Monetary Policy in Challenging Times

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Thank you for that kind introduction. I'm delighted to be here in Toronto tonight to offer my perspective on the state of the U.S. economy. This is my first official visit to Canada as president of the Federal Reserve Bank of Chicago, and I am most appreciative of this opportunity presented by the C.D. Howe Institute. I hope to be able to offer some insight into U.S. monetary policy and I look forward to hearing from you during our question and answer period.

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.

At the conclusion of last September's Federal Open Market Committee (FOMC) meeting, we announced two important policy actions that have been much talked about since. The first was the initiation of a new open-ended program to buy mortgage-backed securities that will continue until the outlook for the labor market improves substantially. The second was a clear statement that we expect to maintain a highly accommodative policy stance for a considerable time after the recovery strengthens. In particular, the Committee expects that short-term interest rates near zero will be appropriate at least through mid-2015.[1]

Tonight, I'd like to discuss these innovative actions in some detail, especially in terms of how they might inform future policy actions and in light of the growing concern over a variety of long-run issues facing the U.S. and other advanced economies.

Long-Run Issues Facing the U.S. and other Advanced Economies

The recent global downturn began in the United States in late 2007, and accelerated sharply following the collapse of Lehman Brothers in September 2008. The U.S. economy bottomed in the summer of 2009. However, the following economic recovery has been modest by any standard. The near-term obstacles to growth are numerous and much discussed; but looking forward, I see even more complex challenges confronting the United States over the next three to four years and beyond.

Some of these issues also affect other major industrial economies in the world, and many of these challenges imply difficult decisions for fiscal policymakers. Tonight, I will touch on a few of these issues.

[1] See Board of Governors of the Federal Reserve System (2012).

Let me be very clear about something at the outset: As a monetary policymaker in the United States, my only responsibility regarding fiscal policy is to have an understanding of how alternative fiscal choices influence the trajectories of economic growth and inflationary pressures and thus what these choices may imply for monetary policy—our job at the Federal Reserve.

At the risk of oversimplifying the long-term challenges for the U.S., it seems to me to be characterized by two important features. First, the current level of debt-to-GDP (gross domestic product) of about 70 percent is high by historical standards; and in the absence of changes in taxes or spending, the projections are that it will continue to climb. Second, a critical long-term driver of higher future debt is the need to fund and deliver large benefits to an increasingly aging population. Baby boomers are beginning to retire, and it is imperative to ask whether old-age pensions and safety nets are adequate. With the added responsibilities of caring for the elderly being borne by fewer people, will we be able to finance the pension and health care demands that come with aging?

The U.S. long-run fiscal imbalance is quite significant, and it is important that we soon develop plans for controlling the long-run increase in our debt. Of course, there are several policy levers the U.S. government might use to return to a more sustainable fiscal path. None of these choices are painless. For example, future beneficiaries may be forced to pay higher out-of-pocket expenses or face greater limits on available care (that is, lower benefits). Another possibility is to ask younger workers to pay more during their working lifetimes to finance programs for their retirements. Other strategies would increase general taxes and/or lower a variety of public expenditures today in order to save resources to pay for obligations tomorrow.

When the United States settles on effective policies to close the fiscal financing gap, these policies will result in an increase in either current or prospective government saving—which is the same as reducing government fiscal deficits. Moreover, with most people expecting to receive lower future benefits or pay higher future taxes, it is likely that current workers will want to save more for their retirements. Regardless of how these matters are resolved, national saving must rise.

Four Messages to Emphasize Regarding Long-Run Challenges

An aging population places obvious strains on fiscal finances over the long run. At the same time, the recent financial downturn and a prolonged period of high unemployment have complicated the process that would allow us to adjust to a new sustainable fiscal path. In this context, I want to emphasize four important messages that I think are implied by trends in the U.S. and global economies.

First, the U.S consumer is no longer in a position to be the engine of world growth. It should be evident that long-term demographic changes of the sort we face require increases in personal or government saving. Furthermore, over the near term, many U.S. households continue to be challenged by a debt overhang and large losses of wealth that were incurred during the financial crisis. All of these factors point to lower rates of personal consumption in the United States. Moreover, many advanced economies face their own fiscal challenges and unfavorable demographics that also will likely weigh on total world consumption. Some of the resulting drop in global aggregate demand could be taken up by consumers in emerging market economies. In many cases, past growth in such economies has been largely export driven. With reduced aggregate demand expected from their trading partners, emerging market economies will need to endorse policies that encourage domestic consumption and demand. Making that transition will be challenging.

The second point I want to emphasize is that the United States must consolidate its finances gradually over time if we are to avoid further economic turmoil or another downturn. Of immediate concern is the looming fiscal cliff, which some have labeled "the austerity bomb." Under current law, many tax and spending provisions enacted in various past stimulus packages are scheduled to expire on January 1, 2013. In addition, in the absence of a budget deal, automatic sequestration of spending goes into effect. If not quickly reversed, the effects on the economy could be huge. The Congressional Budget Office recently estimated that the full suite of scheduled budget actions could shrink real GDP in 2013 by 2-1/4 percent. It would also raise the unemployment rate by about a percentage point relative to the less draconian scenario in which only the payroll tax cut and extended unemployment insurance benefits were allowed to expire[2].

More generally, economic growth is already weak in many advanced economies throughout the world. Indeed, Europe is in a recession. And fiscal policy in several European countries is currently restrictive. Certainly, progress needs to be made on reducing outsized deficits. But too much austerity too soon could be very damaging to near- and medium-term growth. Economic theory tells us that in times when central banks have lowered short-term nominal interest rates to essentially zero, fiscal multipliers are likely quite high.[3] This means that overly abrupt moves to increase taxes or reduce government spending could have an amplified effect on reducing real growth. Furthermore, such fiscal moves could cause longer lasting damage to already fragile economies—by reducing the growth in productive capital stock and by keeping the long-term unemployed out of jobs, resulting in the erosion of their job skills.

With so much hanging in the balance, one way to reduce the impact of an austerity bomb would be for policymakers to delay the strongest negative effects of fiscal consolidation today, but still credibly commit to reducing deficits later as their economies recover more robustly. This is no easy task.

As a central banker, I am always careful in assessing the interest rate environment that will influence the short- and longer-run growth prospects for the economy. This is a key aspect of calibrating monetary policy. Let me state the third message very frankly: The longer-term implications for market interest rates are complex and ambiguous. If policymakers punt on making tough fiscal choices or choose too little fiscal consolidation with continued high fiscal deficits, it is likely that the overall demand for

[2] See Congressional Budget Office (2012).
[3] See Christiano, Eichenbaum and Rebelo (2011) and Batini, Callegari and Melina (2012).

so-called loanable funds will be very high relative to the supply. This will be especially evident once the United States is past the worst of our current liquidity trap conditions. In this setting, large increases in real interest rates would discourage capital investment and dampen long-run growth. However, a large fiscal consolidation could lead to higher private precautionary saving, along with higher national saving. This scenario could also dampen growth; but it would be associated with lower real interest rates, reminiscent of deeper liquidity trap conditions. Where market interest rates end up is not obvious. Central bankers and monetary policymakers will need to be attentive to assessing the market's implication for real interest rates in deciding the appropriate benchmark for nominal policy interest rates.

My fourth message may be obvious, but it is still worth highlighting: All of the long-term challenges we face become easier to meet if we can increase the underlying growth potential of our economies. Many public policy choices are relevant here, and so I offer only a few modest suggestions. In the United States, we can improve our educational system, leading to a more productive work force. In peripheral Europe, economic liberalization, particularly of labor markets, can produce a more efficient allocation of resources and increased potential. And in all countries, smart regulation, efficient tax codes and support for free international trade can increase our productive capacities.

The payoff here can be quite large. Increasing long-run average rates of output growth, even by a few tenths of a percent, can make the budget calculus much easier. In the United States, the Congressional Budget Office estimates that if growth of real GDP each year were only 0.1 percentage point higher for the next ten years than is assumed in its baseline projections, the cumulative deficit for 2012 through 2022 would fall by over $300 billion. Permit me to adapt a saying attributed to the late Senator Everett Dirksen from Illinois: When it comes to growth, a tenth here and a tenth there, and pretty soon, you're talking about real money! Having said this, we need real, bona fide growth policies — not simply fanciful budget assumptions that tomorrow will bring a better future.

Economic Outlook: A Modest Recovery and Contained Inflation

In the United States, the fiscal and economic strains due to our aging population will occur over a long time horizon. That said, monetary policymakers must formulate policy for today. In the United States, forecasts by both private analysts and FOMC participants see real GDP growth in 2012 coming in at a bit under 2 percent. Growth is expected to move moderately higher in 2013, but only to a pace that is just somewhat above potential. Such growth would likely generate only a small decline in the unemployment rate. For example, the latest *Survey of Professional Forecasters* projection had the unemployment rate at 7.6 percent in the fourth quarter of 2013—just 0.3 percentage points below where it is today. Against this backdrop of modest growth and still elevated unemployment, inflation is expected to run at or a bit under the FOMC's stated goal of 2 percent.

The reasons for sluggish U.S. growth are well known. The 2008 financial crisis destroyed trillions of dollars of wealth, forcing consumers and businesses to deleverage.

This process has not yet been completed. Fiscal policy is probably a slight drag on growth now; and as I just discussed, further consolidation could be coming soon. And as I also just noted, global growth has been disappointing. There is no shortage of uncertainty as I look at the economic situation in the United States and around the world, and the insecurity it creates is weighing heavily on the spending decisions of businesses and households.

Having said all that, most forecasters are predicting that the pace of growth will pick up as we move through next year and into 2014. Underlying these projections is an assumption that fiscal disaster will be avoided—and with this, that some important uncertainties restraining growth should come off the table. Also, deleveraging will run its course, and as it does, the economy's more-typical cyclical recovery dynamics will take over. As the FOMC indicated in its policy moves last September, the current highly accommodative stance for monetary policy will be kept in place for some time to come.

Recent Monetary Policy Actions

At the September meeting, faced with evidence that the recovery was not proceeding fast enough, the FOMC decided to provide additional policy accommodation in order to make more rapid progress toward our dual mandate goals of maximum employment and price stability. There were two important parts of this additional policy accommodation that bear closer examination.

First, we announced a new open-ended round of large-scale purchases of agency mortgage-backed securities. This was on top of our existing program of extending the maturity of our Treasury security holdings. As with previous large scale asset purchases (LSAPs), these purchases are aimed at putting downward pressure on longer-term interest rates and helping to make broader financial conditions more accommodative, thereby stimulating business and household spending.

An important new aspect of current round of purchases was to tie its length to economic outcomes, rather than announcing a fixed amount of purchases over a predetermined period as we have done in the past. In particular, the FOMC said that the purchases will continue until there is substantial improvement in labor markets. This is subject, of course, to a continued environment of price stability. Tying the length of time over which our purchases will be made to economic conditions is an important step. Because it clarifies how our policy decisions are conditional on progress made toward our dual mandate goals, markets can be more confident that we will provide the monetary accommodation necessary to close the large resource gaps that currently exist; additionally, markets can be more certain that we will not wait too long to tighten if inflation were to become an important concern.

The natural question at this point is to ask: What constitutes substantial improvement in labor markets? Personally, I think we would need to see several things. The first would be increases in payrolls of at least 200,000 per month for a period of around six months. We also would need to see a faster pace of GDP growth than we have now — something noticeably above the economy's potential rate of growth. Such concurrent gains should be enough to produce sustainable downward momentum in the unemployment rate and to make us more confident that the improvements are sustainable. Once we established that there has been this substantial improvement in labor markets, we would stop adding to our balance sheet. But we would keep the funds rate near zero for some time longer.

The second major policy action at the FOMC meeting in September was to make it clear that the highly accommodative stance of monetary policy would remain in place for a considerable time *after* the economic recovery strengthens. According to our statement, the funds rate would likely stay near its current level until mid-2015.

Why should policy remain accommodative even after we have a stronger recovery? The 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.[4] As you know, in response to the severe recession and weak recovery, the Fed brought down the federal funds rate to near zero in 2008 and has kept it there since then. Economic conditions have been bad enough that if we could have, we would have lowered the fed funds rate to below zero. But we cannot do that. So instead, modern theory tells us that we should promise that once economic activity recovers, for a time we will hold rates below what they typically would be. This makes up for the period when we were constrained from taking rates negative. In other words, the average path is right over time.

Some people claim we are trying to lower real rates by purposely boosting inflation above the central bank's target. While it is certainly true that we are trying to stimulate activity by lowering long-term real interest rates, higher inflation isn't necessarily part of the story.

For illustrative purposes, suppose inflation was constant at our target of 2 percent. Now consider two paths for short-term rates: one in which they are zero for a year and then rise and another in which they are zero for two years and then rise. Obviously, the second scenario implies a lower average path for short-term rates. So, given that long-term rates tend to move with average expected short-term rates, the second scenario implies lower current long-term rates. Such lower long-term rates would provide a boost to real economic activity today and bring unemployment down more rapidly. Yet, by assumption, under both paths, inflation would be the same, so the channel for these beneficial effects comes from lower long-term nominal interest rates, not higher inflation.

In addition, there is another way for policy to influence long-term real rates. If the extended period of low policy rates is well communicated, then uncertainty regarding future interest rate movements can be reduced. And lower uncertainty will result in lower risk premium being built into longer-term rates.

Of course, we will not maintain low rates indefinitely. For some time, I have advocated the use of specific, numerical thresholds to describe the economic conditions that would

[4] See, for instance, Eggertsson and Woodford (2003 and Werning (2011).

have to occur before it might be appropriate to begin raising rates. I am not alone in this view. As the minutes of our FOMC meetings have indicated, we had a vigorous discussion about numerical thresholds at our October meeting, and many participants said they saw important benefits in adopting them. My colleagues on the Committee, Narayana Kocherlakota, Eric Rosengren and Janet Yellen have all said in public that they support adopting such markers.

In the past, I have said we should hold the fed funds rate near zero at least as long as the unemployment rate is above 7 percent and as long as inflation is below 3 percent. I now think the 7 percent threshold is too conservative. Our latest actions put us on a better policy path than we had when I first proposed the 7/3 markers a year ago. At the same time, there still are few signs of substantial inflationary pressures. If we continue to have few concerns about inflation along the path to a stronger recovery there would be no reason to undo the positive effects of these policy actions prematurely just because the unemployment rate hits 6.9 percent — a level that is still notably above the rate we associate with maximum employment.

This logic is supported by a number of macro model simulations I have seen, which indicate that we can keep the funds rate near zero until the unemployment rate hits at least 6-1/2 percent and still generate only minimal inflation risks. Even a 6 percent threshold doesn’t look threatening in many of these scenarios. But for now, I am ready to say that 6-1/2 percent looks like a better unemployment marker than the 7 percent rate I had called for earlier.

With regard to the inflation safeguard, I have previously discussed how the 3 percent threshold is a symmetric and reasonable treatment of our 2 percent target[5] This is consistent with the usual fluctuations in inflation and the range of uncertainty over its forecasts. But I am aware that the 3 percent threshold makes many people anxious. The simulations I mentioned earlier suggest that setting a lower inflation safeguard is not likely to impinge too much on the policy stimulus generated by a 6-1/2 percent unemployment rate threshold. Indeed, we’re much more likely to reach the 6-1/2 percent unemployment threshold before inflation begins to approach even a modest number like 2-1/2 percent.[6]

So, given the recent policy actions and analyses I mentioned, I have reassessed my previous 7/3 proposal. I now think a threshold of 6-1/2 percent for the unemployment rate and an inflation safeguard of 2-1/2 percent, measured in terms of the outlook for total PCE (Personal Consumption Expenditures Price Index) inflation over the next two to three years, would be appropriate.

The fact that this inflation safeguard is in terms of a forecast is important. A threshold based on the forecast for inflation would avoid triggering a policy reaction in response to transitory movements in prices — say, to some temporary swing in energy prices. It

[5] See, for example, Evans (2012).
[6] Yellen (2012).

would also take into account everything we are seeing in the economy in terms of cost pressures and inflationary expectations — factors that influence the inflation outlook before they show up in actual inflation data. The forecast therefore provides a better safeguard than a backward-looking measure.

Conclusion

To conclude, I believe that the U.S. and other advanced economies are facing significant long-term challenges in credibly controlling future debt levels. At the same time, we are also confronting the immediate challenge of not imposing too much austerity on our fragile economies. Clearly our fiscal authorities must find the appropriate balance between meeting these two challenges. As most everyone agrees, this implies putting in place policies that slowly but surely bring the prospects of future revenues into balance with future spending.

Under this scenario, monetary policy also has an important contribution to make. In my mind, this contribution should provide financial conditions that help produce the most robust demand growth we reasonably can achieve, with appropriate measures in place to safeguard price stability. As I've explained, the FOMC has recently taken important steps in this direction. And I believe we have the ability to go even further in reassuring financial markets and the general public that policy will stay appropriately accommodative and that such steps would provide the stimulus to growth that can benefit our future well-being in the United States and around the world.

Thank you.

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