

ECONOMIC OUTLOOK AND POLICY RESPONSES IN THE UNITED STATES

by

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Thank you for inviting me to speak to you today. It is a pleasure to be here and thank you for your hospitality.

My presentation will focus on 4 main topics: (1) Why the United States economy is growing so slowly and what we can expect going forward; (2) the policy response to this slow growth; (3) the new tools used by the Federal Reserve, our central bank, and its Federal Open Market Committee (FOMC)* and (4) the outlook for the economy and the risks to that outlook. Although the main focus of my remarks is the U.S. economy, given your interest in Japan, I will draw some comparisons to the Japanese economy as well. And I will discuss the leadership transition at the Federal Reserve.

Why is the U.S. economy growing slowly?

In order to understand the sluggish performance of the U.S. economy, we must take a step back to the great recession which started in late 2007. In a typical recession, (Chart 1), the economy becomes overheated and inflation expectations and inflation accelerate. The Federal Reserve tightens monetary policy which results in higher interest rates. The higher interest rates cause the growth rate of the economy to slow, typically led by the interest sensitive sectors such as auto and housing. As the economy slows, the unemployment rate increases and with a lag, inflationary pressures subside enabling the Federal Reserve to loosen monetary policy by reducing interest rates. Housing, auto, and other interest rate sensitive sectors then typically lead the upturn in the economy and the subsequent reduction in unemployment.

*The Federal Open Market Committee (FOMC) is the monetary policy making committee of the Federal Reserve. It consists of the seven members of the Board of Governors and the 12 reserve bank presidents. Throughout this presentation I will use the term FOMC and Federal Reserve interchangeably.

Unfortunately, the 2007 recession did not follow the typical pattern because it was caused by a financial crisis. There was not a large increase in inflation rates that led to the Federal Reserve tightening monetary policy.

Instead, we had a bubble, and this bubble burst with a vengeance in 2008. Consumer debt, primarily in home mortgages, expanded rapidly in the years prior to 2007 and reached unsustainable levels. Rapid increases in housing prices and a substantial increase in the portion of our households owning homes from 64% to 69% helped enable the increase in mortgage debt to continue. Housing prices, for example, increased at an annual rate of 13% from 2001 to 2005 as compared to an increase over the long term of about 3% per year or 1 percent faster than overall inflation.

During this period many households who were not ready for home ownership received financing. And in some cases, lenders made misleading statements, encouraging consumers to buy homes. The well-publicized problem centered on subprime borrowers who received short term financing at low rates, often with low down payments, which required them to refinance usually in two years. However, their ability to re-finance depended on housing prices continuing to increase which, of course, came to a screeching halt in 2007 and 2008 when the average home price declined at an annual rate of 14%.

So part of the economic growth that we experienced in those go-go years stemmed from credit growth that was not justified by the fundamentals. We were overleveraged. In the aftermath, overall consumer credit declined. Borrowers could not borrow as much because the value of their collateral (homes) declined, and lenders could not lend as much because they incurred losses on earlier loans causing reductions in their capital available to support new loans. The resulting deleveraging was a necessary but painful part of the recovery.

It is important to keep in mind that excessive leverage was not confined to the United States. Ireland and Spain had their own housing booms with housing prices increasing rapidly

and home loans expanding as well. Greece and Portugal experienced rapid and unsustainable increases in government borrowing – a different, but equally problematic, form of excessive leverage.

So let's now look at deleveraging in the credit card industry, an industry of great importance to all of us (Chart 2). This chart shows the growth in revolving credit each year since 1983. As you can see in most years growth in revolving credit has been quite robust, averaging about 10% per year from 1987 to 2007. However, once the recession hit in late 2007, revolving credit actually declined for two years and has grown only nine-tenths of a percent in 2013. Obviously, these declines and slow growth are unprecedented and contrast sharply with prior recessions. As a result, the credit card business is changing, and I am sure that you will talk more about these developments during this conference.

Turning back to the overall economy in the United States, the next chart (Chart 3) shows the change in real gross domestic product or GDP by year from 2000 to present. Real GDP measures the total output of goods and services in all sectors of the economy adjusted for change in prices. The gray shaded areas are recessions. As you can see, the 2001 recession was relatively mild with GDP still remaining slightly positive in 2001. We also experienced a significant rebound in economic growth to 4.3% during the recovery phase in 2003. The 2007 recession, of course, was much deeper and lasted 18 months. We also had negative GDP growth in 2008 and 2009, an extremely rare phenomenon in the United States. In fact, this recession was the most severe since the 1930s depression. To make matters worse, we did not have a significant rebound in economic growth in the years following the recession. If you have a sharp decline in growth, you would expect to see a sharp rebound in succeeding periods – the proverbial “V-shaped” recovery. Unfortunately, we have not had a “v-shaped” recovery. Instead, we have had slow and sluggish growth, and that stems back to the fact that this recession was caused by a financial crisis. This type of recession tends to be

deeper and longer, and recoveries then tend to be slower and more sluggish which is exactly the kind of recovery that we have had. Unfortunately, I do not expect that pattern to improve anytime soon.

Using technical terms like GDP growth and economic cycles masks the adverse impact that this recession has had on many American families. Many have suffered as the value of their homes and savings have declined. As shown in the next chart (Chart 4) we lost 8.7 million payroll jobs from the peak of employment in 2007. Today, six years later, total employment is still 1.9 million below the 2007 peak. The next chart (Chart 5A) shows the sharp spike in the unemployment rate to 10% in 2009 from the 4.6% rate in 2007. Since 2009, the rate has declined to 7.3% which is still much higher than the 5-5.5% rate that most economists believe is full employment in the United States. The pink shaded portion of the chart is the International Monetary Fund (IMF) forecast for the unemployment rate which shows a continued slow decline for the next five years.

The current 7.3% unemployment rate does not include the large number of people who are not counted as unemployed because they have given up looking for jobs and are therefore considered “out of the labor force.” When you add this group to those who are involuntarily working part time and those counted as unemployed, 14% of the work force is still adversely affected.

Let me turn briefly to the labor market in Japan which is quite different from the United States. The red line shows a much lower unemployment rate in most years as compared to the United States (Chart 5B). But, as you know, the overall population in Japan is now declining and relatively more retired Japanese citizens are dependent on those working than in any other industrialized country. The declining population will make it increasingly difficult for Japan to increase its rate of economic growth unless other measures are taken such as increasing immigration, increasing the participation rate of females in the

workforce, or making structural changes to increase productivity growth such as the ones Prime Minister Abe has discussed.

Policy Responses to the Great Recession:

When the recession in the United States began in late 2007, policy makers recognized its potential severity and took steps to reduce its magnitude and impact. A \$787 billion stimulus program was enacted by the Congress in 2009. The purpose was to temporarily increase federal government spending in order to partially offset the reduction of spending by consumers and business firms. In addition, special programs were enacted to support automobile and new home sales. Unfortunately, most of the \$787 billion took the form of one time payments to individuals or states and local governments. Only a small portion of the stimulus spending was devoted to infrastructure spending that can increase productivity growth and therefore have a multiplier effect on our rate of economic growth. And the special “cash for clunkers” program for automobiles and special tax credits for housing did little more than move forward spending on these two categories as opposed to increasing total spending.

Now the momentum has shifted to slower government spending. We have seen this last year and this year in the negotiations on increasing the debt limit. Both parties agree that we have to slow down the rate of increases in government spending but priorities obviously differ. Note that I very carefully said “slow down the rate of increase in government spending,” which is different from an absolute reduction in the level of government spending. In Washington, a spending cut is not a real reduction in government spending. It is a reduction from the projected rate of increase which takes into account population growth and price increases. So we must listen carefully when politicians speak about spending cuts.

Time does not permit me to discuss the long term problems we face with federal government spending and increasing levels of government debt, but this year and next year

government spending is not boosting economic growth. The tax increases and sequester that went into effect this year reduced overall growth of GDP by about one percentage point which is quite significant considering that we have only grown by 1.6% (AR) in the first half of 2013.

As you know, Congress and the President did not reach agreement on a budget for the fiscal year that started October 1 until last night, so we have had a partial shutdown of government services. Shutdowns of this type have occurred 17 times before and will not have a significant impact on the economy if they are of short duration. On the other hand, we came very close to the legislative ceiling for federal government debt which, unless increased, precluded the Treasury from issuing additional debt. Since we are running large deficits, we would either have had to default on our government debt or make painful reductions in payments to creditors such as employees, military personnel, Social Security recipients, Medicare providers, suppliers etc. or some combination of the two options. Both options would do significant damage to our economy and to investor confidence in the U.S. I consider them in the category of “unthinkable” and doubt that we will go down that road but recognize that the threat will likely be recurring and as soon as next year since the agreement reached last night on the budget lasts only three months.

New Monetary Policy Tools:

Let's now shift from fiscal policies to the extraordinary monetary policy actions taken during the great recession. Early in this presentation, I showed this chart (Chart 6) which describes Federal Reserve policy during a typical recession and recovery. Recall that in a typical recovery, the Fed loosens monetary policy by reducing interest rates which leads to increased economic growth albeit with a lag. To be specific, the Fed reduces its target for the federal funds rate which is the rate that banks charge each other for overnight borrowing. But, as we know, because this recession was so severe, the Fed loosened as much as possible by

reducing its target federal funds rate to between zero and 25 basis points which is as low as it can go. In other words, it had hit the “zero bound;” short term rates could not go any lower than zero. Its models suggested that the federal funds rate should be negative so the FOMC firmly believed that it should be providing additional stimulus beyond the zero federal funds rate. Exactly how the added stimulus should be provided led to extensive policy discussions within the FOMC. I will discuss two techniques: forward guidance and quantitative easing.

One approach is forward guidance which has been utilized extensively and modified as the FOMC assessed its effectiveness and better understood the reaction of financial markets. Initially the FOMC said that it anticipates that it would keep the federal funds target low for “an extended period of time.” Later to further elaborate that time period, it specified dates such as 2014 or 2015 before it anticipated increasing short term interest rates. In its current approach instead of time frames the FOMC utilizes forward guidance such as the following which is a quote from its September 18, 2013 statement (Chart 7):

“... the Committee decided to keep the target range for the federal funds rate at 0 to ¼ percent and currently anticipates that this exceptionally low range for the federal funds rate will be appropriate at least as long as the unemployment rate remains above 6-1/2% percent, inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee’s 2 percent longer-run goal, and longer-term inflation expectations continue to be well anchored.”

The FOMC has emphasized that the conditions that it listed – unemployment below 6-1/2%; projected inflation no higher than 2-1/2%; and well anchored inflation expectations are thresholds and not triggers. In other words, action to increase rates is not guaranteed once any of the conditions is met.

The purpose of forward guidance is to provide a firmer basis for the future outlook for monetary policy to consumers and business firms. Research indicates that this will enable

them to better plan their spending and investment activities and therefore increase the rate of economic growth.

In order to provide greater transparency on the timing of increasing the federal funds target, the FOMC has provided information on the views of the individual members on this question. As shown in the chart (Chart 8), 12 members of the FOMC believe that 2015 will be the appropriate year for the FOMC to start increasing rates. The other 5 members are split between 2014 and 2016. In the next chart (Chart 9) further information is provided on the target federal funds rate that each of the 17 members of the FOMC expect at year end. Each dot represents a member. The wide divergence of views on what the rates will be at year end 2015 and 2016 is quite noticeable. Information is also provided on the expected longer run target federal funds rate, about 4 percent, when the economy is operating at full employment and expanding at its potential rate of growth.

A second new tool now being utilized by the FOMC is asset purchases of longer term Treasury securities and agency mortgage-backed securities (MBS), more popularly called quantitative easing (QE). Since it has hit the zero bound on short term rates, the FOMC is attempting to reduce longer term rates by purchasing securities in the 7-10 year duration. These large scale purchases are expected to drive up the price of these securities and therefore lower longer term interest rates. The lower long term rates affect the economy in three ways: (1) lower long term rates, especially rates for MBS, should reduce mortgage rates and therefore make housing more affordable to consumers. The lower rates should also encourage additional business investment; (2) the lower longer term rates make fixed income securities less attractive to investors and therefore encourage them to purchase riskier assets driving up the price of equities. Higher equity prices have a positive wealth effect on consumers, encouraging them to increase their purchases. Economic research indicates that for every \$100 dollar increase in wealth, consumers will spend an additional 4 percent or 4

dollars; (3) and lower long term rates, other things being equal, should reduce the value of our currency therefore leading to increased exports.

The FOMC instituted two QE programs with fixed amounts of security purchases in 2008 and 2010. Last September it took a more significant step when it announced that it would purchase \$85 billion of securities each month until further notice. These programs have significantly increased the monetary base in the United States as indicated in Chart 10. As you can see from 1990 until 2007, the monetary base which is the total supply of currency and reserves increased by \$525 billion. But from 2007 to date, the monetary base has increased by \$2.7 trillion. This incredibly rapid increase in the monetary base could lead to rapid inflation except for the fact that there is substantial unused capacity and bank credit is at a low level relative to reserves in the system. Consumers are still deleveraging which is one reason that credit is not expanding relative to the expansion in reserves. In addition inflation is running below the FOMC target of 2%, and inflation expectations are well anchored (Chart 11A) so higher inflation is not a current concern.

This chart shows inflation in the United States from 1994 to present. The data exclude food and energy prices because they are highly volatile and separating them out provides a better understanding of the underlying inflation trends. In recent years the rate of inflation has been below the 2% FOMC target. In the next chart (Chart 11B), comparable inflation data for Japan are shown as the red line. As you know, Japan has experienced a 15-year period of deflation which has slowed economic growth. Earlier this year, the Bank of Japan set a 2% inflation target and announced measures to achieve the target within two years. The Bank of Japan introduced a new policy of quantitative and qualitative easing (QQE) in April of this year. Under QQE, the BOJ has shifted its operating target to the monetary base and intends to double the monetary base in two years. (See Chart 12). It has stated that it will continue QQE

as long as necessary to achieve its 2% inflation objective. Obviously there are some similarities between QE in the United States and QQE in Japan.

I want to emphasize, however, that the QE program in the United States is not without risks. QE is a new monetary policy tool and it is extremely difficult to understand fully the impact of the program and its potential unintended consequences as well as the impact of keeping interest rates at very low levels for long periods of time. Furthermore, the FOMC will at some point slow down purchases of long term securities and eventually reduce the size of the monetary base. All of these steps have never been done before, so we are in uncharted waters.

The FOMC has provided forward guidance on the timing and process for exiting QE. It has said that it will continue its purchase of long term securities until there is a substantial improvement in the labor market in the context of price stability. Some confusion has developed because the threshold “substantial improvement in the labor market” utilized here contrasts sharply with the more precise 6-1/2% unemployment rate threshold for starting to increase the federal funds target. Even after it stops purchasing securities, it will continue to hold its stock of securities by reinvesting proceeds from maturing securities. At some undetermined point as the economy improves, it will have to start reducing its stock of securities, and eventually it will have to increase short term interest rates. The FOMC will have to resist the inevitable opposition to tightening monetary policy when it is appropriate to tighten. It is much easier for central banks to lower rates than to raise rates.

Outlook for the U.S. Economy:

Having reviewed the Great Recession and its aftermath, as well as the extraordinary fiscal and monetary policies that have been put in place, let us turn now to the outlook for the U.S. economy. All of you know how difficult it is to forecast in your businesses, and the same is true for forecasting the economy. So economists have to be humble when they speak

about the future because their record in forecasting is at best uneven. With this caveat, let's start by looking at what the FOMC believes the economy will look like for the next five years.

This chart (Chart 13) shows the mid-point of the forecast of the 17 member FOMC through 2016 and longer term. The growth rate of GDP increases from approximately 2% this year to approximately 3% from 2014 to 2016. Moving from 2% to 3% may not sound like a lot but if that happens, it would be a 50% improvement from the 2% rate of growth that we have been experiencing in our slow and sluggish recovery. The FOMC also expects that the unemployment rate will decline and reach full employment by 2016 which is the same year that they expect inflation to come close to their 2% target. This chart also includes the longer run projections, which shows their view on the normal or trend rate of growth and the normal unemployment rate.

This FOMC forecast is a bit more optimistic than the consensus forecast for the U.S. economy, and for several years the FOMC has forecasted improvement in outer years that has not materialized. My own forecast shows some improvement going forward but not as much as the FOMC. I hope that I am wrong.

So recognizing previous overly optimistic forecasts, why do the FOMC and most private sector forecasters expect the economy to improve in the coming years? First, fiscal policy restraint from higher taxes and reduced increases in government spending in 2013 is expected to be significantly reduced. Second, further improvement in credit availability together with less household deleveraging is expected. And finally, monetary policy has been and is expected to continue to be highly accommodative.

What are the downside or upside risks to the numbers that we just reviewed? (Chart 14). First, economic growth in the European Union, which is a major importer of U.S. products and services, could be slower or faster than the current outlook which is for a very

slow recovery to 1% in 2014. Deviation either way from the current forecast would affect our rate of growth. The same can be said for growth of other major economies including China and Japan. Last week the IMF reduced its growth forecast for the world economy for this year and next. The reductions were focused mainly on emerging market economies particularly China, India, and Brazil. So at this point, the downside risks appear to be of more concern regarding growth of our trading partners.

A second risk is unforeseen increases in energy prices. Of course, recent discoveries of extensive shale gas deposits in the U.S. and new technologies for accessing the shale gas could reduce energy costs in the U.S. which would be a major upside to the forecast.

Third, inflation and deflation are both potential threats to the forecast. Temporary increases in inflation, such as from higher energy costs, are not a concern unless higher inflation or inflation expectations become embedded into wage decisions. This is not a present concern in the U.S. because inflation expectations are anchored and because we continue to have excess capacity. In fact, some commentators are more concerned about the prospect for deflation, or unwelcomed disinflation, because inflation in the United States continues below the 2% target. As an aside in order for the Bank of Japan to reach its 2% inflation target, wage increases in Japan will have to increase and become embedded in price decisions. Temporary increases in inflation will not be sufficient. Furthermore, if inflation increases and wages stagnate, Japanese households will experience a reduction in their purchasing power and well-being.

Finally, an important risk is how the slowdown in our accommodative monetary policy will transpire or what is commonly referred to as the exit strategy. The Federal Reserve will need to exercise great care in slowing down the flow of its purchases in its QE program and reducing the stock of securities it holds on its balance sheet. It will most likely start this process this year or early next year. And looking out further, it will eventually need

to start increasing its federal funds target. It will be important that the timing and communications to the public are done in a way that does not stifle the recovery but also prevents inflation from getting out of control. Risks surrounding the exit from our highly accommodative monetary policy must be carefully assessed because so much of our monetary policy is new and untested. We do not know how the financial markets and the public will react or what the impact will be on other countries as the Federal Reserve starts its wind down. So even with the most skillful actions of the Federal Reserve, there always is the risk of unforeseen consequences.

Last week President Obama nominated Janet Yellen to replace Ben Bernanke as Chair of the Federal Reserve Board after his term ends on January 31, 2014. Transitions in leadership at the Federal Reserve are always significant; in this case probably more significant because as we discussed we are using so many new monetary policy tools. Assuming confirmation by the Senate, Yellen will head the Federal Reserve during her four year term when it will make extremely important and difficult decisions regarding exiting from QE, increasing interest rates, and next steps in improving its communications and forward guidance. In addition, the composition of the seven member Board of Governors will change significantly. When she becomes Chair, there will be three vacancies and one or two more are likely next year.

In my judgment, Janet Yellen is well-qualified to lead the Federal Reserve during this important period. When I headed the Federal Reserve Bank of Chicago, I worked closely with her during the time when she was a member of the Board of Governors and later when she headed the Federal Reserve Bank of San Francisco. She has the academic training, the leadership qualities, experience at the Federal Reserve, and the interpersonal skills that equip her well for this difficult job. She has an outstanding record of public service, and I believe

that she will be willing to tighten policy when appropriate even though it will inevitably be unpopular to do so.

In conclusion, let me review some of the major points that I have discussed. The U.S. experienced a different kind of recession in 2007 that was very deep and the recovery continues to be slow and sluggish. We reviewed the extraordinary fiscal and monetary policies that were adopted and how these policies have evolved as policy makers gained more experience with them. We concluded by examining the current outlook for the economy and the risks to that outlook as well as next year's transition in leadership of the Federal Reserve. Finally, we drew comparisons to unemployment and inflation in Japan as well as the new monetary policies adopted this year by the BOJ.

It has been a pleasure for me to speak to you this morning. I hope that this presentation has been helpful, and I look forward to participating in the other sessions of the conference.

Appendix:

- Chart 1: Typical Recession/Typical Recovery
- Chart 2: Annual Growth in Revolving Credit Outstanding
- Chart 3: Real Gross Domestic Product (GDP)
- Chart 4: Payroll Employment, 1980-2013 – U.S.
- Chart 5A/B: Unemployment – U.S. & Japan
- Chart 6: Typical Recession/Typical Recovery
- Chart 7: Selection of September 2013 FOMC Statement
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