



## *“The Economic Outlook”*

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Good morning. It is a pleasure to once again participate in your economic summit and outlook event.

I have had the opportunity to speak at your event during the depths of the recession, during the extended tepid phase of the slow recovery, and now when we hope the recovery is gaining traction – hopefully growing faster than its so-called “potential,” which would mean a more rapid return to full employment and to the Federal Reserve’s 2 percent inflation target.

As always, the views I express today are my own, not necessarily those of my colleagues on the Board of Governors or the Federal Open Market Committee (FOMC).

All of us who follow the economy have been waiting for the drag from fiscal austerity to wane, for consumers to regain confidence and increase demand, and for the housing market to solidify its nascent recovery. These represent the underlying drivers in most forecasts that expect 3 percent growth beginning this year – a view I share. Three percent GDP growth is also consistent with stronger employment growth and declines in the unemployment rate – which would continue a pattern of improvement that we have been seeing of late.

Today I will briefly summarize current economic conditions, which have recently been improving and suggest positive news for the 2014 outlook. Then I will discuss my viewpoint that, despite this improvement, we remain far from where we need to be. Inflation, both in the U.S. and in many developed countries, is lower than the targets set by central banks. The very low inflation rate is a concern in its own right, as I will discuss, but it should also give U.S. policymakers another reason to remain patient in removing monetary accommodation – patience I counsel because the U.S. remains far from what I and most others consider a level of unemployment that represents “full employment.”

High unemployment has obvious human and economic costs. But *prolonged* unemployment – a long spell of joblessness – is damaging in additional ways. High unemployment implies personal hardship suffered by the many who are unemployed, and their families. Prolonged unemployment can cause longer-lasting damage to individuals if skills atrophy, and also “leave marks” on the labor market and economy more broadly,

long after the recovery is complete. These long-term labor markets scars, which result from a very slow recovery, lead me to believe that the Federal Reserve should remain highly accommodative and wind down our extraordinary programs only very gradually, in order to minimize the costs and risks of not returning to full employment more quickly.

## **I. Current Economic Conditions**

Since the fall of 2013, the “tone” of the incoming economic data has improved in two respects. First, data for the most recent months have generally come in stronger. Second, we have seen a number of positive revisions to data released earlier.

Payroll employment data are a good example of this dynamic. **Figure 1** shows, for example, that the August and September numbers were revised upward with each subsequent release date; and three-month averages, having dipped with the August, September, and October releases, have rebounded to levels around 200,000 per month. Thus, the combination of new data and data revisions has given us more confidence in positive momentum in labor markets as we go into 2014.

**Figure 2** provides the national unemployment rate. We currently have a 7 percent U.S. unemployment rate, well down from the cyclical peak of 10 percent. While this certainly represents significant improvement, we should keep in mind some other sobering facts about the labor market. First, some of the improvement in the unemployment rate reflects discouraged workers leaving the formal workforce. Second, it is worth remembering that the current unemployment rate still remains higher than the

unemployment rate peak of the *previous* cycle, and well above my estimate of the full employment rate – which I consider to be about 5.25 percent unemployment.

Of late, we have seen additional data that are consistent with faster GDP growth in 2014 than we have experienced so far in this recovery. One issue that contributes to this more optimistic outlook is the likely decrease in fiscal drag in 2014. In part, this reflects confidence that the federal budget agreement will avoid a further fiscal disruption (although the debt ceiling still must be increased). **Figure 3** shows that while government spending (a component of GDP) has been a drag on GDP growth through much of this recovery, the growth of real government spending was slightly positive for the third quarter. This represents a significant change from the previous three quarters, although much of the improvement was in state and local spending and we all know the federal picture remains unsettled.

Along with less fiscal drag, most forecasters expect consumers to increase spending. There is already evidence of reasonably strong growth in consumption in the fourth quarter of 2013. As it has become more likely that disruptive fiscal problems will be avoided, consumer confidence has rebounded from the declines that accompanied the shutdown of the federal government in 2013, as shown in **Figure 4**.

Furthermore, key financial conditions that typically support consumer spending have continued to improve. The stock market, represented by the Dow 30 Industrials shown in **Figure 5**, rose significantly in 2013. Together with higher home values and improvements in employment, consumers should be better situated to spend in 2014 than in 2013.

## **II. The Economy in Relation to Where We Need to Be**

Despite the improving situation shown in recent data, the economy remains far from where we would like it to be. **Figure 6** shows that the current economic situation still leaves wide employment and inflation gaps. With the unemployment rate at 7 percent, we remain well above my estimate of full employment, 5.25 percent. The total PCE inflation rate is 0.9 percent, well below the 2 percent target that the FOMC has adopted. In short, the Federal Reserve continues to miss both elements of its dual mandate from Congress – inflation and employment – by fairly large margins. With unemployment too high and inflation too low, there is ample justification for maintaining a highly accommodative stance for monetary policy that can help us more quickly return to an economy with full employment and the targeted 2 percent inflation rate.

## **III. Inflation**

**Figure 7** shows various inflation measures. It is striking that over the past two years, and well after the trough of the recession, we are continuing to experience a deceleration in inflation across such a wide range of inflation indices. Most forecasters are expecting that with well-anchored expectations and reductions in what economists call “resource slack,” inflation will indeed move toward the 2 percent target – but that outcome has yet to clearly appear in the data. The longer we remain below the 2 percent target, the greater the risk that this lower inflation rate will start to be reflected in lower inflation expectations. I will discuss why this is problematic in a moment.

**Figure 8** shows how prices would have evolved if inflation had continued at 2 percent from the cyclical peak in 2007. In contrast, actual *total* PCE prices have grown less than 2 percent, and the *core* measure of PCE (which sets aside the volatile food and energy sectors that the Fed cares about but cannot control) is even further below that hypothetical 2 percent inflation path – and the divergence from the 2 percent path appears to be widening. Some have pointed to temporary factors as the likely cause of low inflation in the U.S., but **Figure 9** gives me pause in considering that interpretation. The figure shows that low inflation rates have, of late, been characteristic not only of the U.S. but of many advanced economies.

Persistently low inflation rates can be a problem for several reasons. First, at very low inflation rates, a sizable negative shock to the economy can result in negative inflation – deflation – which can become entrenched in expectations, leading to a protracted period of deflation. This is what occurred in Japan in the 1990s, and Japan’s deflationary situation has persisted ever since. To finally exit the deflationary environment, Japanese monetary policymakers have needed to take extraordinary measures this past year. Such extraordinary measures – during a period where most central banks have already been unusually inventive – highlight just how difficult it can be to reach inflation targets once very low inflation expectations have become embedded.

A second concern with low inflation is the implication that *real* short-term interest rates may remain too high. **Figure 10** shows measures of real short-term interest rates. With short-term nominal interest rates bound at zero, the inflation rate is what determines the real short-term interest rate. With inflation low and nominal interest rates at zero, additional declines in inflation – such as those that have occurred in the past year – raise

short-term *real* interest rates further, likely restraining growth and making it more difficult to attain the growth rate that is needed to more quickly normalize a struggling economy.

Thus, inflation rates persistently below the stated target can be a cause for real concern. Furthermore, persistently low inflation can theoretically undermine the credibility of the central bank – if the central bank announces an inflation target but is unable to achieve that target in a reasonable time frame, some may call into question its ability to do so in the medium- or long-term as well.

#### **IV. Unemployment**

It can also be quite costly to have only slow improvement in labor markets. **Figure 11** shows the so-called “quits rate,” which measures the fraction of workers who voluntarily leave their job. The quits rate is more likely to rise when workers are confident that they can improve their labor market position by switching jobs. When jobs are plentiful, workers are more likely to change jobs if they feel they are underpaid or can improve their future prospects by changing jobs.

However, the quits rate, while somewhat improved relative to that in the depths of the recession, is still well below the levels that occurred before the financial crisis. With workers concerned about job opportunities, there continues to be a reluctance to leave current employers – despite the fact that real wages for many employees have shown little improvement during this recovery.

Another indicator of the generally weak labor market is the low employment-to-population ratio. While the overall employment-to-population ratio can change for demographic reasons, **Figure 12** focuses on the employment-to-population ratio for individuals between the ages of 25 and 54. This age range captures the prime working age for most people, and includes the period when most people are finished with school and not yet planning to retire. Even within this fixed age cohort, employment has grown only fast enough to keep up with population growth, suggesting little evidence of a robust recovery in labor markets for this prime working-age group.

Moreover, **Figure 13** shows that *long-term* unemployment has been unusually prevalent during the most recent recession and the ensuing recovery. Despite the falling unemployment rate I mentioned earlier, the percentage of workers that have experienced long-duration unemployment remains well above the experience in previous recessions and recoveries. This partly reflects that economic recoveries have tended to be more robust than this one, so workers were able to more quickly regain employment.

In sum, while there has been improvement in some measures of the labor market, these figures highlight that the labor market remains far from where it needs to be. A very slow recovery risks a more permanent loss of workers from the formal labor force, as skills atrophy and workers stop assuming that jobs matching their skills are available. Thus, policymakers need to consider the cost of a slow recovery relative to the risk of taking actions that would more quickly return the economy to full employment.



## **V. Concluding Observations**

In December, the FOMC decided to pare back the central bank's bond purchase program – from \$85 billion a month to \$75 billion a month. However, the FOMC statement made clear that the process of reducing accommodation would be gradual, and that short-term interest rates were likely to remain at the zero lower bound well past the time the unemployment rate fell below the 6.5 percent unemployment threshold. I certainly believe that a very gradual normalization is very appropriate given that the unemployment rate remains unusually high and the inflation rate remains unusually low.

As I have discussed today, there are significant costs to a slow recovery. It poses great strains on unemployed workers (and their families) who might be returning to work more quickly if the economy grew faster. It can potentially have longer-lasting and structural implications for labor markets and the economy. There may also be an impact on the Federal Reserve's ability to reach its inflation target in a reasonable time frame.

As the economy continues to improve, we should reduce and ultimately remove the unusual support that the Federal Reserve's monetary policy has provided. But this support should be removed only gradually. This recovery has already been too slow, and we do not want premature tightening of monetary policy to delay the return to more normal economic conditions.

Thank you, and best wishes for 2014.