Yellen says ‘high-pressure’ policy may be only way back from crisis

By Howard Schneider and Svea Herbst-Bayliss
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The Federal Reserve may need to run a “high-pressure” economy in order to reverse damage from the crisis that depressed output, sidelined workers and risks becoming a permanent scar, Fed Chair Janet Yellen said in a broad review of where the recovery may still fall short.

Though not addressing interest rates or immediate policy concerns directly, Ms. Yellen’s lunch address on Friday to a conference of policymakers and top academics laid out the deepening concern at the Fed that U.S. economic potential is slipping - and may need aggressive steps to rebuild it.

The question, Ms. Yellen said, is whether that damage can be undone “by temporarily running a ‘high-pressure economy,’ with robust aggregate demand and a tight labor market. One can certainly identify plausible ways in which this might occur.”

“Increased business sales would almost certainly raise the productive capacity of the economy by encouraging additional capital spending, especially if accompanied by reduced uncertainty about future prospects,” Ms. Yellen said. “In addition, a tight labor market might draw in potential workers who would otherwise sit on the sidelines and encourage job-to-job transitions that could also lead to more efficient - and, hence, more productive - job matches. Finally, albeit more speculatively, strong demand could potentially yield significant productivity.”

U.S. stocks posted further gains after Ms. Yellen’s remarks, while the dollar dropped and Treasuries rose, pushing yields on the 2-year note to session lows.

Her remarks, while pointing largely to research she feels needs to be done, nevertheless add an important voice to a debate that is intensifying within the Fed over whether the economy is close enough to normal to need steady rate increases, or whether it remains subpar and scarred.

That could figure importantly in coming debates over rate policy, and over whether support is building at the Fed to risk letting inflation move above its 2 percent target in order to employ more workers and perhaps encourage more investment.

From weak inflation to the effect of low interest rates on spending, little in the economy has been acting as the Fed expected.

Ms. Yellen said it may be the case that the crisis has done such permanent damage that fiscal and monetary officials will have to retool how they approach their jobs. For central bankers, that would mean keeping a broader set of less conventional tools at the ready, and using them more quickly in a new downturn. The aim, she said, would be to avoid further scarring.

“This post-crisis experience suggests that changes in aggregate demand may have an appreciable, persistent effect on aggregate supply - that is, on potential output,” Ms. Yellen said.

“If strong economic conditions can partially reverse supply-side damage after it has occurred, then policymakers may want to aim at being more accommodative during recoveries than would be called for under the traditional view that supply is largely independent of demand,” Ms. Yellen said. It would “make it even more important for policymakers to act quickly and aggressively in response to a recession, because doing so would help to reduce the depth and persistence of the downturn."

With public expectations about inflation so hard to budge, Ms. Yellen said that tools like forward guidance, "may be needed again in the future, given the likelihood that the global economy may continue to experience historically low interest rates, thereby making it unlikely that reductions in short-term interest rates alone would be an adequate response to a future recession."