Are We There Yet?

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Introduction

Good morning. Thank you, John, for that kind introduction and the invitation to speak as part of the AgFirst Summit Meeting this week. It's always a pleasure to return to South Carolina.

Before I begin, let me say that the views I express here are my own and do not necessarily reflect the views of my colleagues on the Federal Open Market Committee (FOMC) or within the Federal Reserve System.

The mission of the Federal Reserve is to foster conditions in the economy that support maximum employment and price stability. Since the beginning of 2008, that mission has been put to the test as the country struggled through a very serious financial crisis, a two-year recession and what, so far, has been a most unsatisfying recovery. In response, the Fed has acted decisively to provide extraordinary monetary policy accommodation to help the economy regain its footing.

Almost five years ago, we reduced our short-term policy rate to zero, and since then, we have repeatedly indicated that this low short-term interest rate will continue for a very long period of time. We also have undertaken a series of large-scale asset purchase (LSAP) programs — including our open-ended quantitative easing (QE3) program that is still in progress.

These initiatives have resulted in the Fed's balance sheet increasing from $800 billion in August 2007 to more than $3.5 trillion today.

Notwithstanding the Fed's policy responses, many are still concerned that the economy has not yet arrived at a path to sustainable growth. This begs the question, "Are we there yet?" and the inevitable follow up, "If not now — when?"

In the face of substantial economic headwinds over this period, the FOMC has taken aggressive monetary policy actions, which have been aimed at shortening our country's long period of unacceptably high unemployment and at getting our current low rate of inflation back up toward our long-run objective of 2 percent. There is significant evidence that our policies have helped a great deal, and this is part of the reason that I have a relatively optimistic forecast. Namely, I expect that by 2014, economic growth will pick up to a pace of better than 3 percent and that inflation will be moving back toward our 2 percent target.

Now, having presented this background and recognizing the financial sophistication of this audience, I can imagine a few questions that are on your minds.

How much longer will the Fed continue with QE3 purchases?

How large will the Fed’s balance sheet become by the time these asset purchases end?

And will the balance sheet ever shrink?

Well, some days I wish that questions like these could be answered with a firm date, a single number and a confident “yes,” accompanied by a fist pump. Unfortunately, the answer to the first question is not as simple as giving a calendar date. Instead, uncertainty over the pace of the recovery means all of this depends on the progress that the economy makes toward our goals of maximum employment and price stability. In my view, this means continuing our current QE3 asset purchase program until three conditions are met. First, the unemployment rate must be in the vicinity of 7 percent with expectations for it to continue falling in a self-sustaining fashion. Second, other important labor market indicators must show a commensurate improvement. And third, we must have considerable confidence that inflation is moving back toward our target of 2 percent. Currently, my best assessment is that by the time these conditions have been met, our QE3 asset purchases since January of this year will total at least $1.25 trillion. By comparison, that would be twice the size of our QE2 purchases made in 2010 and 2011. This would mean that our System Open Market Account (SOMA) balance sheet will reach approximately $4 trillion.

Once our monthly QE3 flow purchase rate is substantially reduced and we approach the $4 trillion SOMA mark, the composition and efficacy of our policy tools will shift more importantly to our forward guidance regarding to the federal funds rate. We have said we will keep the funds rate at zero at least until the unemployment rate is 6-1/2 percent, so long as the outlook for inflation remains below 2-1/2 percent over the medium term. Now, 6-1/2 percent is a threshold, not a trigger; even after reaching this threshold, if the outlook for growth is not consistent with further improvements in labor markets or the outlook for inflation is too far below 2 percent, we would likely delay increasing rates even longer.

OK, I have done my best to provide you with my central banker responses. How long will QE3 last? It depends on the data. Of course, the person on the street would prefer a time, date and place. When, in calendar time, do I see these economic conditions being reached? For asset purchases, my current forecast has that occurring sometime in mid-2014. For the interest rate thresholds, my outlook is for the unemployment rate to be 6-1/2 percent sometime in early to mid-2015. But I also think there is a very good chance that at that time inflation will still be far enough below our 2 percent target that it will be appropriate to wait longer before increasing the funds rate; currently, I think it’s more likely that conditions for the first funds rate increase will be met in late 2015.

Of course, these are just some possibilities. Is it possible that it might be appropriate to end QE3 earlier? Yes — absolutely — if the labor market improved faster and that was supported by stronger growth. Under these conditions, if the unemployment rate fell to 7 percent by December 2013, labor force participation was healthy and inflation was running higher than today, then I would endorse a quicker end to our asset purchases.

This would be an excellent outcome. But my current optimism does have its limits. So let me turn now to a broader discussion of my economic outlook.

Mixed News on Economic Activity

Since we began our open-ended approach to asset purchases last September, the labor market has definitely improved. When we initiated that program, the available data showed the unemployment rate at 8.1 percent and job growth over the previous three months averaging 135,000. Since then, the unemployment rate has fallen to about 7.5 percent and job growth has averaged around 192,000 per month. These are certainly important positive developments. Still, the U.S. economy has a long way to go to return to healthy normalcy. The unemployment rate is well above the 5-1/4 to 6 percent range that covers most FOMC participants' views of its long-run normal level. Payrolls remain on the order of about 5 million below where they should be. In addition, an unusually high number of productive, potential workers are not even looking for jobs right now. In economist-speak, the labor force participation rate is quite low, and I should note that this is true even after accounting for structural factors such as the aging of the baby boomers and other long-run trends that are holding down the rate.

While the labor market has been improving since last fall, overall growth in production and spending has been quite modest. Over the past three quarters real gross domestic product (GDP) has grown at an annual rate of around 1-1/4 percent. The higher income tax rates and the end of the 2 percent payroll tax holiday, which went into effect at the beginning of the year, are holding back household spending. Furthermore, some households are still coping with the effects of lower house prices and the erosion in their stock market wealth that occurred during the recession. With only modest demand from consumers, businesses have not been eager to add to capacity. Additionally, fiscal expenditure restraint — which, of course, includes mandatory sequestration — is also weighing on spending. And international growth appears likely to remain on the soft side, holding back demand from abroad for U.S. goods and services.

Given this economic setting today, how soon before we can grow our way out of this slow recovery? This has been the ongoing dilemma for four years running. In 2009, I predicted that growth would pick up. I did the same in 2010, 2011 and 2012. And I was not alone — most FOMC participants and many outside analysts shared this overly optimistic view. Undaunted, I make my intrepid forecast: I anticipate growth to average about 2-1/2 percent in the second half of the year and to be in the neighborhood of 3 percent next year. I expect the unemployment rate to be somewhat below 7 percent by the end of 2014.

Given our collective difficulties and the downbeat description of growth over the past few quarters, you might well ask why is this year's projection going to be more accurate.

The principal reason is that the economic fundamentals are much improved. The cyclical repair process is well under way. Although many households are still distressed, the housing sector as a whole is much better off than it was earlier in the recovery. Housing prices have risen noticeably over the past year.[1] The number of mortgages underwater is down from 12.1 million in early 2010 to 9.7 million in the first quarter of 2013.[2] Equity markets have largely recovered and are now around 5 percent above their pre-recession peaks. After several years of restraint, there is pent-up demand for consumer durables. Businesses that had generally delayed capital expenditures are in a relatively favorable position today to finance these outlays. Most big businesses' balance sheets are in good shape, and surveys show that fewer small businesses see access to credit as a major concern and that there has been an increase in demand for loans from small firms.

Another factor behind my forecast is that it appears there will be less fiscal restraint in 2014 and 2015. Specifically, fiscal restraint will still have a negative impact on GDP growth, but it is expected to be smaller for the next few years. The tax hikes that occurred at the beginning of this year won't be repeated in 2014. Furthermore, under current law, much of the impact of the sequester on government spending occurs in 2013; so, fiscal reductions in the next few years will be smaller, and the negative impact on growth will be less.

Thus, the stage is set for what we economists like to refer to as "virtuous cyclical dynamics." Continued growth in jobs and income as well as greater confidence in the labor market will lead to higher household spending. As firms see actual demand rising, they have an incentive to expand capacity, undertake previously delayed capital expenditures and increase hiring. This then further improves the well-being of households and continues the self-reinforcing virtuous cycle. One challenge to this self-reinforcing mechanism is that there is a chicken-and-egg problem: Who will start this first? In order to dramatically increase households' spending, they need more employment and income certainty. To expand businesses' hiring, they need more customers walking through their doors. Who will first ratchet these spending cycles up to the next level?

The process is more likely to get rolling if the economy experiences more positive impetuses and fewer negative jolts. And, indeed, there are a number of downside risks that could produce such jolts. The U.S. fiscal situation has not been fully resolved. It is possible that Congress will enact further belt-tightening measures, which would further depress growth over the next year. Although Europe may finally be in recovery mode, the outlook for growth there is still weak and the level of activity remains substantially below the previous business cycle peak. Furthermore, growth in emerging market economies has slowed. It's difficult to gauge how structural transformations in China and developments in other emerging markets will affect overall world growth over the next few years. These downside risks take on greater prominence when we consider them in the context of weaker U.S. consumer demand. For most of the past 15 years, the American consumer has been the strongest engine of world growth. However, that American consumer has been knocked down several rungs. In order to speed up the economic recovery across the globe and in the U.S., someone else needs to step up to fill the gap left by reduced American consumer demand. If 2014 U.S. growth comes in at a lackluster pace or worse, I expect that one or more of these downside risk story lines will be the culprit.

Inflation Is Running Low

What about inflation? Providing financial conditions that deliver low and stable inflation is an important part of the Federal Reserve's dual mandate. However, recent inflation data have been unusually low and well below our 2 percent long-run objective. Low wage growth and low interest rates are other indicators that confirm our low inflation experience. To many Fed critics, this low inflation environment has been a big surprise.

Let's think back about five years. Recall that in December of 2008, we had brought the federal funds rate down to zero, as low as it can go. In November 2008 we had embarked on our first asset purchases, which we then expanded in March 2009 to a $1.75 trillion asset program. When we took these measures, many critics claimed that the U.S. was headed for double-digit inflation. I'm from Chicago, home of the well-known monetarist Milton Friedman. Some of the critics invoked his name when issuing warnings that with this kind of balance-sheet growth, inflation will surely come soon! Actually, a couple of nice folks mailed me worthless $100 trillion Zimbabwe notes to warn me of the inflationary consequences of our policies.

What a difference a few years makes. As I mentioned before, instead of skyrocketing, inflation now stands at 1-1/4 percent, which is 3/4 percentage points below our long-run target of 2 percent. Indeed, it has averaged well below 2 percent since this all began back in 2007. Inflationary expectations have not risen at all. And there are simply no signs of cost pressures building. Most importantly, wage growth has been quite modest and there is no evidence of labor cost pressures. Without rising labor costs, a 1970s-style cycle of price increases cannot be sustained. That would be a set of price increases feeding through to higher wages that then again fuel further price increases, and the wage–price spiral would continue.

Incidentally, despite what some of the critics have said, this benign outcome for inflation is actually quite consistent with my reading of Milton Friedman's analysis. The measures of money he associated with inflation were broad measures that include money created by the banking system. The increases in those measures have been much more moderate. One of the big points from his *Monetary History of The United States*,[3] which Friedman wrote with Anna J. Schwartz, was that focusing too much on the size of the Fed's balance sheet was a bad idea. Indeed, in the early 1930s, the Fed increased the size of its balance sheet quite substantially. But it wasn't enough. Given the struggles of the banking system, broad measures of money actually declined, leading to deflation. The Fed needed to have increased its balance sheet even more. That's a lesson we've taken to heart this time around.

Inflation falling below our target of 2 percent is costly. If inflation is lower than expected, then debt financing is more burdensome than borrowers expected. Problems of debt overhang become that much worse for the economy. This is a symmetric problem: If inflation is higher than expected, lenders are disadvantaged. So, that is why it is important for the Fed to provide for inflation that averages over time to our 2 percent long-run objective.

I see us making gradual progress in returning inflation to 2 percent over the next few years. However, in the near term, inflation appears to be held down by some temporary factors, such as the effect of the sequester on Medicare payments and some unusually low readings for some components of the Personal Consumption Expenditure Price Index for which prices are measured indirectly. That said, these aren't a big part of the story. More importantly, as the real economy improves, the large resource gaps we have will close. Sustained over time, this closing of gaps will feed through to higher wage and price growth. Also, inflation expectations are well anchored and above the current inflation rate and, thus, provide another upward pull to prices. However, it could take a long time for us to return to our 2 percent inflation objective, and I will be monitoring our progress closely when making my decision about appropriate monetary policy.

Continued Monetary Policy Accommodation Is Necessary

This brings me to an important point about my relatively upbeat projections for both growth and inflation — and returns me to the issues about policy that I opened with here today. These forecasts are based on the assumption that we will continue to provide the economy with substantial monetary policy accommodation. With our traditional instrument for conducting monetary policy, the fed funds rate, effectively at its zero lower bound, this accommodation now takes the form of our forward guidance about what we will do with the funds rate in the future and our open-ended purchases of longer duration assets.

Forward guidance refers to the conditions under which we will begin to raise the fed funds rate that I talked about earlier. Namely, the FOMC has said that the current fed funds rate will be appropriate at least as long as the unemployment rate remains above 6-1/2 percent, inflation between one and two years ahead is projected to be no more than 2-1/2 percent and longer term inflation expectations continue to be well anchored. An important feature of this policy is that it holds rates lower for longer than we normally would if the funds rate had not been stuck at zero. We would have liked to lower the funds rate further over the past four-and-a-half years, but we couldn't. The forward guidance says we will make up for that lost time. In other words, by postponing the time of policy liftoff, the lower path for rates generates an average path that is closer to what would have been selected if lower and negative rates had been possible.

Our asset purchases of U.S. Treasuries and agency mortgage-backed securities (MBS) provide additional accommodation by further lowering longer term interest rates. They also serve as an important communication device in reinforcing our forward-guidance commitment to maintaining low interest rates into the future.

Low interest rates provide a necessary support for economic activity at this stage of the recovery. Think about some of the better fundamentals for the economy that I discussed earlier. Lower mortgage rates have allowed qualifying households to refinance at very favorable rates. And more households are "in the money" for refinancing as lower interest rates help support higher house prices. I continually hear from automakers how low financing rates have helped boost motor vehicle sales, which are getting within shouting distance of their pre-recession levels. On the business side, companies with access to bond markets have been able to restructure into substantially lower cost debt. With lots of cash and lower debt-service burdens, they are well positioned to increase capital spending and hiring when they decide to do so. And even small businesses face a more attractive borrowing environment than they did earlier in the recovery.

Continued monetary accommodation also is key to my forecast that inflation will gradually return to 2 percent. Part of the effect comes through the reduced resource gaps engendered by higher growth. Part of it also comes through a signal to markets of our commitment to achieving our inflation target of 2 percent. With enough accommodation, monetarist arithmetic will eventually gain traction and inflation will rise to meet our target. But it could take time.

Monetary Policy Is Data Dependent

As I noted in the introduction, adjustments to asset purchases and changes in the federal funds rate will depend on the data; we are not on a preset course.

I do expect, however, that the outlook will materialize in such a way that we'd likely reduce the LSAP rate starting later this year and subsequently wind down these purchases over a couple of stages. For me, to start the wind-down, it will be best to have confidence that the incoming data show that economic growth gained traction during the third quarter of this year and that the transitory factors that we think have held down inflation really do turn out to be transitory. I'd note, too, that the exact pattern of the reduction in purchases that we eventually take isn't so critical because the path is likely to have only a marginal impact on what is important — the total amount of purchases that we eventually get to. As I mentioned earlier, under my current forecast, total asset purchases since January 2013 would be in the neighborhood of $1.25 trillion. This is a very substantial program — one that is about double the size of our QE2 program that we ran between the fall of 2010 and the summer of 2011.

Furthermore, when we ultimately end the current purchase program, we won't be doing anything to reduce the balance sheet. Even though it will no longer be expanding, the balance sheet won't actually begin to shrink until sometime much later when we make the decision to stop reinvesting maturing assets. Even then, it will only gradually decline as assets mature. As you may recall, Chairman Bernanke announced at his June press conference that it was most likely that the FOMC would simply let the MBS on our books run off and not actively sell them during the period of policy normalization. Accordingly, our expanded balance sheet will be providing accommodation for a long time after we have ceased adding assets to our portfolio.

Similarly, our policies with regard to the federal funds rate will depend on the course of the economy. I want to reiterate the point that the Chairman and other members of the Federal Open Market Committee have made recently and that I talked about in the introduction. The unemployment rate hitting 6-1/2 percent will not automatically result in an increase in the federal funds rate. When we cross the 6-1/2 percent unemployment rate mark, we will closely evaluate the available information. When evaluating policy, we will take into account a couple of basic principles. One is that our 2 percent inflation goal is a symmetric target, not a ceiling — we're shooting for inflation to average 2 percent over the medium term, not for it to go no higher than 2 percent. Since we have averaged well below 2 percent for several years, there is no urgent inflation risk as long as inflation expectations remain anchored near 2 percent. Another principle is that when setting policy, we will take a balanced approach to achieving our dual mandate objectives. These principles will govern our judgment of whether or not it will be appropriate to raise the funds rate when we hit an unemployment rate of 6-1/2 percent.

Suppose the unemployment rate reached 6-1/2 percent and inflation were 1-1/2 percent. One-and-a-half percent strikes me as much too low relative to our 2 percent target, especially since inflation has been running below 2 percent for quite a long time. I think that in this situation, it would be appropriate to hold the funds rate at zero to get inflation confidently moving back up toward 2 percent. I can easily envision certain circumstances in which the unemployment rate could go below 6 percent before we moved the funds rate up.

Conclusion

As we move closer to the time when we begin to pare back the flow of additional accommodation and contemplate eventually returning to a more normal monetary policy environment, the need for clear and effective communication is essential. In answer to the question of are we there yet, I decidedly say no. It is not yet time to remove accommodation. I expect our policies to remain highly accommodative for some time to come. My colleagues on the FOMC and I have laid out certain markers that should help gauge the timing of when we will begin to change the stance of policy. When those markers are reached, we will carefully weigh incoming data to determine if we can improve economic activity and bring inflation in at our 2 percent objective.

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[1] The Federal Housing Finance Agency's (FHFA) Quarterly House Price Purchase-Only Index.is 7.2 percent higher than in the second quarter of 2012. By comparison, the S&P/Case-Shiller Home Price Index shows a 10.2 percent increase for the first quarter of 2013 relative to a year earlier.

[2] CoreLogic (2013); note that changes in methodology by CoreLogic in 2011 may affect comparisons to earlier numbers. See also Timiraos (2013).

[3] See Friedman and Schwartz (1971).

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