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"The Economic Outlook and Monetary Policymaking"

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President & Chief Executive Officer
Federal Reserve Bank of Boston

Lake Champlain Regional Chamber of Commerce

Burlington, Vermont
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Thank you for the invitation to speak with you today. It is a pleasure to be back in Vermont, where every season is wonderful but fall can be spectacular. I hope that a strong foliage season this year will provide further support to a Vermont economy that has recovered more quickly than the rest of New England, and much faster than many other parts of the country.

I would like to take a moment to recognize and thank Tom Torti, president of the Lake Champlain Regional Chamber of Commerce, and Ernie Pomerleau, president of Pomerleau Real Estate here in Burlington. Ernie serves on the Boston Fed's New England Advisory Council. It is one of our advisory groups, and provides an important link to what is happening within businesses around New England. At council meetings, Ernie draws on his strong connections in Vermont to provide very helpful insights on trends in the state's business activity and economy. Tom and the Boston Fed have worked together for a number of years, and he was instrumental in helping us recruit Ernie to that Advisory Council. Ernie and Tom were kind enough to make sure this opportunity to speak with you today came to fruition, and for that too I am grateful.

The Federal Reserve's policymaking has been much discussed of late, in particular in the two weeks since the monetary policy committee (the Federal Open Market Committee or FOMC) last met. There has been significant public discussion and debate over the Fed decision to continue with the program of purchasing $85 billion a month in Treasury and mortgage-backed securities. There has also been a good deal of commentary on the messaging that occurred in the lead-up to the meeting.

Today I would like to explain my perspective, as one committee member. In particular, I would like to describe why I thought the incoming economic data did *not* show the progress I had hoped and expected at the time of the June FOMC meeting, when the committee discussed a possible reduction in the rate of asset purchases sometime in the fall.

As always, I would point out that my remarks today convey my own views, not necessarily those of my colleagues on the Federal Reserve Board or the Federal Open Market Committee.

Several factors caused me to strongly and unequivocally support continuation of the Fed's asset purchase program at the last policy meeting:

- first and foremost, the disappointing incoming economic data, which had reduced my own and most participants' forecasts for gross domestic product (GDP) this year and next;
- the possibility of disruptions in the nation's fiscal policies that might provide a further potential slowdown in economic activity, going forward; and
- long-term market rates that had already risen more than I thought was consistent with interest-sensitive sectors providing needed support to the economy's continued recovery.

Asset purchases, like all monetary policy actions of the central bank, should be rooted in and dependent on incoming data. Forecasts are of course imperfect – and have tended to be overly optimistic over the previous four years. As a result, I believe we need to see data that compellingly suggest that over the next three years we are indeed on a path to reach full employment and 2 percent inflation. Today, I would like to review with you some of the data that, to my thinking, indicated that conditions were not yet strong enough to assume the economy is on that positive and appropriate path – the data that led me to believe it would have been premature to begin reducing the rate of Fed asset purchases.

It is also important to emphasize that a policy that is data dependent cannot always be "signaled" clearly, in advance. The FOMC forecasts can be wrong – reality doesn't always live up to our forecasts. Had U.S. fiscal matters not been so problematic, and incoming data on real GDP and employment stronger, it may well have been appropriate to take some action in September. Unfortunately, those were not the facts we faced, before the meeting.

I would add that *interpreting* the data is an important and nuanced matter. The FOMC is a committee, and different participants can and often do have different perspectives on the strength of the incoming data. Some of the indicators the committee must weigh in preparation for policy meetings include data that provide only partial information on an aspect of the economy – so that their import only becomes clear once we have the fuller context provided by other, related data. Also, importantly, assembling a coherent picture of the overall economy is challenging even with complete data, and involves "art" as well as science.

That points to the value of the committee members gathering together to arrive at policy decisions. I will say that listening to the way in which other members, with different perspectives, interpret the same data helps me form a more robust sense of where the economy is going. All this means that our fundamental reliance on data in policymaking may result at times in less signaling, before FOMC meetings, about small changes in the purchase program.

I would hope it goes without saying, but let me take a moment to stress the following. As Chairman Bernanke suggested in his press conference,[1] Fed actions are not determined by Wall Street's expectations of what we might or should do. Rather, our policies need to be consistent with achieving key goals like supporting Main Street's more rapid return to full employment – and keeping away the extremely low inflation that characterized troubled economies like Japan's in its "Lost Decade" and moving toward the Fed's two percent inflation objective.

I do not mean to imply that the communications and signaling issues of the last few months have not been difficult, for many. Without question, there are difficulties inherent in communicating a data-contingent policy – but a data-contingent policy is far preferable to the alternatives. The Federal Reserve will continue to refine its policy-related communications, but I would just point out that predictive certainty will never be the case when policy is rooted in actual incoming data, which may or may not follow forecasts.

Recent Economic Data

With that as introduction, let me now turn to the recent economic data that helped inform decisions at the September FOMC meeting. Figure 1 shows the path of the unemployment rate over the past five years. From the beginning of 2008, when the unemployment rate was 5 percent, the rate kept climbing – past the end of the recession. Indeed, it peaked at 10 percent in October of 2009. One year ago, the August unemployment rate was 8.1 percent, and as of August of this year the rate had fallen to 7.3 percent. Clearly the unemployment rate has been declining since its peak – albeit slowly – and there has been slow but steady progress in reducing the rate over the past year.

However, other employment indicators have not been so positive. Figure 2 provides the labor force participation rate – the percent of the population 16 years of age and over that is either working or actively searching for work – over the past five years. It has declined gradually over this period, which may mean the unemployment rate in the previous chart underestimates reality.

Let me explain why. The decline in the labor force participation rate reflects two factors. The first is longer-term trends in demographics, like baby-boomers reaching normal retirement age and leaving the labor force. But most estimates suggest that demographics alone cannot account for all the change we have observed in labor-force participation. Unfortunately, the second factor reflects current weakness in the demand for workers, apart from demographic and other factors. Some workers who were looking for work have become discouraged by the shortage of job offers – a shortage that has been persisting over an extended period of time.

Were the economy to strengthen, some of these workers would likely return to the labor force as demand for labor increased. If the demand for labor were strong enough — if the number of new job openings matched the number of workers returning to the labor force — we could see increases in payroll employment with little change in the unemployment rate.

Unfortunately, what sounds like a temporary decline in the labor force participation rate could turn into a permanent one. A significant concern is that the longer we have such an elevated unemployment rate, the more likely it is that some of those who have left the labor force due to the lack of jobs will simply never return. In this way the decline in labor force participation could become permanent, implying an ongoing loss of employment and income for those workers – a very serious matter for our fellow citizens and for our economy.

Figure 3 shows payroll employment growth over the past five years. Over the past year, payroll employment has grown by an average of 184,000 jobs per month – and for a few months we were averaging over 200,000 jobs a month. Unfortunately, that pace of job growth has recently slowed down. Over the past three months, payroll employment has averaged only 148,000 jobs per month, which coupled with only 2 percent growth in real GDP suggests the economy is in a "holding pattern" – just treading water rather than gearing up to make significant improvement in the still very elevated unemployment rate.

Real GDP has grown by just over 2 percent on average since the beginning of the recovery more than four years ago. Unfortunately, growth this year has shown no improvement over that pace, with real GDP advancing a little less than 2 percent in the first half of this year. Most private forecasters are projecting that growth in real GDP in the third quarter will be roughly 2 percent once again.

The bright spot in real GDP through much of the recovery has been the interest-sensitive sectors. Figure 4 shows that residential investment has been strong – in fact it has averaged just over 15 percent growth over the last four quarters. This strength comes, in part, in response to the Federal Reserve's asset-purchase program, which was designed to lower market rates and boost interest-sensitive economic activity. Similarly, auto sales have been quite strong – helped by unusually low auto-loan rates, which reflect competitive forces among auto lenders (including community banks) as well as the Fed's asset-purchase program. In short, the most interest-sensitive sectors have been growing strongly, in part because of highly accommodative monetary policy.

Despite the resilience of the interest-sensitive sectors, the overall economy has grown much more slowly than is the norm for economic recoveries. Obviously, it is very important to understand what accounts for this persistently slow growth. Figure 5 shows that for the first half of this year some sectors, like exports, have grown faster than 2 percent despite weakness among many foreign trading partners. This is partially due, again, to low interest rates – low rates mean a lower value for the dollar in relation to other currencies, which makes U.S. exports relatively more affordable overseas.

But the figure highlights that the main drag on the economy has come from declines in government spending at the state and federal level, coupled with the tax increases that depressed consumer spending earlier this year.[2] However you feel about the political economy of fiscal matters, government spending is a component of GDP, and tax policy obviously affects consumer spending. I would note that historically speaking, significant fiscal austerity such as we have recently seen is quite unusual at a time when the economy is trying to recover from a severe recession. Figure 6 shows the contribution of government spending to the percent change in real GDP – historically positive, on average, but usually negative in the current recovery.

I would echo Chairman Bernanke and others who urge a return to long-run fiscal sustainability, while observing that excessive austerity in the near-term subdues an already tepid recovery. I would note that fiscal headwinds can – and have – come in the form of lower spending as well as higher taxes. To underline the end result, Figure 7 shows just how restrained employment growth has been in the current recovery versus previous ones.

Most private forecasts had assumed that in the second half of this year the less interest-sensitive components of consumer spending would pick up, and the headwinds created by fiscal austerity would begin to ebb. However, Figure 8 shows that, to date, consumer spending has not picked up as hoped. And while some of the effects of fiscal austerity will eventually ebb, to date fiscal austerity is one reason we have yet to see growth much faster than 2 percent.

Unfortunately, this remains an area of significant uncertainty, given debates in Congress on continuing resolutions and potentially allowing the country to default on its debt. The uncertainties, not to mention the outcomes themselves, threaten to have a collateral impact on the rest of the economy.

Figure 9 shows the central tendency (which excludes the three highest and three lowest projections) for the FOMC's Summary of Economic Projections.[3] Comparing the left and right bars in each chart, the figure makes clear that FOMC participants reduced their estimates of growth in real GDP between the June and September FOMC meetings. While earlier the expectation was for real GDP to grow 2.3 to 2.6 percent in 2013, the central tendency is now 2.0 to 2.3 percent for 2013. Similarly, projections for 2014 are for an improvement over 2013, but are now lower than was anticipated at the June meeting.

In short, the data arriving since June have not ratified the earlier expectation that the increase in real GDP would occur this year, and many of the FOMC participants are now expecting that pick-up to occur instead in 2014, although by a more modest magnitude. That pattern of expected strength eventually disappointed by tepid reality has persisted for several years now.

At the same time that the economy seems to have slowed, the inflation rate remains quite low, as shown in Figure 10. The *core* Personal Consumption Expenditures (PCE) inflation rate has been low for the entire recovery, and is currently at only 1.2 percent over the past year. Similarly, *total* PCE inflation has been running consistently below our 2 percent target – only breaching 2 percent temporarily, in response to higher oil prices earlier in the recovery. Total PCE inflation over the past year has averaged only 1.2 percent, and oil prices have recently been declining as the possibility of a military strike on Syria subsided.

Returning to the Committee's forecasts, Figure 11 provides the midpoint of the central tendency of participants' forecasts for PCE inflation and core PCE inflation. These forecasts show only a very gradual increase in inflation for both the total and core measures. My own forecast is quite similar, with both total and core measures of inflation over the next several years falling below the Federal Reserve's 2 percent target.

Unfortunately, most of the risks to the outlook remain on the downside. Concerns over untimely fiscal austerity here and abroad, and the possibility of problems once again emerging in parts of Europe, could cause the Federal Reserve to miss on both elements of its dual mandate – employment and inflation – through 2016.

In my view, the asset-purchase program should remain dependent on incoming economic data, and we should seek to get the economy on a path to achieve both elements of the Fed's dual mandate – employment and inflation – as soon as possible, hopefully by 2016. Should the economy speed up more rapidly than is sustainable, we can remove accommodation more quickly. Should the economy unexpectedly slow down, we can and should provide more accommodation than is currently anticipated. If the economy evolves as expected, policy should in my view include only a very slow removal of accommodation over the next several years – and that should only occur when the data ratify our forecast for an improvement in real GDP and employment.

Concluding Observations

The last FOMC monetary policy statement made clear that we are not following a predetermined path for monetary policy. Unfortunately, the incoming data do not show the economic improvement that we had hoped for in June, and still ultimately expect.

It is likely that for such improvement we will need to see the fiscal headwinds subside, and also see consumers become more confident. This would be consistent with most private-sector forecasts that still anticipate an improving economy.

However, in my view if the economy is not improving as expected, we should not reduce the monetary policy accommodation. Doing so risks slowing the sectors of the economy that have shown the greatest strength – the interest-sensitive sectors that have been most responsive to policy actions. That, in turn, will prolong this period of elevated unemployment and slow job growth, turning what has been a long – but we hope still temporary – economic disruption into one with very long-lasting undesirable consequences for U.S. households and businesses.

Thank you again for inviting me to speak with you today.

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[1] See http://www.federalreserve.gov/monetarypolicy/fomcpresconf20130918.htm

[2] Obviously business investment is also a weak spot. While it is certainly interest-sensitive, it also may be impacted by fiscal uncertainty, only modest GDP growth, and subdued growth in consumer spending (consumption).

[3] See http://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20130918.pdf