John C Williams: The economic outlook and monetary policy

Presentation by Mr John C Williams, President and Chief Executive Officer of the Federal Reserve Bank of San Francisco, to the CFA Hawaii Seventh Annual Economic Forecast Dinner, Honolulu, 1 March 2012.

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I would like to thank John Fernald, Rob Valletta, and Sam Zuckerman for assistance in the preparation of these remarks.

The economic outlook and monetary policy

Thank you. It's a pleasure to participate in this event and to enjoy the beauty and hospitality of the wonderful state of Hawaii. Sadly, this is my first visit here in 25 years. In fact, the last time I was here was back when I worked for a small business in the San Francisco Bay Area after I graduated from college. The business owner sent me on an all-expenses-paid, week-long vacation as a reward for hard work. Throughout my career at the Federal Reserve, I've tried to convince my bosses of the productivity-enhancing benefits of such an enlightened management practice. Unfortunately, I never succeeded. Now, as President of the San Francisco Fed, it is my pleasant duty to visit all nine states in the 12th Federal Reserve District. I plan to be diligent in fulfilling that duty. So, I assure you, it won't be another 25 years till I'm back.

In my remarks this evening, I'm going to talk about the current state of the economy, where it's headed, and what the Federal Reserve is doing to boost growth while keeping inflation low. My remarks represent my own views and not those of others in the Federal Reserve System.

It's been over two-and-a-half years since the end of the worst recession of the post-World War II period. The economy is growing, and the recent economic news has been increasingly positive. This is very welcome progress, but it's brought us only part of the way back. Unemployment remains a huge problem, and that means real hardship for millions of Americans.

The severe recession and subdued recovery have prompted the Fed to carry out a series of extraordinary policy actions to restore the economy to health. Most notably, we've kept our benchmark short-term interest rate near zero for over three years. This aggressive Fed response is an important reason why the economy has moved to more solid ground. But, as I'll explain, the Fed's job is not over yet. Far from it. Congress has assigned the Fed two goals: maximum employment and stable prices. We have lots of work to do before we can say we've met those goals. Looking at past deep recessions, you would have expected the economy to be doing much better than it is by now. Why has this recovery been so lackluster? The reason has everything to do with what took place beforehand. We've had a wild ride – first a housing boom of epic proportions, then a housing bust, a near-collapse of the financial system, and a terrible recession.

Let's go back to 2006, right before the recession hit. That marked the peak of an unprecedented run-up in U.S. home prices. But the bubble burst. Home prices plunged by over 30 percent nationwide, and even more in states such as Nevada, Arizona, and Florida. As the housing market went into a tailspin, about a quarter of borrowers found themselves owing more than their homes were worth. Delinquencies and foreclosures surged.

With millions of mortgages going sour, financial institutions that had placed big bets on home loans posted massive losses. It was like an epidemic. No one knew which financial institutions were infected with toxic assets. Everyone was suspect. Financial institutions were afraid to lend money to anybody, including each other. That choked off the flow of funds that financial institutions and businesses depend on for their day-to-day operations. The result was a worldwide financial crisis.

If left unchecked, this kind of financial panic could have ushered in an economic cataclysm like the Great Depression, when 25 percent of the workforce was out of work. Why didn't we plunge into the abyss? A key reason was that the Federal Reserve did what it was supposed to do. The Fed is the nation's government-chartered central bank. And one of the most important duties of a central bank is to safeguard the financial system. In a crisis, that means acting as lender of last resort, supplying emergency loans to financial institutions when normal funding isn't available. The U.S. Treasury Department and other federal agencies were also doing all they could to shore up the financial system.

Now, I know that this financial support to big banks and Wall Street firms made many people irate, especially when so many Americans were losing their jobs or their homes. We should remember, though, that ordinary people suffer terribly when the financial system breaks down. The ultimate goal of our programs was to avert a major depression and much higher unemployment.

Because of these programs, we were able to avoid a meltdown of the financial system and head off a depression. But we couldn't prevent a terrible recession. The shock waves from the burst housing bubble and the financial crisis were simply too great.

As it happens, it's normal that severe recessions and sluggish recoveries follow financial crises.[1] Research at the San Francisco Fed and other places shows that downturns following financial crises are much more severe when the preceding expansions had unusually rapid growth of credit and leverage.[2] When the credit pendulum swings, it takes many years for household and business spending to return to normal. And, in fact, there was extraordinary credit growth before the recession. Between 1999 and 2006, housing debt more than doubled.[3]

So it's not so surprising that we got an anemic rebound. The financial crisis unleashed powerful forces that have damped spending and sapped the recovery of its vigor. I'll mention three. First, it destroyed a huge amount of household wealth. Second, it flattened the housing market. Third, it made it hard for businesses and households to get credit. Let's look at each of these.

First, when house prices collapsed, the wealth of American households plunged by about six-and-a-half trillion dollars. That equals more than 40 percent of the total size of the U.S. economy. Many people went from feeling rich to feeling poor, with neither the means nor the will to spend. Instead, they became intent on repairing their finances by increasing their saving and trimming their debt. In other words, they deleveraged. During the recession, the household saving rate climbed to about 6 percent of income from about 1 percent. It's still about 4-1/2 percent. In the long run, higher saving is healthy. But, in the near term, it puts a brake on spending and slows growth.

Second, the depressed housing market has been a drag on growth. Home construction plays an important role in the economy, of course. When you add in items that often go with a new home – things such as furniture, carpets, and appliances – you're talking about a significant fraction of overall economic activity.[4] Today, there are still millions of homes in foreclosure, and millions more on the verge. All those distressed properties are acting like a weight

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1 Reinhart and Rogoff (2009).

2 Jorda, Schularick, and Taylor (2011).

3 Federal Reserve Bank of New York (2010).

4 See, for example, Mian, Rao, and Sufi (2011) and Feroli et al. (2012) for analysis of the effects of the housing crash on the economy.

keeping home prices from rising. The result is that new home construction and sales are still near the lowest levels recorded since the early 1960s.

Tight credit is a third powerful force holding back the recovery. Lenders who were too quick with a loan in 2006 have turned very cautious. Consumers who lack gold-plated credit scores and cash for a hefty down payment find it tough to get a mortgage. That limits home sales and refinancing. Fortunately, there are signs that credit conditions are easing a bit. Already, corporations that can sell securities have great access to capital.

These three forces – household finances, housing, and credit – are likely to hold down spending growth for some time. But let me emphasize, though – overall, things are getting better. You can sense greater optimism out there – albeit cautious optimism.

Let's look then at the positive side of the ledger. Little by little, households are repairing their finances. Businesses are gradually increasing production and hiring. The housing sector appears to have stabilized and is showing some signs of life. Consumer spending, which represents close to 70 percent of all economic activity, hasn't been growing fast, but it's been growing steadily. More motor vehicles were sold in January than in any month in nearly four years. The growth in consumer spending is also evident here in Hawaii. Last year was the best for tourist visits since 2007.

Exports have consistently been a bright spot for the economy over the past few years. Overseas demand for American products continues to grow. This increase has been rapid to our North American trading partners, and also to emerging economies of East Asia, including China. Indeed, exports are one reason U.S. manufacturers have been creating jobs at a pace not seen since the 1990s.

Gross domestic product, or GDP, measures the nation's total output of goods and services. After adjusting for inflation, GDP grew at less than a 1 percent annual rate in the first half of 2011, dragged down by temporary factors, including the surge in oil prices, and the Japanese tsunami. Growth picked up to about 2¼ percent in the second half of 2011 as those temporary factors receded. My forecast calls for GDP to rise about 2¼ percent this year and 2¾ percent in 2013. That's not rip-roaring by any means. But it's an improvement.

I'm especially encouraged by the good news from the job market. In the past four months, the unemployment rate has fallen about three-quarters of a percentage point. It's now at its lowest level in nearly three years. All the same, the kind of moderate economic growth I forecast won't keep bringing the unemployment rate down quickly. That rate is currently 8.3 percent. I expect it to remain over 8 percent into next year and still be well over 7 percent for several years to come. If my forecast is correct, the unemployment rate will have stayed at or above 8 percent for more than four years. Such a long period of unemployment above 8 percent has not happened in over 70 years.

For its part, inflation has been relatively contained. The prices of oil and other commodities did surge early last year in the face of strong global demand. This caused the overall inflation rate to rise above our 2 percent target. Oil prices have run up again recently, and have returned to their peak levels from last spring. As far as other commodity prices are concerned, we haven't seen a similar surge. With the economy still underperforming and wage growth modest, inflation should remain subdued. I expect inflation to be about 1¾ percent this year and to be about 1½ percent next year, down from about 2¾ percent in 2011.

There's a risk the economy could do worse than this moderate forecast. The main threat is the debt crisis in Europe. The latest news from that continent is somewhat reassuring, although more severe turmoil is still possible. Once again, European leaders have found a short-term fix to Greece's problems. Hopefully, that will prevent the situation from spinning out of control and igniting a wider financial crisis in Europe.

In addition to the actions of European political leaders, central banks have been actively supplying liquidity to the European banking system. The Fed set up temporary currency swap lines with several foreign central banks last November. These lines allow those central banks to borrow dollars and, in turn, lend those dollars to banks in their countries. In addition, the European Central Bank has provided hundreds of billions of euros in three-year loans to European banks. These actions have defused concerns about the ability of European banks to renew credit when their debts come due. In this way, Europe has avoided what could have been a massive credit crunch as banks pulled back lending sharply. I don't need to remind you that, in today's interconnected world, financial turmoil in Europe would definitely hurt our economy as well.

Even if the European crisis doesn't flare up again, growth is slowing in many parts of the world. Many European countries already appear to be in recession, and there is a danger that this situation could worsen significantly as governments put in place austerity measures. Turning to Asia, growth in China has also slowed as that country has tightened monetary and credit policies to reduce inflation. Indeed, the list of countries that are still experiencing solid growth is getting shorter all the time. If China's economy has a hard landing, there really aren't many sources of strength left in the global economy.

Let me move now to what this all means for Fed policy. As I noted earlier, our statutory mandate is to achieve maximum employment and price stability.[5] We are far short of maximum employment. And I expect inflation to fall this year below the 2 percent level that we view as consistent with our mandate. This is clearly a situation in which we have to keep applying monetary policy stimulus vigorously.

The Fed's monetary policy body is called the Federal Open Market Committee, or FOMC. As you know, the Fed influences the economy through its ability to affect interest rates. In December 2008, when the recession was hitting with full force, the FOMC lowered the federal funds rate, the rate banks pay to borrow from each other on overnight loans, close to zero. It's been there ever since. Given the weakness in the economy, standard monetary policy guidelines indicate that the federal funds rate should have gone deep into negative territory. But, of course, it's not possible for interest rates to go much below zero.

So the Fed has had to look for alternative ways to stimulate the economy. For example, we've purchased over one-and-three-quarters trillion dollars of longer-term securities issued by the U.S. government and mortgage agencies. This raises the prices on these securities, which lowers their yields. And lower yields on longer-term Treasury securities tend to push down other longer-term interest rates. That reduces the cost of borrowing across the board, from mortgages, to business loans, to corporate debt. Our securities purchases are an important reason why longer-term interest rates are at or near post-World War II lows.

In addition, we've publicly announced that we expect to keep the federal funds rate exceptionally low at least through late 2014. This guidance tells investors that short-term interest rates are likely to stay low for a long time, which then gets passed through to longer-term rates. Of course, our statements are not an absolute commitment to keep rates near zero. It's simply the FOMC's current judgment about the best future course of policy. If the economic outlook changes, then the guidance could change too.

Let me emphasize that the unusually stimulatory monetary policy now in place won't last forever. Eventually we will cut back the size of our securities holdings and raise our unusually low interest rate target. We've thought hard and communicated frequently about how to exit from these special conditions.[6] The key point is that the economy currently needs an

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5 See Williams (2012) for a discussion of the Fed's mandate and the implications for the conduct of monetary policy.

6 See the discussion of exit strategy in the minutes for the June 2011 FOMC meeting (Board of Governors 2011).

extraordinarily supportive policy. But we'll reverse course when the time comes to remove this support.

We've also taken two steps to improve our communication of the Fed's monetary policy strategy and plans. First, we released a statement of our longer-run goals and strategies – essentially, a declaration of our monetary policy principles.[7] That statement noted that we view a 2 percent inflation rate as most consistent with our mandates. It also emphasized that we will continue to balance our goals of maximum employment and price stability in making policy.

Second, we now regularly report our views about the probable course of short-term interest rates over the next few years. Under current economic circumstances, most Fed policymakers judge that near-zero short-term interest rates will be appropriate well into 2014. In this way, our interest rate forecasts reinforce our public guidance. Releasing the views of policymakers in this fashion should further reduce public uncertainty about our plans. And that, in turn, improves the effectiveness of our policies.

We at the Fed are broadening our commitment to openness and accountability. And we're doing all we can to carry out the mission Congress gave us. The Fed's powers are limited. Lower interest rates alone can't fix all the economy's problems. But monetary accommodation is indispensible. The economy would be in much worse shape if the Fed weren't acting so energetically.

Looking ahead, we may need to do more if the recovery falters or if inflation stays well below 2 percent. If the economy does need more stimulus, restarting our program of purchasing mortgage-backed securities would probably be the best course of action. The policy actions the Fed takes will depend on how economic conditions develop. If circumstances change, our policies will adapt. No matter the circumstances, I assure you that we at the Fed are doing everything we can to achieve the goals of maximum employment and stable prices. Thank you very much.

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7 For more information, see Board of Governors (2012).

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