The Recovery and Monetary Policy

Additional Information

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Introduction

If you have been following the news, you are aware that the Federal Reserve recently decided to purchase an additional $600 billion in Treasury securities over the next six months. That decision has received a lot of attention. Tonight, I'm going to explain why I supported the decision to purchase additional Treasury securities.

To do that, I think it would help to provide some background and context. So I will begin by briefly describing the issues we consider when making monetary policy decisions. I will also talk about my outlook on the economy. Finally, I'll talk about why I decided that purchasing additional Treasury securities was the right course of action.

Issues in Monetary Policy Decisions

Let me start with some background on the issues we consider when making monetary policy decisions. I am a member of the Federal Open Market Committee, or FOMC, the Federal Reserve's policymaking group. The FOMC consists of the members of the Federal Reserve Board in Washington, DC, and the presidents of the 12 Federal Reserve Banks across the country. Congress has given the Federal Reserve a dual mandate to conduct monetary policy in ways that will promote price stability and maximum employment over time.

So let's look at the first half of the dual mandate—price stability. Because Congress has not given us a numerical objective for inflation, FOMC members have some latitude in selecting the inflation rate we think is the most compatible with healthy economic growth over the long run. The purchasing power of the dollar over time is determined by the monetary policy decisions we make. Put more simply, inflation is a monetary phenomenon.

Centuries of economic history have taught central bankers to avoid both inflation and deflation. When the general level of prices increases year after year, people come to expect their money to lose its purchasing power, and they will tend not to make the best spending and investing decisions. In particular, inflationary conditions encourage people to borrow funds for speculation. They figure they can just repay their loans with cheaper dollars in the future.

On the other hand, deflationary conditions discourage borrowing for investment, since people believe that the debt they hold now will become more expensive to service and repay. But that isn't the only danger of deflation. Once consumers start expecting price declines, they will put off buying things until prices go down further. These

price declines could lower sales, shrink profits, hold down wages, and limit hiring. So inflation and deflation can each bring bad outcomes and undermine healthy economic performance.

As a practical matter, FOMC members tend to think that inflation over the longer run in the range of 1½ to 2 percent is most compatible with healthy economic growth. My preference is to have inflation average 2 percent over the longer term. If I lived in the world of economic textbooks, I would choose zero inflation, but I have chosen 2 percent to provide some room for measurement error and to keep some distance from the perils of deflation. I'll have more to say about that risk later when I discuss the current policy situation.

The other half of the Federal Reserve's dual mandate, as I said, is maximum employment, but we tend to think differently about a working definition for this concept. That's because the amount of employment that equals "full employment" can vary over time due to changes in a variety of areas like technology, business practices, taxes, labor market regulations, and other public policies. As a result, FOMC members estimate what level of employment our economy is capable of sustaining, and we reassess these estimates from time to time. At our last meeting in early November, most FOMC members indicated that when our economy returns to full employment, the unemployment rate would move back down to a range of 5 to 6 percent.

Over the longer term, the FOMC is trying to achieve price stability and maximum employment. So now let me explain how we decide which policy actions are most likely to foster those outcomes.

The decisions the FOMC makes today have immediate effects on financial markets, but their effect on output, employment, and prices develops much more slowly, and begins to show up six to 18 months after a monetary policy decision. To do our jobs effectively, then, we have to make forecasts. Each member of the FOMC develops his or her own economic forecast using data, models, and information we gather from talking to business and community leaders. In fact, you may have seen coverage of a meeting I moderated at The Ohio State University this week with Chairman Bernanke, where we engaged a group of business leaders in a discussion about labor markets.

All of this information—both hard data and real-time anecdotes—is useful for the FOMC members as we develop our projections for the economy under a variety of economic scenarios. At our meetings, we debate the pros and cons of monetary policy options under these scenarios—whether output is likely to be growing either faster or slower in the months ahead.

Not surprisingly, FOMC members don't always hold the same views. But the forecasting process provides a structured way for us to discuss the outlook and our policy options, and to reach decisions. The Committee publishes a summary of our projections quarterly, and many members discuss their views about the outlook at events and forums such as this one here at Oberlin.

Since the outlook plays such a prominent role in the policy process, I want to tell you what I see when I analyze the economic situation.

The State of the Recovery and My Outlook

Let me begin by telling you something you are already painfully aware of—the economy has been through its worst recession since the Great Depression in the 1930s. The downward spiral began with the housing crisis, which led to the financial crisis. Financial markets

froze, production collapsed, and employment plummeted.

The Federal Reserve responded aggressively and creatively to this crisis. The FOMC quickly reduced short-term interest rates to near zero and helped lower long-term rates by purchasing about $1.7 trillion worth of mortgage-backed securities, government agency debt, and Treasury securities. I'm firmly convinced that these actions helped us avoid the worst possible scenario: a repeat of the Great Depression worldwide. Yet many challenges remain.

Today, the economy is growing and has officially emerged from the recession, but I'm sure you would agree that this recovery just doesn't feel like much of a recovery. Here's why: research shows that when recessions are preceded by financial crises, the downturn is more severe and the recovery period takes longer than normal. In fact, this has been the slowest economic recovery we've experienced in the post-World War II era, and the remnants of the financial crisis are still holding back economic progress.[1] Households have become more cautious in this environment. Consumers have sharply cut back on spending, and they continue to reduce their debt and save more. And, of course, housing markets remain stressed. Finally, in the face of weak demand, companies are still hesitant about adding people back onto their payrolls.

Although the economy is growing, it is still digging itself out of a deep hole. In fact, based on real GDP estimates that were revised in July, we now know that output growth for 2007, 2008 and last year was actually worse than previously reported. In other words, the economy began its recovery deeper in the hole—and has more ground to make up—than everyone thought earlier this year.

Nowhere is the depth of this hole more evident than in labor markets. Right now, nearly 15 million Americans are unemployed, and the unemployment rate stands at 9.6 percent. While it was encouraging to hear that the economy added another 150,000 jobs in October, we still have a long way to go just to reach 2007 employment levels. In normal times, about 150,000 new workers enter the labor force every month. That means to even start making a serious dent in the unemployment rate, we would need to add substantially more than 150,000 jobs every month.

Troubling as these numbers are, what is even more troubling is how long people are remaining out of work. About half the people who are unemployed have been out of work for at least six months. In another severe recession, back in 1982, the average duration of unemployment peaked at 21 weeks, but today the average duration is 34 weeks.

These long spells of unemployment can lead to some unfortunate consequences. Labor economists have repeatedly shown that the longer people are out of work, the harder it is for them to find jobs. And for some who are unemployed for a long time, when they finally do return to work, they may be forced to take jobs that pay less or aren't as well-matched to their skills as the jobs they lost. When this erosion of human capital is repeated millions of times over, it can reduce economic efficiency and possibly even our overall standard of living.

Some academics are speculating that the American job market has changed permanently, and that we'll simply have to get used to a higher rate of unemployment even after the economy recovers. They argue that the structure of our economy has changed, and that there will be a continuing mismatch between the types of skills employers seek and the skills the labor force has to offer. Obviously, this debate has important implications for the maximum employment aspect of the Federal Reserve's dual mandate.

But a group of economists at my Bank have studied this question as well, and they conclude that most of the rise in unemployment our country has experienced is cyclical, not structural.[2] In other words, the most important reason employers are hiring so slowly is that their business activity has been slow to pick up, not because there has been a sudden mismatch between worker skills and available jobs.

I know that some people are skeptical about this conclusion. It is clear that for many people, jobs are hard to find. Indeed, the job finding rate is pretty low, and economists at my Bank have shown that this rate has been on a downward trend for 25 years. But the recent cyclical downturn created a huge new glut of unemployed workers, with the result that it will likely take a lot longer than normal for people to find the jobs they want.

Let me bring this closer to home. While I recognize that it is never easy to start out and find a job after you graduate, even from a great school like Oberlin, a few years ago it was a lot easier than it is now. Currently, the unemployment rate for college graduates under the age of 25 is running at almost 9 percent. Before the recession, that rate was under 5 percent. Unless you think that recent college graduates are less well-prepared than they were before the recession, I think it is reasonable to conclude that this is more evidence of cyclical rather than structural unemployment, and that a more rapidly growing economy should lead to more job growth.

Even though I expect overall economic activity to pick up in the next couple of years, I expect hiring to strengthen only gradually. The unemployment rate is likely to remain elevated for quite some time. In fact, I do not expect it to fall below 8 percent before 2013.

And what about my outlook for inflation? The bottom line is that inflation is too low. How could that be, you might ask? Aren’t prices for many items such as tuition and medical care going up? The answer is yes, but these price increases do not mean that overall inflation is rising at the same pace.

Inflation is a deterioration in the purchasing power of money, which leads to a general rise in most prices and wages. But prices can change for reasons other than inflation. Relative price changes—both up and down—happen as individual prices adjust to changing supply and demand pressures. For example, although prices rose last month for tuition and medical care, the prices of cars and clothing declined.

Central banks cannot do anything about relative price changes. But through our monetary policy actions, we can influence overall inflation. So, in developing our outlooks, we take a lot of care to look closely into the details of the price statistics to distinguish between the changes in the ups and downs of individual goods and services, versus the average rate at which the whole market basket of consumer prices is changing.

One of the most important inflation guideposts is the core Consumer Price Index, or CPI. The core CPI is a measure of the rise in prices based on goods and services people commonly buy, but it excludes food and energy costs, which can change sharply from month to month. By this measure, inflation has fallen to a record low of 0.6 percent.

I find that core inflation is a better predictor of future inflation than the CPI itself. And an even better predictor than core inflation is the median CPI—an inflation measure that my Bank publishes monthly. The median CPI is considered about 50 percent more accurate in gauging future inflation than the overall CPI. The median CPI doesn’t take the averages of all of the prices in the consumer basket of goods

that the CPI measures each month. Instead, it looks at the price change that's right in the middle of the entire long list of individual price changes. Here is why that is important: if you're just measuring averages, as the CPI does, it's easy for a big price shift in one item in that basket of goods to push the whole CPI up or down. As it stands today, the median CPI is also at a record low of 0.5 percent on a 12-month basis.

Based on these two measures, I see no evidence of inflationary pressures in the economy. If anything, there appears to be a slight trend toward further disinflation. When you really drill down into the CPI data, as my staff and I always do, you'll find that nearly 40 percent of the items in the consumer's market basket showed price declines over the past month, while just 12 percent of the market basket showed price increases above 3 percent.

In addition to regularly examining the CPI data, I also look at indicators of future inflation coming from financial markets, where investors are putting serious money behind their views about where inflation is heading over time. At the Federal Reserve Bank of Cleveland, we have constructed a statistical model that uses data on financial market transactions to infer the inflation expectations of these market participants.[3] In the latest release of our inflation expectations model, which is a very popular feature on our website, inflation expectations remain below 1.5 percent for 10 years, and below 2 percent as far as the eye can see.[4]

Given today's extremely low inflation rates and the expectations in financial markets that those rates will remain low, I think that inflation will remain quite subdued through 2013. I do not expect to see deflation—which is an outright decline in the general level of prices—but with demand in the economy still weak and unemployment so high, continuing disinflation is a risk to my outlook. In periods of significant economic slack, there is the potential for very low inflation to tip into deflation.

Admittedly, deflation is rare in the modern experience of industrialized economies. The last time this country had deflation was in the Great Depression of the 1930s. As a result, very few Americans have direct experience with the problems associated with deflation. On the other hand, Japan—which has a large industrial economy—has been struggling for several decades, and scholars point to deflation as a root cause.

Deflation could prove much harder to fight than inflation. The FOMC has experience dealing with inflation above our objectives, but we have no experience dealing with outright deflation, and I'd like to keep it that way.

Why I Supported the Decision to Purchase Additional Treasury Securities

So, I headed into the November 3 FOMC meeting with an economic outlook that had the economy falling short on both parts of the Federal Reserve's dual mandate of price stability and maximum employment. With monetary policy already highly accommodative, the question I faced was whether further monetary stimulus could improve the situation. Would more monetary stimulus ease financial market conditions in ways that would promote some additional growth in spending, output, incomes, and employment? And would this extra boost, modest though it might be, also act to counter any lingering disinflationary pressures? In the end, I concluded that there were enough negative risks to growth and disinflation in my outlook to merit taking steps that would protect the economy from those risks.

As I contemplated the potential benefits of further large-scale purchases of Treasury securities, I evaluated the potential costs as well. The most important cost in my mind was a possible increase in inflation and inflation expectations. The public might question the Federal Reserve's ability to head off destructive inflationary pressures after expanding our balance sheet so dramatically. The FOMC is firmly committed to maintaining price stability, and we have developed tools that we expect to be very effective in eventually shrinking our balance sheet. If we do begin to see a buildup of undesirable inflationary pressures, I am confident that the FOMC has the resolve and tools to counteract them.

In the weeks before the last FOMC meeting, markets were already anticipating further policy accommodation. In other words, even well in advance of the November 3 announcement, we saw evidence of the likely effect of additional purchases as investors began to anticipate easier financial conditions. Initially, stock prices rose and long-term interest rates fell, and I believe that this easing in financial conditions will, over time, promote more economic growth. Lower mortgage rates will support home purchases and mortgage refinancing. Lower corporate bond rates will support more investment. Each of these developments will help to increase confidence, which in turn encourages more spending, which leads to somewhat more employment, and then to higher incomes and profits. In this way, small gains can build into significant progress over time.

Putting it all together, my choice was clear. I voted to support additional asset purchases. I think our policy action offers the right kind of insurance that the Federal Reserve's monetary policy will support the economic expansion while stabilizing inflation and inflation expectations consistent with our price stability mandate.

Conclusion

In conclusion, I've studied the financial and economic situation carefully to determine the right policy actions to fulfill our dual mandate of price stability and maximum employment. I will continue to do so, constantly evaluating the costs, benefits, and results along the way. The FOMC will regularly review incoming economic and financial data, update our outlook, and make adjustments as needed. We know that our economy faces a multitude of challenges, and a full recovery will take some time. We also know that the Federal Reserve cannot solve all of the economy's problems on its own. A sustainable recovery will also depend on prudent, sensible approaches to fiscal policy, tax policy, trade policy, and many other considerations far beyond the Federal Reserve's scope. But responding to inflationary and disinflationary pressures gets to the heart of what a central bank can and must do. The main variable the Federal Reserve can control over time is the price level. Ensuring price stability is our job. My belief is that by promoting price stability, the Federal Reserve is following the best course for supporting the economic recovery.

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1. For recessions since 1948, the average length of time it took for real GDP to return to its pre-recession peak level was just over 12 months. We are already 33 months into this business cycle and in the third quarter of 2010, real GDP still remained nearly a full percentage point below its 2007 peak.

2. Tasci, Murat, and Saeed Zaman. "Unemployment after the Recession: A New Natural Rate?" *Economic Commentary* 2010-11, September 2010. Available at: http://www.clevelandfed.org/research/commentary/2010/2010-11.cfm ➤

3. "Inflation: Noise, Risk, and Expectations," by Timothy Bianco and Joseph G. Haubrich. Federal Reserve Bank of Cleveland, *Economic Commentary*, no. 2010-5 (June 28, 2010). Available at: http://www.clevelandfed.org/research/commentary/2010/2010-5.cfm.

4. "Estimating Real and Nominal Term Structures using Treasury Yields, Inflation, Inflation Forecasts, and Inflation Swap Rates," by Joseph G. Haubrich, George Pennacchi, and Peter Ritchken. Federal Reserve Bank of Cleveland, working paper, no. 08-10 (November 2008). Available at: http://www.clevelandfed.org/research/workpaper/2008/wp0810.