Economic Recovery and the Expansion Beyond

Additional Information

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Introduction

I've been with the Federal Reserve for more than 26 years now. At the risk of resorting to understatement, I can say with confidence that this past year has been unlike any other. Our economy has not experienced a shock of such intensity since the 1930s. Even so, it is important to note that whenever our country has faced economic challenges, it has always overcome them and has often emerged stronger for the struggle.

The painful economic story being told today is typically reported in the financial press in broad statistics - employment data, foreclosure tallies, GDP declines. But it's a story being felt by individual households and businesses. Here in Kentucky, you are feeling these challenges, too, especially in terms of your unemployment rate, which has risen to nearly 10 percent.

But many of us, whether we happen to be businesspeople or policymakers, are already thinking beyond the troubles of today to an economic recovery and the expansion beyond. In my remarks today, I will briefly describe some forces that will help pull our economy out of its steep decline. Then I will discuss why several long-standing imbalances within the economy will likely cause the recovery to proceed slowly. Finally, I will discuss some structural changes in the labor market and the drivers that will lead us again to long-term prosperity.

Of course, the views I express today are my own and do not necessarily reflect the views of my colleagues in the Federal Reserve System.

I. Forces that Will Lead to Recovery

By now we are all very familiar with the drumbeat of negative economic news associated with this deep recession - the steep declines in output in the fourth quarter of last year and the first quarter of this year, coupled with the loss of 4 million private-sector jobs during the past six months. And unfortunately, we may hear more disconcerting news over the coming months. Nevertheless, there are several powerful forces at work that will put the economy back on track for recovery.

First among these forces are expansionary monetary and fiscal policies. On the monetary policy side, the Federal Reserve has been acting aggressively for well over a year now. We began our stimulative monetary policy by lowering our short-term interest rate target, and now that rate stands at practically zero. We have continued to respond to the financial crisis and the recession through

a variety of innovative programs that have dramatically expanded our balance sheet. These programs are providing liquidity to the financial system, offsetting some of the deleveraging in the nonbank financial sector, and improving the functioning of key credit markets. For example, the Federal Reserve is in the process of purchasing up to $1.25 trillion of mortgage-backed securities from government-sponsored enterprises by the end of this year. Since we announced our plans, the 30-year fixed, conventional mortgage loan rate has fallen considerably - even though mortgage rates have inched up a bit in recent weeks.

Fiscal policy also plays a key role. The Administration and Congress have enacted a very sizable stimulus package that will boost spending throughout the economy. Much of the spending on infrastructure will begin to appear this summer, but the stimulus bill has already helped certain state and local governments avoid immediate cutbacks in programs and services.

The second force is the moderation in the contraction of the housing sector. As weak as the housing markets may still appear at the moment, we know that lower mortgage interest rates can help increase the demand for housing. In addition, the Administration has launched efforts to make home ownership more affordable for first-time buyers and to help millions of distressed Americans cope with burdensome mortgage payments without losing their homes. Lower mortgage rates, lower home prices, and tax incentives are combining to encourage an active real estate market, which should further slow the downward movement of home prices. Existing home sales have stabilized since October, and the rate of decline has tapered off for new single-family home sales over the past few months. This is welcome news for homebuilders, who watched new housing starts reach a record low in April.

A third force working to lead us to recovery is the return of stability and confidence to the financial sector. Underlying our current economic problems is a collapse in our financial markets. To grow, an economy needs a well-functioning financial system that can help move capital from savers to entrepreneurs and businesses. Stability and confidence have to be restored to make that happen. That is why policymakers are trying to break the remaining logjam in the financial markets and to get the credit markets back in good working order. Credit conditions have certainly improved since last fall, and more recently, banks have successfully raised large amounts of private capital, which seemed impossible just a month or two ago. This capital will be available for funding renewed loan growth as the economy improves.

A final force - one that I see in this room today and that is possibly the most important in moving us from recession to recovery - is the entrepreneurial spirit of American business. Economic research shows that most business owners react to harsh economic times by cutting labor and operational costs, by narrowing their focus to core business activities, and by scaling back on expansion plans. They get defensive. They don't seek out new loans or lines of credit.

But as time passes, some bold-minded business owners begin to see opportunities brought on by retrenchment. They move first and they move quickly, investing in R&D, launching expansion plans, and even starting new enterprises from scratch. Recoveries are built on the opportunities made available by recessions.

I have been hearing some scattered reports of progress on new business activity in my discussions with business contacts lately, but I am sure that we would all like to hear many more of these reports, all across the country, so that we can feel more confident that we are on a clear track to recovery. Let me say that it is always a

challenge to pinpoint when the economy will transition from recession to recovery and to the expansion beyond. It is especially difficult to forecast in this current environment because of the global nature of this recession and because of the financial turmoil we have been facing for so long.

Over the past few weeks, incoming news has been mixed, and the data we receive are volatile and subject to revision. In my view, the steep decline in our economy has begun to moderate, and I expect sales and production to begin to recover, although gradually, during the second half of the year. Currently, a lot of attention is focused on the date when this recession will end, but not enough attention is being paid to how much ground we will have to cover before we return to our pre-recession level of economic activity.

II. Long-standing Imbalances within the Economy

Once the recession ends, we may be tempted to hope that the economy will take off at a full gallop, but that is not likely to happen because of some long-standing imbalances within our economy. Addressing these imbalances may result in a slower, lengthier recovery period, but doing so will increase our ability to achieve sustainable economic growth over the longer term.

One of the most important imbalances is the one that confronts many Americans who now need to rebuild their personal wealth. For most of the past decade, the United States has been a nation of spenders, not savers. During the expansionary period in the early part of the decade, savings rates dipped down toward zero, but household wealth continued to grow for many people as a result of the rising stock market and appreciating home values. Of course, as is true for most things that seem too good to be true, that pattern came to an abrupt halt last year. The double whammy of stock and home price declines caused the net worth of U.S. households to decline by a staggering 18 percent in 2008. As households have begun to retrench, their savings rate has risen. The personal savings rate was a meager 0.6 percent in 2007 and only 1.8 percent last year. In the first four months of this year, the rate has averaged 4.7 percent.

Simply put, many people today have no choice but to save. They are rebuilding their personal balance sheets. And as people come to grips with the fact that their finances are more uncertain than they had ever thought they would be, they are not likely to resume spending at the pace they once did. As a result, we should not expect consumer spending to return to the 70 percent share of GDP that it posted just before the recession began. This transition from an environment of heady consumption to one of greater savings presents considerable short-term challenges. We can see signs of those challenges all around us as car dealerships shut down and retailers post disappointing sales figures. But a higher savings rate also has certain advantages in the longer run. The economy can benefit because a higher savings rate creates a pool of capital that could fund productive investments, including those in new industries. This, in turn, will boost future incomes.

As Americans focus on rebuilding their wealth, can we rely on international markets to make up for this slowdown in domestic consumer spending? Unfortunately, few countries are being spared the effects of this downturn. The International Monetary Fund predicts that the global economy will shrink by 1.3 percent in 2009 - marking the first time it has contracted since World War II.

Even if we could count on international markets for help, this could not happen overnight because of the second major imbalance within

the U.S. economy - our massive trade deficit. For decades, our nation has struggled with this persistent trade imbalance, which reached new heights as a share of GDP in late 2005. Given the weakened state of our trading partners, it is going to be a real challenge to get trade flows - both imports and exports - to bounce back. During the previous expansion, we were importing more and more goods and services from abroad, and our export growth failed to keep pace. Imports have declined as a result of our domestic recession, but due to the global nature of the recession, demand for our exports has declined as well. Even so, if U.S. international trade moves toward a state of greater balance over the longer term, we should eventually see exports rebound and generate new jobs.

The third imbalance we must address is our looming federal spending obligations. While the fiscal stimulus package was an important response to extraordinary circumstances, it is neither possible nor desirable for such an elevated level of federal spending to continue indefinitely. Our country faces a substantial fiscal imbalance that will require a number of tough fiscal policy decisions. The Congressional Budget Office estimates that our federal budget deficit will reach $1.8 trillion this fiscal year. To make matters worse, Medicare and Social Security are projected to begin imposing additional cash drains on the federal budget beginning as early as eight years from now under current program requirements.

For years, we have been able to finance a large share of our budget deficits with relatively cheap capital from abroad, and for years this has worked to our benefit. But our country should not regard international capital markets as a bottomless well. As access to this well becomes more limited, the cost of financing our fiscal deficits could rise.

It takes time to forge a consensus around new fiscal priorities, so a lot of careful thought must go into deciding how to best move our budget toward balance over time. In the short term, these steps might limit the federal government's ability to contribute directly to economic growth. And in the longer term, the budget deficits of today will need to be offset with surpluses in better times.

III. Labor Markets and Drivers of Long-term Prosperity

Another reason to expect a slower, more prolonged recovery is the sizable adjustment occurring in our labor markets. As you know, people are continuing to lose jobs at a significant pace during this recession, and unfortunately I believe that the jobless rate is likely to stay elevated for quite some time.

Our economy is changing. Many of the job losses we are experiencing are not just a cyclical response to weak demand, but the result of structural shifts also under way in our economy. Some sectors of our economy will emerge smaller from this recession and will face lingering adjustments. Consider construction employment, for example. Given the glut of housing in many markets, it is hard to imagine employment in the construction industry making a quick return to its peak levels of 2006. Even when the economy resumes a more normal growth rate, many laid-off workers will need to find jobs in new business sectors because their former industry has simply become a smaller part of our economy.

This pattern is already evident in the unemployment statistics. Only 12 percent of currently unemployed workers expect to return to their former employer, and a new Bureau of Labor Statistics survey shows the lowest number of job openings seen since the data first became available in December 2000.

We know that the U.S. economy is one of the best in the world at re-integrating laid-off workers, but the reality is that it takes a long time to match people seeking employment with jobs in expanding industries. Many unemployed workers in sectors like construction or finance, or in specific industries like auto manufacturing, will need to acquire new skills and training to enter fields that will be expanding once the economy starts to recover. So it could take a long time before the unemployment rate returns to levels we think of as normal, and we might even need to revisit our definition of normal.

Over time, however, we are likely to see some long-term productivity benefits. For example, consider the employment changes we have seen in Kentucky's mining industry. Despite recent gains, mining employment is less than half of what it was in 1982, as new technologies have taken over some of the work that was once done by human hands. The downside, of course, is that some well-paying mining jobs have been lost. But even though the mines in Kentucky don't employ the number of people they once did, they are now run more efficiently and productively. At one point, the Kentucky coal mining industry might have looked endangered, yet changes in technology and business practices have enabled it to become more competitive and viable. In the bigger picture, as some mining jobs disappeared, jobs in other industries expanded. From 1982 to 2008, Kentucky's total employment rose by 60 percent.

Market forces tend to direct resources to wherever they are most productive. Capital and creative energy - and eventually jobs - flow toward the new goods, services, and processes that will deliver greater value than the old ones. In the long run, this shift will increase our economic productivity, and I am encouraged by the potential benefits that will bring to our part of the country.

So what can we do in the near term while the painful adjustments are taking place? I think we need to set our sights on two key drivers of long-term prosperity - education and innovation. Economists at the Federal Reserve Bank of Cleveland have conducted research showing that these two factors are essential drivers of state income growth.

We are continuing to benefit as a nation from stronger educational attainment. That is also true here in Kentucky, where you have been focused on boosting educational attainment for some time. In the past 20 years, the share of the population with at least a bachelor's degree has increased notably.

Regarding innovation, the recession has not put a dent in our nation's creativity. While all sorts of capital spending activities were cut back, patent applications throughout the country actually rose in 2008. This continues a long upward trend: last year, the U.S. patent office received 80 percent more applications than it did in 1998.

Our greatest strength for the future will be our ability to create new technologies, to embrace change, and to remain flexible amid evolving economic conditions. A sustainable growth strategy must build on our existing strengths - using the industrial knowledge and workplace skills from older industries and applying them to new tasks and new industries. Indeed, recoveries are built in no small part on the opportunities created by recessions. In the words of the great American philosopher Emerson: "Our strength grows out of our weakness."

Conclusion

I would also add, in conclusion, that our strengths outweigh our weaknesses. I have talked about the forces I firmly believe will lead us back to recovery. These four forces expansionary monetary and fiscal policies, the stabilization of the housing market, the return of

confidence to the financial sector, and above all the entrepreneurial spirit of American business - collectively build a strong foundation for growth.

Still, our economy has been characterized for years by strong imbalances that will hold back the pace of our recovery. Households are now saving more, and we cannot look to the rest of the world to finance so much of our spending. Similarly, we cannot expect the current elevated level of federal borrowing to continue indefinitely. Finally, our labor markets are undergoing a major structural change, with many regions now finding themselves burdened with long-term unemployment issues that will not be corrected quickly.

This economic crisis has heightened our awareness of these imbalances and compelled us to reexamine them. I am convinced that if we can make progress in addressing these imbalances, we will increase our prospects for greater prosperity over the longer term. Today, in this beautiful setting, I think we can begin to believe in better days ahead, not just because we're hopeful or optimistic, but because our nation has made it happen before. This will be a long journey. But education and innovation have helped to pull us through some difficult times before, and I know that our collective energy, imagination, and abilities will lead us on to a balanced and healthy economic expansion.