

The Economic Recovery and Monetary Policy: The Road Back to Ordinary

BY JOHN C. WILLIAMS

Monetary policy is moving slowly and cautiously towards normalization. Signs of improvement—falling unemployment, better financial conditions, and abating headwinds—indicate the United States is changing from extraordinary economic times back to ordinary ones. Risks to the recovery's momentum linger, and “normalizing” should not be confused with “tightening.” Monetary policy will remain highly accommodative for some time. Overall, however, the outlook is positive. The following is adapted from a presentation by the president and CEO of the Federal Reserve Bank of San Francisco to the Association of Trade and Forfeiting in the Americas in San Francisco on May 22, 2014.

For the past five years, monetary policy in the United States has reflected the extraordinary economic times we were in: interest rates held at essentially zero, multiple rounds of quantitative easing, and a lot more talk from the Fed about our intentions.

Now, thankfully, the extraordinary is turning back into the ordinary, and we are starting down a path towards normalization, both for the economy and monetary policy. We'll venture down this path slowly, and monetary policy will remain highly accommodative for some time. But I am happy to say that we *are* on the road back to normal. I'd like to give an overview today of the economic outlook and its implications for monetary policy.

A sustained recovery

Winston Churchill once said, “I always avoid prophesying beforehand, because it is a much better policy to prophesy after the event has already taken place,” and that's good advice. But I'm going to ignore it and go ahead and say that the outlook is, overall, quite good. While the winter wasn't too kind to many parts of the country, and it looks like growth in real GDP stalled in the first quarter, things are looking positive for the rest of the year.

The severe weather in parts of the country accounts for some, though not all, of that first-quarter weakness. By some estimates, weather conditions reduced GDP growth by as much as 1½ percentage points. Most of the other factors depressing first-quarter growth appear to be temporary and more recent economic indicators point to substantial underlying momentum. In particular, consumer spending has rebounded from winter lulls.

The jobs numbers are also encouraging. Following weak jobs data during the worst winter months, employment gains bounced back up to average nearly a quarter-million jobs per month from February

through April. This rebound in employment growth is evidence that businesses view the winter's inactivity as temporary. Taking a longer view, over the past year, the U.S. economy has added nearly 2.4 million jobs. This has helped reduce the unemployment rate to 6.3%.

Despite all this good news, there is one area of concern, which is housing. Historically, most recessions have been followed by housing revivals, which significantly boosted the early stages of recovery. I therefore expected housing to be a much stronger tailwind by now. While home construction and sales showed substantial momentum in 2012 and the first half of 2013, the wind has been taken out of the sails since then. Much of the slowdown in housing market activity appears to be due to last year's jump in mortgage interest rates. Although that is unlikely to reverse, other factors driving this sector should improve, and I remain cautiously optimistic about the outlook for housing over the next few years.

One source of the as-yet unrealized demand for housing is the number of adults living with their parents. The recession saw a substantial increase in the percentage of Americans forced to move back home, or unable to make it out in the first place (Rudebusch 2014). As job growth continues, huge numbers of these young people are likely to move out—a relief to both them and their parents, I should think—and many will buy homes.

Homes are also still pretty affordable. Household incomes are growing, mortgage interest rates—despite last year's jump—are still low, and in most areas of the country home prices have remained well below their pre-recession peaks. And while those prices are still relatively low, they are continuing to rise.

Together, these various signs indicate that the disappointing data are likely temporary, and housing should begin to provide the support to the recovery we've been waiting for.

In other good news: Some of the key headwinds that were holding back the economy have eased. This is offsetting the weakness in the housing sector and contributing to the favorable outlook for the remainder of the year.

One headwind that is abating is from the government sector. Fiscal policies are exerting less drag on growth. State and local governments have seen substantial improvements in their budgets, and federal spending cuts have eased. The avoidance of another round of brinkmanship over the federal budget has been important in mitigating uncertainty, which had been holding back spending and employment (Leduc and Liu 2013). Financial conditions also continue to improve, with substantial stock market gains and strengthening balance sheets for households, businesses, and banks. And we are seeing an easing of credit availability to consumers and businesses.

With the recent spending data and dissipating headwinds, the turnaround in momentum from the first quarter is palpable. I expect a rebound in the current quarter and look for real GDP growth to average around 3% for 2014 and 2015. This exceeds the underlying trend rate of GDP growth of around 2%, based on population growth and productivity gains. This sustained recovery in spending should continue to fuel sizable gains in employment and income.

Of course, nothing in life is certain, and there are factors outside our control that could get in the way—heightened geopolitical tensions, for instance, or instability in foreign financial markets, particularly in

emerging economies. We'll continue to keep an eye on those developments, but as things stand, the domestic outlook is positive.

Challenges for monetary policy

While the economic outlook is favorable, there are still challenges for monetary policy and how we at the Fed go about meeting the two goals Congress has set for us: maximum employment and stable prices.

As I said, employment has been growing at a good clip. In fact, the number of private-sector jobs is back above its pre-recession peak. Overall employment, which includes the public sector, will probably reach its previous peak in another month or so. But that's the *number* of jobs. In the interim, the population has been growing, bringing more potential workers into the fold. At the same time, the first round of baby boomers is headed into retirement, which means people being taken out of the labor pool.

Those variations mean that the number of jobs consistent with maximum employment will always be a moving target. That's why economists typically rely on the unemployment rate as the primary metric for assessing the overall health of the labor market. The unemployment rate measures the number of people who are actively looking for employment as a percentage of the labor force. In a strong economy, obviously, that number will be low. But it will never be the case that literally nobody is unemployed. There will always be people just out of school looking for new jobs or people seeking work after getting laid off—that's the normal process in a dynamic and changing economy like ours. So economists think in terms of a "natural rate" of unemployment, which is the rate consistent with a typical, well-functioning economy over the long term. It's hard to know precisely what the natural rate is, but I put it around 5¼ to 5½%. To put things in perspective, the current unemployment rate of 6.3% is still well above the natural rate. My forecast is for the unemployment rate to gradually decline over the next two years, reaching the natural rate sometime in 2016.

One indication that unemployment is still higher than its natural rate is that growth in workers' pay has been pretty modest. In fact, wage growth has averaged only about 2% over the past few years, and there are few signs of any acceleration in wages. That said, I expect that once the unemployment rate gets even closer to its natural rate, wage growth should pick up.

Now you may be worried that if wages take off that would inexorably lead to higher price inflation. As I said, along with maximum employment, the Fed is charged with achieving price stability, by which we mean an inflation rate that is low and stable, averaging 2% over the longer run. At the moment, the Fed's challenge is that inflation has been well below that 2% rate. We actually need to *increase* inflation a bit, so a pickup in wage growth would help us achieve that. On top of that, faster wage growth puts more money in consumers' pockets, which leads to more spending and a stronger economic recovery.

You may ask, "Why is low inflation a problem?" The full answer to that would take far more time than we have—and not just because economists tend to be long-winded. But one key problem with very low inflation or even deflation—that is, falling prices—is that it increases the debt burden on borrowers by forcing them to repay loans using money that is worth more than they planned on when they took out the loan. (See Bernanke 2002 for an extensive discussion of these issues.) The resulting debt overhang damps the willingness and ability of people and businesses to spend, putting a drag on economic growth.

America's recent bout with low inflation is not unique. Japan and Korea have inflation rates well below their target levels. The countries in Europe that use the euro are experiencing inflation below 1%, and some of them are living through out-and-out deflation.

For the United States and other advanced economies, economic slack is the main culprit behind abnormally low inflation levels. That is, the gap between unemployment and its natural rate or in GDP relative to its potential. Another factor for the United States was lower import prices during 2012 and 2013. We're starting to see a reversal of that trend, with import prices no longer exerting downward pressure on inflation. And as the recovery proceeds and economic slack abates, inflation should gradually move back up to 2%.

Policy options and tools

The ongoing need to reduce unemployment and increase inflation both call for the same medicine: highly accommodative monetary policy. Although the goals and overall direction of monetary policy have been clear, reaching those goals has been far more challenging.

We started with our conventional monetary policy tool, the federal funds rate. That's the rate at which banks lend to each other overnight, and serves as a benchmark for short-term interest rates in general. We lowered the federal funds rate to essentially zero in late 2008, in the throes of the financial crisis, and have kept it there since. We can't move rates much lower than that, and that constraint is referred to as the "zero lower bound." Unfortunately, the severity of the recession called for even greater monetary accommodation than could be achieved by lowering the federal funds rate, and we had to get creative.

We turned to what most people know as quantitative easing, and what we at the Fed refer to as LSAPs, or large-scale asset purchases. We've had three rounds of QE since late 2008, raising the asset side of the Fed's balance sheet to over \$4 trillion. The latest round was announced in September 2012, with a peak monthly rate of purchases of \$85 billion in combined long-term Treasury and mortgage-backed securities. What we sought to do with the asset purchases was lower a wider range of interest rates than we could with the fed funds rate alone. Lower rates translate into more borrowing and economic activity (see, for example, Williams 2014).

You'll sometimes hear people assigning a liberal slant to quantitative easing—but it was actually proposed by Milton Friedman. In 2000, he was asked what more the Bank of Japan could do to combat deflation, since they were constrained by the zero lower bound. Friedman (2000) said, "It's very simple. They can buy long-term government securities." Which is exactly what the Fed has been doing.

Other countries have successfully implemented similar programs as well. The Banks of England and Japan have used extensive asset purchases to improve financial and economic conditions in their countries. The evidence so far is that it's working. In particular, Japan, which had been mired in deflation for much of the past two decades, is seeing positive and increasing inflation.

We started easing off the gas a bit in December of last year. The Fed's monetary policy body, the Federal Open Market Committee, decided that the recovery was far enough along to take the first steps toward ending the process of adding monetary accommodation. This was based primarily on improving conditions in the labor market and the economic outlook.

We agreed to reduce the pace of asset purchases—the “taper” everyone was talking about—by \$10 billion that month, with additional monthly reductions of \$10 billion at the next three meetings. We’re down to \$45 billion for May, and the process of gradual reductions in the pace of purchases will likely continue until the purchase program comes to an end late this year. At this point, it would take a substantial shift in the economic outlook to derail the tapering process.

I say this a lot, because it’s an important message to get across: The taper does not reflect a tightening of monetary policy. We’re not putting out the fire, we’re just gradually adding less and less fuel. It’s just one small step towards policy normalization, when the economy has sufficient heat on its own. A real tightening of policy—which would mean raising the fed funds rate—is still a good way off.

What I just said is part of another unconventional policy the Fed undertook to help combat the effects of the recession: Clearly communicating our expectations about the future path of the fed funds rate. We refer to it as “forward guidance.” We’ve been using FOMC statements, press conferences, and speeches to make it clear that we are going to keep the funds rate low for a significant period, which helps hold down longer-term interest rates as well.

In the past, the FOMC tied the eventual lifting of the funds rate to the unemployment rate—specifically, saying that we wouldn’t raise the rate until unemployment fell below 6.5%. At the time, with 6.5% fairly far off, using a numerical benchmark was helpful to be clear about our policy intentions. But as we got nearer to that marker, things got more complicated. The fundamental truth of monetary policy is that decisions as large as when to raise rates cannot be based on a single indicator. Now that we’ve passed the 6.5% threshold, it’s clear that the labor market is quite a ways from a complete recovery. And in the meantime, the risks to the inflation outlook and financial developments also factor in to decisions.

So after our March meeting, the FOMC made a shift to qualitative, rather than quantitative, guidance. Specifically, the statement said it would base decisions on “a wide range of information, including measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial developments” (Board of Governors 2014).

When the FOMC does eventually begin to raise rates, there will be challenges. Most importantly, the Fed’s highly accommodative stance of monetary policy over the past five years may exacerbate potential risks to financial stability. For example, interest spreads for risky assets such as junk bonds and leveraged loans have grown quite narrow. That suggests that financial market participants who are awash in liquidity may be ignoring or taking on outside potential risks. These narrow risk spreads should be monitored closely, but for the near term, they do not pose a significant threat to the economy or financial system. Similarly, the market for Treasury securities seemed to be getting overly frothy early last year, with unusually low yields. Since then, however, yields have risen on 10-year Treasuries, and other long-term securities such as mortgages are back in better alignment with economic fundamentals.

Another challenge is that raising the funds rate, and the level of other short-term interest rates more generally, will be more complicated given the large amounts of bank reserves. But just as the Fed adapted to the financial crisis and recession by relying on unconventional tools, we have new ways to adapt to normalizing policy. Most importantly, the Fed has conducted extensive tests of a “reverse repo” facility, in which it essentially lends out some of its Treasury securities and absorbs some of the excess liquidity in

the market. This facility and similar tools will enable tighter control of short-term rates when the economic recovery is strong enough to bring monetary policy back to normal.

Conclusion

To sum things up: As the outlook continues to improve, the Fed is taking the first steps towards normalization. The process will be gradual; it is not set in stone; and the Fed will respond flexibly to economic developments. But barring any major shocks, monetary policy is finally on the road to normal. And simply put, that's good news.

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