The Long Road Back to Full Employment

Today I will share with you my outlook for the economy and inflation, and I will focus on why unemployment is remaining so stubbornly high. Finally I will share my thoughts on monetary policy in today's environment.

As always, the views I express are mine alone and do not necessarily reflect those of my colleagues in the Federal Reserve System.

Let me start with a few comments about the Federal Reserve. The Federal Reserve sets the monetary policy for the nation. Simply put, this is the policy controlling the availability of money and credit. Fiscal policy, which is tax and spending policy, is the domain of the United States Congress and the executive branch.

Monetary policy is important because it affects the availability and cost of credit to businesses and consumers. It also largely determines the long-run rate of inflation, and can influence economic growth. Within the Federal Reserve, most of the work of monetary policy falls to the Federal Open Market Committee or FOMC. The FOMC consists of the members of the Board of Governors of the Federal Reserve System in Washington, D.C., plus the presidents of the 12 Federal Reserve Banks. The Federal Reserve Bank of Cleveland is one of those 12 banks.

To guide us in setting monetary policy, Congress has passed laws requiring the Federal Reserve to promote low inflation and low unemployment over time. These objectives are more formally referred to as our dual mandate for stable prices and maximum employment. During the financial crisis, the Federal Reserve took unprecedented steps to avoid another Great Depression, and we have continued to act aggressively with an accommodative monetary policy to promote economic growth while maintaining price stability.

I will have more to say about monetary policy after I talk about my economic outlook and labor market conditions.

Despite our current accommodative monetary policy, the recovery from the recent financial and economic crisis has been frustratingly slow. A number of headwinds are holding back growth. Housing markets continue to be depressed. The government sector has been reducing spending and employment. Add to the mix that Europe could well be headed for recession, which will negatively affect our exports.

Uncertainty also plays a key role in holding back growth. I spend a lot of time talking with business leaders. Almost without exception, they tell me that uncertainty is making them more cautious. There are uncertainties regarding the resolution of federal, state, and local

Additional Information

Sandra Pianalto

President and CEO,
Federal Reserve Bank of Cleveland

Wooster Area, Orrville Area and Holmes County Chambers of Commerce

Wooster, Ohio

January 10, 2012

budget problems, which will translate into tax and spending issues. Then there are also regulatory uncertainties: healthcare, environmental, and financial reform, to name just a few.

Uncertainty is clearly an important factor, but businesses leaders are also telling me that weak demand for their products and services is the primary reason they are not expanding their businesses and hiring new workers. Indeed, consumer spending has been much softer than normal in a recovery period. It has grown only about half as much in this recovery as it did in previous recoveries. Consumer spending on goods and services has accounted for about 70 percent of the nation's GDP during the past few years. Consequently, the spending pattern of consumers is critical to overall economic performance.

Given these numerous headwinds, I am expecting the economic recovery to remain moderate and for the economy to grow around 2-1/2 percent in 2012, and about 3 percent in 2013.

Despite the sluggish recovery, the inflation rate nearly reached 4 percent[1] early last year, due primarily to the rising prices of oil and food. But lately these elevated rates have been seen for what they were – temporary spikes rather than sustained increases. In recent months the overall inflation rate has trended down, and I expect inflation to dip below 2 percent during the first half of this year.

In fact, the outlook for inflation is pretty good. Incoming inflation data across a broad range of products are soft, commodity prices are no longer trending higher, and wage growth continues to be moderate. Wage growth is a critical factor in my inflation outlook, which makes sense because more than half of consumers' purchases are services. Labor costs are important components of many consumer products, but labor costs figure even more prominently in the cost of services because many services are almost entirely labor. The elevated unemployment rates stemming from the recession have already brought down wage growth from just below 4 percent per year to less than 2 percent. This reduced compensation growth, which is continuing, is due primarily to the excess supply of labor in the economy relative to the current demand for labor, or said more simply, due to the high rate of unemployment.

I am going to spend some time on the unemployment situation because it is a critical issue for our economy. As I discussed earlier, along with implementing policies that support stable prices, the Federal Reserve is also charged with implementing policies that aim toward full employment. Our goal is not zero unemployment, but rather what we call the "natural rate of unemployment." Zero unemployment is not possible because people are always entering and returning to the workforce, and people are always leaving jobs and searching for new ones. Such searches take a while, so that at any given time there will be people who are seeking employment.

Unfortunately, putting a specific number to the concept of the natural rate of unemployment is technically difficult and, wouldn't you know it, economists have different estimates for this rate. Moreover, the natural rate of unemployment can shift up or down with changes in technology and the skill level of the unemployed, and so on. Obviously what we have now – an unemployment rate of 8.5 percent – is too high, and zero is impossible. My staff and I currently estimate that the natural rate of unemployment is somewhere around 6 percent. Given my current outlook for economic growth of 2-1/2 percent for this year and 3 percent for next year, it is going to take four to five years to reach that rate.

So why do I think it will take so long to return to the natural rate of unemployment? I have three main reasons. First, despite recent progress, we are still at a high level of unemployment. The second

reason is that the slow rate of growth is restraining job creation. And the third reason is that it is taking longer to match workers with available jobs.

Let's look at the first reason--the high level of unemployment. The financial crisis and recession were severe. We lost almost 9 million jobs during the recession. This was a far more severe destruction of jobs than in any of our nation's recessions since the Great Depression. The unemployment rate more than doubled from 4.4 percent to 10.1 percent. Since employment began to recover, we have regained only 2 million of the lost jobs. This is a big hole to dig out of and, therefore, it will take time. Even if we continue to generate 200,000 jobs each month, as we did in December, it would still be four years before we reached 6 percent unemployment. And that estimate assumes that the many people who stopped looking for work in the recession will not return to the labor force. If they do, as is typical when times get better, four years may be a conservative estimate.

That leads me to the second reason that it will take some time to return to full employment-- weak output growth. There is a strong and steady relationship between output growth and employment patterns going back to the 1950s. That relationship shows that our meager employment gains are entirely consistent with the weak level of growth we have seen. Typically our economy needs to grow at a rate of 2 percent just to accommodate new entrants to the workforce and to keep the unemployment rate from rising. Unfortunately, the economy grew at less than 2 percent in each of the first three quarters of 2011, so it was not a surprise to me that we did not see more progress on employment last year. I was surprised that the unemployment rate declined as much as it did last year. But it looks like weak labor force participation played a key role in that decline.

The impact of our slow recovery is evident in the limited number of job openings available for today's unemployed workers. You may have read about job openings going unfilled for lack of qualified applicants. But in an economy as large as ours, this is not the primary issue. It always takes time for employers to find the best candidate for an open position, but today the number of open jobs is unusually low when compared with the number of unemployed people. Before the recession, there were fewer than two job-seekers for every open job. Today there are about four people looking for work for every job opening. The only real solution to the unemployment problem is to increase the number of job openings through more growth in the economy.

Now let's look at the third reason--the speed of matching workers to available jobs. The labor market appears to be adjusting more slowly than it did in the 1980s, which was the last time we had such a high unemployment rate. In the 1980s there was more churning in the labor markets--that is, more people were losing jobs each month, but more people were also being hired each month. While we don't necessarily want more layoffs, a more dynamic labor market in this sense produces more rapid declines in unemployment.

What's changed in the labor market to make it less dynamic? We are not really sure. It is probably due to more than one factor. For example, demand for more specialized skills requiring higher levels of education and training makes it harder to find a candidate who meets all the requirements. There have also been important structural changes in industries--some industries are shrinking, homebuilding for example, and some industries are upgrading their skill requirements as they introduce new technology--manufacturing comes to mind. The good news is that although the labor markets have been sluggish in

matching workers to available jobs, the history of workers in this country, and notably in the state of Ohio, shows that workers will eventually shift industries and get training as needed for the current workplace.

During the harsh recessions of the early 1980s, Ohio lost almost a half million jobs or more than 10 percent of its total employment. Ohio alone accounted for about 20 percent of the entire country's job losses in this difficult period. Unemployment in Ohio peaked near 14 percent in the early 1980s, which was three percentage points above the national rate, and remained high for several years. It probably seemed like Ohio's unemployment rate would never recover, but by 1989 Ohio's unemployment rate was down to 5.3 percent, similar to the national rate. By the early 1990s, Ohio had an unemployment rate below the national average. This happened because the jobs recovery occurred primarily outside the hard-hit manufacturing sector. Many workers changed industries, and some even left the state for other opportunities. It wasn’t pleasant or quick, but the economy eventually did adjust, and we saw unemployment decline below pre-recession levels.

So while the unemployment picture remains very difficult, as an FOMC member, I am committed to moving our economy toward full employment and maintaining price stability – keeping in mind that the natural rate of unemployment is hard to quantify and can move for reasons beyond the scope of monetary policy.

So let me now turn to monetary policy. The FOMC meets in two weeks, and this year I am a voting member. The FOMC conducts monetary policy to achieve its dual mandate of stable prices and maximum employment. We tighten and ease monetary conditions in order to keep the economy on a path that is consistent with these goals. Monetary policy affects the economy in various ways, most especially in terms of interest rates and the rate of inflation. When monetary policy is restrictive, interest rates tend to rise, spending and employment tend to slow or even contract, and inflation tends to decline. When the Federal Reserve pursues accommodative monetary policy, interest rates tend to decline, economic activity strengthens, and inflation tends to rise.

If today's economic circumstances were not so unusual, the FOMC would be conducting monetary policy the way we usually do: by targeting the federal funds rate, which is the interest rate that banks pay one another for borrowing money overnight. Raising the federal funds rate tightens monetary conditions, and lowering that rate eases them. Of course, businesses and households don’t borrow at the federal funds rate, but by controlling the path of the federal funds rate, we are actually able to influence the path of corporate bond rates, mortgage rates, car loan rates, and so on throughout the economy.

It takes time for our monetary policy actions to work through the economy. The impacts of our actions are first felt in spending, output, and employment, and later on in the inflation rate. Consequently, as a policymaker I recognize the different lags at work as monetary policy affects the economy, as well as what monetary policy can and cannot do. Therefore it is important to form views about how the future is likely to unfold.

My staff uses several economic models of the economy to make projections. They review projections made by other professional forecasters, and they very thoroughly analyze the available economic statistics and research studies that bear on the issues we face. My staff collects business information through a survey we conduct a few weeks before each FOMC meeting, and I personally hear from business leaders throughout my District through my boards of

directors, advisory councils, and small group meetings.

As we all know from our own first-hand experiences, our current economic circumstances are remarkably unusual, and that fact requires us to conduct monetary policy differently. Early in 2008, to ease monetary conditions, we reduced the federal funds rate to nearly zero, and it has remained there ever since. Once the federal funds rate fell that low, easing monetary conditions further required us to employ some different techniques. Think of it as taking the back roads when the freeway is shut down; it may not be as efficient, but the new route can still get you to your original destination. In our case, the new techniques included purchasing large quantities of U.S. Treasury securities and mortgage-backed securities guaranteed by Fannie Mae and Freddie Mac. We also lengthened the average maturity of the securities we hold in our portfolio. Our objective in taking these alternative routes is to push down medium- and longer-term interest rates—exactly the same objective we have in more normal times.

Even though we have introduced some new techniques, we are still operating to achieve the same dual mandate of stable prices and maximum employment, we still have to make policy decisions based on forecasts, and we still have to wait for the effects of monetary policy to work their way through the economy.

Let me connect this background on how monetary policy works with what I shared with you earlier about my outlook. In my view we are close to price stability, which I define as an inflation rate of 2 percent over the medium term. But the economy remains far away from full employment. According to my outlook, an unemployment rate of 6 percent will take longer to reach, perhaps even four or five years. Sooner, of course, would be better for everyone, but I want to be on a path toward full employment that doesn’t create an inflation problem down the road. Keep in mind that, inflation over the longer run is primarily determined by monetary policy, whereas the maximum level of employment is largely determined by nonmonetary factors that may change over time.

I know that some observers think that today's economic problems are fundamentally non-monetary, and therefore, policy solutions should be nonmonetary. However, I think that we should ask, "What can monetary policy do, and do the benefits exceed the costs?" From that perspective, let me outline some of the problems facing us today.

In today's monetary policy environment, it is a lot harder to calibrate exactly how accommodative monetary policy actually is as compared with the norms I am used to from before the financial crisis. While it is true that the federal funds rate has been near zero for some time, some economic policy models indicate that monetary policy should be even more accommodative than it is today. And this is true even after accounting for the large scale asset programs the FOMC has initiated to compensate for the fact that the federal funds rate cannot go below zero.

I have supported our policy decisions, and there is evidence that they have been effective. For example, an analysis published early last year by Federal Reserve Bank of San Francisco President John Williams and several economists at the Federal Reserve Board concludes that by the end of this year the expansion of the Federal Reserve's securities holdings since late 2008 results in an unemployment rate that is 1-1/2 percentage points lower than what it would have been absent the purchases. They also conclude that the asset purchases most likely prevented the U.S. economy from falling into deflation.[2]

These policy actions were taken after careful consideration of the

costs and benefits, and going forward I will continue to weigh the costs and benefits of further policy actions.

We are, as I'm sure all of you in this room understand, in a challenging environment for policy makers. We do not have a good deal of concrete history for monetary policy to fit these exact circumstances, but I am confident the Federal Reserve is making the most of its tools to move the economy in the right direction. Other policymakers and the private sector can make their own contributions to strengthen our economy and to speed progress to full employment.

In Franklin Roosevelt's first augural address in March 1933 he famously said, "We have nothing to fear but fear itself." Less quoted is the sentence just before. He said, "This great Nation will endure, as it has endured, will revive and will prosper." I believe we can say as much again. This great Nation will revive and will prosper, but achieving the kind of prosperity we want will take some time.

---

1. Quarterly PCE inflation rate in the first quarter of 2011.

2. Chung, Hess, Jean-Philippe Laforte, David Reifschneider, and John C. Williams. 2011. "Estimating the Macroeconomic Effects of the Fed's Asset Purchases." FRBSF Economic Letter 2011-03, January 31.