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## **Some Thoughts on Global Risks and Monetary Policy**

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Those of the Federal Reserve System or the FOMC.

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## Introduction

Thank you for the invitation to speak to you today. I am very happy for the opportunity to participate in Market News International seminar and to offer my thoughts on the U.S. and world economies.

We live in an amazingly interconnected world — a world in which financial markets are linked by the instantaneous transmission of information and business activity is intertwined among nations. For a long time, U.S. consumers and firms have been an important source of demand for Asian economies. This comes with pluses and minuses: Without the robust growth in the U.S. in 1997–98, the Asian financial crisis may well have been much worse than it actually was; in contrast, the recession and sluggish growth in the U.S. over the past five years have weighed heavily on the demand for products from Asia.

My comments today will focus primarily on the outlook for the U.S., but with an eye on its potential impact on Asian economies. Of course, here I have to cover the substantial downside risks to the forecast stemming from both the European debt situation and the U.S. fiscal cliff. I will also discuss how this outlook and other economic analyses shape my views for the appropriate stance of monetary policy.

Before I turn to the focus of today's discussion, I would like to remind you that the views expressed are my own and do not necessarily represent those of the Federal Open Market Committee (FOMC) or the Federal Reserve System.

## Outlook

Let's start with the economic outlook. We are all too familiar with the fact that the financial crisis that unfolded in 2007 and 2008 precipitated a global recession that was unusually deep and lengthy in the U.S. and other advanced economies. Perhaps this shouldn't have been surprising. The detailed analysis by Carmen Reinhart and Kenneth Rogoff (2009) concludes that recessions caused by financial crises generally are severe and are followed by anemic recoveries. By any yardstick, this certainly describes the U.S. recovery to date: Output growth has averaged only 2-1/4 percent annually, and resource gaps remain huge. In particular, the unemployment rate remains over 8 percent — well above the 5-1/4 to 6 percent rate most FOMC participants view as being consistent with a fully employed labor force over the longer run.

Both public and private sector forecasts see relatively modest rates of growth over the next few years. For example, most recent forecasts by the private sector have 2012 gross domestic product (GDP) growth at less than 2 percent; a pace that may not even be enough to keep up

with potential.<sup>1</sup> Growth in 2013 is expected to be only moderately higher. Moreover, both the European debt situation and the looming U.S. fiscal cliff impart substantial downside risks to the forecast.

Even absent any negative shocks, such tepid growth rates would close the large existing resource gaps only very gradually. Indeed, I expect that we will face unemployment well above sustainable levels for some time to come.

### ***Implications for Asia***

In the aftermath of the Great Recession, most Asian economies enjoyed a return to solid levels of growth. Today, however, growth in Asia faces some new challenges. One of these challenges is that Asian economies will not be immune to the tepid growth prospects facing the world's advanced economies. Forecasts for growth in Asia have been marked down over the past year, reflecting in part the impact of the downgrade in the outlook for Asian exports for the U.S. and the euro area. For example, the U.S. and the euro area account for about one-third of China's merchandise exports. The recession and weak recoveries in those economies were big factors in the Chinese current account surplus falling from about 10 percent of GDP in 2007 to less than 3 percent in 2011. This weakness remains a consideration as we look forward; indeed, it is an important reason why the International Monetary Fund (IMF) is projecting that the Chinese current account surplus will fall even more by 2013.<sup>2</sup>

International trade is an excellent thing: Exploiting comparative advantages raises living standards for all nations. However, all countries can't simultaneously export their way out of their problems. For the world as a whole, the current account has to balance. Thus, countries with large external surpluses face risks to their economies posed by slowdowns in their trading partners. Aggregate world growth must reflect aggregated domestic demands. So if demand is going to be sluggish in a large share of the world economy, other nations must take up the slack, or world growth will fall.

### ***Inflation***

With regard to inflation, as you know, the FOMC's long-run inflation objective is 2 percent as measured by the price index for personal consumption expenditures (PCE). For a number of reasons, I don't foresee much risk that inflation will rise above reasonable tolerance levels relative to this objective. First, we see evidence of low expectations for inflation and growth in the today's historically low Treasury yields. If there were warning signs of dangerous inflationary pressures, the ten-year rate wouldn't be in the neighborhood of 1-3/4 percent! Second, even with the latest increase in oil prices, energy and commodity prices remain well off

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<sup>1</sup> Note that many analysts believe that a number of factors—such as reduced capital formation and dislocations in the labor market—have temporarily lowered the rate of potential output growth relative to its longer-run rate. For example, the Congressional Budget Office (2012a) estimates the rate of potential output growth in 2011–12 to be about 1-3/4 percent per annum, but sees it picking up to about 2-1/2 percent in 2015–16.

<sup>2</sup> Between September 2011 and April 2012, the International Monetary Fund revised down its 2012 growth projections for both advanced and emerging Asian economies by more than 0.5 percentage point, partly because of a deterioration of growth prospects in Europe (see figure 2.1 in International Monetary Fund, Research Department, 2012). The IMF's July 2012 forecast update lowered the growth forecast for developing and newly industrialized Asia economies in 2012 by 0.3 and 0.6 percentage point, respectively. The July update did not contain updated details on current accounts; the projection for the Chinese current account surplus in the text refers to the April IMF forecast.

their recent peaks as the global outlook dims. Third, as I just noted, the output gap remains large and is likely to close only slowly. In this economic environment, wage pressures are practically nonexistent. And it is hard to envision how major persistent inflation pressures will emerge without a parallel increase in wage costs. Such parallel price and wage increases were a big part of the 1970s inflation, a scenario some fear repeating today. Fourth, inflationary dynamics depend in large part on the momentum generated by people's expectations of future inflation; currently, inflation expectations are well anchored, which will tend to keep inflation from moving either up or down. Putting all of these factors together along with the fact that core inflation averaged 1.8 percent over the past year, I conclude that inflation will likely remain near or below our 2 percent target over the medium term.

### **Sources of Risk and Their Implications**

I would now like to turn to two important downside risks to the outlook for growth. This will be a bit of a U.S.-centric view, but clearly these risks also have important implications for growth here in Asia and the rest of the world.

#### ***Europe***

Let me begin with the European debt situation. Obviously, the developments in Europe pose a significant downside risk to the U.S. economy and world economic growth more broadly. The direct effects of slower European growth on the U.S. economy would be relatively small. The eurozone nations account for less than 15 percent of U.S. merchandise exports.<sup>3</sup> Thus, according to standard elasticity estimates, even a moderate eurozone recession would reduce U.S. exports by only a couple of tenths of GDP.<sup>4</sup> In Asia, European exposures vary by country but overall, the direct effects of a further slowing in the euro area on Asian economies probably would be manageable.<sup>5</sup>

The indirect effects of eurozone developments could, however, be more severe, both in the U.S. and Asia. One possible channel would be through financial contagion. If losses on euro-centric assets put a large enough dent in the balance sheets of financial institutions that lend to U.S. households and businesses, the increases in the cost and availability of credit would reduce growth in the U.S. with possible spillover effects into Asia as well. Clearly, this is a risk worth monitoring. Fortunately, though, U.S. financial institutions are in much better shape to handle such potential losses than they were in 2008. Recognizing the risks posed by the European debt situation, U.S. institutions have reduced their direct exposure to European assets and tightened lending standards to European banks.<sup>6</sup> On the regulatory front, the most recent stress tests made large U.S. banks demonstrate that they would have adequate capital even in the event of a sharp European recession with contagion to global financial markets.

A second possible channel would be through the effects of uncertainty on current demand. Throughout the recovery, U.S. business and household sentiment has been very fragile. Every hint of bad news seems to generate a wave of increased caution and an associated pullback in spending as firms and families seek to protect their individual balance sheets. After what the

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<sup>3</sup> According to data reported by the United Nations Conference on Trade and Development (UNCTAD), the euro area received 13.9 percent of U.S. merchandise exports in 2010. See <http://unctadstat.unctad.org>.

<sup>4</sup> Crane, Crowley and Quaayum (2007) estimate U.S. export elasticity with respect to income to be 2.34 on data from 1981 through 2006. Cardarelli and Rebucci (2007) estimate it to be 1.85 using data from 1973 to 2006.

<sup>5</sup> UNCTAD reports that in 2010 the euro area accounted for 14.8 percent of China's exports, 8.3 percent of Japan's, 8.3 percent of Korea's and 7.5 percent of Thailand's. See <http://unctadstat.unctad.org>.

<sup>6</sup> See [www.federalreserve.gov/boarddocs/snloansurvey/](http://www.federalreserve.gov/boarddocs/snloansurvey/).

U.S. economy went through in the Great Recession, this skittishness is understandable — particularly if one can envision a very large downside to the news event. And, as I just noted, given developments in Europe, there certainly are some serious downside scenarios one can envision, even if they are not the most likely outcomes. So it would be no surprise if yet another wave of uncertainty put a further dent in consumption and investment.

### ***U.S. fiscal cliff***

Another risk to the U.S. economy comes from the so-called fiscal cliff. Under current U.S. law, numerous tax and spending provisions enacted in various stimulus packages dating as far back as 2001 are scheduled to expire on January 1, 2013. In addition, if no budget agreement is reached by Congress, there will be significant automatic spending sequestration and other spending cuts in January. According to projections made by the Congressional Budget Office (CBO),<sup>7</sup> if all these things took place, real GDP growth would be reduced by about 4 percentage points in 2013.

I'm not saying that a pullback of this magnitude should be the base-case scenario. The orders of magnitude are just too big to be a base case. But when you go through the various items and make guesses at which may stay and which may go, it is easy to envision scenarios that include a marked increase in fiscal restraint in 2013. In addition, given the political process, it seems unlikely that we will know much about the size or composition of the cuts until late in the process. It's also easy to see how the rhetoric of public negotiating stances could produce an atmosphere that causes already jittery households and businesses to put some spending plans on hold. In sum, a messy resolution to the fiscal cliff problems presents an important downside risk to U.S. growth prospects and, by extension, to world economic growth. And even the possibility of such an outcome could be a drag in the second half of the year.

### **Policy Choices**

Let me now switch gears and talk about my views regarding the choices facing monetary policymakers in the U.S. Yes, we have substantial liquidity already in place in our financial system. On the surface, this looks like substantial monetary accommodation. But as a large body of economic theory tells us, for this liquidity to be sufficiently accommodative, the public needs to expect that we will keep it in place for as long as is necessary to restore the economy to a sound footing. This is why I believe we should clarify the Fed's forward guidance with regard to the future course of policy. Let me now go into the details behind these thoughts.

### ***An explicit economic state-contingent policy***

In weighing alternative policy approaches, I think the best way to provide forward guidance is by tying our policy actions to explicit measures of economic performance. There are many ways of doing this, including setting a target for the level of nominal GDP. But recognizing the difficult nature of that policy approach, I have a more modest proposal: I think the Fed should make it clear that the federal funds rate will not be increased until the unemployment rate falls below 7 percent. Knowing that rates would stay low until significant progress is made in reducing unemployment would reassure markets and the public that the Fed would not prematurely reduce its accommodation.

Based on the work I have seen, I do not expect that such policy would lead to a major problem with inflation. But I recognize that there is a chance that the models and other analysis supporting this approach could be wrong. Accordingly, I believe that the commitment to low rates should be dropped if the outlook for inflation over the medium term rises above 3 percent.

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<sup>7</sup> See Congressional Budget Office (2012b).

The economic conditionality in this 7/3 threshold policy would clarify our forward policy intentions greatly and provide a more meaningful guide on how long the federal funds rate will remain low. In addition, I would indicate that clear and steady progress toward stronger growth is essential. Because we are not seeing that now, I support further use of our balance sheet to provide even more monetary accommodation. In June we decided to continue our Maturity Extension Program, which puts downward pressure on long-term interest rates by extending the average maturity of the Federal Reserve's securities portfolio. I thought that was a useful step. However, I believe it is time to take even stronger steps, such as the purchase of more mortgage-backed securities, to increase the degree of monetary support for the recovery. As suggested recently by my colleagues Eric Rosengren and John Williams, these could be open-ended purchases, meaning that they would continue at a certain rate until there was clear evidence of improvement in economic conditions. To me, one example of clear evidence would be a resumption of relatively steady monthly declines in unemployment for two or three quarters. Once this momentum was confidently established, the Fed could stop adding to our balance sheet but keep the funds rate at zero. The funds rate would remain unchanged in my thinking, until the unemployment rate hit at least 7 percent or the medium-term inflation outlook deteriorated dramatically and rose above 3 percent. Later, reductions in the Fed's balance sheet assets would occur sometime after the first increase in the funds rate. This corresponds to the general exit principles the FOMC agreed upon last year. Presumably, the pace of asset reductions would be measured and consistent with a continued, robust recovery in the context of price stability.

### **Accommodation in the Context of a Symmetric Inflation Target and Balanced Policy**

I can't tell you how often people look at me in horror when I say that we should adopt a conditional policy that tolerates the risk of inflation exceeding our target by as much as 1 percentage point. How can I accept inflation rising above our stated target? Isn't this blasphemy for a central banker?

In January, in the same framework document that announced our 2 percent inflation target, we also stated a number of principles for the conduct of monetary policy. One was that policy would take a balanced approach in achieving the two legs of the Federal Reserve's dual mandate — maximum employment and price stability. An explicit real-side mandate makes the Federal Reserve different than most central banks. While just about all central banks follow a flexible inflation targeting approach, in which they seek to minimize real-side fluctuations in pursuit of their inflation objective, most are explicitly charged only with an inflation objective. But for the Fed, maximum employment is an explicit part of our policy mandate.

I strongly support the policy principles document we released in January. But we're still hearing questions about whether our inflation goal is symmetric and about the specifics of how policy will be implemented under the balanced approach articulated in this framework.

As Chairman Bernanke (2012) stated at his April press conference, the 2 percent inflation goal is a symmetric objective and not a ceiling on inflation. Symmetry means that inflation below 2 percent should be viewed as the same policy miss as if inflation overran 2 percent by equal amount.

We need to take symmetry seriously. If we disproportionately recoil at inflation a little above 2 percent versus a little below, then we are not symmetrically weighing policy misses. And we will not average 2 percent inflation, which is our goal. There is some risk of this misperception taking hold. Consider the FOMC's latest *Summary of Economic Projections* (SEP), which

includes the projections of all FOMC participants, voters and non-voters alike. In it, several forecasts have the funds rate rising before 2014, even though throughout the projection period most see inflation at or below 2 percent and unemployment well above the sustainable rate indicated by the long-run projections. Without further explanation, it's difficult to see how this is consistent with a symmetric inflation goal and a balanced approach to achieving the two legs in our dual mandate.

I believe the FOMC can do better at describing our thinking with respect to tolerance bands around our long-run inflation and unemployment goals. Clarification would increase both transparency and accountability. Importantly, it would reassure economic agents that Fed policy would not tighten prematurely.

To me, a symmetric inflation goal and a balanced approach to policy mean that if we are missing our employment mandate by a large amount, but are close to our inflation target, then we should be willing to undertake policies that could substantially reduce the employment gap even if they run the risk of a modest, transitory rise in inflation that remains within a reasonable tolerance range of our target. I believe such actions, such as the 7/3 threshold policy I have been advocating, would produce smaller net losses relative to our dual mandate goals than would current policy.

### **Conclusion: The Need for a Vibrant Economy to Cushion Risks**

Finding a way to deliver more accommodation — whether it is monetary or fiscal — is particularly important now because delays in reducing unemployment are costly. An unusually large percentage of the unemployed have been without work for quite an extended period of time; their skills can become less current or even deteriorate, leaving affected workers with permanent scars on their lifetime earnings. And any resulting lower aggregate productivity also weighs on potential output, wages and profits for the economy as a whole. The damage intensifies the longer that unemployment remains high. Failure to act aggressively now could lower the capacity of the economy for many years to come.

Such potential costs would come with the continuation of a subpar pace of economic recovery. The significant risks I discussed earlier – financial disruption from a worsening of the situation in Europe or a messy resolution of U.S. fiscal policy – raise the specter of an even more worrisome outcome. At the moment economic growth is not much above stall speed. Another negative shock could send the economy into recession. And if a recessionary dynamic takes hold, it would be especially difficult to regain momentum.

I have outlined some policy actions that I think can take us in the direction of a more vibrant and resilient economy. Given the risks we face, I think it is vital that we make such moves today. I don't think we should be in a mode where we are waiting to see what the next few data releases bring. We are well past the threshold for additional action; we should take that action now. Thank you.

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