policy cannot solve all problems that affect our economy. But it can help speed the pace of recovery and get our country back on track sooner. Our policy actions are completely consistent with the statement of longer-term goals and policy strategy the FOMC released in January.[9] I'm convinced they represent the best course to move us closer to those goals. Thank you very much.

[9] For more information, see Board of Governors (2012a).

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