

Sarah Bloom Raskin: Monetary policy and job creation

Speech by Ms Sarah Bloom Raskin, Member of the Board of Governors of the Federal Reserve System, at the University of Maryland Smith School of Business Distinguished Speaker Series, Washington DC, 26 September 2011.

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Good morning. It's a great pleasure to be with you, and I want to thank the Center for Financial Policy at the Robert H. Smith School of Business for inviting me to participate in this forum. Indeed, I am delighted to see that the Center for Financial Policy is already thriving. Back in 2008, when I was the Commissioner of Financial Regulation for the State of Maryland, two of the founders of the center talked with me about its inception and asked for my ideas about what it might accomplish. And I am so glad to see that – despite the formidable challenges facing all such new projects – the center is now fully engaged in addressing financial policy issues that are critically important to our nation.

Today I want to discuss how monetary policy can promote the objective of maximum employment in a context of price stability. I will set the stage by reviewing current labor market conditions, and then I will talk about the tools that the Federal Reserve has been deploying to foster job creation and promote a stronger economic recovery. I will do my best to make these points in plain English rather than economic jargon, but feel free to correct me if I lapse back into it – my children certainly do. Of course, it goes without saying that these remarks are intended to express my views only and not necessarily the opinions of my colleagues on the Federal Reserve Board or the Federal Open Market Committee (FOMC).

Current labor market conditions

The global economy began slowing in late 2007 and early 2008 and turned downward sharply in the autumn of 2008 when the financial crisis intensified, resulting in the worst recession in many decades. By the end of 2009, the unemployment rate reached a horrifying 10 percent, corresponding to more than 15 million Americans being out of work, with all of the attendant social consequences, including lost income and wealth, mortgage foreclosures, family strains, health problems, and so on.

Officially, the recovery from the recession began in the third quarter of 2009, but the pace of recovery has been modest. We have learned from recent comprehensive revisions of government economic data that the recession was deeper and the recovery weaker than had previously been thought. Indeed, the most recent reading on real gross domestic product (GDP) in the United States – the one for the second quarter of this year – still has not returned to the level that it had attained before the crisis, and the increases in economic activity over the past two years have been at a rate insufficient to achieve any sustained reduction in the unemployment rate.

The latest employment report issued by the Bureau of Labor Statistics was bleak. Private-sector employers added only 17,000 nonfarm jobs in August, far fewer than the already weak average monthly gain of about 110,000 recorded over the previous three months. The headline unemployment rate was 9.1 percent, representing about 14 million Americans who were out of work in August.

Nonetheless, as many families know, the headline unemployment numbers don't fully capture the weakness in labor market conditions. Beyond the headline number, an additional 8.8 million workers were classified as "part time for economic reasons" in August because their hours had been cut back or they were unable to find a full-time job. In addition, about

2-1/2 million Americans were classified as “marginally attached” to the labor force because even though they wanted to get a job, they had not searched for one in the past four weeks. And almost half of that group – nearly 1 million individuals – have given up searching for employment altogether, because they do not believe any jobs are available for them.

So it is not just those who are currently classified as unemployed who are excluded from work. The underemployed, the marginally attached, and the discouraged – all of whom are concerned about the security of their livelihood, their housing, and the rising cost of living – can speak powerfully to the weaknesses of the recovery.

The economic data in this regard correspond to what I have seen firsthand over the past several years. I have traveled to once-robust manufacturing cities in the Midwest and have observed vacant lots, burnt-out factories, metal scrap heaps, and foreclosed homes. I have visited unemployment insurance offices and job training centers, and I have met lots of people who have been out of work for more than a year or two – out of work for so long that some of them are embarrassed to show their resumes to potential employers.

These circumstances have called for forceful policy measures. I will now talk about the conventional and unconventional actions that the Federal Reserve, for its part, has taken to foster economic recovery and job creation.

Conventional monetary policy actions

The conventional tool of monetary policy is to modify the near-term path of interest rates. To be more specific, a reduction in current short-term rates and a corresponding downward shift in private-sector expectations about the future path of such rates will tend to reduce borrowing rates for households and businesses, including auto loan rates, mortgage rates, and other longer-term interest rates. This policy accommodation also tends to raise household wealth by boosting the stock market and prices of other financial assets.

With greater household wealth and cheaper borrowing rates, consumers tend to increase their purchases of houses, cars, and various other goods and services. In response, businesses ramp up their production to meet the increased level of sales. Moreover, with lower costs of financing new equipment and structures, businesses may be inclined to increase their own spending on investment projects that they might previously have seen as only marginally profitable. In the near term, firms can meet increased demand by resorting to temporary and part-time workers, but over time they have strong incentives to increase the number of regular full-time employees. Consequently, the monetary accommodation leads to greater job creation, though sometimes with substantial time lags.

The Federal Reserve has used this policy tool aggressively since the onset of the financial crisis. In particular, the federal funds rate target, which stood at 5-1/4 percent in mid-2007, was subsequently reduced to a range of 0 to 1/4 percentage point by the end of 2008, and that target range has been maintained since then. Indeed, because currency has an implicit interest rate of exactly zero, economists generally agree that a zero interest rate is the effective lower bound for the federal funds rate because investors could simply choose to hold cash if a central bank tried to drive short-term interest rates significantly below zero. In effect, therefore, the FOMC has been deploying its conventional policy tool to the maximum extent possible since late 2008.

Rather than reviewing the vast academic literature regarding the effect of conventional monetary policy, I will simply pose the counterfactual question: What would have happened to U.S. employment if monetary policy had failed to respond forcefully to the financial crisis and economic downturn? Economic models – the Fed's and others – suggest that if the federal funds rate target had been held at a fixed level of 5 percent from the fourth quarter of

2007 until now, rather than being reduced to its actual target range of 0 to 1/4 percent,¹ then the unemployment rate would be several percentage points higher than it is today. In other words, by following our actual policy of keeping the target funds rate at its effective lower bound since late 2008, the Federal Reserve saved millions of jobs that would otherwise have been lost. Of course, substantial uncertainty surrounds various specific estimates, but there should be no doubt that the FOMC's forceful actions helped mitigate the consequences of the crisis and thereby spared American families and businesses from even greater pain.

Unconventional monetary policy actions

Given the magnitude of the global financial crisis and its aftermath, the Federal Reserve clearly needed to provide additional monetary accommodation beyond simply keeping short-term interest rates close to zero. Consequently, like a number of other major central banks around the world, the FOMC has been deploying unconventional policy tools to promote the economic recovery.

In particular, we have provided *conditional forward guidance* about the likely future path of the federal funds rate, and we have engaged in *balance sheet operations* that involve changes in the size and composition of our securities holdings. Broadly speaking, these policy tools affect the economy through channels that are similar – though not identical – to those of conventional monetary policy. I'll now spend a few minutes describing how each form of unconventional policy can be helpful in promoting a stronger economic recovery.

Monetary policy communication

An essential element of good monetary policy is effective communication. In a democratic society, central banks have the responsibility to clearly and fully explain their policy decisions. Good communication is also essential for strengthening the effectiveness of monetary policy. Expectations about the future play a key role in the decision-making of households and firms: how much to spend, save, work, invest, or hire. Moreover, when financial market participants understand how the central bank is likely to react to incoming information, asset prices can adjust in ways that reinforce the central bank's expected policy actions and thereby support the central bank's objectives. Finally, clear communication can help anchor the public's long-term inflation expectations and hence improve the extent to which the central bank can take forceful actions to promote job creation in a context of price stability.

With the federal funds rate constrained by its effective lower bound, effective communications with the public have become more important than ever. Since 2009, the Federal Reserve has published the Committee participants' longer-run projections of the inflation rate, the unemployment rate, and economic growth four times a year in conjunction with the minutes of FOMC meetings. Based on their longer-run projections for inflation, Committee participants judge that an inflation rate of 2 percent or a bit less, as measured by the price index for personal consumption expenditures, is most consistent with our statutory mandate of maximum employment and price stability.² The Committee currently strives for as low an unemployment rate as possible, consistent with price stability. In our most recent projections, Committee participants estimated that the longer-run sustainable rate of

¹ The simulation described here assumes, as is common in the literature, that the policy follows its historically typical behavior once the assumed counterfactual path for the federal funds rate ends.

² As indicated in figure 2c of the June 2011 Summary of Economic Projections, 11 out of 17 Committee participants projected a longer-run inflation rate for personal consumption expenditures of 2 percent while the remaining participants' projections were a bit below 2 percent; see www.federalreserve.gov/monetarypolicy/fomcminutes20110622epa.htm#figure2c.

unemployment is around 5 to 6 percent – well below the current unemployment rate of 9.1 percent.

Since December 2008, the FOMC has been providing conditional forward guidance about the likely path of the target federal funds rate. From March 2009 through June 2011, the Committee's forward guidance indicated that exceptionally low levels of the federal funds rate were likely to be warranted "for an extended period." In August, we decided to be more specific about the timing, and our two most recent meeting statements have indicated that "economic conditions – including low rates of resource utilization and a subdued outlook for inflation over the medium run – are likely to warrant exceptionally low levels for the federal funds rate at least through mid-2013."³

Forward guidance can provide monetary accommodation by leading investors to expect a longer period of low interest rates. As I noted earlier, a downward shift in the expected path of the federal funds rate is associated with reduced longer-term interest rates and generates a significant boost to consumer and business spending. Simulations of the FRB/US model and other evidence suggest that forward guidance can be a potent tool of monetary policy.⁴

Balance sheet operations

Since late 2008, the FOMC has engaged in two rounds of *large-scale asset purchases* (LSAPs). The first round of LSAPs involved purchases of about \$1.4 trillion in agency mortgage-backed securities (MBS) and agency debt securities and about \$300 billion in longer-term Treasury securities; those purchases were executed during 2009 and the first quarter of 2010. The second round of LSAPs – often referred to as QE2 – involved an additional \$600 billion in purchases of longer-term Treasury securities and was completed at the end of June of this year.

By purchasing longer-term securities in the open market, the Federal Reserve can exert downward pressure on longer-term yields, thereby reducing private borrowing rates and raising household wealth. Consequently, just as with conventional monetary policy, LSAPs help boost consumer spending, business investment, and net exports. And the resulting increase in aggregate demand helps generate a stronger pace of job creation.⁵

At last week's FOMC meeting, the Committee announced that we intend to extend the average maturity of our securities holdings over the coming months by selling \$400 billion of short-term Treasury securities and purchasing an equivalent amount of long-term Treasury securities. This maturity extension program – referred to by some as Operation Twist – should exert downward pressure on longer-term interest rates and help make broader financial conditions more accommodative, thereby supporting a stronger economic recovery. Indeed, recent work by an economist at the Federal Reserve Bank of San Francisco suggests that a similar policy put in place in 1961 had effects on longer-term interest rates that were roughly comparable to those of QE2.⁶

³ The August and September FOMC meeting statements, as well as related FOMC information, are available on the Federal Reserve Board's website at www.federalreserve.gov/monetarypolicy/fomccalendars.htm.

⁴ See Janet L. Yellen (2011), "Unconventional Monetary Policy and Central Bank Communications," speech delivered at the U.S. Monetary Policy Forum, New York, February 25, www.federalreserve.gov/newsevents/speech/yellen20110225a.htm.

⁵ See Hess Chung, Jean-Philippe Laforte, David Reifschneider, and John C. Williams (forthcoming), "Have We Underestimated the Likelihood and Severity of Zero Lower Bound Events?" *Journal of Money, Credit and Banking*.

⁶ See Eric T. Swanson (2011), "Let's Twist Again: A High-Frequency Event-Study Analysis of Operation Twist and Its Implications for QE2 (PDF)," Federal Reserve Bank of San Francisco Working Paper 2011–08 (San Francisco: Federal Reserve Bank of San Francisco, February), www.frbsf.org/publications/economics/papers/2011/wp11-08bk.pdf.

Another significant policy action taken at last week's FOMC meeting is that the principal payments from our holdings of agency securities will now be reinvested in agency MBS rather than in Treasury securities. Our announcement appears to have been successful in narrowing the spread between rates on agency MBS and Treasury securities of comparable maturity. That spread had widened substantially since earlier this year, and the continuation of such a trend could have pushed up mortgage rates and adversely affected the housing sector.

Potential attenuating factors

In my judgment, the Federal Reserve's deployment of our policy tools has been completely appropriate in promoting maximum employment and price stability. Ideally, such policy decisions would be informed by precise quantitative information about the effects of each tool. In reality, however, the estimated effects of the FOMC's policy actions are subject to considerable uncertainty. Such uncertainty is intrinsic to real-world monetary policymaking at any time but is particularly relevant under circumstances where the scope for conventional monetary policy is constrained by the zero lower bound on the federal funds rate, leaving unconventional tools as the only means of providing further monetary accommodation.

Although these monetary policy tools have been successful in pushing down interest rates across the maturity spectrum, the magnitude of the transmission to economic growth and employment has been somewhat more muted than I might have expected. Indeed, it seems plausible that the effectiveness of our policy tools is being attenuated by a number of unusual persisting factors, including an excess supply of housing and impaired access to credit for many households and small businesses.

Under normal circumstances, residential construction is an interest-sensitive sector of the economy that has played an important role in contributing to previous economic recoveries – especially the brisk recovery that followed the steep downturn in 1981 and 1982. In the wake of the bursting of the housing bubble, however, the housing sector has remained exceedingly weak. In effect, there is an excess supply of housing that seems likely to decline only gradually despite the record-low level of mortgage rates. Thus, in this crucial sector, one can argue that lower interest rates have not shown through to higher activity in the same way that would be expected under more usual recoveries.

Consumer spending is also being restrained by the excess supply of housing, which has put downward pressure on home equity values and household wealth. A substantial portion of homeowners now have negative home equity and are effectively unable to refinance at historically low mortgage rates. Many more have seen a drastic decline in the value of their homes, which would typically serve as collateral for home equity lines of credit or second mortgages.

The slow progress in repairing and restructuring households' balance sheets may also be lowering the normal responsiveness of consumer spending to a decline in market interest rates. In particular, lenders continue to maintain relatively tight terms and standards on credit cards and, to a lesser extent, other consumer loans. Consequently, many households may be unable to take advantage of the lower borrowing rates that are available to those who have a high net worth and pristine credit records.

Many small businesses also appear to be facing unusual obstacles in obtaining credit. If times were more typical, we would expect a smooth transmission in which lower interest rates would fuel credit expansion that would be used to finance expanding payrolls, capital investment, inventories, and other short-term operating expenses. Nonetheless, the latest Federal Reserve Senior Loan Officer Opinion Survey on Bank Lending Practices, which was taken in July, indicated that although domestic banks continued to ease standards on their commercial and industrial loans, the net fraction reporting easing on such loans to smaller firms (those with annual sales of less than \$50 billion) remained low and was well below that

of loans to large and middle-sized firms.⁷ In its August survey, the National Federation of Independent Businesses reported a noticeable increase in the proportion of small businesses reporting that credit has become more difficult to obtain.⁸ These businesses not only expect credit to become tighter in coming months but – like other businesses – have turned sharply more pessimistic about the broader economic outlook.

Finally, and perhaps most comprehensively, it is worth observing that the financial crisis has undermined the wealth of many Americans. Low- and moderate-income families entered the recession with little financial buffer against the adverse effects of wage cuts, job loss, and drops in home values. According to the 2007 Survey of Consumer Finances (SCF), home equity accounted for about half of the total net worth for low- and moderate-income families, which made them extremely vulnerable to the eventual housing market collapse.⁹ Families at the lower end of the income distribution saw a substantial drop in their net worth between 2007 and 2009, and families in the middle of the income distribution fared even worse.¹⁰ Combined with widespread unemployment, housing and stock price declines, and increasing rates of mortgage defaults, foreclosures, and bankruptcies, the assets of many American families have been significantly eroded. The effect of these developments may be to attenuate the revival of normal consumption patterns that would otherwise be dictating increases in consumer demand and growth.

Diversity of views

Even if the usual effectiveness of monetary policy is being attenuated by the factors that I have mentioned, that conclusion should *not* be taken as implying that additional monetary accommodation would be unhelpful. Indeed, the opposite conclusion might well be the case – namely, that additional policy accommodation is warranted under present circumstances.

My FOMC colleagues and I have recently been faced with complex decisions about the use of unconventional policy tools under extraordinary economic and financial conditions. And while we may not all agree with every decision, I believe that the public can have a very high degree of confidence in the fundamental integrity and soundness of our decision-making process.

Indeed, some commentators assign a label of “hawk” or “dove” to the various FOMC participants in an attempt to characterize how we prioritize the goals of maximum employment and price stability. In my view, such labels are ill conceived and misleading because everyone on the Committee is fully committed to promoting both of these goals. Incidentally, since my kids now love describing everyone as a hawk or a dove or some other kind of bird, I have taken to reminding them of this conviction I have: When my colleagues and I are doing our job correctly, we are neither hawks nor doves but *owls* – that is, we are trying to be as wise as possible in deploying all the tools we have to fulfill our legal mandate.

⁷ The Senior Loan Officer Opinion Survey on Bank Lending Practices is available on the Federal Reserve Board's website at www.federalreserve.gov/boarddocs/SnLoanSurvey.

⁸ See National Federation of Independent Businesses (2011), *NFIB Small Business Economic Trends* (PDF) (Nashville: NFIB, August), www.nfib.com/Portals/0/PDF/sbet/sbet201108.pdf.

⁹ See Brian K. Bucks, Arthur B. Kennickell, Traci L. Mach, and Kevin B. Moore (2009), “Changes in U.S. Family Finances from 2004 to 2007: Evidence from the Survey of Consumer Finances (PDF),” *Federal Reserve Bulletin*, vol. 95 (February), pp. A1–A55, www.federalreserve.gov/pubs/bulletin/2009/pdf/scf09.pdf.

¹⁰ See Jesse Bricker, Brian K. Bucks, Arthur B. Kennickell, Traci L Mach, and Kevin B. Moore (2011), “Surveying the Aftermath of the Storm: Changes in Family Finances from 2007 to 2009 (PDF),” *Finance and Economics Discussion Series 2011–17* (Washington: Board of Governors of the Federal Reserve System, March), www.federalreserve.gov/pubs/feds/2011/201117/201117pap.pdf.

Conclusion

In summary, the economic recovery has fallen well short of restoring labor market conditions to historically typical levels. Given the elevated rate of unemployment and the large number of individuals who are experiencing long spells of unemployment, both fiscal and monetary policymakers should be considering a wide array of approaches for promoting job creation. In my view, the deployment of our monetary policy tools needs to be carefully gauged, appropriately timed, and clearly communicated to the public. Moreover, to the extent that some factors may attenuate the usual effectiveness of monetary policy, there is a compelling case to identify and implement policy measures to mitigate those factors and thereby strengthen the effect of the monetary accommodation that we have already put in place. Finally, in light of the economic hardships that are facing our nation, I want to underscore that the Federal Reserve is fully committed to doing everything we can to promote maximum employment in the context of price stability.

Thank you again for the opportunity to speak with you today, and I look forward to hearing your comments and questions.