Assessing the Economic Recovery

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Fed’s Monetary Policy Partially Offsets “Headwinds”

- Purchasing Treasury and mortgage-backed securities totaling $85 billion per month
- Keeping short-term interest rates at their exceptionally low levels at least as long as the unemployment rate remains above 6.5 percent and inflation and inflation expectations are well anchored
Some Positive Progress

- The national unemployment rate has declined from 7.9 to 7.2 percent since the beginning of the year
- Interest-sensitive sectors such as housing and autos have continued to improve
- Inflation has stabilized, but at rates well below the Fed’s 2 percent target
However, We Need to See Much More Progress

- Inflation is below our target – levels that are too low risk a negative shock leading to deflation
- At 7.2 percent, unemployment is well above my estimate of the “full employment” rate (5.25 percent)
- Headwinds from fiscal policy, slow growth among trading partners, and lingering impact of the financial crisis
Monetary Policy Needs to be Data Dependent

- Monetary policy should respond to the actual state of the economy and incoming data.
- But policy should also be forward-looking, taking into consideration *how long* it is expected to take to return to full employment within a context of price stability.
Regarding the Fed’s Asset Purchase Program

- When we see more compelling evidence of a sustainable recovery making satisfactory progress toward full employment, it may be appropriate to gradually reduce the size of our purchase program.
- This will still be adding stimulus, but in smaller increments than before.
Figure 1
Treasury Yield Curves
May 1, 2013, September 16, 2013, and October 31, 2013

Source: U.S. Department of the Treasury
Figure 2
Primary Dealer Survey Results: Distribution of Probabilities for the Timing of First Reduction

Survey Results as of September 9, 2013 and Updated as of September 23, 2013

Source: Federal Reserve Bank of New York, Survey of Primary Dealers, September 2013
Figure 3
Federal Reserve System Assets and Projections

March 2008 - October 2013 Actual, November 2013 - April 2014 Projected

Trillions of Dollars

- No Tapering Through March 2014
- Tapering Beginning December 2013

No tapering through March 2014: Purchases reduced to $75 billion in April 2014.

Tapering beginning December 2013:
- Purchases reduced to $75 billion in December 2014.
- Purchases reduced to $50 billion in January 2014.
- Purchases reduced to $25 billion in March 2014.
- Purchases reduced to $0 in April 2014.

Source: Federal Reserve Statistical Release H.4.1 / Haver Analytics and author's calculations
Figure 4
Employment Change from Peak Employment

Most Recent and Three Previous Peaks

Source: BLS, NBER / Haver Analytics
Figure 5
Government Employment
2003:Q1 - 2013:Q3

Source: BLS, NBER / Haver Analytics
Figure 6
Government Employment Change from Official Trough

Current and Three Previous Recoveries

Index, Official Trough = 100

Months from Trough of Recession

Official Trough:
- November 1982
- March 1991
- November 2001
- June 2009

Reflects Temporary Decennial Census Workers

Source: BLS, NBER / Haver Analytics
Figure 7
Housing Starts

Source: Census Bureau, NBER / Haver Analytics
Figure 8
Auto and Light Truck Sales
2003:Q1 - 2013:Q3

Source: BEA, NBER / Haver Analytics
Figure 9
Change in Real GDP from Official Business Cycle Peak

Most Recent and Three Previous Peaks

Percent Change from Official Peak

Quarters Before and After Official Trough

Source: BEA, NBER / Haver Analytics
Figure 10
Change in Real GDP from Official Trough

Current and Three Previous Recoveries

Index, Official Trough = 100

Quarters from Official Trough of Recession

Source: BEA, NBER / Haver Analytics
Figure 11
Estimates of Annual Real GDP Growth Needed to Return to Full Employment

Note: Estimates are based on a modified Okun's Law and potential GDP growth of 2.1%.

Source: BEA, NBER / Haver Analytics and author’s calculations
Estimates of Annual Real GDP Growth Needed to Return to Full Employment

Source: BEA, NBER, FOMC Summary of Economic Projections / Haver Analytics and author’s calculations
Concluding Observations

- Highly accommodative monetary policy has partially mitigated the effects of the financial crisis, significant fiscal restraint, and slow growth of trading partners.
- Remove the degree of accommodation as headwinds subside, economic growth increases, and labor markets improve.
- Monetary policy is likely to need to remain accommodative for some time to achieve full employment within a reasonable forecast horizon.
Policy Conclusions

- Policy should be data driven, mandate focused, and achieve goals in an appropriate timeframe
  - We likely need to leave short-term interest rates at very low levels until there is much more progress reaching full employment and the inflation target
  - The pace at which the Fed raises rates, when that becomes appropriate, should be quite gradual, unless the economy picks up much faster than currently expected