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## **Perspectives on Current Economic Issues**

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**FEDERAL RESERVE BANK OF CHICAGO**

The views expressed today are my own and not necessarily  
Those of the Federal Reserve System or the FOMC.

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## Introduction

Thank you for that kind introduction. I'm delighted to be here today at the Bank of Ann Arbor to offer my perspective on the state of the U.S. economy. Before I begin I must state that the views I express 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.

Last week, in response to accumulating evidence that we were not achieving a significant and substantial improvement in U.S. labor markets, the Federal Open Market Committee (FOMC) took some important policy actions. First, it initiated a new program to buy mortgage backed securities that will continue—and, if necessary, be augmented by other policy actions—until the outlook for the U.S. labor market improves substantially. Second, the Committee stated that it expects to maintain a highly accommodative stance for policy for a considerable time after the recovery strengthens. In particular, it expects that near zero short-term interest rates will be appropriate at least through mid-2015.<sup>1</sup>

For more than two years, I have vigorously supported strongly accommodative monetary policy measures as the appropriate response to the unacceptable state of the labor market and benign outlook for inflation. I believe the combination of new asset purchases and enhanced forward guidance about future policy should provide an important added stimulus to economic activity and hiring. However, as I'll explain later, I think there are additional steps the Fed can take to further strengthen its positive effects on the economy.

The context for our recent actions is an economy that has been growing, but not at a pace fast enough to restore it to its productive potential in anything close to a reasonable amount of time. And today, even the growth we do see faces some big risks — risks that further bolster the argument for strong accommodation.

I regularly talk to a large number of chief executive officers (CEOs) about business conditions. Many of these executives run big firms with an international presence. Throughout the summer, they increasingly pointed to the U.S. as the bright spot in the global economy. Their comments, however, were not a testament to the U.S. recovery, but an indication that global economic activity was weakening — first in Europe and later elsewhere around the world. In addition, at home, we could face substantially more restrictive fiscal conditions if federal budget negotiations fail to resolve the issues

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<sup>1</sup> Federal Open Market Committee (2012).

surrounding the so-called fiscal cliff. And for both the global situation and the U.S. fiscal cliff, there is a lot of uncertainty over what the eventual outcomes will be.

More monetary accommodation and greater confidence in the future mean a stronger U.S. economy. A stronger economy would be more resilient to a large-scale decline in global growth or a sharp fiscal retrenchment. In contrast, piling these risk-events on a weak economy could throw us back into recession.

Our economy today is simply not resilient enough. The damage from the Great Recession was substantial; and to date, the recovery has been disappointing. The real value of goods and services produced in the U.S. today is probably more than 5 percent below what economists call potential — that is, the economy's ability to produce goods and services without generating inflationary pressures. The unemployment rate has been stuck at around 8 percent for nearly a year — well above the 5 percent to 6 percent level we would see if all of our resources were fully engaged. In the absence of further monetary stimulus or fiscal repair, the outlook would be for more of the same: moderate growth that is not strong enough to generate substantial improvement in the labor market; an unemployment rate that is likely to remain above its long-run level for a long time to come; and an economy that would be vulnerable to shocks at home and abroad.

Now, I am an optimist. I think we can do better than this gloomy outlook. That is why action is important. A great deal of state-of-the-art analysis — done both inside and outside of the Fed — indicates that the severe downturn in 2008–09 was mainly the result of a large drop in aggregate demand which left the economy operating below its potential. Research also shows that better and more accommodative policies have the power to reverse these setbacks and raise employment, output and incomes.<sup>2</sup> In other words, more accommodative policy can deliver a stronger economy and the resiliency we are seeking. Furthermore, appropriate policy can deliver these better outcomes without generating inflation that is significantly higher than the Fed's long-run goal of 2 percent.

There are many who believe otherwise. In their view, our current low output and high unemployment are the hallmarks of an economy that has lost its competitiveness — an economy that experienced permanent disruptions in its infrastructure, the skills base of its work force and its technological capability. In such a dismal view of the economy, monetary policy is powerless and cannot generate a stronger, more robust expansion. Any attempt to increase aggregate demand through more accommodative monetary policy would simply lead to higher inflation rather than better resource allocation.

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<sup>2</sup> A number of articles and working papers estimate that the role of structural factors in explaining recent high unemployment rates is relatively modest. These include Barlevy (2011), Şahin et al. (2012), Valletta and Kuang (2012) and Lazear and Spletzer (2012). Supporting these assessments, the Congressional Budget Office (2012b) estimated that in late 2011 the natural rate of unemployment was about 6 percent, up from about 5 percent before the recession, although far below the 8.5 percent unemployment rate reported in December of that year.

I see little evidence to support such a pessimistic view of the world. And I refuse to be so nihilistic in the absence of strong evidence of permanent disruptions. It is very hard to believe that millions of people who were working productively just a few years ago have suddenly become unemployable. And while many of the pessimists have been predicting higher inflation for several years, it hasn't materialized. Indeed, core inflation has been under 2 percent since the end of 2008; and except for some near-term transitory movements in food and energy prices, most forecasters do not see any major change in inflation over the next few years.

### **Forces Restraining Growth**

Before I discuss the risks to the economy, let me explain forces that have been restraining growth for some time.

Reviewing the historical record from around the world, Carmen Reinhart and Kenneth Rogoff and others find that, given the monetary and fiscal policies that are typically pursued, a prolonged period of slow growth following a financial crisis is the unfortunate norm.<sup>3</sup> And, despite the fact that the Federal Reserve has turned to many atypical monetary policy responses, the current U.S. experience is following the typical pattern. The recent financial crisis set in motion powerful forces that generated huge losses in wealth, greatly restrained aggregate demand and created difficult credit conditions. The effects have lingered, notably through a long period of deleveraging as many households and businesses seek to repair their damaged balance sheets.

There are a number of facets to this process. The financial sector is still recovering from its losses during the crisis and realizes the need — partly because of new regulatory standards — to hold larger liquidity and capital cushions against potential shocks. Many nonfinancial firms see weak or erratic demand for their products and few profitable investment opportunities. Moreover, these businesses are well-attuned to the downside risks to the economy. These factors lead them to reduce debt burdens and save cash. In addition, households still face high unemployment risk and slow wage growth, while holding a stock of wealth that has yet to return to its pre-crisis level. Furthermore, for many families, credit conditions are still tight. As a result, growth in consumer spending has been sluggish.

This is important because the ultimate end-user for all production is the consumer. For example, intermediate goods ultimately go toward the production of consumer goods. Likewise, investment expands businesses' productive capacity to make even more consumer goods. And U.S. exports to other countries provide goods and services to consumers abroad. Therefore, deleveraging by domestic households and less robust consumption by our trading partners both eventually translate into weaker overall aggregate demand in the U.S.

Whenever the economy operates below its potential, the key mechanism that returns the economy back to potential is a fall in real interest rates. This decline reduces the supply of saving and boosts the demand for investment, resulting in increased

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<sup>3</sup> See Reinhart and Rogoff (2009) and Jordà, Schularick and Taylor (2011).

spending. This equilibrating process has been made more difficult because our traditional interest rate policy tool, the federal funds rate, has already been lowered to essentially zero.<sup>4</sup> We can't lower it any further. Instead, we have turned to nontraditional policies, such as providing forward guidance about future policy rates and making large-scale purchases of longer-dated Treasury bonds and mortgage-backed securities. These policies have helped support growth — the economy would be in much worse shape if we had not made these moves. That said, they were not enough to generate robust growth in the face of unexpectedly strong and persistent headwinds throughout this recovery period. In part, last week's additional monetary policy actions were a response to the disappointing pace of the recovery. However, they were also intended to increase the resiliency of the economy in the face of the increasing headwinds and greater downside risks posed by the slowdown in global economic growth, the economic turmoil in Europe and the fast-approaching U.S. fiscal cliff.

Let me now go into some more detail on each of these risks.

### **A Slowing Global Economy**

In the first couple years following the 2008–09 recession, we saw a two-speed global recovery: moderate growth in the U.S. and other advanced economies and strong growth in emerging economies, such as China, Brazil and India. But today, Europe is in recession, and other advanced economies are growing only modestly. Growth in the emerging economies has slowed; notably, gross domestic production (GDP) in China appears to be rising at about an 8 percent pace this year. This sounds like a big number, but it is well below the more than 11-1/2 percent rate it averaged in the five years prior to the global recession. According to the latest projections by the International Monetary Fund, growth in overall world output is expected to be about 3-1/2 percent in 2012; this compares with gains that averaged roughly 5 percent prior to the recession.<sup>5</sup>

As I noted earlier, my conversations with CEOs, as well as the recent earnings reports of international firms more generally, indicate that the impact of slower growth abroad is already evident in sales of U.S. firms that operate in global markets. This means that we can't count on a boost to U.S. output from robust exports. And this dynamic is true for the world as a whole. Demand has to come from somewhere. No country can count on export growth if their trading partners aren't economically healthy. Since the global balance of trade must by definition balance, the math is straightforward: It is impossible for every country to run a trade surplus and export their way to better economic health.

Over the past couple of decades, world economic growth has depended heavily on U.S. consumers. Our consumer spending was a critical driver of growth in auto sales, electronics, housing and technology — all of which not only benefited the U.S. economy, but also supported growth beyond our borders. Given the forces holding back U.S. consumers, the world economy can no longer count on U.S. households to drive growth. Other countries need to take steps to stimulate their own domestic demand.

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<sup>4</sup> My thinking on liquidity traps can be found in many of my speeches, such as Evans (2012b, c).

<sup>5</sup> See International Monetary Fund, Research Department (2012).

Hopefully, the recession in Europe will be confined to Europe. And hopefully, other advanced and emerging market economies will spur vibrant recoveries that allow them to achieve their full potential. But for the moment, there's a significant risk that the global recovery might weaken further. One only has to think about the statement that the U.S. is the bright spot for growth to infer the sense of pessimism many business leaders have about prospects around the rest of the world.

### **European Crisis**

The second risk we face is the potential for serious fallout on the U.S. economy from the ongoing crisis in Europe.

Europe is in an extremely difficult situation: Not only is the euro area in recession, but there are existential questions about the viability of the currency union itself. Clearly, the eurozone's periphery countries, such as Greece, Ireland, Portugal, Spain and Italy, face great economic difficulties. The problems for these periphery countries are many and vary from the excessive government spending and the inability to collect taxes in Greece to the hangover of insolvent banks resulting from past exuberance in Spain and Ireland.

Most of the focus has been on the immediate ability of the periphery countries to finance their debt. Of course, the fundamental problem in these countries is the lack of growth and competitiveness. These problems are manifest in their large trade deficits, which are mostly with other countries in the eurozone. For such countries this requires an increase in competitiveness. For a country with its own currency, a quick channel for achieving improved competitiveness is currency depreciation. As Milton Friedman said "It is far simpler to allow one price to change, namely, the price of foreign exchange, than to rely upon changes in the multitude of prices that together constitute the internal price structure."<sup>6</sup> This automatically increases the country's international competitiveness, provides immediate support to growth and gives the country more time to institute the structural and regulatory reforms needed to permanently increase its productive capacity and competitiveness.

The experiences of the United Kingdom (UK) and Italy in 1992 are classic examples of such an adjustment process. At the time, a number of European countries were part of the European Exchange Rate Mechanism (ERM), in which members agreed to maintain their exchange rates within a narrow band around the anchor set by the strong deutsche mark. To do so, members' monetary policy rates could not stray too far from each other. At the time, German policy rates were kept high to address domestic inflationary pressures arising from the reunification of East and West Germany. In contrast, other ERM members, such as the UK and Italy were dealing with high unemployment and trade imbalances. Germany's high interest rates were too restrictive for them. Eventually, the UK and Italy abandoned the ERM, lowered policy rates, and let the pound and lira depreciate significantly. With a lower exchange rate, their products became more competitive and growth rebounded relatively quickly.

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<sup>6</sup> Friedman (1953).

Today, however, within the eurozone, a currency realignment is impossible because every country uses the same currency. Periphery countries must find other means to increase productivity and regain competitiveness. These could include large nominal wage cuts and substantial product price reductions, as well as structural labor and regulatory reforms. At the moment, the expectation is that a combination of liquidity support for banks and sovereigns will reduce financial restraint, allowing sovereigns the time to address individual imbalances and deficits. But regardless of how the adjustment occurs, the periphery countries will almost certainly experience a great deal of pain.

The U.S. is largely a bystander to European policies. But we are not immune to the developments in Europe. In the past two years, our trade with Europe has grown at a significantly slower pace than our trade with the rest of the world. Some of this reflects weaker demand for U.S. goods due to lower income growth in Europe, and some of this reflects the appreciation of the dollar against the euro. Should economic and financial conditions in Europe deteriorate further, they could have significant adverse effects on our growth and in our financial markets. And just the uncertainty over the downside scenarios is likely already putting a damper on investment and spending decisions in the U.S.

### **Fiscal Cliff**

This brings me to the third risk on my list: the U.S. fiscal cliff.

Under current law, tax and spending provisions enacted in various stimulus packages dating as far back as 2001 are scheduled to expire on January 1, 2013. These include the expiration of the so-called Bush tax cuts, the expiration of the payroll tax holiday and the conclusions of numerous other provisions. In addition, under current law, in the absence of a budget deal, there will be automatic sequestration of spending amounting to \$1 trillion over a 10-year period.

The impact of permitting these programs to all expire at once would be huge. The Congressional Budget Office recently compared the full force of the current law with a scenario in which only the payroll tax cut and extended unemployment insurance benefits were allowed to expire. Their central estimate was that the full suite of scheduled budget actions could shrink real GDP in 2013 by 2-1/4 percent and increase the unemployment rate by about a percentage point relative to the less draconian scenario.<sup>7</sup>

Such fiscal contraction would be a serious threat to our fragile recovery. And it would be an unusual response to economic weakness. Normally, fiscal policy acts as an economic stabilizer as it did in the 1970s, 1980s and 2000s, when robust government spending boosted real GDP growth as we recovered from recession. However, as in other aspects, the current recovery does not fit the usual mold. Although policy was stimulative in 2008 and 2009, over the course of the expansion the government's

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

purchases of goods and services as a share of GDP has fallen by more than 2 percentage points, with state and local government spending having a large negative effect on growth.

There is a great deal of uncertainty as to how these fiscal issues will be resolved. With the presidential campaign in full swing, a solution is unlikely until after the outcome of the election. And unfortunately, a political stalemate that triggers slated spending cuts — an extreme outcome — cannot be ruled out. So it comes as no surprise that business people who must plan for 2013 and beyond are nervous and unsure how to proceed.

### **The Case for More Accommodation**

All of this was the setting for our September FOMC meeting. Given the slow and fragile recovery, the large resource gaps that still exist, and the large risks we face, it remains clear that we needed a more resilient economy that can withstand the headwinds that might come its way. Last week the FOMC provided a more accommodative monetary policy that can help us achieve such resilience. I strongly supported the Committee's policy actions. These actions, along with Chairman Bernanke's powerful commentary that the employment situation remained a "grave concern," moved quite a ways toward my preference for providing more explicit forward guidance with respect to monetary policy reactions to changes in labor market conditions.

In many venues over the past couple years I have laid out my preferred way to provide additional accommodation.<sup>8</sup> Specifically, I believe we should adopt an explicit state-contingent policy rule that commits the Fed to providing accommodation at least as long as the unemployment rate remains above 7 percent and the outlook for inflation over the medium term is under 3 percent. If our progress toward this unemployment marker falters, then we should expand our balance sheet to increase the degree of monetary support. Indeed, we took such an action last week. Note the importance of the inflation trigger — it is a safeguard against unacceptable outcomes with regard to price stability. I also believe we should be more explicit about what it means for the inflation target to be symmetric, as Chairman Bernanke has stated. Namely, symmetry means that the costs of an inflation rate above our 2 percent goal are the same as the costs of equal-sized miss in inflation below 2 percent. Its implication is that we should not be resistant to policies that could move the unemployment rate closer its longer-run level, but run the risk of inflation running only a few tenths above our 2 percent goal. Such accommodative policies could further improve the employment picture, even beyond our recent highly beneficial actions.

While our policy actions last week don't exactly match my preferred policy structure, I support them wholeheartedly. Tying the period of time over which we will purchase assets to the achievement of significant improvement in the labor market is a strong step towards economic conditionality — that is, it conditions our actions to the economy's performance instead of a calendar date. And stating that we expect to keep a highly accommodative stance for policy for a considerable time after the recovery

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<sup>8</sup> See, for example, Evans (2012a, b and 2011).



strengthens is an important reassurance to households and businesses that Fed policy will not tighten prematurely. A large body of economic research says that committing to such a delay is a key feature of optimal policies during periods when policy rates are constrained to be zero, such as we have experienced in the U.S. since late 2008.

## **Conclusion**

Let me be clear. This was the time to act. With the problems we face and the potential dangers lying ahead, it is essential to do as much as we can now to bolster the resiliency and vibrancy of the economy. We cannot be complacent and assume that the economy is not being damaged if no action is taken. I am optimistic that we can achieve better outcomes through more monetary policy accommodation.

Some have argued that the circumstances we find ourselves in today are so different from the way in which monetary policy normally operates that we must tread cautiously. They argue that more monetary policy accommodation may lead to unintended consequences. Yet, being timid and unduly passive can also lead to unintended consequences. If we continue to take only modest, cautious, safe policy actions, we risk suffering a lost decade similar to that which Japan experienced in the 1990s. Underestimating the enormity of our problems and the negative forces holding back growth itself exposes the economy to other potentially more serious unintended consequences. That type of passivity is a gamble that is not worth taking. Thank you.

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