

Sarah Bloom Raskin: Prospects for a stronger recovery

Speech by Ms Sarah Bloom Raskin, Member of the Board of Governors of the Federal Reserve System, at the Society of Government Economists and the National Economists Club, Washington DC, 16 May 2013.

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Thank you. I am very pleased to be here among an audience of professional economists, which is certainly preferable to appearing before an audience of unprofessional economists. I like your kind! Your talents are needed now more than ever as we try to put the tools of the economic profession to work for the common good. It's easy to be an economist who looks back on crises and crashes and tries to explain why they happened, but much harder to be an economist whose efforts manage to help stop them from happening in the first place. Economic policymaking, at its best, reflects a continuous struggle to make sure that data and explanations of such data are consistent with real experience. If we're to engage in this struggle honestly, it's no easy task. It involves understanding not just the reliability and signal in various data, but also questioning whether the data accords with our understanding of actual experience. So, to get this right requires many different perspectives, not just on the data but on the underlying realities the data are trying to capture. Government economists understand that non-economists bring something valuable to the table in policymaking – a grounded perspective in what is happening in the economy.

With that said, what is really happening now in the American economy? What do the economic data we see at the Federal Reserve currently show, and how do we think these data line up with the economic realities of most American households and businesses? In my remarks today I will offer my assessment of recent economic developments and the economic outlook, and I will discuss the actions that the Federal Reserve has been taking, in light of its view of developments and the outlook, to support the economic recovery. Before I begin, I should note that the views that I will be presenting are my own and not necessarily those of my colleagues on the Federal Open Market Committee (FOMC) or the Board of Governors.

Recent Economic and Financial Developments

For the past three and a half years the U.S. economy has been in a recovery – albeit a very weak one – from a severe financial crisis and the deepest recession of the post-World War II period. The unemployment rate, which reached a high of 10 percent in the fall of 2009, has since come down 2-1/2 percentage points, to 7.5 percent in April.

The increase in economic activity and the decline in the unemployment rate are, of course, welcome, but we still have a long way to go to reach what feels like a healthy economy. In fact, the pace of recovery has been slower than most had expected. The gap between actual output and the economy's potential remains quite large, according to estimates from the Congressional Budget Office, and the unemployment rate today remains well above levels seen prior to the recession, and well above the level that the Committee thinks can be sustained once a full recovery has been achieved. In addition, the number of long-term unemployed – people who have been unemployed for 27 weeks or more – remains historically high.

My interpretation of the economic data that we have received over the past few quarters is that the recovery has continued to gain traction. The Bureau of Economic Analysis reported last month that real gross domestic product (GDP) rose at an annual rate of 2-1/2 percent in the first quarter of this year after barely expanding at all in the fourth quarter of 2012. The step-up in growth in the first quarter partly reflected a rebound from last year's drought and Hurricane Sandy. Smoothing through these factors, real GDP was about 1-3/4 percent above

its year-earlier level in the first quarter, a modest gain that is about in line with the pace of growth during much of the recovery.

The strength of the recovery among the components of GDP has been mixed recently. In terms of the housing sector, there is no question that many communities and neighborhoods were devastated by the effects of the financial crisis. Recently, we see that overall demand has been strengthening, with both home sales and prices rising markedly in many areas. Both new and existing home sales have moved up, on net, since late 2011, and housing starts averaged an annual rate of nearly 1 million units in the first quarter of this year, up considerably from the extremely low levels that prevailed through 2011. Inventories of new homes for sale have become quite lean in most markets over the past year, a notable change from earlier in the recovery. The increase in activity in the housing sector has been driven by historically low mortgage rates, growing optimism about future house prices, continued gains in the job market, and sizable purchases of homes by investors.

Elsewhere in the household sector, consumer spending – about two-thirds of overall final demand – has continued growing at a moderate pace. On the whole, families have benefited from the modest improvement in the labor market, and rising stock prices and rebounding home values have helped some households recoup part of the wealth they lost during the recession.

However, overall wage growth has been anemic, and many households have not seen their circumstances improve materially. As I described in a speech last month, globalization and technological change have continued to shift the occupations and industrial distribution of new jobs available. These currents of globalization and technological change continue on their path, making it more likely that workers who were laid off during the recession would be unable to find reemployment that is of comparable quality to their previous jobs.¹ About two-thirds of all job losses in the recession were in middle-wage occupations – such as manufacturing, skilled construction, and office administration jobs – but these occupations have accounted for less than one-fourth of the job growth during the recovery.² By contrast, lower-wage occupations, such as retail sales, food service, and other lower-paying service jobs, accounted for only one-fifth of job losses during the recession but more than one-half of total job gains during the recovery. As a result of these trends in job creation, which could well have been exacerbated by the severe nature of the crisis, the earnings potential for many households likely remains below what they had anticipated in the years before the recession. Moreover, as you all know, the temporary payroll tax cut has now expired, and many households have seen their disposable incomes reduced for this reason as well.

Spending in the business sector recently has increased only modestly, perhaps due in part to the effect of these recent tax changes on consumers. Real spending on equipment and software rose about 4 percent over the past 12 months, according to the most recent GDP report, a modest gain for this category of spending. Indicators for capital investment in the months ahead, including new orders for durable capital goods and survey measures of business sentiment, suggest that growth in business spending on new equipment and software is likely to remain modest in the coming quarters.

Turning to the government sector, the legislated reduction in spending by the federal government is exerting a clear and continuing drag on economic activity. Even prior to the bulk of the spending cuts associated with sequestration, real purchases by the federal

¹ See Sarah Bloom Raskin (2013), "[Aspects of Inequality in the Recent Business Cycle](#)," speech delivered at "Building a Financial Structure for a More Stable and Equitable Economy," the 22nd Annual Hyman P. Minsky Conference on the State of the U.S. and World Economies, sponsored by the Levy Economics Institute of Bard College, held in New York, April 17–19.

² See National Employment Law Project (2012), "[The Low-Wage Recovery and Growing Inequality \(PDF\)](#)," *Data Brief*, report (New York: NELP, August).

government were reported to have dropped at an annual rate of more than 8 percent in the first quarter of this year, following an even larger drop in the fourth quarter of last year. These cuts in federal spending are likely to be an important influence on the near-term prospects for economic growth, and I will say more about this issue in a moment.

In contrast to the federal government, the budget outlook for state and local government continues to improve, and the drag on economic activity from this sector's cutbacks in spending has diminished considerably.

Reflecting some of these mixed influences, as I already noted, real GDP has been rising at a very modest rate, and the labor market has shown similarly modest gains over the past year, with the unemployment rate coming down about 1/2 percentage point. To more fully understand the experience of the 11.7 million Americans who can't find work, we look to broader measures of labor underutilization, which take into account job seekers who have stopped looking for work because they have become discouraged, and people working part time but who would prefer to work full time. Recently, these numbers seem to be coming down. The gains in payroll employment over this period have been about in line with the decline in the unemployment rate, although, as is typical, the pace of job gains has been somewhat erratic in recent months. Since the beginning of the year, the increases in payroll employment have averaged 196,000 per month, a little above the 183,000 average monthly gains observed during 2012.

Other indicators from the labor market have also shown some improvement recently. Initial claims for unemployment insurance have declined since last summer, and the number of job openings appears to be increasing. I hope these indicators mean we are turning the corner on some of the painful costs associated with being unemployed or underemployed in America.

Turning to inflation, recent data show that price pressures have remained subdued. Both total and core inflation were only about 1 percent over the 12 months ending in March, below the FOMC's long-run objective of 2 percent. Inflation is being restrained by the continued slack in labor and product markets, while stable inflation expectations have offset disinflationary pressures to some extent. Moreover, the increase in gasoline prices that we saw earlier in the year appears to have fully reversed, and the path of oil futures prices is downward-sloping, suggesting that energy prices are likely to hold down headline inflation rates in the years ahead.

The economic outlook

Let me now turn to the outlook. As my Federal Reserve colleagues and I have noted in the past, the pace of the economic recovery has been restrained by lingering effects of the financial crisis. Assessing the current strength of the headwinds related to these lingering effects is an important determinant of the economic outlook for the coming years.

Unfortunately, current federal fiscal policy is one headwind to the recovery that has intensified this year. In fact, federal fiscal policy has been tightening since 2011, after having been quite expansionary during the recession and early in the recovery. More recently, actions by the Administration and the Congress to reduce the budget deficit have led to further tightening of federal fiscal policy.

As I already mentioned, both the tax legislation signed into law in January and the sharp spending cuts associated with sequestration will likely significantly hinder GDP growth this year. Indeed, the Congressional Budget Office has estimated that these changes in fiscal policy would reduce GDP growth by 1-1/2 percentage points this year relative to what we

otherwise would have achieved.³ Looking further ahead, fiscal policy seems likely to remain restrictive at the federal level.

The headwinds from the housing sector have eased, and housing market activity is likely to continue to contribute to GDP growth over the next few years. These headwinds had been substantial, as the aftermath of the financial crisis and housing bubble left many homeowners underwater on their mortgages, a large overhang of vacant homes, and mortgage credit very hard to obtain for anyone without an excellent credit record and a sizable down payment. The rise in house prices over the past year or so has lifted household net worth and pushed some homeowners above water on their mortgages. These developments may help to ease credit for many households as well, although mortgage credit remains very tight.

In a speech last month, I described how the net decline in housing wealth since the recession has had particularly acute effects on the balance sheets of lower- and middle-income households, which tend to hold a relatively high share of their total wealth in their homes.⁴ Households at the bottom of the income distribution have also had a harder time than others finding jobs during the recovery and their wages have continued to stagnate. In my view, the large and increasing amount of inequality in income and wealth, which has been an ongoing development for decades, may have exacerbated the crisis and I think more research is required to determine whether it may also pose a significant headwind to the recovery from the crisis for years to come. So, while I am hopeful that pressures will ease further as home prices continue to rebound, I also believe that some of the restraints on the recovery may be quite long-lasting.

The headwind from the financial sector also has diminished somewhat over the past year and should present less of a restraint on economic growth than has been the case in the recent past. U.S. equity prices are up more than 10 percent so far this year following last year's 13 percent increase. Risk spreads embedded in the interest rates paid by many American businesses, although still above their pre-crisis levels, have also moved down substantially over the past year to levels that are moderate, given the state of the broader economy.

The situation in Europe, although still uncertain, appears to have improved since last summer – aided importantly by the policies of the European Central Bank (ECB) – and these developments have led to an improvement in financial conditions globally. Policy actions and promises, including the ECB's program to purchase the sovereign debt of vulnerable euro-area countries and discussions about creating a banking union, appear to have helped market participants negotiate past some recent hurdles, including the challenges in forming a governing coalition in Italy and the severe banking difficulties in Cyprus. If policymakers in Europe can follow through on their commitments to financial integration and structural reforms, among other things, financial stress in Europe should continue to lessen, and European economies should gradually recover from their current slump. If the economy in Europe were to begin to grow again, it could support global economic growth more broadly.

The financial condition of the U.S. banking sector has also continued to improve from the perspective of regulatory capital. While much work remains for regulators and banks implementing pending capital requirements, most large, medium-sized, and community banks are in stronger capital positions today than they were prior to the financial crisis.

Although not all, some consumers at least, are seeing the benefits of improvements in financial markets. In combination with low interest rates, the easing of financial stress has

³ See Raskin, "Aspects of Inequality in the Recent Business Cycle," in note 1.

⁴ For a discussion and list of references regarding the effects of recent monetary policy actions, see Ben S. Bernanke (2012), "The Economic Recovery and Economic Policy," speech delivered at the Economic Club of New York, New York, November 20.

allowed some homeowners to refinance their mortgages to lower their monthly payments, and some types of loans, such as those for purchasing a new or used car, have become available to more people. That said, we clearly still have a long way to go in assuring that Americans have access to affordable credit. As I noted, an especially large number of people are unable to obtain mortgage credit, and credit card borrowing is also tight.

Taken together, the incoming data and my own analysis of recent developments in fiscal policy suggest that the recovery will continue at a moderate pace, and the unemployment rate will fall gradually. According to the Summary of Economic Projections that was released by Federal Reserve Board members and Reserve Bank presidents after the March FOMC meeting, my colleagues and I expected real GDP growth to step up moderately this year, rising roughly 2-1/2 percent after having risen 1-3/4 percent in 2012. In the projection, participants also expected the unemployment rate to be in the range of 7.3 to 7.5 percent by the end of the year. Looking a bit further ahead, FOMC participants largely expected the unemployment rate to continue receding, but it was expected to remain above its long-run sustainable level for several years. Meanwhile, inflation was expected to remain close to or a little below the Committee's objective of 2 percent, consistent with ongoing slack in the labor and product markets and well-anchored inflation expectations.

Monetary policy developments

In light of this outlook and the risks around the outlook, it has been appropriate for the Federal Reserve to continue to pursue a highly accommodative monetary policy. As you all know, during the financial crisis and at the onset of the recession, the Federal Reserve took strong easing measures, cutting the target for the federal funds rate – the traditional tool of monetary policy – to nearly zero by the end of 2008. During the recovery, we have provided additional accommodation through two non-traditional policy tools aimed at putting downward pressure on longer-term interest rates even with short-term rates stuck at zero: (1) purchases of Treasury securities and mortgage backed securities and (2) communication about the future path of the federal funds rate.

Our most recent policy actions have sought to strengthen the recovery in the face of only slow improvements in labor market conditions and subdued inflationary pressures. After last September's policy meeting, the FOMC announced that the Federal Reserve would continue asset purchases until the outlook for the labor market has improved substantially in the context of price stability.

Then, at the meeting in December, the FOMC voted to continue purchasing longer-term Treasury securities at a pace of \$45 billion each month and agency mortgage-backed securities at a pace of \$40 billion each month, and we have maintained that pace of asset purchases so far this year. In considering changes to the pace of asset purchases in the future, we take into account judgments about both the efficacy and potential costs of these purchases, including potential risks to inflation and financial stability, as well as the extent of progress toward our economic objectives.

At its December meeting, the FOMC also recast its forward guidance to clarify how the target for the federal funds rate is expected to depend on future economic developments. Specifically, we said that we anticipate that an exceptionally low funds rate is likely to be warranted at least as long as the unemployment rate remains above 6-1/2 percent, inflation over the period between one and two years ahead is projected to be no more than 1/2 percentage point above 2 percent, and longer-term inflation expectations remain well anchored. These thresholds are intended to make monetary policy more transparent and predictable to the public by making more explicit our intention to maintain policy accommodation as long as needed to promote a stronger recovery in the context of price stability.

Although it is still too early to assess the full effects of the most recent policy actions, available research suggests that our previous asset purchases have eased financial conditions and provided meaningful support to the economic recovery.⁵

Given its statutory mandate, the FOMC's policy actions and communications have naturally sought to lower interest rates as a means of strengthening aggregate demand, promoting the pace of recovery in the labor market, and keeping inflation from falling further below the rate preferred by the Committee over the longer run. We will continue to calibrate monetary policy – including both the ongoing pace of asset purchases and communications about the likely path of the federal funds rate – in light of our interpretations of the latest data and the implications of those interpretations for the outlook for economic activity, labor market conditions, and inflation.

Conclusion

In summary, the U.S. economy has continued to recover from the effects of the financial crisis and deep recession, though at a pace that has been disappointingly slow. The recovery does appear to have picked up steam in some sectors, most notably in housing, likely reflecting the easing of some of the headwinds that had been holding back the pace of the recovery in earlier years. However, federal fiscal policy remains an important source of restraint.

In light of these factors, most members of the FOMC project a modest improvement in the pace of the recovery this year and next, and, accordingly, a modest decline in the unemployment rate. The Federal Reserve will continue to conduct monetary policy so as to promote a stronger economic recovery in the context of price stability.