

Janet L Yellen: The economic outlook

Testimony by Ms Janet L Yellen, Chair of the Board of Governors of the Federal Reserve System, before the Joint Economic Committee, US Congress, Washington DC, 7 May 2014.

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Chairman Brady, Vice Chair Klobuchar, and other members of the Committee, I appreciate this opportunity to discuss the current economic situation and outlook along with monetary policy before turning to some issues regarding financial stability.

Current economic situation and outlook

The economy has continued to recover from the steep recession of 2008 and 2009. Real gross domestic product (GDP) growth stepped up to an average annual rate of about 3-1/4 percent over the second half of last year, a faster pace than in the first half and during the preceding two years. Although real GDP growth is currently estimated to have paused in the first quarter of this year, I see that pause as mostly reflecting transitory factors, including the effects of the unusually cold and snowy winter weather. With the harsh winter behind us, many recent indicators suggest that a rebound in spending and production is already under way, putting the overall economy on track for solid growth in the current quarter. One cautionary note, though, is that readings on housing activity – a sector that has been recovering since 2011 – have remained disappointing so far this year and will bear watching.

Conditions in the labor market have continued to improve. The unemployment rate was 6.3 percent in April, about 1-1/4 percentage points below where it was a year ago. Moreover, gains in payroll employment averaged nearly 200,000 jobs per month over the past year. During the economic recovery so far, payroll employment has increased by about 8-1/2 million jobs since its low point, and the unemployment rate has declined about 3-3/4 percentage points since its peak.

While conditions in the labor market have improved appreciably, they are still far from satisfactory. Even with recent declines in the unemployment rate, it continues to be elevated. Moreover, both the share of the labor force that has been unemployed for more than six months and the number of individuals who work part time but would prefer a full-time job are at historically high levels. In addition, most measures of labor compensation have been rising slowly – another signal that a substantial amount of slack remains in the labor market.

Inflation has been quite low even as the economy has continued to expand. Some of the factors contributing to the softness in inflation over the past year, such as the declines seen in non-oil import prices, will probably be transitory. Importantly, measures of longer-run inflation expectations have remained stable. That said, the Federal Open Market Committee (FOMC) recognizes that inflation persistently below 2 percent – the rate that the Committee judges to be most consistent with its dual mandate – could pose risks to economic performance, and we are monitoring inflation developments closely.

Looking ahead, I expect that economic activity will expand at a somewhat faster pace this year than it did last year, that the unemployment rate will continue to decline gradually, and that inflation will begin to move up toward 2 percent. A faster rate of economic growth this year should be supported by reduced restraint from changes in fiscal policy, gains in household net worth from increases in home prices and equity values, a firming in foreign economic growth, and further improvements in household and business confidence as the economy continues to strengthen. Moreover, U.S. financial conditions remain supportive of growth in economic activity and employment.

As always, considerable uncertainty surrounds this baseline economic outlook. At present, one prominent risk is that adverse developments abroad, such as heightened geopolitical tensions or an intensification of financial stresses in emerging market economies, could

undermine confidence in the global economic recovery. Another risk – domestic in origin – is that the recent flattening out in housing activity could prove more protracted than currently expected rather than resuming its earlier pace of recovery. Both of these elements of uncertainty will bear close observation.

Monetary policy

Turning to monetary policy, the Federal Reserve remains committed to policies designed to restore labor market conditions and inflation to levels that the Committee judges to be consistent with its dual mandate. As always, our policy will continue to be guided by the evolving economic and financial situation, and we will adjust the stance of policy appropriately to take account of changes in the economic outlook. In light of the considerable degree of slack that remains in labor markets and the continuation of inflation below the Committee's 2 percent objective, a high degree of monetary accommodation remains warranted.

With the federal funds rate, our traditional policy tool, near zero since late 2008, we have relied on two less conventional tools to provide support for the economy: asset purchases and forward guidance. And, because these policy tools are less familiar, we have been especially attentive in recent years to the need to communicate to the public about how we intend to employ our policy tools in response to changing economic circumstances.

Our current program of asset purchases began in September 2012 when the economic recovery had weakened and progress in the labor market had slowed, and we said that our intention was to continue the program until we saw substantial improvement in the outlook for the labor market. By December 2013, the Committee judged that the cumulative progress in the labor market warranted a modest reduction in the pace of asset purchases. At the first three meetings this year, our assessment was that there was sufficient underlying strength in the broader economy to support ongoing improvement in labor market conditions, so further measured reductions in asset purchases were appropriate. I should stress that even as the Committee reduces the pace of its purchases of longer-term securities, it is still adding to its holdings, and those sizable holdings continue to put significant downward pressure on longer-term interest rates, support mortgage markets, and contribute to favorable conditions in broader financial markets.

Our other important policy tool in recent years has been forward guidance about the likely path of the federal funds rate as the economic recovery proceeds. Beginning in December 2012, the Committee provided threshold-based guidance that turned importantly on the behavior of the unemployment rate. As you know, at our March 2014 meeting, with the unemployment rate nearing the threshold that had been laid out earlier, we undertook a significant review of our forward guidance. While indicating that the new guidance did not represent a shift in the FOMC's policy intentions, the Committee laid out a fuller description of the framework that will guide its policy decisions going forward. Specifically, the new language explains that, as the economy expands further, the Committee will continue to assess both the realized and expected progress toward its objectives of maximum employment and 2 percent inflation. In assessing that progress, we will take into account a wide range of information, including measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial developments. In March and again last month, we stated that we anticipated the current target range for the federal funds rate would be maintained for a considerable time after the asset purchase program ends, especially if inflation continues to run below 2 percent, and provided that inflation expectations remain well anchored. The new language also includes information on our thinking about the likely path of the policy rate after the Committee decides to begin to remove policy accommodation. In particular, we anticipate that even after employment and inflation are near mandate-consistent levels, economic and financial conditions may, for some time, warrant keeping the target federal funds rate below levels that the Committee views as normal in the longer run.

Because the evolution of the economy is uncertain, policymakers need to carefully watch for signs that it is diverging from the baseline outlook and respond in a systematic way to stabilize the economy. Accordingly, for both our purchases and our forward guidance, we have tried to communicate as clearly as possible how changes in the economic outlook will affect our policy stance. In doing so, we will help the public to better understand how the Committee will respond to unanticipated developments, thereby reducing uncertainty about the course of unemployment and inflation.

Financial stability

In addition to our monetary policy responsibilities, the Federal Reserve works to promote financial stability, focusing on identifying and monitoring vulnerabilities in the financial system and taking actions to reduce them. In this regard, the Committee recognizes that an extended period of low interest rates has the potential to induce investors to “reach for yield” by taking on increased leverage, duration risk, or credit risk. Some reach-for-yield behavior may be evident, for example, in the lower-rated corporate debt markets, where issuance of syndicated leveraged loans and high-yield bonds has continued to expand briskly, spreads have continued to narrow, and underwriting standards have loosened further. While some financial intermediaries have increased their exposure to duration and credit risk recently, these increases appear modest to date – particularly at the largest banks and life insurers.

More generally, valuations for the equity market as a whole and other broad categories of assets, such as residential real estate, remain within historical norms. In addition, bank holding companies (BHCs) have improved their liquidity positions and raised capital ratios to levels significantly higher than prior to the financial crisis. Moreover, recently concluded stress tests mandated by the Dodd-Frank Act have provided a level of confidence in our assessment of how financial institutions would fare in an extended period of severely adverse macroeconomic conditions or a sharp steepening of the yield curve alongside a moderate recession. For the financial sector more broadly, leverage remains subdued and measures of wholesale short-term funding continue to be far below levels seen before the financial crisis.

The Federal Reserve has also taken a number of regulatory steps – many in conjunction with other federal agencies – to continue to improve the resiliency of the financial system. Most recently, the Federal Reserve finalized a rule implementing section 165 of the Dodd-Frank Act to establish enhanced prudential standards for large banking firms in the form of risk-based and leverage capital, liquidity, and risk-management requirements. In addition, the rule requires large foreign banking organizations to form a U.S. intermediate holding company, and it imposes enhanced prudential requirements for these intermediate holding companies. Looking forward, the Federal Reserve is considering whether additional measures are needed to further reduce the risks associated with large, interconnected financial institutions.

While we have seen substantial improvements in labor market conditions and the overall economy since the financial crisis and severe recession, we recognize that more must be accomplished. Many Americans who want a job are still unemployed, inflation continues to run below the FOMC’s longer-run objective, and work remains to further strengthen our financial system. I will continue to work closely with my colleagues and others to carry out the important mission that the Congress has given the Federal Reserve.

Thank you. I will be pleased to take your questions.