Economic Outlook

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It's a pleasure to be with you this morning to discuss the economic outlook. I'll be talking about the prospects for real economic growth for the United States as a whole, but I'll also share some observations about West Virginia's economy, which, as you all know, has some very special features. One aspect of the economic outlook in which many people have a keen interest is the Federal Reserve's monetary policy. This makes sense, since it plays an important role in fostering an environment in which people can work, save and invest to expand prosperity. But the role of monetary policy is often overstated, so in my remarks I will talk about what it can, and cannot, accomplish. I should emphasize that the views expressed are my own and should not be attributed to anyone else in the Federal Reserve System.[1]

Monetary policy is primarily about inflation, so let me begin with an overview of the inflation situation. Over the last 20 years, inflation has averaged 2.07 percent per year. To be sure, inflation has varied from year to year. But these temporary swings have evened out over time, and inflation has tended to return to around 2 percent. In fact, over the last three years, inflation has averaged 2.06 percent. Although the inflation rate has been elevated in recent months because of the recent bulge in retail gasoline prices, most economists are expecting headline inflation to average about 2 percent, or a little less, over the next year or two. I agree with that outlook.

The record of low and fairly stable inflation over the last two decades is a substantial improvement over previous decades, and it should be kept in mind whenever we think about monetary policy in recent years.[2] The Federal Open Market Committee, or FOMC (the group that determines monetary policy), issued an important statement in January on its "Longer-Run Goals and Policy Strategy."[3] In that document, the Committee stated that inflation at the rate of 2 percent, as measured by the annual change in the price index for personal consumption expenditures, is most consistent over the longer run with the Federal Reserve's statutory mandate. This confirmed a long-held belief among Fed watchers that 2 percent constituted the FOMC's unofficial target for inflation.

Beginning an economic outlook talk with a discussion of inflation is not the usual approach, even among Fed officials. I did so simply to emphasize that the behavior of inflation is fundamentally attributable to the actions of the central bank. Over the long haul, monetary policy determines the purchasing power of money. Central banks have a monopoly on the supply of certain critically important monetary assets, namely currency and bank reserves. That supply, together with the

demand for those assets, determines their value. An excessive supply leads to inflation — that is, a rise in the overall price level. Similarly, an insufficient supply leads to deflation — that is, a fall in the overall price level. Excessive inflation — or deflation — can therefore legitimately be blamed on the central bank. Conversely, the central bank should get credit when inflation is low and stable.

While U.S. inflation is the responsibility of the Federal Reserve, real economic growth and labor market conditions are affected by a wide range of factors outside the Fed's control. Even at their best, modern economies take time to adjust to unanticipated shocks, and our economy was hit with a very large shock when residential construction collapsed. The pace of adjustment is, in turn, affected by a variety of frictions in the economy — frictions in the way firms determine the right prices of their goods, frictions in the process of searching for the most promising opportunities to deploy newly available capital and labor resources, and frictions in the way workers and employers search for each other, among others. Monetary policy is simply unable to offset all of the ways in which various frictions impede the economy's adjustment to various shocks. It's unfortunate, but the effects of monetary stimulus on real output and employment are less than is widely thought; they consist largely of the transitory byproducts of frictions that delay the timely adjustment of prices to changes in monetary conditions.

Let's turn to the growth outlook now. The Great Recession officially bottomed out at the end of the second quarter of 2009, but the expansion in economic activity since then has been disappointing. Real gross domestic product (GDP), for example, has risen at an average annual rate of 2.16 percent during this recovery. Labor market conditions have been especially disheartening. We lost over 8 million jobs in the recession and its immediate aftermath; since bottoming out in early 2010, we've added 4.5 million new jobs, which leaves us far from a complete recovery.

In West Virginia, labor market conditions followed a similar path during the recession, although the timing of the job loss lagged the national trend by several months. The state lost over 25,000 jobs from the peak of employment to the trough reached in early 2010. Since then, the recovery has seen just one-third of those jobs added back. Labor market conditions have weakened in recent months, and the unemployment rate here has climbed now for five consecutive months, bucking the national trend. Recent job losses have been concentrated in the energy sector, no doubt reflecting depressed prices for coal and natural gas, as well as the fallout from shifting regulatory regimes.

Several factors appear to have impeded a more rapid recovery in the U.S. economy. First, by the end of the housing boom, we had built many more new homes than we truly needed. The resulting inventory overhang has led to a large and persistent decline in new residential investment. It now looks as if the worst is behind us and new construction activity is gradually improving. Moreover, home prices in many markets have bottomed out and begun to increase. That said, residential investment is still less than 2.8 percent of GDP, versus 6.2 percent back in 2005. We still have not seen the rapid rebound in housing that has often contributed to swift recoveries in overall economic activity in the past. Given the extent of housing oversupply that developed just before the recession, we probably should not expect housing markets to boom the way they did in many places in the past.

A second, and related, factor behind the slow recovery was the significant shift in economic activity away from residential construction, housing finance and related supply industries. The rapid loss of jobs in these industries, layered on top of ongoing longer-run sectoral shifts, resulted in large inflows into the ranks of the unemployed, and it has taken considerable time to whittle down the unemployment rate. In part, this was predictable; it often requires significant retraining for laid-off workers to find new employment in other sectors of the economy. In addition, capital investment is often required when workers move to new sectors. Thus unemployment can remain elevated for a long and frustrating interval following a severe shock.

Third, the Great Recession appears to have made many consumers more cautious and less willing to spend, relative to their income and wealth. Prior to the recent recession, American households experienced a two-and-a-half-decade run with just two mild recessions in which job losses were relatively limited. In contrast, the declines in income and wealth during the recent recession were far more severe. As a result, consumers have become more apprehensive about their future income prospects. So while consumer spending has grown during this recovery, the tempered pace of that growth has limited the overall pace of the expansion, relative to previous recoveries.

Finally, for most of this year, our business contacts have been emphasizing that uncertainty has caused them to delay hiring and investment commitments. While their uncertainty may have multiple sources, including the situation in Europe, the most widely mentioned source is the nation's fiscal policy. Here I'll mention two aspects of the federal fiscal situation. One is the fiscal cliff, the combination of spending cuts and tax increases that will automatically occur next year if Congress fails to act. The total size of these changes is such that, should they all take effect and remain in effect for a considerable period, the economy is likely to contract and move back into recession. The second relevant aspect of the federal fiscal outlook is the long-run imbalance between taxes and spending. According to projections by the nonpartisan Congressional Budget Office, the deficit is likely to decline somewhat for a few years, but then move higher, both in dollar terms and as a fraction of GDP. This implies that the outstanding stock of federal debt will increase without bound as a ratio to GDP. This is not a feasible scenario and it cannot persist indefinitely. At some point Congress will have to bring taxes and spending into closer alignment. The set of policy choices that are likely to be considered would affect almost every household or business in a meaningful way. Until a fiscal plan is adopted that is sustainable over the longer run, consumers and businesses will make decisions under a cloud of uncertainty.

In short, much of the recent sluggishness is understandable. Economies take time to recover from severe shocks. In fact, if you look back at how advanced economies have typically behaved following recessions associated with housing slumps, you will find that our current recovery is actually not out of the ordinary.[4] What is exceptional about the current recovery is the depth of the contraction that preceded it.

But what does the future hold for our economy? My best guess is that growth will continue into next year at an annual rate of 2 percent or above. Toward the end of 2013, we should see growth begin to firm with further improvement beyond that. Several important suppositions lie behind

that forecast, however. First, I expect to see meaningful progress on federal budget issues now that the election is behind us. As I mentioned a moment ago, it will not be enough to simply sidestep the fiscal cliff. To meaningfully reduce the uncertainty about tax and spending policy that is discouraging private sector commitments, we will have to see convincing progress toward a sustainable long-run trajectory for federal policy. Giving the proverbial can a few more kicks down the road is likely to mean continued uncertainty and further disappointment with labor markets.

Second, while the European recession and fiscal challenges pose risks to the U.S. outlook, I expect those risks to diminish next year. European growth has been dampened by the strains of constructing a new collective fiscal regime while coping with the aftermath of the previous regime. But despite repeated visits to the brink of financial disorder, eurozone policymakers have made notable progress toward new institutional arrangements. To date, the impact on U.S. exports has been manageable and the spillover to U.S financial institutions and markets has been limited.

Third, my outlook is predicated on a continuation of the gradual improvement we've seen in household confidence about future income prospects. Improvements in labor market effectiveness and modest growth in home prices should combine to reduce consumer apprehension about downside risks and thereby bolster spending.

Finally, this outlook is built on the usual assumption of no unanticipated shocks. Indeed, by definition, it would be hard to forecast any other way. Significant energy price increases would tend to temporarily reduce overall growth, although they ultimately would be likely to stimulate exploration and new production. An unexpected downturn in growth among our major trading partners also has the potential to impede U.S. growth. On the other hand, a stronger-than-expected resurgence in confidence is not inconceivable; rapid and convincing progress toward fiscal sustainability, for example, might release a rush of pent-up spending.

Even though growth has been below our long-run trend rate since the recession, I believe that the fundamental prospects for longer-term U.S. growth remain quite strong. Increases in real income ultimately depend on the implementation of new products and services and new ways of providing existing products and services. We have a proven ability to generate advances in scientific knowledge and new commercial applications. The flexibility and resilience of our markets, along with a relatively well-educated population, make this an exceptional place to implement innovations. Our major challenge over the longer haul is to find effective ways to deepen the knowledge and skills of our people, because expanding our human capital is fundamental to improving our standards of living.

In short, I am cautiously optimistic about the near-term outlook and see grounds for more optimism about longer-run growth prospects.

What role does monetary policy play in this outlook? Our primary responsibility at the Federal Reserve is to keep inflation low and stable; this allows businesses and consumers to make economic decisions without needing to worry about inflation. The FOMC took an important step to solidify confidence in our commitment to price stability with its January statement on

"Longer-Run Goals and Policy Strategy," which formalized a long-run goal for inflation of 2 percent. Having stated that goal, it's incumbent upon us to follow through with policy actions that are consistent with maintaining 2 percent inflation.

Beyond hitting our inflation target, though, it's not clear whether monetary policy, by itself, can bring about any material improvement in economic growth right now. The Fed is currently increasing the quantity of reserves held by the banking system by buying securities — both long-term U.S. Treasuries and agency mortgage-backed securities. In my view, the supply of bank reserves is already quite ample and is certainly large enough to support a strengthening recovery. At the same time, it's important for us to remember that we cannot continually buy more securities and create more bank reserves without jeopardizing our inflation goal. Accordingly, I have opposed additional easing steps at FOMC meetings this year. My main concern is that we have eased policy aggressively for over four years; at some point, the growth outlook will improve enough that the FOMC will need to begin raising interest rates and reducing the supply of bank reserves in order to preserve the price stability that we have enjoyed over the last 20 years. As a technical matter, I do believe that we have the tools we need to withdraw accommodation soon enough and rapidly enough to keep inflation on target. But as a practical matter, we are in uncharted territory, and that will make it difficult to get the timing just right. In the Fed's 99-year history, we have never eased monetary policy as aggressively as we have over the last few years. The larger our balance sheet when the time comes to withdraw monetary stimulus, the more difficult and risky that process will be. In my view, the balance of considerations suggests that we should be standing pat now rather than easing policy further.

One other aspect of Fed policy is unprecedented right now, besides the sheer size of our balance sheet. Until this recession, we have generally restricted ourselves to purchasing U.S. Treasury securities. But as I noted, we also have been buying mortgage-backed securities, most recently at a pace of about $40 billion per month. This raises broad concerns that ought to worry us. Buying mortgage-backed securities rather than U.S. Treasuries may reduce borrowing rates for conforming home mortgages, but if so, it will raise interest rates for other borrowers — such as small businesses. I have yet to see a convincing case for distorting markets by channeling credit toward housing debt and away from other sectors. Moreover, this is an inappropriate role for the Fed, a principle that was recognized in the Joint Statement of the Department of Treasury and the Federal Reserve on March 23, 2009: "Government decisions to influence the allocation of credit are the province of the fiscal authorities," that is, Congress and the administration.

As I said earlier, our main responsibility at the Federal Reserve is price stability. On that score the situation is reasonably good, with inflation averaging quite close to our 2 percent objective in recent years. Our focus should be maintaining our record of success. *That* would be the best contribution we can make to the economic outlook.

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[1] I am grateful to Roy Webb, John Weinberg and Ann Macheras for assistance in preparing these remarks.
[2] For an account see Marvin Goodfriend, "Monetary Policy Comes of Age: A Twentieth Century Odyssey." Federal Reserve Bank of Richmond Economic Quarterly, Winter 1997, vol. 83, no. 1, pp. 1-22.
[3] Board of Governors of the Federal Reserve System, "Longer-Run Goals and Policy Strategy." News and Events, Monetary Policy Press Release, January 25, 2012.
[4] Board of Governors of the Federal Reserve System, "Are Recoveries from Banking and Financial Crises Really So Different?" International Finance Discussion Papers, November 2011, no. 1037. See in particular Figure 12, page

24. The current recovery is within one standard error of the average advanced economy recovery from recessions that occur during housing slumps.