Economic Conditions and Conditionality

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Introduction
Thank you for the invitation to speak to the CFA Society of Iowa this evening. I always look forward to having an opportunity to share my views on the economy and monetary policy. In return, your feedback is of great help to me when shaping my thinking about the economy, and I look forward to hearing your comments and answering your questions at the end of my prepared remarks.

Tonight I'm going to talk about my outlook for the economy. I'll also explain how monetary policy supports the improvements I expect to see. Before I begin, though, I would like to remind you that the views I express are my own and do not necessarily represent those held by my colleagues on the Federal Open Market Committee (FOMC) or within the Federal Reserve System.

Outlook: The Pace of Economic Growth Should Accelerate
Let me begin with my outlook for the economy. Needless to say, the pace of growth coming out of the Great Recession of 2008 and 2009 has been disappointing, and the recovery certainly continues to face important headwinds. Nonetheless, I am cautiously optimistic about the future. An important reason is that I think we have the appropriate monetary policies in place to help the recovery reach escape velocity. So, after rising a disappointing 1-1/2 percent in 2012, real gross domestic product (GDP) should increase in the range of 2-1/2 to 3 percent this year and then grow between 3-1/2 and 4 percent in 2014, according to my forecast. This growth ought to be sufficient to bring the unemployment rate close or maybe even a little below 7 percent by the end of next year.

This outlook hinges critically on continuing our current highly accommodative stance for monetary policy. Of course, one aspect of that accommodation is the exceptionally low level of our primary policy tool, the federal funds rate. But there are two other important tools I would like to highlight. One is the open-ended large-scale asset purchases (LSAPs) we currently are undertaking. Each month, we are buying $85 billion of mortgage-backed securities and long-term Treasury securities. These purchases are open-ended, meaning that the program will continue until the FOMC is highly confident that we are seeing a substantial improvement in the outlook for the labor market, which is both a prerequisite to and an indication of a broader, self-sustaining recovery. The second tool is our forward guidance about the fed funds rate—that is, our commitment to leave the rate at essentially zero until adequate progress is made toward economic recovery.

Now, in one form or another we've had a commitment keep the fed funds rates low for some time now. First, the statement used words to say that we thought economic conditions would merit keeping the funds rate exceptionally low "for some time." Then we switched to giving a calendar date through which we expected it would be appropriate to hold the funds rate at zero. Finally, at the FOMC meeting this past December, we made an important change when we linked the possible timing of the first increase in the funds rate to specific economic conditions. Namely, we committed to keeping rates near zero at least as long as unemployment remains

above 6-1/2 percent, provided that inflation projections over the medium term remain less than 2-1/2 percent.

Numerical Thresholds: An Important New Feature of Monetary Policy
Why change to this type of conditionality? The Federal Reserve has a dual mandate to foster financial conditions that help the economy achieve maximum employment and price stability. Progress toward our dual mandate goals is measured by the state of economic conditions, not calendar time. So our policy position should also be dependent on economic conditions, rather than a calendar date.

Unforeseen events always prompt us to reassess and revise our forecasts for economic activity and inflation and hence, the time when we would expect to reach a threshold. In turn, these events should also automatically move the expected date for the liftoff in policy. For example, in my current forecast, I expect the economy will hit the 6-1/2 percent unemployment rate threshold in mid-2015. But suppose we had some pleasant surprises that led the economy to progress faster than I currently expect; well, we would then hit 6-1/2 percent unemployment at an earlier date, and if the inflation outlook was not uncomfortably below 2 percent, we could begin increasing rates. There would be no change in the economic conditions governing the liftoff in rates, only in the timing of when those conditions are met. Accordingly, there also would be no change in how long exceptional monetary accommodation was provided relative to the state of the economy.

This last point relates to another important feature of the economic conditionality in our policy. The thresholds for increasing the fed funds rate were chosen so that rates will remain near zero even after the recovery becomes more firmly entrenched. This delay is a feature of what modern macroeconomic theory tells us is the optimal policy response to the extraordinary circumstances we have faced over the past four years. Given the weak state of the economy, we would have liked to take policy rates negative. Of course we can’t do that; so, instead, the federal funds rate has been stuck at zero since December 2008. Because of this constraint, theory says that a central bank should promise that even when economic activity recovers, it will hold rates below what they typically would be for some additional time. This makes up for the period of time when we could not drive rates negative. In other words, by postponing the time of policy liftoff, the average path for rates is closer to being right over time.

Economic Conditionality in Our Asset Purchases
Let me return now to the first policy tool I mentioned: our open-ended large-scale asset purchase (LSAP) programs. This is another conditional policy. Originally, our LSAP programs bought predetermined quantities of Treasury securities and mortgage-backed securities over a fixed period of time. Their aim was to put downward pressure on longer-term interest rates by lowering the term premiums. Last September, we began a new program of open-ended asset purchases. The important new aspect of this program is that the length of time over which we will buy assets is tied to economic outcomes. In particular, the purchases will continue until there is substantial improvement in the outlook for the labor market, subject, of course, to a continued environment of price stability. To me, this means job growth of around 200,000 per month over a six-month period. However, that alone is not sufficient. We also need to see output growth above potential reinforcing that job growth; together, these improvements also ought to lead to a steady decline in the unemployment rate.

Policies Are Working
Today, we are seeing evidence that our accommodative policies are working. Financial markets recognize that low returns on the safest fixed-income assets are an economic reality that will

continue for a long time. Not being satisfied with these low returns, investors are repositioning into other asset classes that will more directly bolster spending. The stock market has rebounded significantly and is back near its pre-recessionary level. In an encouraging development, commercial and industrial lending by banks is picking up while their credit terms, which had been quite restrictive during the recession, are easing. Indeed, from a variety of sources, markets are increasingly channeling money to promising projects that had previously lacked funding.

Accommodative monetary policies also are supporting some more-familiar cyclical recovery mechanisms that lead to a virtuous cycle of growth in economic activity. Although bottlenecks certainly remain for many households (particularly those whose home mortgages are under water or those that have imperfect credit scores), low mortgage rates have facilitated a pickup in refinancing and a slow but steady rise in new residential construction. Some further increase in demand will spill over from the improvement in housing markets, coming in the form of higher demand for construction materials and appliances. Furthermore, for years now, consumers and businesses have made do with old household durable goods and capital equipment, and there likely is much pent-up demand for replacing such items with new ones. Low interest rates are helping to support some pickup in this demand to replace old items; for example, I've heard from several carmakers how low-interest financing has contributed to an improvement in auto sales.

In general, low rates have helped many households and businesses pare debt burdens and restructure their balance sheets. This has particularly been true for businesses with access to the bond market. And so today many firms have plenty of cash on hand and are well-positioned to ramp up activity when more and more customers show up at their doors.

Now, all investment projects carry some degree of risk. And so, by their very nature, increased lending and investment activity entail some economic players taking on greater risk profiles. But this is not a bad thing per se. In fact, it's a normal channel through which accommodative monetary policy encourages better growth during a recovery from a period of economic weakness. And I believe what we are seeing today is such a restoration of a more balanced approach to risk-taking after an extended period during which a heightened sense of precaution meant that many promising ventures were left unfunded.

Of course, there is no easy way to measure when markets are underpricing risk or when such mis-valuation poses a meaningful threat to financial stability. To date, concerns about a degree of froth in the financial markets that would pose a significant risk at the macroeconomic level seem to me to be largely speculative. However, one result of the financial crisis is that we at the Federal Reserve are much more attuned to monitoring financial markets, risk pricing and potential stress points in the financial system. We will continue to monitor the situation closely. Indeed, with the work being done by the new Office of Financial Stability Policy and Research (OFSPR) at the Board of Governors and the increased efforts by the regional Reserve Banks, the Fed is devoting significantly more resources to assessing financial conditions. I would note that if we do find significant stresses, the Fed has a number of macroprudential tools, such as supervisory approval of capital plans, to shore up potential sources of weakness by using a targeted approach. And I would favor the use of these tools when and where they are appropriate.

Restraints on Growth

As I weigh the most recent data, I believe that there are many reasons to be optimistic. Nevertheless, I am mindful of the significant risks to the outlook that remain, emanating from both here and abroad.

Domestically, although the immediate threats from the turn-of-the-year fiscal cliff were avoided, there still are many issues to resolve regarding the course of government spending and tax policy. The present projected path for federal debt is not sustainable and needs to be addressed. But this should be done carefully over time, and not front-loaded on an economy that is less than robust. Current estimates of the economic drag in 2013 coming from fiscal consolidation without the sequester are on the order of 1 percent, and I am concerned about the risk that Washington might jam the recovery at the line of scrimmage by piling some more unhelpful near-term fiscal restraint on top of this already sizable effect.

Overseas, our trading partners confront their own economic and financial difficulties. The eurozone currently is in recession, and the most recent International Monetary Fund (IMF) forecasts look for only modest growth during 2013 as a whole.[1] While Europe has made strides in reducing immediate financial tail risks, other downside risks remain. The eurozone's peripheral countries must still overcome the fundamental problem of their lack of competitiveness. To do so while remaining in the common currency zone of the euro requires difficult and painful adjustments. Much hard work has been done, but there is more to go.

In Asia, growth in China appears to be gaining momentum after slowing down somewhat last year. But analysts are not forecasting a return to the heady double-digit growth rates China experienced a few years ago. Furthermore, emerging market and other export-oriented economies can't be counting on a huge rebound in demand from the advanced economies of the world. Notably, the U.S. consumer is no longer in a position to be the engine of world growth. The demands of reducing high levels of federal government debt while also providing funding for future retirees will require lower consumption. Consequently, foreign economies that currently are largely export-driven will need to find more internal sources of growth.

Inflation Risks Are Low

I've spent a lot of time this evening talking about economic growth and monetary policy. But I have barely mentioned inflation. I assure you that this is not because I think inflation is unimportant. On the contrary, as a central banker, I am committed to our goal of price stability, and so I evaluate the outlook for inflation carefully in gauging monetary policy. That is why I see the 2-1/2 percent inflation threshold in our forward guidance as an appropriate safeguard against the possibility that our current policies might generate unwanted inflation.

However, I see high inflation as quite unlikely under the unusual circumstances we face. Currently, inflation is running a bit below 1-1/2 percent. This needs to be measured against the FOMC target for inflation of 2 percent.[2] I expect inflation to move up some with the improvements in the real economy, but I also see a risk that it will remain below 2 percent for the next several years. There are no cost pressures to speak of. In particular, wage growth and increases in unit labor costs have been quite modest. And inflation expectations have remained

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[1] The International Monetary Fund forecast is for the eurozone's GDP to increase 0.5 percent between 2012:Q4 and 2013:Q4; this follows an estimated 0.7 percent decline in output over the four quarters of 2012. See International Monetary Fund, 2013, *World Economic Outlook Update*, Washington, DC, January 23, available at www.imf.org/external/pubs/ft/weo/2013/update/01/pdf/0113.pdf.

[2] The Committee judges that inflation at the rate of 2 percent, as measured by the annual change in the price index for personal consumption expenditures, is most consistent over the longer run with the Federal Reserve's statutory mandate.

well anchored—if anything, they are helping prevent inflation from falling even further below our 2 percent target.

This subdued outlook for inflation means that as economic growth improves, we are likely to hit our unemployment threshold before we hit our inflation threshold. This returns me to an important point I alluded to earlier: Our contingent policy does not mean that once we see unemployment below 6-1/2 percent, we will automatically begin to raise short term rates. Six-and-a-half percent is a threshold and not a trigger. It also is above the 5-1/4 or 5-1/2 percent rate that I think is the long-term equilibrium rate of unemployment. Generally, because of the time it takes for policy to affect the economy, we would want to begin to remove accommodation before we reached 5-1/2 percent unemployment. So 6-1/2 percent probably would be a good spot. But suppose we reach that threshold and the outlook for inflation is uncomfortably below 2 percent. Then I believe that it would still be appropriate to keep the funds rate at an exceptionally low level. The extra accommodation would serve two purposes—enabling further reductions in the unemployment rate more quickly and restoring inflation to our longer-run target.

Conclusion

I am optimistic that we have appropriate policies in place to help the economy achieve escape velocity by 2014. Even so, there remain plenty of headwinds and downside risks that can impede our progress. Our numerical thresholds go a long way in lessening policy uncertainty. Households and businesses can now base their spending decisions on clearer information about how long interest rates will remain at their current low levels. But we need to be careful not to undermine our own policies and remove accommodation prematurely, as the Japanese did. It is the specter of repeating the Japanese experience that now keeps me up at night. Mindful of this danger, we must guard against complacency and not deviate in our approach.