Acting to Avoid a Great Stagnation

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Avoiding a Great Stagnation

- Historians use “Great” to reflect success – e.g., Alexander the Great
- Economists use “Great” to reflect difficult episodes and policy that contributes or fails to alleviate – e.g., Great Depression, Great Recession
- Forceful action necessary – and being taken – to avoid a Great Stagnation
What Would Constitute A Great Stagnation?

- Policymakers accepting as inevitable a slow growth economy and underutilized economic resources
- Allowing high unemployment to become a more permanent feature of the economy
- Policy only reacting to large negative shocks; accepting slow growth that makes little progress in returning to full employment
Seek faster growth than has occurred or is likely to occur without action

- Asset purchases (agency mortgage-backed and Treasury securities)
- More open-ended focus on economic outcomes rather than calendar dates or amounts purchased
- Communicating that we anticipate low short-term rates likely to be warranted at least through mid-2015; accommodative until recovery is sustainable
- Context of price stability; assessment of costs, efficacy
Unconventional policy has risks, but they are preferable to the risk of another year or more of economic stagnation

My rationale for policy change…
Real-World Example of Stagnation

- Japan and Europe have both suffered long periods of slow growth

- Today I will focus on Japan – despite some key differences from the U.S.
  - Demographics – Japanese population’s average age is rapidly rising
  - Slow response to banking problems
Figure 1
Japan’s Real Gross Domestic Product
1980:Q1 - 2012:Q2

Source: Cabinet Office of Japan / Haver Analytics
Figure 2
U.S. Real Gross Domestic Product
1980:Q1 - 2012:Q2

Source: BEA, NBER / Haver Analytics
Causes of Slow Growth

- Not unusual after a financial crisis
- Let’s look at a few factors (not enough time for a detailed discussion)
Figure 3
Growth in Real GDP and Real GDP Excluding Housing and Government Spending
2009:Q2 - 2012:Q2

Index, 2009:Q2=100

Real GDP Excluding Residential Investment and Government Spending
(Average Annual Growth of 2.45%)

Real GDP
(Average Annual Growth of 2.21%)

Source: BEA, NBER / Haver Analytics
Figure 4
Housing Starts
2000:Q1 - 2012:Q2

Thousands of Units, Seasonally Adjusted Annual Rate

Source: Bureau of the Census, NBER / Haver Analytics
Figure 5
Growth in Real State and Local Government Spending
2000:Q1 - 2012:Q2

Source: BEA, NBER / Haver Analytics
Figure 6
Change in Real GDP from U.S. Business Cycle Peak by Country
2007:Q4 - 2012:Q2

Source: BEA, CAO, Eurostat, ONS, INSEE, StatCan / Haver Analytics
The Significant Costs of a Slow Recovery

- Impact on those unemployed or underemployed
- Temporary labor market problems can eventually become more permanent because of a slow recovery
Figure 7
Employment-to-Population* Ratio
January 2000 - August 2012

*Includes population 16 years and older

Source: BLS, NBER / Haver Analytics
Figure 8
Long-Term Unemployment
January 1980 - August 2012

Percent of unemployed out of work for 27 weeks or more

Source: BLS, NBER / Haver Analytics
What Should Monetary Policymakers Do?

- Conventional response – lower short-term rates... not possible at the zero lower bound

- Unconventional responses
  - More costs
  - Impact less certain
  - Still, not a reason to avoid necessary actions
Figure 9
Japan’s Central Bank Assets and Inflation Rate
1990:Q1 - 2012:Q2

Source: Japanese Ministry of Internal Affairs and Communications, Bank of Japan / Haver Analytics
Figure 10
Federal Reserve System Assets and U.S. Inflation Rate

January 1990 - July 2012

Source: Federal Reserve Board / Haver Analytics
FOMC Announcement

- Asset purchases
  - $40 billion per month of agency Mortgage-Backed Securities (MBS)
  - Continued exchange of short-term Treasury securities for an equal amount of long-term securities through the end of the year – $45 billion per month – via the maturity extension program begun in June
Plan is more open-ended – continue purchases until there has been sustained improvement in labor markets – end based on economic outcomes, not a set purchase amount or a date.

Committee expects the highly accommodative stance of monetary policy will remain appropriate for a considerable time after the economic recovery strengthens – currently anticipate low rates are likely to be warranted at least through mid-2015.
# Figure 11

Financial Market Response to FOMC Announcement

August 1, 2012 - September 14, 2012

<table>
<thead>
<tr>
<th></th>
<th>September FOMC Statement 9/12 - 9/13</th>
<th>Day After FOMC Statement 9/12 - 9/14</th>
<th>Chairman Bernanke’s Jackson Hole Speech 8/30 - 9/14</th>
<th>Previous FOMC Statement 7/31 - 9/14</th>
</tr>
</thead>
<tbody>
<tr>
<td>S&amp;P 500 (Percent Change)</td>
<td>+1.6%</td>
<td>+2.0%</td>
<td>+4.7%</td>
<td>+6.3%</td>
</tr>
<tr>
<td>Exchange Rate: Euros Per Dollar (Percent Change)</td>
<td>-0.1%</td>
<td>-1.9%</td>
<td>-4.9%</td>
<td>-6.3%</td>
</tr>
<tr>
<td>5-7-Year Investment-Grade Corporate Bond Yield (Change in Basis Points)</td>
<td>-4.4 bp</td>
<td>-3.8 bp</td>
<td>-5.4 bp</td>
<td>-12.9 bp</td>
</tr>
<tr>
<td>Yield on 30-Year FNMA Current Coupon MBS (Change in Basis Points)</td>
<td>-24.4 bp</td>
<td>-12.5 bp</td>
<td>-12.1 bp</td>
<td>-1.7 bp</td>
</tr>
</tbody>
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Source: Federal Reserve Board, Bank of America Merrill Lynch, WSJ, Bloomberg / Haver Analytics
Conclusion

- Action intended to promote faster growth and return to full employment more quickly
- But monetary policy is not a panacea – large shocks can be mitigated, but likely not offset
- While policy will quicken recovery – it still will take time
- This underlines the importance of forceful and timely action necessary to avoid the dubious title of “Great”