Monetary Policy and the Jobless Recovery Puzzle

Since you are all avid market watchers, I'm sure you've read articles or heard news stories about the Fed—and many of those stories claim to know what the Fed's next move will be. I'm certainly not here to tell you what is going to happen to interest rates. First of all, I am not allowed to. Second, as you'll learn from my talk, I couldn't tell you even if I wanted to, because our policy moves depend on developments in the economy and are the result of deliberations by our key policymaking group, the Federal Open Market Committee, or FOMC. What I am here to do is tell you a little bit more about the Fed's policymaking process, and discuss some of the challenges we face while setting monetary policy. In particular, I'd like to talk about a puzzle we currently face, namely, the prolonged “jobless recovery” that we've seen over the last few years.

But, first, I'd like to give you a little background on the Federal Reserve. At the Fed, our overarching mission is to foster monetary conditions that promote both price stability and maximum sustainable economic growth. We think of these goals as related—it is difficult to have maximum sustainable growth without price stability.

We carry out our mission primarily by conducting monetary policy. We also support these goals by ensuring that the financial payments system works efficiently and by supervising and regulating financial institutions. Our role in the payments system has helped us meet financial challenges, such as providing liquidity following the tragic terrorist attacks on September 11. Our supervision and regulation function gives us important insights into developments in the banking system and the borrowers and lenders that it serves.

One of the Fed’s distinct attributes is its regional structure. The Federal Reserve System comprises twelve District Reserve Banks across the U.S. and the Board of Governors in Washington D.C. I serve...
As president of one of these District banks, the Federal Reserve Bank of Chicago. The Chicago Fed District covers most counties in five Midwestern states—Illinois, Indiana, Iowa, Michigan, and Wisconsin.

As president of the Chicago Fed, I serve on the FOMC, along with the other Reserve Bank presidents; the Fed Chairman, Alan Greenspan; and the other six members of the Board of Governors. The FOMC has eight scheduled meetings each year…but the process of formulating policy begins well in advance of the meetings.

The first step in the process—and truly this step is always ongoing—is gathering non-quantitative and anecdotal information about the economy. Each District maintains a wide network of business and other contacts in their region. Through direct conversations and informal surveys, our contacts provide real-time insights on current and future trends in a wide range of economic indicators.

The information we get from our contacts is summarized in a document known as the Beige Book, which is then distributed to all of the FOMC members and released to the public two weeks before the meeting.

After the Beige Book is released, economists at most District banks develop economic forecasts for their bank presidents. The staff at the Board of Governors also produces a forecast, which is distributed to FOMC members in a document known as the Greenbook. In our forecasts, we use the same data and similar methods as many private sector forecasters, but we also incorporate the additional, contemporaneous information from our wide network of business contacts.

Just before the FOMC meetings, each bank president and the governors in Washington are extensively briefed by their staffs on the forecasts as well as a variety of other issues related to the policy decisions. Once we have gone through this process, it is time for the meeting in Washington.

Typically, FOMC meetings open with an update on financial market conditions and a presentation of the Greenbook forecast by the Board staff. After some discussion of the forecast, each Reserve Bank president gives his or her perspective on economic conditions in their regions and in the nation as a whole. The members of the Board of Governors offer their views on the national economy.

The Committee then discusses two or three policy options that had been described in a document known as the Bluebook. The policy options in the Bluebook center on two things. One is what we do with our target for the federal funds rate, which is the interest rate that U.S. banks charge each other for overnight lending. The other is our statement on the balance of risks in the economy.

After more discussion, Chairman Greenspan has developed a good sense of where the Committee stands. He usually then offers his views on the economy and policy options, and lays out his sense of the consensus regarding the fed funds rate target and the balance of risks statement. Each member of the FOMC expresses his or her view on the course for policy and then we are ready to vote.

When it comes to policymaking votes, the Federal Reserve is somewhat different from other central banks. Not through any specific policy or initiative, but perhaps just by its culture, the Fed has always placed a premium on uniting around the consensus policy action. While some on the FOMC might express different opinions, we strive for a consensus and most of our votes are unanimous. In
fact, in my nine and a half years on the FOMC, there have never been more than two dissenting votes for any given monetary policy decision. At other central banks, dissent is much more common. For example, in the Bank of England's policy decisions last year, dissents by at least three out of the nine policymakers were more common than unanimous votes.

The fact that our votes are usually unanimous does not mean that our decisions are easy. It seems there is always a new challenge tossed our way—and each challenge is unique.

Some, like 9/11, are external shocks to the underlying workings of the economy and come with no warning. Some, like Y2K, are apparent long in advance.

Others are more like puzzles: puzzles about how the economy works and what long-term changes it might be going through. Consider one puzzle we experienced in the late 1990s. From 1973-95, productivity growth had averaged 1½ percent, but starting in the mid-1990s, it began to grow much faster. After seeing this for a number of quarters, we were faced with the question: Had the underlying trend rate of productivity growth permanently changed? Or was it a temporary surge? The answer had important implications for us on the FOMC and the appropriate stance for monetary policy. If productivity growth had shifted higher, the economy's sustainable growth rate would be higher as well, and the inflationary risks of faster economic growth would be diminished.

Looking back today, we can see that the change in productivity was not temporary. In fact, in the late 1990s productivity growth averaged 2½ percent and since 2000 it has averaged over 4 percent. But the higher productivity trend was not obvious when we were deliberating policy during the 1990s. The economy is complex and constantly buffeted by shocks. And time must elapse before any permanent changes can be confirmed. Yet, as policymakers, we cannot afford to wait until all the data are in before making a decision.

The most prominent puzzle we face now is the so-called jobless recovery. The most recent recession ended in November 2001, but employment gains remain the missing link in the recovery. Over two years later, payrolls are still more than 700,000 jobs, or ½ percent, below where they were when the recession ended. In the two years after a typical recession, employment increases by 5 percent. Even in the two years that followed the 1990-91 recession, which was the original jobless recovery, employment had not only surpassed its level at the end of that recession, but also its previous peak.

To be sure, we have seen signs of improvement in labor markets during recent months. Unemployment insurance claims and other indicators suggest that the pace of layoffs has slowed substantially. And we have seen some job gains recently—an average of 60,000 jobs per month since last August. But the economy needs to create between 100,000 and 150,000 jobs per month just to keep pace with population growth.

So, we are left to solve an important puzzle: Why haven't we seen the kind of job growth we typically observe after a recession ends? Like any tough puzzle, the answer is not obvious. Analysts have proposed many solutions. One we hear frequently is that extensive changes in the economy have resulted in a greater than normal need for workers to move among industries and occupations.

Why might this reduce employment growth? First let me give you a little background.
The economy is constantly changing due to a variety of factors. Consumers shift their demand for products and services. International markets open up new opportunities for trade. And new technologies emerge that create entire new industries. As these events occur, workers move from industries and occupations that are shrinking to those that are expanding.

In the long run, this movement or reallocation promotes efficiencies and is essential for achieving maximum sustainable growth. However, in the short run, the process of matching qualified workers with the labor demands of firms costs time and money, and can cause significant hardship for displaced workers. If the need for reallocation is very high, it can temporarily lower the productive capacity of the economy, reduce employment growth, and raise the unemployment rate.

Some analysts believe we currently are in such a period of heightened reallocation. As evidence, they point to the sharp declines in the manufacturing sector and to the increased ability to outsource both manufacturing and service jobs overseas.

Certainly these developments are noteworthy. But do they imply that sectoral reallocation is unusually high?

After all, even in good times, many jobs disappear, and many new ones are created. When I said earlier that the economy needs to create between 100,000 – 150,000 jobs per month to keep pace with population growth, I was referring to the net increase in employment. This net increase is the difference between the total number of new jobs created and the total number of jobs destroyed. These gross rates of job creation and destruction are huge. In fact, out of approximately 130 million payroll jobs, over 2½ million jobs are created each month and approximately the same number are destroyed.

As one would expect, the gross rate of job destruction spiked during the recession but has fallen back to the low level that prevailed before then. In contrast, the gross rate of job creation fell during the recent recession and, unfortunately, it has stayed low since. But the fact that both rates are now low suggests that the current pace of job reallocation is not especially high.

This evidence is consistent with research by one of our economists at the Chicago Fed, Ellen Rissman. She found that most of the recent changes in employment shares across broad industries appear consistent with long-run trends and the usual changes over the business cycle.

How do these observations square with all of the discussion on the decline of manufacturing and international outsourcing?

With regard to manufacturing, its share of total employment has been trending down for decades. This long-run trend is largely due to higher productivity growth in the manufacturing sector compared to the overall economy. And manufacturing employment usually is hit harder by business cycle downturns and periods of weak growth. Ellen's work suggests that the recent losses in manufacturing employment are about what one would expect given these two factors.

With regard to outsourcing, accurately measuring its impact is quite difficult, and we do not have good information on the number of jobs that have moved overseas. But, even the higher estimates one hears of jobs lost to outsourcing are only a few hundred thousand over the last few years. For an
economy the size of ours, these are not large numbers—especially in relation to the \( \frac{2}{7} \) million jobs created and lost each month in the U.S.

Outsourcing also is not new. Over the past 50 years, we have heard concerns about job losses attributed to competition from Japan, the Asian Tigers, Mexico, and, now, China and India. These developments are often thought of as permanently reducing the number of jobs in the U.S. Indeed, certain jobs are lost forever. But other new jobs—many in new industries that spring up with advances in technology—take their place. That’s why over the past 50 years, even while there has been a decline in the manufacturing sector’s share of employment and increases in international competition, the U.S. economy has generated over 80 million net new jobs.

Now, I do not want to minimize the impact of the job losses associated with changes in the economy, no matter what their source. The human costs of this process are significant and compelling. Existing factories or offices may close and workers lose their jobs. We must always strive to ease the transition for these workers and their families, whether it is through financial assistance, retraining programs, or other efforts. But the dynamic changes in the economy are important if we are to continue to increase overall incomes and our standard of living.

So if there isn’t an unusual amount of reallocation taking place, what else might be causing weak employment growth? A number of factors could be in play. One is the basic story relating aggregate supply and aggregate demand. Namely, the increases in aggregate demand have not kept up with gains in the productive capacity of the economy. Because the relative growth of aggregate demand is a key determinant of employment growth, it is important in explaining what’s been going on in the labor market.

Firms have been—and continue to be—very successful in developing innovative ways to reorganize their production and distribution networks, especially by exploiting advances in technology. As I alluded to earlier, productivity growth has averaged 3 percent since 1995. This has likely resulted in sharp advances in the potential productive capacity of the economy.

It goes without saying that aggregate demand was weak during the recession. However, after the recession ended, the economy was hit by a series of shocks: The start of the war on terrorism, the revelations of corporate malfeasance, and the buildup to the war in Iraq. All of these heightened uncertainty and diminished confidence about the economy, which in turn, weakened aggregate demand. In particular, businesses continued their reluctance to invest in new equipment and to hire new workers.

Subsequently, as we moved through 2003, we saw signs of improvement in several key sectors of the economy. Household spending, which had held up quite well throughout the recovery, posted solid gains. But, more importantly, business spending on capital equipment rose strongly in the second half of last year and appears to have increased at a brisk pace so far this year. And many of our business contacts have told us that they will have to hire soon if strong demand continues.

And I think that it will. Last year’s round of tax cuts and the Federal Reserve’s highly accommodative monetary policy stance should support business and consumer spending. More fundamentally, productivity itself will help support growth in demand and employment. Over time, higher produc-
tivity generates higher income, higher income generates higher spending, and the higher spending
helps create the new jobs that eventually put unemployed workers back on payrolls.

And because they often are the result of unforeseeable innovations in technology, it is impossible to
say now what new jobs will be created in the future. For example, GE Healthcare recently announced
plans to expand their Information Technology and Ultrasound operations in Wauwatosa, Wisconsin.
As many as 2500 employees at the new facility will engineer and manufacture innovative medical
equipment, including computed tomography, or CT systems. These products allow doctors to readily
diagnose health problems like cancer or aneurysms without exploratory surgery, and the machines
are now widely available. It would have been virtually impossible to anticipate these jobs five years
ago, because no one could predict how the use of CT technology would evolve.

In closing, the current jobless recovery is just one in a long line of challenges that the country has
faced in its economic history. However, to its credit, time and time again our economy has proven
itself resilient in the face of these short-term challenges. With its entrepreneurial culture, market-
based principles, and continuing technological advances, our economy has the ability to handle its
current challenges.

At the Federal Reserve, our role is to foster the monetary conditions that will best help the economy
meet its challenges. We remain committed to achieving our overarching goals of price stability and
maximum sustainable growth.