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2014 Fed Challenge Script: Current State of the Economy

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2014 Fed Challenge Script: Current State of the Economy

Abstract
Good afternoon everyone and thank you for having us here today. Though the recession began in 2007 and officially ended in 2009, recovery has been painfully slow. GDP growth has been insufficient to close the output gap, there continues to be slack in the labor market and inflation has stabilized below the Federal Reserve percent target. We are not meeting our dual mandate of full employment and stable prices even 6 years after the end of the recession. Despite some signs of strengthening in the economy during the past year, we do not believe that economy is on a self-sustaining path of recovery. Furthermore, the monetary policy actions taken by the Fed thus far to pull us out of the Great Recession have been insufficient. We propose a substantial strengthening of the our forward guidance; specifically, a commitment not to raise the federal funds rate until nominal GDP has returned to a path that we consider consistent with the dual mandate. [*excerpt*]

Keywords
Federal Reserve, GDP, economic growth, recession

2014 Fed Challenge Script

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Current State of The Economy

Good afternoon everyone and thank you for having us here today. Though the recession began in 2007 and officially ended in 2009, recovery has been painfully slow. GDP growth has been insufficient to close the output gap, there continues to be slack in the labor market and inflation has stabilized below the Federal Reserve percent target. We are not meeting our dual mandate of full employment and stable prices even 6 years after the end of the recession. Despite some signs of strengthening in the economy during the past year, we do not believe that economy is on a self-sustaining path of recovery. Furthermore, the monetary policy actions taken by the Fed thus far to pull us out of the Great Recession have been insufficient. We propose a substantial strengthening of the our forward guidance; specifically, a commitment not to raise the federal funds rate until nominal GDP has returned to a path that we consider consistent with the dual mandate.

The Congressional Budget Office estimates the output gap to be around 3.6% in 2014 and projects a return to full employment by 2017. However, this forecast reflects the fact that the CBO has revised downward its estimate of potential GDP every year for the last 7 years. The economy is approaching full employment not because of strong growth in actual GDP but because of repeated downward revisions in potential GDP. [VoxEU slide] Larry Summers estimates that half of the decline in potential output is due to a drop in the capital stock due to lower investment since 2008, a phenomenon that could be reversed with sufficient economic expansion.

The unemployment rate fell to 5.8 percent in October, at the top end of our current range of estimates for the natural rate of 5.2 percent to 5.8 percent. But, the low unemployment rate disguises a large amount of slack in labor markets. For instance, the labor-force participation rate has fallen from 65.9percent to 62.8 percent since the beginning of the recession. While some is due to structural factors, research by Stephanie Aaronson and her co-workers finds that 0.25 – 1.0 percent of the decline is due to cyclical factors. The employment - population ratio is low, also suggesting cyclical factors contributing to unemployment. Probably the most convincing evidence of slack in the labor market is the failure of wages to rise significantly: average nominal hourly earnings increased only 2.2 percent in the year ending in October.

Inflation has been below the 2 percent target since 2012. According to the Bureau of Economic Analysis, the core PCE chain-type price index increased at a rate of only 1.4 percent for the twelve months ending in October. There are no signs of inflationary pressure in the economy. Oil prices have fallen in recent months due to global economic weakness and new energy supplies. The price of West Texas Intermediate crude oil has fallen to $81 per barrel at the end of October from over $100 in June.

In addition, the dollar has appreciated significantly against other major currencies, putting downward pressure on prices of imported goods. And again, wage growth has been subdued. The absence of inflationary pressure is apparent from the decrease in the spread between the yields of 5-year nominal Treasury Securities and 5-year TIPS bonds (or the 'breakeven inflation rate') which has fallen from 2 percent in June to 1.6 percent in November. This indicates that the market expectations are currently that inflation will fall short of the target for the next five years.

The current sustained weakness in the economy is likely to persist for a long time. The crash in the housing market weakened household balance sheets. Research by Atif Mian and Amir Sufi has shown convincingly that the debt overhang has contributed to weak consumption growth. Richard Koo calls this a 'balance sheet recession' and notes that recovery will be slow because of household deleveraging, which reduces consumption spending. Koo and other economists such as Larry Summers and Olivier Blanchard warn of the possibility of insufficient aggregate demand for as long as the next 10-15 years.

A self-sustaining recovery cannot occur until households have worked off the debt overhang. Data on household debt show that there is a long way to go. Total credit market debt of households is 105 percent of disposal income, still higher than any year before 2002. Consistent with Koo's theory, household savings remains high, especially relative to pre-recession trends. The personal saving rate has been above 5 percent since the recession, compared to 2-4 percent from 2005-07. Recovery in the housing market is widely seen as essential for improvement in household finances. But after signs of strength in 2013 the housing market has cooled off in 2014. Acording to Case-Shiller home price index, house prices fell 1.3 percent from April to August of this year. Real residential investment has fallen by one percent in the year ending in the third quarter of 2014.

Recent positive developments have caused speculation that we will start raising interest rates in mid-2015. This is premature. Though GDP growth was estimated to be 3.5% in 2014 Q3, the widening of the trade deficit for September suggests that this figure will likely be revised downward.The results of the midterm elections suggest that fiscal policy could become more of a drag on economic performance in the near future due to increased pressure to cut spending. The low employment growth domestically, coupled with slow projected growth for Europe and certain emerging economies, suggest that making monetary policy less accommodative would be premature and costly to a still-shaky American economy.

Our Policy Recommendation: Clarify Forward Guidance

With the phasing out of large-scale asset purchases last month, we are currently relying on forward guidance to reduce long-term interest rates. But the type of forward guidance that we have employed since 2009 has been less effective than it could be. From August 2011 to October 2012 we specified that we would keep the federal funds rate near zero until a particular date, a policy known as calendar-based forward guidance. In December 2012 the we switched to a data-based forward guidance strategy by promising not to raise the federal funds rate until the unemployment rate fell to 6.5%. But in March 2012, as the unemployment rate was dropping more quickly than anticipated, we changed our criteria to a mix of labor market conditions. Michael Woodford has argued that the our statements to this point have not had the desired effect because the we have not been clear enough about the criteria that we will use to judge whether to raise the federal funds rate. As a result the we have not been as successful in managing long-term interest rates as it could be.

We propose that the Federal Reserve clarify the criteria that will trigger the beginning of interest rate increases. Under our proposal, which is similar to recommendations made by Michael Woodford and others, the FOMC will pledge to maintain the federal funds rate target at its current range as long as nominal GDP remains below a deterministic path. This path would represent the path it would have followed if monetary policy had not been constrained policy by the zero lower bound since 2008. Specifically, as indicated by our proposed statement, we project a trend of 4% annual growth in nominal GDP from the fourth quarter of 2007. We commit to holding off on interest rate increases until we are close to the target. When we are close to the target we will begin to increase interest rates at a measured pace so that policy is normalized at the trend level of GDP.

Our proposal improves on the current forward guidance strategy in the following ways.

- The nominal GDP criterion clarifies the ultimate goals of the FOMC. It replaces the vague references in the current statement to "a wide range of information, including measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial developments." We thereby send a clearer signal to the public about how much more growth must occur before the we begin to raise interest rates.

- We estimate that under this proposal we will not begin raising interest rates for at least two years. This is a more expansionary signal than the current policy, under which expectations are for rate increases beginning next summer, which will lower long-term interest rates.
- The nominal GDP criterion promises a combination of real economic expansion and higher inflation. The prospect of economic expansion will increase consumer and business confidence and generate higher spending. The prospect of higher inflation will generate more spending by lowering real interest rates. Higher inflation also reduces the real value of household debt, which will assist in recovery of balance sheets. This is an improvement over the current policy, which risks signaling to the public that the Fed views the current state of the real economy and inflation under two percent as satisfactory outcomes.

We have prepared some forecasts of what our policy implies for the economy. The scenarios shown on the graph assume that the real output gap is currently 4 percent and the growth rate of potential GDP is 2 percent. Real GDP has grown at an annual rate of 2.3 percent in each of the last two years. At this pace, it will take over 13 years for the economy to reach full employment.

- Nominal GDP is currently 8.7% below the nominal GDP trend line that we hope to achieve. We assume that trend nominal GDP grows at 4% per year.
- Scenario 1 assumes that the combination of lower long-term interest rates and increased expectations of growth and inflation causes nominal GDP to reach its target in two years. This requires nominal GDP to grow at an average rate of 8.4% per year. Inflation in excess of current levels is unlikely unless there is a strong pickup in real GDP growth, so it is reasonable to assume that nominal growth is roughly evenly divided between real growth and inflation. This would imply 4.2% real growth and 4.2% inflation per year, which would eliminate the output gap in the year that the nominal GDP target is achieved.
- Scenario 2, which we believe is more likely, assumes that the nominal GDP trend line is reached in three years. This requires nominal GDP to grow at an average rate of 6.9 percent per year. If growth is evenly divided between real growth and inflation, this implies 3.5 percent real growth and 3.5% inflation per year, and again the output gap is eliminated when the trend line is reached.
- Scenario 3 assumes a four year path to recovery. This requires nominal GDP to grow at an average pace of 6.2 percent per year. Real GDP grows at 3.1 percent and inflation is 3.1 percent, and the output gap is eliminated when the trend line is reached.

Our policy risks higher inflation if the output gap turns out to be smaller than we believe it is. For example, under Scenario 2, nominal GDP grows at a rate of 6.9 percent per year. If the output gap is two percent rather than four percent, we could conceivably see the output gap eliminated in two years and real growth falling to two percent in year three, which would imply a 4.9 percent rate of inflation in that year. Clearly inflation at that level is not acceptable in the long run, but a temporary burst of inflation is a small price to pay for full recovery from the recession. In the final analysis, even in the high inflation scenario the average inflation rate beginning in 2007 will be near the our target of 2 percent; the higher period of inflation we promise for the most part merely compensates for the below-target inflation of the last several years.

To conclude, we find that the economy is in worse shape than it appears to be judging from the unemployment rate and the CBO's estimate of the output gap. The Federal Reserve has fallen short of its mandate of full employment and price stability since the recession began in 2007. Our proposal offers a chance to restore full employment and price stability. It does so by clarifying the our forward guidance statement: specifically, by committing us in terms that are as explicit as possible to a period of growth and reflation. It is a bold step, but one that is absolutely necessary in light of current economic conditions. Thank you for listening, and we welcome your questions.

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