Remarks-University of Akron

Additional Information

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Introduction

Let me open today with a brief overview of my current outlook for the economic recovery and for inflation. Then I will be happy to join the discussion.

As always, the views I express today are mine alone and do not necessarily reflect those of my colleagues in the Federal Reserve System.

Economic Outlook—a Moderate Recovery

So let me begin with my outlook for the economy. Since the recession ended in mid-2009, the economy has been recovering, but at a gradual and bumpy pace.

More recently, though, the recovery seems to have established a firmer footing. I am seeing clearer signs of a virtuous cycle of growth. Rising incomes and rising profits are supporting growth in retail sales and business demand, which in turn fuels more growth in incomes and profits.

Up to this point, the recovery has been supported significantly by strong growth in exports, manufacturing, and business investment in equipment and software. Exports and investment have been growing at double-digit rates, and manufacturing production has been growing at an annual average rate of 8 percent. Looking ahead, I expect these sectors to continue to expand at strong rates, and this should help sustain a solid pace of recovery.

So with this good news, why isn't everyone cheering? Well, there are still many Americans who don't have all that much to cheer about. Following the deepest recession since the Great Depression, the recovery so far has been pretty uneven. While some economic sectors such as manufacturing have expanded at strong rates, many other sectors have lagged behind.

To many Americans, one of the most unforgiving aspects of the recession has been the continuing problems in the housing sector. Even today, home values have not rebounded, and a large number of properties remain available for sale. Many homes remain in the foreclosure pipeline, and we are looking at well over a year before the number of bank-owned properties begins to decline significantly.[1]

I see these problems in the housing sector acting as a drag on economic growth. Historically, investment in new home construction and improvements to existing homes help the economy snap back quickly from recessions. But in this recovery these investments have actually fallen.[2]

Another lingering problem is the loss of nearly 9 million jobs in the recession. While the employment rolls are gradually improving, to date we've only added back 1.3 million jobs. Reflecting these labor market conditions, average household income excluding government benefits is still down nearly 7 percent from its 2007 level. And with incomes remaining weak, many households have not been able to rebuild much of the wealth they lost during the recession as their home values declined and their financial investments fell sharply.[3] Recouping these losses will take some time.

Despite these challenges in both housing and labor markets, I expect the economy to expand at a moderate pace, slightly above the average growth rate of about 3 percent a year. That said, as a policymaker, I must take heed of key risks facing the economy. At this point, the recent sharp rise in energy costs associated with unrest in the Middle East and North Africa is a key risk. If the spike in oil prices is sustained, it will potentially slow the pace of GDP growth. But these effects would be tempered by the fact that energy is less central to the service sector, which now represents about 60 percent of our economy, and even manufacturers and other large users of energy are far more energy efficient than they once were. Even if the growth consequences turn out to be relatively small, a sustained increase in the price of oil could cause some people to worry about higher inflation.

The Inflation Outlook—Moderate Underlying Inflation

So let me turn to my outlook for inflation. Americans have been hit with sharply higher prices for food and energy. These price increases have been especially hard on lower-income households, who spend a higher proportion of their after-tax income on food and energy.[4]

Some of the most recent rise in gasoline prices reflects the dramatic recent global events that have pushed oil prices significantly higher. The natural question in these times is whether these higher prices will be enough of a driving force to cause a lasting increase in the rate of inflation. At this point, I don't think they will, and let me explain why.

First, large increases in food or energy prices have often been balanced out over time by sharp declines. For example, in 2006, oil prices rose significantly over the first eight months of the year but then dropped in the remainder of the year. While periods of rising energy prices cause inflation to rise, the subsequent periods of falling energy prices cause inflation to fall.[5]

Second, to cause a lasting rise in inflation, the increases in food or energy prices have to be large enough and persist long enough that they spill over and cause sustained increases in a wide array of other consumer prices. At this point, there is no evidence of broad spillover, but as a central banker I keep a close eye on this.

To assess the underlying trends in a broad array of consumer prices, my staff at the Federal Reserve Bank of Cleveland calculates and publishes an indicator known as the median CPI. This index is designed to provide a reliable measure of the average increase in a wide set of consumer prices, and it has been shown to be a superior predictor of future inflation rates. To this point, inflation in the median CPI remains very low: just 1 percent over the past year. Based on the behavior of the median CPI, I don't expect recent rises in food and energy prices to cause broader inflation.

In fact, I expect the underlying trend in broad consumer prices, which is currently quite low, to rise only gradually toward 2 percent by 2013. I think several factors will keep inflation in check. One factor is the continuing slow growth in wages, which helps determine the cost of producing goods and services and, in turn, the prices set by firms. Another factor is many retailers' reluctance to raise prices in the face of strong competition and soft business conditions.

But another important factor keeping inflation contained is the public's expectation that the Federal Reserve will keep inflation contained. While it may sound like a self-fulfilling prophecy to say that we will have low inflation because we collectively expect low inflation, the relationship between actual and expected inflation has been borne out over history. This makes sense when you think about it a bit: when firms expect lower inflation, they raise prices more slowly. And despite the recent surge in food and energy prices, measures of longer-run inflation expectations remain below 2 percent.[6] The stability in inflation expectations we see today is not achieved just by good fortune. The key to stability of long run inflation expectations, of course, is policy credibility. As a member of the FOMC, I believe it is my responsibility to do everything I can to underscore confidence in our resolve to maintain price stability.

To sum up, I expect the recovery to continue at a moderate pace. Regarding inflation, commodity and energy prices are currently generating upward pressure. Nevertheless, I expect these effects to be transitory.

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1. As measured at current rates of foreclosure resolution. See Venkatu, Guhan. 2010."Out of the Shadows: Projected Levels for Future REO Inventory,"Federal Reserve Bank of Cleveland, Economic Commentary 2010-14, October.
2. For example, in the six quarters following the 1990-91 recession, residential investment shot up nearly 20 percent. But in the past six quarters, investment has actually fallen by more than 2 percent.
3. In fact, one study indicates that the median household's net worth in 2010 was still down about 35 percent from 2007. See Dunn, Lucia, and Randall Olsen. 2010. "Housing Price Declines and Household Balance Sheets: Updated Tables." Economics Letters. vol. 107. no. 2: 161-64.
4. Households in the bottom 20 percent of the income distribution spend 44 percent of their after-tax income on food and energy.
5. In fact, in 2009, the rate of consumer price inflation declined so much that it turned negative.
6. As calculated from interest rates on bond yields and surveys of

economic forecasters.