



Emerging from Recession: Implications for Growth, Inflation, and Monetary Policy

Introduction

When I last spoke in New York, during the first quarter of last year, the worst of the financial crisis was still ahead of us. I'm delighted to be able to speak to you this evening about the contours of a recovery.

Indeed, the media is full of stories these days about how the economy is emerging from recession, and whether we will have a V-shaped, U-shaped, or W-shaped recovery. I am not a big fan of using letters to describe economic conditions, but I do detect a sense of optimism about the economy that I was not hearing a few months ago. Without question, this has been a severe recession. Its depth can be measured not just by the economic data but also by the pain it has inflicted on people and businesses across the nation.

In my remarks this evening, I will comment on current economic conditions, and I will explain why I think our economic recovery will be gradual and bumpy. I will conclude with some thoughts on what this gradual path to recovery may mean for inflation and monetary policy.

Please note that the views I express today are my own and do not necessarily reflect the views of my colleagues in the Federal Reserve System.

Economic Conditions are Improving, but This Recession Has Been Severe

Let's start with a quick look at current economic conditions. We are seeing early signs that the economy is emerging from its steep decline.

I am certainly pleased and encouraged to see these signs. Nearly a year ago, when I spoke in Cleveland, I set out the three conditions that I would need to see as evidence that our economy is starting to recover. First, banks would have to begin lending to one another again, and credit markets would have to operate without extraordinary involvement from the Federal Reserve and the Treasury. Second, home prices would need to stabilize. And third, the very low trading volumes in the private markets for mortgages, student loans, and auto loans would have to pick up.

Although we still have a long way to go, we have seen some progress recently on all three of these fronts. Interbank lending has been reestablished as financial institutions have acquired more information

Additional Information

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about the health of their counterparties and regained confidence in one another. We have also seen a significant drop in LIBOR rates. Confidence returned, in part, as the federal government and many financial institutions themselves took actions to bolster capital on banks' balance sheets. We are off to a promising start, but broader credit market conditions remain tight, and the level of overall lending continues to contract. Also, some financial markets and institutions still have substantial support from the Federal Reserve and the Treasury.

On the housing front, after more than a year of declines, all major indices of housing prices have recently begun to head higher. We have even seen some growth in new single-family home starts. Of course, this has come with considerable government support. The first-time homebuyer tax credit has drawn in new buyers, but much of the purchase activity has been concentrated in less-expensive homes. More generally, the housing market now depends on a broad array of support from the federal government, and it is not yet clear how soon the market will be able to stand on its own feet.

Finally, we have seen some limited success in the markets for asset-backed securities. After trading nearly came to a halt for securitized automobile, credit card, and student loans last winter, trading volumes have improved over the spring and summer, due in part to the success of the Term Asset-Backed Lending Facility, or TALF.

These encouraging developments are having a positive impact on the broader economy. I have no doubt everyone in this room was relieved to see second-quarter GDP down by less than 1 percent, and at this point most private-sector forecasts show actual gains in third-quarter GDP. I would not be surprised to find that when we look back a year from now, we will see that mid-summer marked the end of this recession.

But it is far too early to celebrate. Our economy has, without question, taken a staggering blow. Even as the second quarter began this year, it was far from clear that our economy was anywhere near a turning point, despite the substantial contribution of many innovative monetary and fiscal programs. My colleague Janet Yellen, president of the Federal Reserve Bank of San Francisco, compared the economy to a hospital patient who was in the intensive care unit and only gradually stabilizing.

And make no mistake—our economy was in critical condition. This has been the deepest recession since the 1930s, with the economy posting its sharpest six-month decline since the end of World War II. The typical recession ends in a little over two quarters and generally recovers to pre-recession levels of output in a little over a year. As of the end of the second quarter of this year, the current recession has lasted nearly seven quarters. Even with today's encouraging signs, we have a lot of ground to make up before we even get back to the levels of output seen in 2007.

For example, payroll employment has dropped by more than double the typical amount for an average recession. The unemployment rate, which typically increases less than 2 and a half percentage points in an average recession, has already risen about 5 percentage points in this recession, and it is likely to continue to climb higher. In addition, capacity utilization in our industrial sector is at a 60-year low. Our economy has a considerable amount of slack, and to stretch our medical analogy a bit further, recovery from this critical condition will require a long convalescence.

Here is another way to think about how much ground we have to reclaim. The output gap is the conventional measure of the economy's current level of activity compared with its potential. The

most popular measure is produced by the Congressional Budget Office. Using the CBO's approach, the current output gap is more than 7 percent which, again, is the largest gap since the Great Depression. That's a big number, but many researchers and policymakers have questioned relying on output gaps to formulate policy, because these gaps are inherently difficult to measure and are often overestimated.

One critical problem is selecting the appropriate point—or benchmark—where the economy is producing at its full potential. For example, if we look back just a few years to when the economy was humming along, it may be that the output levels then were artificially inflated and unsustainable. If that's true, it is unlikely the economy will soon return to those levels, and the full potential of the economy might not be as large as the output levels of a few years ago.

Also, trend productivity growth—another key assumption in the output gap—is always evolving as a result of new technologies and business practices. But it is hard to measure the progress of underlying productivity trends until years after the fact. These issues, and others, raise questions about the size of the output gap. But pretty much any data on labor markets and economic activity point to an economy with a great deal of slack.

For sure, this is a difficult time to be in the business of economic forecasting. To paraphrase one of my colleagues, we are looking at flawed data through the lens of imperfect models. To try to clarify my perspective on the economy, I also spend a lot of time talking with businesspeople—the heads of Fortune 500 companies, owners of small and medium-sized enterprises, and CEOs from large regional banks and small community banks. I can tell you that across the board, the mood of my business contacts is one of caution and uncertainty.

While business owners report seeing signs that economic activity has leveled off after a steep decline, the drop-off in activity in their businesses has been so severe that any current growth is easily swallowed up by remaining inventories or by small, incremental increases in production. Obviously, many businesses have closed, but most have reduced their production levels and hours of work. Business owners report that they are using furloughs and wage freezes to hunker down, waiting for the economy to recover, but most of them will be ready and able to ramp up once demand recovers.

This real-world information supports my conclusion that the amount of resource slack in the economy remains substantial. So, while no one can be certain about the precise size of any output gap, both data and business reports indicate that the current level of economic activity remains well short of its potential.

Economic Recovery Is Likely to Be Gradual and Bumpy

With this amount of slack in the economy, we would all like to see a speedy recovery. Unfortunately, I expect the rate of growth in the early stages of the recovery to be gradual and bumpy. I have several reasons for this view. First, our financial system is still far from healthy. After all, the FDIC just revealed that 415 banks are at risk for failure, and the latest Federal Reserve Senior Loan Officer Opinion Survey continues to report extraordinarily tight credit conditions. And just as banks are in the process of repairing their balance sheets, so are consumers. We have seen an increase in the savings rate, and it appears that we are making the transition from a nation of spenders to a nation of savers. Of course, this will be a

beneficial trend in the long run, but it presents some challenges for economic growth in the short run.

We all know that the economy is still losing jobs and the unemployment rate is rising. The labor market data reveal a large level of underlying weakness. According to the Bureau of Labor Statistics, the number of people losing jobs has actually declined over the past few months, but the number of new hires and job openings has dropped even more. Unfortunately, the labor markets won't show any lasting progress until businesses have the confidence to begin hiring at a more normal rate.

Finally, the improvements seen today in some critical sectors are tied to short-term stimulus programs. Auto sales got a clear boost from the Cash for Clunkers program. In my District, the effects of this program are still showing up in higher auto production, along with increased demand for steel and other inputs. How long these effects will persist is uncertain, and it is still far from clear when normal consumer demand for autos will return. Similarly, my real estate contacts are concerned that sales will decline once the first-time home buyer tax credit expires on December 1. These incentive programs have boosted output in the current quarter—likely pulling activity forward into this year—and leaving a higher hurdle for next year.

We cannot be sure how much any of these factors—or others—will affect our recovery. But I think that I am safe in predicting that there will be some bumps along the way. Perhaps the strongest reason for anticipating a slow recovery is the history of our past recoveries. Back in the 1950s, recessions tended to be steep, but also very short, and the economy rebounded quickly. Recessions in later decades, regardless of their size, had much slower recoveries. A slow recovery may, in part, be a structural feature of any complex modern economy.

My business contacts reinforce the case for a gradual and bumpy recovery. They report that they will be very cautious about expansion plans, even if that means forgoing some business opportunities right now. In an effort to create efficiencies and lean processes, some producers are increasing the use of just-in-time inventories and more specialized labor, all of which contribute to a strategic emphasis on cautious, lean growth.

Obviously, I am not the only one expecting a gradual recovery. For example, the Survey of Professional Forecasters is calling for GDP growth of roughly 2.5 percent next year and nearly 3 percent in 2011. If this two-year forecast pans out, it would take us until 2011 just to get back to our 2007 level of economic activity. A gradual recovery following a severe recession would still leave the economy short of maximum sustainable growth for a considerable period of time.

Inflation: An Uncertain Environment with Balanced Risks

In this uncertain world of encouraging signs but persistent economic slack, I still get asked questions about the emergence of inflation. Given my expectation of a gradual recovery and given the sheer amount of slack in the economy, you might expect me to conclude that inflation is not at all a risk, or even that we are at risk for further disinflation.

But my views on inflation are more nuanced. Economists have different views on whether slack in the economy will limit price increases, or how reliable and large the correlation between output

gaps and the rate of inflation actually is. Those who regard the relationship as significant tend to discount the prospect of rising inflation, while others say it is a misleading indicator and point to the 1970s, when a large output gap coexisted with high inflation.

Charles Goodhart, formerly of the Bank of England, offers one reason why the relationship between the output gap and inflation is such a challenge to measure. He argues that central bank actions to reduce inflation would inherently weaken the correlations between inflation and the output gap. The reason is that central bank actions to slow inflation typically slow the rate of economic growth, thus increasing the output gap. So, while the output gap might still be dampening the inflation rate, the central bank's actions can limit the usefulness of the output gap in predicting inflation.

Despite all of the varying opinions about the relative significance of slack in the economy and its effects on inflation, I do see tangible evidence suggesting that inflation will remain subdued. Wage pressures are being held down in this environment. In recent productivity reports, unit labor costs have slipped into negative territory, and the employment cost index has steadily declined since the recession began.

Also, economists at the Federal Reserve Bank of Cleveland have provided me with two particular pieces of research that have helped to guide my inflation perspective. One of my economists, along with his colleague at the Federal Reserve Bank of Atlanta, has been examining the detailed price data by splitting the consumer market basket in the CPI according to whether the prices for goods and services are sticky or flexible. Sticky prices, such as the cost of food in restaurants or haircuts—don't change very often. But flexible prices, such as the cost of food at grocery stores or the price of used cars—tend to jump around a lot. Sticky-price goods and services appear to be a particularly informative measure of underlying inflation trends because they predict future inflation rates more reliably than flexible-price goods and services. This analysis shows that the inflation rate of sticky-price goods and services has shifted sharply lower this year. This trend points to suppressed inflation rates for the next few quarters.

The second piece of research is a model of inflation expectations that does not rely on Treasury Inflation-Protected Securities, or TIPS, to estimate inflation expectations. Instead, this model estimates expected inflation using a combination of inflation data, nominal bond rates, survey measures of inflation expectations, and inflation swaps. This model shows inflation expectations holding steady over the two- to ten-year range.

So, in the near term, resource slack is likely to depress core inflation measures, but over the medium term, stable inflation expectations will play a larger role. Nevertheless, some people still believe inflation is a serious risk based on the expanding U.S. fiscal deficit and the unprecedented actions taken by the Federal Reserve. These critics point to the large size of the Federal Reserve's balance sheet, and they question the FOMC's willingness to raise rates when the time comes to do so. They also cite concerns that the Federal Reserve will succumb to political pressure, and monetize the federal debt.

I have to tell you that I do not share these views. As the minutes of the recent FOMC meetings reveal, a variety of tools are being developed to ensure "that policy accommodation can ultimately be withdrawn smoothly and at the appropriate time." Without going into all of the details, I believe that the Federal Reserve has the tools necessary to manage the balance sheet, to make any needed changes in short-term interest rates, and to ensure that our purchase of

Treasury securities is consistent with our dual mandate of price stability and maximum sustainable economic growth. When the time comes to start removing our policy accommodation, I am confident that we have the tools and the will to get the job done.

But the mere existence of inflation concerns must be taken seriously, if for no other reason than to prevent inflationary expectations from becoming a self-fulfilling prophecy. Given that inflation expectations are critical in wage and price-setting decisions, any shift in underlying expectations has the potential to shift the realized rates of inflation. Any destabilization of inflation expectations has to be treated as a monetary policy risk.

Ultimately, the risk that inflation expectations could become unanchored must be balanced against the reality of our slow emergence from this severe recession. It is not surprising, then, that forecasters are uncertain about how, when, or if inflation will develop over time. In the Survey of Professional Forecasters, for example, respondents are asked to provide their PCE inflation outlook for the five-year period of 2009 to 2013. Although you can see a few average annual inflation forecasts as low as 1 percent, and a few as high as 4 percent, the median response is 2 percent. I find it reassuring that the central tendency of these forecasts is in the range of 1.7 percent to 2 percent—which is consistent with FOMC members' projections for inflation over the longer run consistent with appropriate monetary policy.

Conclusion

The financial crisis of the past two years has been a humbling experience for me as a Federal Reserve policymaker. Needless to say, the past two years have reinforced the fact that none of us can predict the future with certainty. We have lived through a brutal recession that is only just starting to lose its grip on the economy, and I do not expect to see a quick turnaround. Our economy must contend with a fragile financial system, a consumer sector that is more inclined to save than to spend, a labor market weakened by a lack of business confidence, and the removal of many governmental supports for the economy.

I expect to see a gradual and bumpy recovery as our economy addresses these challenges. Still, despite some concerns that inflation will be unleashed from its anchors, I believe there is enough slack in the economy to keep inflation subdued for some time. In this environment, I believe that maintaining the current accommodative policy stance helps to foster both the continued recovery of our weakened economy and the stabilization of inflation rates at levels consistent with price stability.

Even so, this complex economic environment makes it important to be ready to react to evolving circumstances as necessary. The Federal Reserve's dual mandate compels us to be ever-vigilant against inflationary pressures, and to ensure our actions promote sustainable economic growth in the context—and only in the context—of price stability.