For release on delivery
3:00 p.m. EDT (1:00 p.m. MDT)
October 21, 2011

The Outlook for the U.S. Economy and Economic Policy

Remarks by

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at the

2011 Annual Meeting of the Financial Management Association International

Denver, Colorado

October 21, 2011

For more than 40 years, the Financial Management Association International has promoted the advancement of knowledge about financial decisionmaking and its dissemination to practitioners worldwide. The association's efforts benefit not only private-sector participants in financial markets, but also policymakers in central banks and governments who strive to ensure that the financial system works effectively to support global economic growth. As one of the many beneficiaries of the association's work, I am honored to receive this year's Outstanding Financial Executive Award.

My comments today will focus on recent economic and financial market developments, along with their implications for the outlook and for economic policy. I will begin by pointing out that, although the U.S. economy continues to grow, the recovery has been proceeding at a disappointingly slow pace. Moreover, slow growth leaves the economy vulnerable to downside shocks, such as the potential for adverse developments in global financial markets. I then will discuss ways that monetary policy and fiscal policy can support the economic recovery and address these risks to the expansion. Let me note at the outset that these remarks reflect my own views and not necessarily those of others in the Federal Reserve System.

The U.S. Economic Outlook

Since the middle of 2009, the U.S. economy has been recovering from the most severe recession and financial crisis to afflict our country since the Great Depression. Certainly, conditions have improved in a number of ways during these past two years: Output growth has resumed, and private-sector employment has risen about 2-1/2 million since payrolls troughed in early 2010. Industrial production has generally advanced solidly, business investment in equipment and software continues to rise briskly, and U.S.

exports have grown at a robust pace. In addition, financial market functioning is much better than in the depths of the crisis; the quantity and quality of capital and the size of liquidity buffers in the banking system have improved significantly; nonfinancial business balance sheets are mostly in solid shape; and credit conditions, although still tight, have eased somewhat for many businesses and households.

Despite these improvements, the pace of the economic recovery has been less vigorous than any of us would have desired and than most forecasters had anticipated. Indeed, recent revisions of economic data by the Commerce Department's Bureau of Economic Analysis indicate that the recession was deeper, and the recovery weaker, than previously estimated. Since the beginning of the recovery in the third quarter of 2009 through the second quarter of this year, the most recent quarter for which an estimate is available, real gross domestic product (GDP) expanded at an average annual rate of about 2-1/2 percent, a slower pace than during the first two years of most U.S. recoveries in the past half-century. As a consequence, aggregate output in the second quarter still had not reached its peak level just prior to the recession. Not surprisingly, the unemployment rate has declined only 1 percentage point from its high of about 10 percent near the end of 2009, and the number of jobs in the private sector remains more than 6 million below the peak level reached in early 2008. The fraction of those now jobless who have been without work for six months or more stands at a very high level. And, in addition to those officially unemployed, many individuals are involuntarily working part time or have dropped out of the labor force entirely.

U.S. economic growth was particularly anemic in the first half of this year, when real GDP rose at an average annual rate of less than 1 percent. Two factors, both largely transitory, played a notable role in depressing growth and in boosting inflation during the first half of the year. First, sharp increases in the prices of oil and other commodities eroded the purchasing power of households' incomes, thus restraining their spending. Gasoline and food prices surged, and a portion of producers' higher input costs were passed through to the prices of a wide range of consumer goods and services. Second, the production and sale of motor vehicles declined sharply because of disruptions in global supply chains in the aftermath of the disastrous earthquake and tsunami that struck Japan last March. These supply disruptions also limited the availability of some popular models, placing upward pressure on motor vehicle prices.

Fortunately, commodity prices have come down from their earlier peaks, which should ease pressures on consumer prices and, in turn, lessen strains on household budgets. Automotive supply chain disruptions have also diminished in recent months, resulting in a rebound of both the production and sales of new motor vehicles. Partly for these reasons, it looks likely that economic growth in the second half of this year will be noticeably stronger, and inflation more moderate, than in the first half. Unfortunately, however, a range of other, more persistent factors also appear to be restraining the recovery. Moreover, financial market conditions have deteriorated, on net, in recent months, intensifying some of the headwinds facing the economy.

Persistent Restraints on the Economic Recovery

The average pace of consumer spending during the past several quarters has been weaker than can be explained by the transitory factors that I just mentioned. High levels of unemployment and underemployment, slow gains in wages, and declines in the values of both homes and financial assets have weighed on household spending. Households appear to have made some progress in deleveraging, but many still face elevated debt burdens and reduced access to credit. Moreover, consumer sentiment dropped markedly over the summer and has remained low since then, reflecting households' concerns about the broader economy as well as their own financial situations.

Weak consumer spending, unsurprisingly, increases concerns among businesses about the prospects for sustained growth in the demand for their products and services. As a consequence, many businesses have been reluctant to significantly expand their payrolls. Indeed, the average pace of hiring during the past several months has been quite a bit slower than earlier in the year. As a result, the unemployment rate has continued to hover in the vicinity of 9 percent since early this year. Furthermore, recent surveys have shown some deterioration in firms' hiring plans, and new claims for unemployment insurance by workers who have been laid off remain relatively high. Such indicators are consistent with job gains remaining tepid in the coming months.

A sharp downturn in housing was at the core of the recent recession, and this sector continues to weigh on the recovery. Robust increases in housing activity have helped spur recoveries from most U.S. recessions in the past 50 years. This time, in contrast, residential construction remains depressed by a large inventory of foreclosed and distressed properties, tight credit conditions for construction loans and mortgages, concerns about further declines in home prices, and the substantial number of homeowners whose mortgage balances exceed the values of their homes. As a result, new home construction currently is at only about one-third of its average pace in recent decades.

In the government sector, with ongoing pressures on their budgets, state and local governments have continued to shrink their payrolls and reduce their spending on construction projects. Moreover, the boost to the economy from earlier stimulus policies by the federal government has begun to wind down, and, absent further actions by the Congress and the Administration, federal fiscal policy will also restrain the pace of the recovery in the year ahead. Of course, it is unclear how the future path for fiscal policy will evolve--a topic I will return to later--and the uncertainty surrounding both the federal budget process and the future course of fiscal policy appears to have weighed on household and business confidence of late.

I noted earlier that the recovery has benefited from rising exports, largely reflecting strong foreign economic growth. But since the spring, the pace of underlying economic growth in many foreign economies has slowed. Economic activity has decelerated particularly sharply in Europe because of the intensification of fiscal and financial stress in the euro area. The substantial reductions in government spending and increases in taxes that some countries have had to put in place to address their fiscal problems also have weighed on the pace of economic activity in the region. In addition, economic growth in many emerging market economies also looks to be moderating. Over the past two years, emerging market economies generally have been expanding at a faster rate than the more advanced economies, which has helped boost the overall pace of the global recovery. The recent step-down in the rate of expansion in many of these economies likely reflects less demand for their exports from Europe and the United States.

Financial Markets and Institutions

Turning to financial markets, I noted that conditions have improved since the depths of the crisis, but obvious strains remain, some of which have intensified in recent months. Since the early summer, financial markets have been experiencing an unusual amount of volatility, and investors have pulled back from risky assets on balance. The result has been lower equity prices, wider risk spreads on corporate bonds and many other debt instruments, and greater pressures on financial institutions. At the same time, heightened demand for safe assets has put downward pressure on Treasury yields and boosted the foreign exchange value of the dollar. These developments partly reflect the response by investors to news about the U.S. outlook that has, on net, fallen short of their expectations, as well as a recognition that growth is slowing elsewhere in the global economy. But they also reflect anxiety in financial markets about the fiscal problems in Greece and other euro-zone countries, along with greater sensitivity to the exposures of the European banking system to troubled sovereign debt. European leaders are strongly committed to addressing these issues and have begun to make some progress on them, but the need to obtain agreement among a large number of euro-zone countries to be able to put in place necessary backstops, as well as difficulties involved in addressing the fiscal imbalances in some of these countries, has slowed the process of developing and implementing solutions. At this time, it is difficult to know just how much these developments in global financial markets have affected U.S. economic activity thus far. But, looking forward, particularly worrisome is the possibility that U.S. financial institutions facing earnings or funding pressures, in part as a result of the problems in Europe, could cut back on lending, tighten credit terms, or attempt to delever by rapidly selling off assets. Indeed, recent surveys suggest that the trend we had been seeing of increased availability of credit and easing of terms among dealers may have been interrupted. A significant deterioration of the U.S. economic outlook, of course, would place financial institutions under additional stress. The potential for such adverse financial developments to derail the recovery creates, in my view, significant downside risks to the outlook.

Inflation

Before turning to economic policy, let me briefly discuss the outlook for inflation. Inflation picked up significantly over the first half of this year, with the price index for personal consumption expenditures (PCE) rising at an annual rate of about 3-1/2 percent--a pace that is well above the level of 2 percent or a little less that most Federal Open Market Committee (FOMC) participants consider consistent with the Federal Reserve's dual mandate for price stability and maximum employment. In contrast, PCE inflation averaged less than 1-1/2 percent over the preceding two years. As I noted at the outset, the recent surge in inflation, in my view, reflected to a substantial degree the sharp increases earlier this year in the prices of oil and other commodities and the effect of the Japanese tragedy on auto production and prices. In the statement following our most recent meeting in September, the FOMC indicated that it anticipates that inflation will moderate over coming quarters, settling at levels at or below those consistent with our dual mandate as the effects of these supply-side shocks on prices continue to wane. Importantly, I see little indication that the higher rate of inflation experienced so far this year has become ingrained in the economy. Longer-term inflation expectations have remained stable according to surveys, and market-based measures of inflation compensation are still subdued; measures derived from yields of Treasury inflation-protected securities (TIPS) suggest that expected inflation over the next five years currently is around 1-3/4 percent. The substantial amount of resource slack that is projected to remain in U.S. labor and product markets over the next several years, coupled with sustained growth in productivity, should continue to restrain the growth in labor costs, helping to contain inflationary pressures. In fact, there is a risk that disinflationary pressures could intensify if the recovery faltered. Indeed, based on imputations from TIPS prices, market participants' assessments of the odds of outright deflation have risen significantly in recent months.

Monetary Policy

Since the onset of the financial crisis, the Federal Reserve has employed a wide array of policy tools to foster our statutory objectives of maximum employment and price stability. In particular, with conventional policy having pushed short-term nominal interest rates close to zero, the FOMC--like a number of other major central banks around the world--has provided additional monetary accommodation by modifying our forward policy guidance and by adjusting our securities holdings.

Forward Policy Guidance

The conventional tool of U.S. monetary policy is to make adjustments to the target for the federal funds rate. That target, which stood at 5-1/4 percent as of mid-2007, was subsequently brought down to a range of 0 to 1/4 percent, and the effective federal funds rate has been maintained in that range since December 2008. Since that time, the FOMC has provided forward guidance about the anticipated future path of the federal funds rate. For example, in each meeting statement from March 2009 through June 2011, the Committee indicated our expectation that economic conditions "are likely to warrant exceptionally low levels for the federal funds rate for an extended period."[1] At our August meeting, the Committee decided to provide more-specific information about the likely time horizon by substituting the phrase "at least through mid-2013" for the phrase "for an extended period."[2] This clarification appears to have reduced market uncertainty about the Committee's current policy expectations.

The Committee's guidance refers to a specific calendar date, which could be periodically revised by the Committee if appropriate. However, it is explicitly framed as contingent on economic conditions, including "low rates of resource utilization and a subdued outlook for inflation over the medium run."[3] Importantly, it is not stated as an unconditional commitment to a specific course for the federal funds rate. Market participants are naturally interested in gaining greater insight into how shifts in the economic outlook would affect the likely timing and pace of policy firming. As noted in the minutes of the August and September FOMC meetings, the Committee has discussed possible approaches to enhance its forward guidance along these lines--that is, to provide greater insight concerning its "reaction function."[4]

One potentially promising way to clarify the dependence of policy on economic conditions would be for the FOMC to frame the forward guidance in terms of specific numerical thresholds for unemployment and inflation. Such an approach was discussed by my colleague Charles Evans, president of the Federal Reserve Bank of Chicago, in a

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[1] See, for example, Board of Governors of the Federal Reserve System (2009), "FOMC Statement," press release, March 18, www.federalreserve.gov/newsevents/press/monetary/20090318a.htm.
[2] Board of Governors of the Federal Reserve System (2011), "FOMC Statement," press release, August 9, www.federalreserve.gov/newsevents/press/monetary/20110809a.htm.
[3] See, for example, Board of Governors, "FOMC Statement," in note 2.
[4] The minutes of the August and September 2011 FOMC meetings are available on the Board's website at www.federalreserve.gov/monetarypolicy/fomccalendars.htm.

recent speech.[5] Evans suggested that the FOMC could indicate its intention to continue holding the federal funds rate close to zero as long as the unemployment rate exceeds a given threshold, conditional on the medium-term inflation outlook remaining at or below a specified level.[6] Such an approach could be helpful in facilitating public understanding of how various possible shifts in the economic outlook would be likely to affect the anticipated timing of policy firming. For example, if there were a further downward revision of the economic outlook, investors would recognize that the conditions for policy firming would not be reached until a later date and hence would have a more concrete basis for extending the time period during which they expect the federal funds rate to remain near zero.

The approach of numerically specifying the values of unemployment and inflation that could prompt policy tightening is not without potential pitfalls, however. For example, such thresholds could potentially be misunderstood as conveying the Committee's longer-run objectives rather than the conditions surrounding the likely onset of policy firming. Thus, in addition to giving careful consideration to this particular approach, it seems sensible to explore other potential enhancements to FOMC communications--a topic to which I will return shortly.

[5] Charles L. Evans (2011), "The Fed's Dual Mandate Responsibilities and Challenges Facing U.S. Monetary Policy," speech delivered at the European Economics and Financial Centre, London, September 7, www.chicagofed.org/webpages/publications/speeches/2011/09_07_dual_mandate.cfm.

[6] For example, if such thresholds were specified to be broadly consistent with professional forecasters' projections for unemployment and inflation in mid- to late 2013, this approach might essentially reinforce current expectations that policy firming is likely to commence around that time. Alternatively, as Evans (2011) has noted, some additional monetary accommodation could be provided by specifying a modestly lower unemployment threshold and a slightly higher medium-term inflation threshold, thereby leading forecasters to push back their assessments of the onset of policy firming.

Securities Holdings by the Federal Reserve

The FOMC has also provided monetary accommodation by modifying the size and composition of the Federal Reserve's securities holdings. In particular, during 2009 and early 2010, the Federal Reserve purchased about $1.4 trillion in agency mortgage-backed securities (MBS) and agency debt securities and about $300 billion in longer-term Treasury securities. Last November, the Committee initiated an additional $600 billion in purchases of longer-term Treasury securities, and those transactions were completed at the end of June.

At our recent September meeting, the FOMC announced that we intend to extend the average maturity of our securities holdings over coming months by selling $400 billion of short-term Treasury securities and purchasing an equivalent amount of long-term Treasury securities. This maturity extension program should exert downward pressure on longer-term interest rates and help make broader financial conditions more accommodative, thereby supporting a stronger economic recovery. At that meeting, we also decided that the principal payments from our holdings of agency securities will now be reinvested in agency MBS rather than in Treasury securities; this step was taken to support mortgage markets.

Both of these decisions will affect the composition of our securities holdings without affecting the overall size of the Federal Reserve's balance sheet or the level of reserve balances of depository institutions. Nonetheless, it is worth noting that the scale of the maturity extension program is necessarily limited by the amount of our holdings of shorter-term securities; furthermore, purchasing a very large proportion of the outstanding stock of longer-term Treasury securities could potentially have adverse effects on market functioning. Thus, securities purchases across a wide spectrum of maturities might become appropriate if evolving economic conditions called for significantly greater monetary accommodation.

Monetary Policy Communications

In recent years the FOMC has taken a number of significant steps to enhance the clarity of our communications about our longer-run objectives, our medium-term outlook, and our policy strategy. Transparency is an essential aspect of conducting monetary policy in a democratic society: The central bank is accountable to the public and hence needs to strive to explain its decisions as clearly as possible. Indeed, I believe that the Federal Reserve qualifies as one of the most transparent central banks in the world.

Moreover, clear communications play an integral role in facilitating the effectiveness of monetary policy actions. Expectations play a critical role in the decisions of forward-looking households and businesses about how much to spend, work, hire, and invest, and their decisions are more likely to be consistent with the objectives of the central bank if they are based on a solid understanding of the shocks affecting the economy and the likely monetary policy response. When financial market participants understand how a central bank is likely to react to incoming information, asset prices should adjust in ways that anticipate the central bank’s expected policy actions, enhancing the monetary policy transmission mechanism and thereby supporting the central bank’s attainment of its objectives. Finally, good communication can help anchor the public’s long-term inflation expectations, which can, in turn, greatly improve the scope for monetary policy to counteract departures of resource utilization from its sustainable level.

Four times a year the FOMC publishes the Summary of Economic Projections (SEP), which conveys information about Committee participants' economic outlook for the next several calendar years and over the longer run. The SEP includes projections of real GDP growth, the unemployment rate, the PCE inflation rate, and the "core" inflation rate for PCE excluding food and energy. Since last spring, the Chairman has been conducting a news conference in conjunction with each release of the projections to help explain the FOMC's policy decisions in the context of our economic outlook.

The longer-run projections in the SEP convey Committee participants' individual assessments of the rates of economic growth, unemployment, and inflation to which the economy would be expected to converge under appropriate policy and in the absence of further shocks. The longer-run inflation projections indicate that most Committee participants judge inflation of 2 percent or a bit less to be most consistent with our statutory mandate. In the latest projections, participants' estimates for the longer-run normal rate of unemployment had a range of 5 to 6 percent--well below the current unemployment rate of 9.1 percent and hence underscoring the degree to which the economy remains quite far from its balanced-growth path.

Of course, there is always room for further improvement, and therefore the Committee continues to explore ways of enhancing the clarity of our communications. For example, as noted in the minutes of our September meeting, we have been discussing potential approaches for providing more information--perhaps through the SEP--

regarding our longer-run objectives, the factors that influence our policy decisions, and our views on the likely evolution of monetary policy.[7]

Fiscal Policy

Turning now to fiscal policy, since the onset of the recent recession and financial crisis, the federal budget deficit has widened significantly. As a result, federal debt held by the public has increased relative to our national income to a level not seen in the past half-century. These budget developments have reflected both the weak economy, which has depressed revenues and pushed up expenditures, and the fiscal stimulus that was implemented to help ease the recession and support the recovery. So long as the economy continues to recover, the deficit should narrow over the next several years as a growing economy boosts revenues and reduces expenditures and as the policies put in place to provide economic stimulus continue to wind down. Even so, the federal budget is on an unsustainable path over the longer run, in large part because of the aging of the U.S. population and fast-rising health-care costs. If current policy settings are maintained, the ratio of federal debt held by the public to national income would continue to rise in coming decades.

It is crucial that the federal budget be put on a sustainable long-run trajectory, and we should not postpone charting that course. A failure to put in place a credible plan to address our long-run budget imbalance would expose the United States to serious economic costs and risks in the long term and possibly sooner. Timely enactment of a plan to eliminate future unsustainable budget gaps will make it easier for individuals and businesses to prepare for and adjust to the changes. In addition, the sooner our longer-

[7] A subcommittee on communication, chaired by Governor Yellen and composed of Presidents Evans and Plosser and Governor Raskin, is reviewing additional ways to enhance the effectiveness of communications with the public about monetary policy.

term budget problems are addressed, the less wrenching the adjustment will have to be and the more control that policymakers--rather than market forces or international creditors--will have over the timing, size, and composition of the necessary adjustments.

At the same time, it is important to recognize that too much fiscal tightening in the near term could harm the economic recovery. Significant near-term reductions in federal spending or large increases in taxes would impose an additional drag on the economy at a time when aggregate demand is already weak. We need, and I believe we have scope for, an approach to fiscal policy that puts in place a well-timed and credible plan to bring deficits down to sustainable levels over the medium and long terms while also addressing the economy's short-term needs. I do not underestimate the difficulty of crafting a strategy for our fiscal policy that appropriately balances short-run needs with long-run considerations, but doing so would provide important benefits to the U.S. economy.

Conclusion

In summary, the Federal Reserve has taken forceful actions to promote its objectives of maximum employment and stable prices, and we strive to communicate as clearly as possible our longer-run objectives as well as our medium-term outlook and policy strategy. Although U.S. economic growth was particularly slow during the first half of this year, I expect that the pace of recovery will pick up over coming quarters and that unemployment will resume a gradual decline toward its longer-run sustainable rate; moreover, I anticipate that the medium-term outlook for inflation will remain subdued. Nonetheless, there are significant downside risks. Therefore, the FOMC will continue to assess the economic outlook in light of incoming information, and we are prepared to employ our tools as appropriate to foster a stronger economic recovery in a context of price stability.