Economic Outlook and Policy

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I'm delighted to be here today to share with you my thoughts on the economy and offer my perspective on monetary policy. Before I proceed further, let me stress that I will be sharing my personal views with you, and not necessarily those of my colleagues on the Federal Open Market Committee or the Federal Reserve System.

With four quarters of positive growth under our belt and employment beginning to rise, the economic recovery from the recession that ended in June 2009 is certainly underway. However, the pace of recovery in both output and employment has slowed recently. Real GDP (gross domestic product) rose at an annual rate of just 1.7 percent in the second quarter, down markedly from 3.7 percent growth in the first quarter. I expect slightly stronger growth going forward — in the range of 2.0 to 2½ percent in the second half of the year, and 3.0 to 3½ percent next year.

This is a quite moderate pace of growth given the severity of the recession we experienced and in comparison with the economy's potential growth rate. We need stronger growth for some time before we return to a more normal level of economic activity.

Notably, at 9.6 percent in September, the unemployment rate remains well above the level I consider to be consistent with the Fed's mandate of maximum employment. To bring the unemployment rate down substantially, the economy needs to grow substantially above the potential rate. But given my outlook for only moderate growth over the next two years, I don't see unemployment falling below 8 percent by the end of 2012.

Perhaps slower job growth is a new feature of recoveries. Following the two prior recessions, many measures of economic activity showed improvement well before the unemployment rate started to decline. But, in the current environment, slow job growth is symptomatic of a generally weak recovery.

To offer some perspective, let me remind you of the aftermath of the deep 1981 to 1982 recession. In the eighteen months following that recession, growth averaged nearly 8 percent and the unemployment rate declined by 3½ percentage points. In contrast, after 15 months of recovery from the recent recession, growth has averaged only 3 percent and the unemployment rate is only marginally lower than at its peak of 10.1 percent in the fall of 2009. Even after more solid growth materializes, unemployment will likely remain stubbornly high. Discouraged workers will resume searching for jobs, adding to the large number of those already looking for work. Furthermore, the number of long-term unemployed is extremely high, and such workers typically have a more difficult time finding a job.

The housing market will also be a factor constraining employment gains by reducing the mobility of homeowners who owe more on their home than it is worth. New construction and home sales remain well below their historical averages; and, supply and demand conditions could continue to weigh on real estate markets for some time. Low mortgage rates and more attractively priced homes suggest housing market conditions will get better as we move further into the expansion, but improvement is likely to be only gradual.

Recently, many observers have questioned what more monetary policy can do to address the very high unemployment rate. Some have suggested that the financial crisis and the accompanying recession precipitated structural change in the demand for labor, raising the economy's natural rate of unemployment. They suggest that it has become significantly more difficult to match job seekers with job vacancies over the past two years. If this is true, then monetary policy is not the appropriate tool to address the ramifications of such a change. If, however, structural factors can only explain a modest part of the rapid rise in unemployment, then monetary policy may be able to play a more constructive role.

There are reasons to think that the natural rate of unemployment has indeed risen over the last couple of years. The extension of unemployment insurance benefits during the recession helped to cushion unemployed workers from the adverse effects of lost income. But it also might have reduced the incentive for some workers to seek out new employment, or kept others from leaving the labor force. It is also conceivable that the recession affected different regions and sectors of the economy unevenly or severed an unusually large number of long-term employment relationships, factors making for an especially difficult transition for affected workers.

The historical relationship between unemployment and job vacancy rates is a useful tool for addressing this issue.[1] When labor markets are functioning well, an increase in job openings is accompanied by a decrease in unemployment. It has only been since the beginning of this year that we have seen an improvement in job openings that was not matched by a correspondingly large reduction in unemployment. Based on this, some have suggested that most of the increase in the unemployment rate over the past two years is due to a mismatch between the skills of the unemployed and those needed by employers.

However, there are problems with this view, including the dearth of sectors reporting strong demand for hard-to-find skilled workers and the continued presence of disinflationary pressures that we would not expect to observe if the natural rate were higher and resource slack were smaller. Even if we take the job vacancy data at face value, the size of the deviation from its historical relationship with unemployment is not large enough to suggest an increase in the natural rate to anything like the current rate

[1] This relationship is often referred to as the "Beveridge curve."

of unemployment.[2] Therefore, the 8 percent unemployment rate I expect to see by the end of 2012 still leaves us with a very large amount of resource slack.

At the same time, measures of consumer price inflation continue to under-run the 2 percent level that I consider consistent with price stability. With inflation expectations stable, inflation is likely to remain below desirable levels for some time. It is not unreasonable to expect 1 percent inflation in 2012. Unless the actual conditions turn out to be very different from my forecast, inflation of less than 1½ percent in 2013 is a strong possibility.

The magnitude of resource slack, combined with the fact that inflation has been running below the level I consider consistent with long-term price stability, suggests to me that it would be desirable to increase monetary policy accommodation. Normally, this would involve lowering the target federal funds rate based on the economic outlook and the historical relationship between policy actions and their impact on the economy.[3] However, at roughly zero, the fed funds rate is as low as it can go. As a result, the current economic environment poses unusual challenges for policymakers.

A key aspect of the current situation that concerns me is the growing evidence that we are in what economists call a "liquidity trap." In a liquidity trap, the supply of savings continually outstrips the demand for investment, but interest rates near zero can't fall to equate supply and demand. Liquidity traps are exceedingly rare. The last time the U.S. economy was in a liquidity trap was during the Great Depression, some 80 years ago.

There's a lot of evidence that we're in a liquidity trap. Despite the accommodative stance of monetary policy, the amount of credit flowing to households and businesses has yet to expand. Undoubtedly, some of the decline in lending reflects tighter lending standards. However, standards for most loan types are no longer tightening, and anecdotal evidence suggests that credit is more readily available.

Rather, it seems to me that part of the reason for sluggish credit flows is that businesses aren't particularly interested in increasing spending. As I assess the incoming data and talk to my business contacts, the impression I get is that executives are very cautious in their outlook and spending plans. They appear to be content to post strong profits generated by unprecedented cost-cutting, rather than grow their top-line revenues by expanding capital investment and hiring. Even after substantial improvement in financial conditions, firms are sitting on the cash generated by profits and the funds raised in capital markets. Some of our business contacts explain their reluctance to invest by pointing to uncertainties raised by regulatory actions and government policies. Yet, most admit they would increase spending if demand were stronger.

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[2] Making some plausible assumptions, my staff estimates that the level of unemployment consistent with recent data on job openings taken from the U.S. Bureau of Labor Statistics Job Openings and Labor Turnover Survey is likely to be between 6 and 7 percent.

[3] A convenient summary of this relationship is given by the "Taylor rule," first expressed in Taylor (1993) and later developed further in Taylor (1999).

To be certain, some forms of business spending are already reviving. Inventory rebuilding contributed strongly to growth in previous quarters; but this process is nearing an end, as firms have made substantial progress aligning inventories with sales. Business fixed investment also increased at a solid pace earlier this year, with firms upgrading IT systems and replacing capital equipment in order to maintain competiveness and profitability. Recent data, however, suggest that the surge in replacement demand is beginning to subside. Absent further improvement in consumer demand, business spending is likely to be more moderate going forward.

Consumers also remain reluctant to spend, adding to their savings nearly in proportion to increases in disposable income. The personal savings rate in August, at 5.8 percent, is well above the near 2 percent savings rate that we saw prior to the recession. In fact, personal savings continue to rise even though there is very little interest income to be earned. This suggests that the high savings rate reflects elevated risk aversion caused by the millions of jobs lost during the recession, as well as the $13 trillion wealth loss that accompanied it. Such an increase in households' propensity to save is accompanied by a decrease in their rate of consumption.

So we have all the ingredients for a liquidity trap: Businesses are cautious about new investment and households are too worried to meaningfully increase consumption. And interest rates can't fall in the way needed to increase investment and consumption because short-term rates are already at zero: They've fallen as far as they can go. If this state of affairs continues, it could very well stifle any reasonably robust recovery. Unemployment would remain unacceptably high, and disinflationary pressures would be reinforced — clearly an undesirable outcome.

These rare occasions of liquidity traps are very different from typical economic recessions. Consequently, they require a unique monetary policy response. Economic theory tells us that in such circumstances monetary policy should aim to lower the real, or inflation-adjusted, rate of interest by temporarily allowing inflation to rise above its long-run path. My preferred way of doing so is to implement an approach called price-level targeting. Simply stated, under this approach, the central bank strives to hit a particular price-level path within a reasonable period of time. For example, if the rate of change of the price-path is 2 percent and inflation has been under-running the path for some time, monetary policy would strive to "catch-up" so that inflation would be higher than the inflation target for a time until the path was regained. This higher inflation rate would decrease the real interest rate, raising the opportunity cost of holding money. This would provide an incentive for banks and corporations to release funds for investment, and in the process spur job creation.

In my opinion, such a strategy is entirely appropriate. The Fed has a mandate from Congress to encourage conditions that foster both price stability and maximum employment. Recently the Fed has missed on both dimensions of this dual mandate, with inflation running below the 2 percent level I associate with price stability, and with unemployment staying well above any reasonable estimate of the natural rate.

Practically speaking, price-level targeting in the current environment would call for a series of large-scale asset purchases to recover the shortfall in inflation. At the same time, we would continue to carry a large balance sheet in order to maintain low interest rates for an extended period. Most important, we would clearly communicate the path for prices that we expect to attain, in order to enhance the public's understanding of the Fed's intentions.

There are operational aspects of a price-level target policy that require much more elaboration and study, including the precise price-level target and how to achieve it. There are also potential challenges that we should be prepared to address. For instance, given the initial uncertainty surrounding the implementation of the new policy approach, inflation may at first continue to be very low. Sustaining our commitment to achieving the price-level target would be critical if we are to achieve success in this case. Conversely, we'd need careful advance planning to ensure that if inflation ran at a more elevated level than expected, we could bring the price level back to the target path. The tools we developed over the last two years to drain reserves from the banking system will prove useful in this regard. It would also be of utmost importance to appropriately use the Federal Reserve's authorities of macroprudential supervision and regulation during this period to avoid the emergence of financial market imbalances.

For many, my proposal will be a hard pill to swallow. Central bankers generally loathe the idea that even a temporarily higher inflation rate could be beneficial for, or consistent with, price stability over the longer term. We do not want to lose what the Fed under Chairmen Volcker and Greenspan won for the American people by fighting inflation and achieving price stability. The current circumstances, however, require that we fight a different battle — namely, the extraordinary instance of liquidity trap conditions not seen since the 1930s. With potentially beneficial policies that are well grounded in rigorous economic analysis available to us, I cannot stare at our current projections for high unemployment and low inflation and think that they are consistent with the best policies to address the Fed's dual mandate responsibilities. [4]

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