FEDERAL RESERVE BANK of CHICAGO

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CFA Society of Chicago Distinguished Speaker Series: Luncheon Economic Forecast

Thank you for that warm introduction. It's just over two years since I became president of the Federal Reserve Bank of Chicago, and I am reminded that one of my first public speaking engagements was to this group in February of 2008. You'll recall that my remarks that day were made as the world financial crisis was in its early stages. In fact I spoke to you just before the collapse of Bear Stearns in mid-March.

So much has happened since then, not the least of which is the fact that the crisis and the actions of the Federal Reserve in helping to resolve it have become a staple for the news media worldwide. In fact, it's almost impossible to read a newspaper or watch television without hearing something about the Fed, the economy, and the financial crisis.

As I have travelled around the country making speeches over the past few months, I find myself being asked the same three questions over and over again. So for my prepared remarks today, I'd like to address those big questions about the economy. Afterwards, I'll also give you an opportunity to ask some questions of your own.

Let me emphasize that the views that I am presenting today are my own and not necessarily those of the Federal Open Market Committee (FOMC) or my other colleagues in the Federal Reserve System.

Let's begin with the question I am asked more frequently than any other: Is the recession really over? In a narrow, technical sense, the short answer is yes. Many broad indicators of economic activity are increasing as we would expect in the early stages of a recovery. Nonetheless, I keep hearing the question because many households and businesses do not yet feel like they are in much of a recovery. Unemployment remains very high, and many businesses are still producing and selling much less than they did two years ago. What people really want to know is when will we make significant progress in returning unemployment and other measures of economic health to more normal levels? We appear to be moving in that direction, but there is much work to be done.

Let me elaborate a little on those points. Although 2009 started as a very weak year, it finished well. Real gross domestic product (GDP), our broadest measure of economic output, increased at a 4.1 percent rate in the second half of last year. A portion of this improvement reflects the effects of government stimulus spending. But private demand is beginning to firm up as well. For example, in the automobile industry, which was hit especially hard by the recession, sales have held up in recent months even after the cash-for-clunkers program ended. In other industries, many firms that cut production and inventories very aggressively during the recession are now dialing back their inventory liquidation. On balance, the latest data on manufacturers' orders have been more positive, both for materials and parts and for capital equipment. Demand from abroad is also increasing; in particular, the emerging-market economies are showing renewed vigor that should benefit U.S. exporters.

In the housing market, the news has been mixed. Sales of new homes and housing starts stopped falling early last year and have been bouncing along without much of a trend over the past several months. Sales of existing homes increased a good deal through most of 2009, but much of the gain was retraced around the turn of the year. Subsidies for first-time home buyers have contributed to the ups and downs in the data, and we have yet to see how well the housing market will hold up once they ultimately expire. However, the declines in home prices that earlier precipitated the financial crisis are now attracting buyers, and so are low mortgage rates. Sadly, many of these sales are for foreclosed homes, but at least they are now moving on the market. Last year's sales and the low level of starts have substantially helped to reduce the overhang of unsold homes, which should help set the stage for a gradual recovery in residential construction.

Most forecasters also expect only a gradual recovery in consumer spending. In part, this is because the drop in home prices and the fall in the stock market during the height of the crisis reduced household wealth. It's also because the availability of household credit has tightened. In addition, the unemployment rate currently is at 9.7 percent. For states in the Federal Reserve's Seventh District, unemployment was 11 percent in December. With such a depressed labor market, workers are seeing little growth in wages and salaries. So, with credit tight and households needing to repair their balance sheets, consumer spending will gain momentum only as people get back to work.

Employment is often the last piece of the puzzle to fall into place during a recovery. This will certainly be true this time. Many businesses slashed payrolls during the recession, and going forward, many are hoping to keep staffing levels lean. Indeed, even though output was increasing, employment still fell substantially during the second half of 2009. Toward the end of the year, however, the pace of job loss moderated significantly. Some of the businesses that cut their payrolls most deeply during the recession have begun to rehire workers. Others have accommodated recent increases in demand by hiring temporary workers.

This is just the first stage of the recovery process. Most employers are very cautious about hiring at this time, given the uncertainty over the pace of the recovery. But I think that many businesses already are finding they can take lean production only so far. These firms should be ready to expand permanent hiring once they see clearer signs of sustained increases in demand.

The picture with regard to financing conditions is complex to say the least. On the plus side, more and more financial markets are functioning well without the need for ongoing government support. As a result, large firms are able to borrow at reasonable spreads, both short term in commercial paper markets and long term in corporate bond markets. On the down side, the availability of bank credit remains a significant headwind for many small- and medium-sized companies. Some of the decline in bank lending that we saw last year reflects weak demand for loans by businesses wary of taking on new debt burdens in an uncertain economic environment. But at least some of the reduced lending arises from banks' tighter lending standards. These tighter standards, in turn, appear to reflect banks' concern over their capital levels and also the credit quality of borrows. More generally, credit flows are being reduced because both borrowers and lenders are still dealing with losses from the recession, especially the busts in residential and commercial real estate. I expect banking conditions to improve, but this is likely to take some time.

Looking ahead, I anticipate that restrictive bank credit, along with business and household caution, will continue to restrain the recovery's strength. Nevertheless I expect these dampening influences to abate as we move through 2010. We at the Chicago Fed expect GDP growth to average 3 to 3-1/2 percent in 2010. Such growth is only slightly above our estimate of the economy's potential growth rate, which means unemployment will likely decline only modestly in 2010.

Of course, the recovery could exceed these expectations. The growth we're expecting is modest for a recovery following a deep recession, which is typically followed by a sharp increase in economic activity. For example, GDP growth in the year and a half following the recession of 1981 and 1982 averaged about 8 percent. While that's not the case now, some of the recent data have been better than expected. Increases in confidence could turn into higher spending sooner than we think. And an important longer-term factor is that productivity growth has remained strong. Technology continues to advance, and firms continue to create new products and find new ways to produce more efficiently. Such productivity gains will result in higher incomes and improving standards of living over the longer term.

Well, that was a long answer to a short question about the recovery. The second question I'm often asked comes in two versions. The first version is: Isn't inflation about to go through the roof? The second version is: Isn't inflation about to fall further—aren't we looking at deflation? The answer is no in both cases: I think inflation will remain relatively stable. But the fact that I get these completely different questions highlights the degree of uncertainty currently underlying the inflation outlook. Surveys of consumer inflation expectations, professional forecasters' projections, and the implied inflation forecasts from the market for Treasury Inflation-Protected Securities all see inflation running close to current rates over the medium term. But these stable inflation expectations balance out some important crosscurrents. I'm reminded of the old joke that says if you put two economists in a room you'll get at least three opinions. Well, that's especially true now.

The current low rates of resource utilization strongly point to lower inflation. The 9.7 percent unemployment rate and the still very low rates of manufacturing capacity utilization are factors that reduce cost pressures and make firms less able to push through price increases. In fact, these factors have significantly contributed to a recent decline in inflation. The Fed's preferred measure of core inflation—the deflator for Personal Consumption Expenditures, or PCE, excluding food and energy—has fallen from 2.7 percent in August 2008 to 1.4 percent in January 2010. That is a large decline for a relatively slow moving data series.

The people who press me on higher inflation point to the Fed's expanded balance sheet and the associated large increase in what economists call the monetary base. We all know that too much money chasing too few goods will generate inflation. But, currently, most of the increase in the monetary base is sitting idly in bank reserves—and because banks are not lending those reserves, they are not generating spending pressure. Of course, leaving the current highly accommodative monetary policy in place for too long would eventually fuel inflationary pressures.

With core inflation at 1-1/2 percent, we see the opposing forces of resource gaps and accommodative monetary policy as roughly balancing out over the medium term. Resource slack could result in core PCE inflation coming down a bit more in 2010 and 2011. As resource slack abates in a recovering economy, I expect inflation to move up to about 1-3/4 percent in 2012.

To achieve this outlook, monetary policy cannot be passive. A large challenge facing policymakers over the next couple of years will be judging the appropriate timing and pace for reducing accommodation. On the one hand, removing too much accommodation prematurely could choke off the recovery. On the other hand, as I noted, if the Fed leaves the current level of accommodation in place too long, inflationary pressures will eventually build. The Fed is preparing for these decisions by carefully monitoring business activity and remaining alert for signs of incipient inflation. In addition, the FOMC is making sure that it has the technical tools it will need when it decides to reduce monetary accommodation. Overall, I am confident that monetary policy will bring and keep inflation near my guideline of 2 percent over the medium term.

Needless to say, the crisis and recession have kept us busy. But we have also devoted a good deal of energy to reflecting on events of the past several years. This is, in large part, because of the importance of the last question I have been asked recently: What have you at the Federal Reserve learned about how to guard against future financial crises again creating such a major recession? It is not always worded so nicely! There are, of course, a number of lessons. I'd like to touch on a couple of them now.

One lesson is that responding effectively during times of crisis may require innovative and targeted policy tools. As the crisis arose, we first used our traditional tools, substantially cutting the federal funds rate and lending to banks through our discount window. However, we lowered the funds rate to zero—as far as it can go—and still were facing frozen credit markets and severely deteriorating macroeconomic conditions. We thus turned to nontraditional tools to clear up the choke points. These included providing liquidity directly to nonbank financial institutions, and supporting a number of short-term credit markets. We also purchased additional medium- and long-term Treasury bonds, mortgage-backed securities, and the debt of government-sponsored enterprises. These purchases further reduced long-term interest rates.

These nontraditional actions helped us avoid what easily could have been an even more severe economic contraction. Of course, in the future it would be best to reduce the chances of facing financial crises in the first place by better protecting the economy from systemic financial risks. Another important lesson is that to be most effective, financial market supervision needs to be based on prospective economic conditions and applied at the same time across the range of institutions. This is an essential aspect of an approach known as horizontal macroprudential regulation. Such an approach was taken during the Supervisory Capital Assessment Program (what we called the SCAP). In the popular press this was better known as the bank stress tests. This was an important effort undertaken in the spring of 2009 that went a long way toward stabilizing and restoring trust in the banking system.

During SCAP, the Fed and other regulators worked with the 19 largest bank holding companies to evaluate the banks' capital adequacy under two macroeconomic scenarios. One was a baseline that embodied the expectations of most professional forecasters at the time. The other was a more adverse scenario, which ended up being closer to how the economy actually performed. As part of the exercise, banks' assets were grouped into several buckets—categories such as First-Lien Mortgages, Junior Mortgages, Commercial Real Estate loans, etc. Both the banks and the SCAP staff of more than 150 examiners, economists, accountants, and other bank supervision specialists were asked to evaluate how these assets would perform under the two scenarios. Comparing the different assessments and working through them led to a much better understanding of the strengths and weaknesses of the leading bank holding companies.

In the end, the results indicated which institutions would need additional capital to cover their losses and maintain good capital ratios in the worse-than-expected macroeconomic environment. With this information in hand, the Fed, the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC) compelled institutions that fell short of this common benchmark to increase their capital. And they did. The information made public after the SCAP helped private investors make more confident valuations of the banks. Nearly all banks then were able to raise new capital on public equity markets without drawing on additional government funds.

I see a number of benefits to making similar macroprudential stress tests routine. Such horizontal cross-bank reviews of balance sheets and risk exposures can identify potential systemic risks that might escape an institution-by-institution analysis. Furthermore, they provide a ready way for supervisory reviews and actions to respond to the latest information on macroeconomic developments. In addition, going forward, we might consider dynamic capital standards that would require banks to build their capital base during periods of strong economic growth and high bank profitability, and let banks draw down their capital cushions during downturns when profits and capital tend to be more scarce.

Such proactive bank supervision requires collaboration between economists and regulators. The Federal Reserve has many well-trained and experienced economists gathering intelligence and analyzing incoming data to prepare the Federal Reserve System's Governors and Bank presidents for their monetary policy decisions. I believe that the same macroeconomic insights can help promote financial stability by substantially improving regulators' ability to identify and assess risks that are relevant to a range of financial institutions. This was demonstrated during the SCAP and this approach will be applied to other supervisory efforts.

At the same time, we have well-trained and experienced bank examiners who can offer sound judgments on the creditworthiness of financial institutions' balance sheets. Such supervisory information can and does make a valuable contribution to monetary policy analysis. For a number of years, we at the Chicago Fed have included information on banks' financial condition and lending activity from our staff in Supervision and Regulation in our regular preparation for monetary policy meetings. Since a recovery in bank lending capacity and inclination will be an important indicator of self-sustaining momentum in the recovery and of the appropriate time to adjust monetary policy, this information is crucial now more than ever.

Just a minute ago, I used the term macroprudential regulation. This is part of a shift in our philosophy spurred by the crisis. Since Congress created the Federal Reserve System in 1913, our approach to preventing financial crises has relied on the microprudential supervision and regulation of individual banks. In theory, ensuring sound lending standards and adequate capitalization on a bank-by-bank basis would reassure depositors that their money was safe and prevent panics. Such panics

were all too common in the late nineteenth and early twentieth centuries, and were important factors leading to the formation of the Fed. If a problem bank slipped through this regulatory safety net, we could use our powers as the lender of last resort to prevent its weakness from contaminating a broader range of institutions. And, if there were macroeconomic consequences, then monetary policy could be eased to mitigate the overall effects on the economy.

Of course, as Chairman Bernanke and other experts on the Great Depression have noted, the 1930s Fed failed to use these tools well enough. But from then until the current episode, this approach appeared to suffice, even as our financial system became more dependent on nonbank financial intermediaries, such as broker–dealers, hedge funds, and other institutions beyond the regulatory reach of the Fed and the other banking regulators. Nevertheless, the scale and scope of the past few years' events have exposed the weaknesses of a bank-by-bank regulatory approach to guarding against the macroeconomic risks stemming from financial instability.

One highly visible characteristic of our recent financial instability was the bubble that arose in the housing market and its subsequent collapse. Now, in the aftermath of that bubble's collapse, there are increasing calls for central banks to be more proactive in responding to signs that an asset bubble may have emerged. This is often described as an imperative to "lean against potential bubbles," meaning that the central bank should act to lower asset prices that, according to some benchmark, seem unusually high. Now not all financial crises arise from bubbles; the implosion of Long-Term Capital Management (LTCM) following the Russian bond default is a case in point, so a policy of leaning against bubbles is at best incomplete. Moreover, there are good reasons to think that using one of the traditional monetary policy tools—namely, adjusting the short-term policy interest rate—to lean against a potential bubble could be ineffective and maybe even counterproductive. One argument is that interest rate policy is too blunt of a tool to effectively prick bubbles—it cannot be targeted precisely, and thus will affect other financial and macroeconomic variables beyond just the set of asset prices in question. A second argument is that the typical changes in interest rates that a central bank might contemplate are likely to be too small to produce big changes in asset prices. I continue to find these two arguments quite persuasive, which is why at this point I think that well-structured regulatory policy provides the most promise in protecting the economy from financial crisis.

I'd like to conclude at this point, but I hope you'll recall that the answers to our three questions about recovery, inflation, and the financial crisis were yes, no, and we've learned a lot. Giving shorter answers to these questions is certainly easy and often necessary, but always frustrating. Today, more than at any time in recent memory, people want to know about the Federal Reserve, the things we do and think about, and how we put the pieces together to create a picture of the current economy. We're doing our best to satisfy that demand by providing as much information as we can to business people and bankers, members of Congress, the media, and, most important, consumers and the public.

Thank you for the opportunity to be with you today. I look forward to your questions.