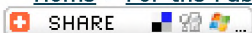


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# The Economic Outlook and the Progress of U.S. Households

## Introduction

Today, I want to talk about the state of the economy and why it is taking so long to fully recover from the recent recession. I will pay particular attention to consumers, since their spending makes up the largest share of our economy. I will conclude by outlining my views on monetary policy. As always, the views I express are mine alone and do not necessarily reflect those of my colleagues in the Federal Reserve System.

## State of the Economy

Let me begin with my assessment of current economic conditions and my outlook for the next couple of years. Since I'm here in Lexington, I could say that watching the economy recover has been like watching your favorite horse run on a sloppy track--you know she's going to turn in a poor performance, and you just hope she doesn't get injured. It is an understatement to say that we live in challenging times. The recovery from the recent financial and economic crisis has been frustratingly slow. The economy has been recovering for more than two years now, but times continue to be tough for businesses and households alike.

The United States has not experienced many serious financial crises in the past century, so there is not much in our national memory about how deep and painful the recessions that follow financial crises can be. The Great Depression of the 1930s serves as the most relevant episode in memory. The financial crisis of 2007 to 2008 had the potential to lead to another depression of that scale, so we can take some comfort in the knowledge that we avoided a repetition.

Unfortunately, we did not avoid a steep downturn and a slow recovery from the bottom. We lost almost 9 million jobs in the recession and have only gained back just over 1 million jobs in the recovery so far. The unemployment rate stands at 9 percent, and millions of people who want full-time work cannot find it. Even more troubling is that many unemployed individuals are experiencing long periods of joblessness. About 40 percent of the unemployed have been out of work for more than six months, and this statistic does not include the substantial number of individuals who have simply left the labor market. The average duration of unemployment today is about 40 weeks. This is double the previous high of 20 weeks, which occurred in 1984 following the 1982 recession.<sup>1</sup>

Some people think that the recession has impaired our labor markets and that we must accept permanently higher unemployment rates -- that is, that we have seen a rise in structural unemployment. I can

## Additional Information

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understand why employment in home building, for example, will not return to pre-recession levels for a very long time. And it is true that some skill sets of the unemployed no longer match well to those skills that employers are looking for right now. Importantly, this structural unemployment view implies that neither the actions of unemployed workers nor economic policies can be expected to reduce the unemployment rate.

However, U.S. economic history does not support this explanation. Based on research from my staff, the most important reason for our high unemployment rates is the very low level of demand for goods and services in our economy. There is a strong and steady relationship between economic growth and employment patterns going back to the 1950s. That relationship shows that our meager employment gains are entirely consistent with the weak level of growth we have seen.<sup>2</sup> In other words, these higher rates of unemployment are predominantly cyclical in nature. As such, I think unemployment can be reduced through economic policies designed to support stronger economic growth. I will have more to say on this topic later, when I discuss monetary policy.

So, the labor market will not improve until the economy grows faster. Typically our economy needs to grow at a rate of 2 percent just to accommodate new entrants to the workforce. Unfortunately, my current outlook anticipates growth that is not much better than that. I am expecting the economy to grow around 2-1/2 percent in 2012, and about 3 percent in 2013. At these rates, I expect it will take quite a few years for the unemployment rate to fall back to a more normal level of around 6 percent.

Our economy isn't growing faster because a number of headwinds are holding back growth. The government sector has been reducing spending and employment. Housing markets continue to be depressed. Add to the mix that Europe could well be headed for recession, which will negatively affect exports.

Uncertainty also plays a key role in holding back growth. I spend a lot of time talking with business leaders. Almost without exception, they tell me that uncertainty is making them more cautious. There are uncertainties regarding the resolution of federal, state, and local budget problems, which will translate into tax and spending issues. Then there are also regulatory uncertainties: healthcare, environmental, and financial reform, to name just a few.

Uncertainty is clearly an important factor, but businesses leaders tell me that weak demand is the primary reason they are not hiring new workers or expanding their businesses. Consumer spending on goods and services has accounted for about 70 percent of the nation's GDP during the past few years. Consequently, the spending pattern of households is critical to overall economic performance. So let me turn to the condition of U.S. households.

## Consumers Are Rebuilding Their Balance Sheets

To fully understand consumer behavior since the financial crisis and recession, we need to first consider how household borrowing and spending have changed over the past decade. Economic growth in the past decade was boosted by households taking on more debt; coping with that debt is holding back growth today.

The growth of household borrowing has been a longstanding trend going back to the 1950s. From 1952 to 2003, households' debt grew about 2 percent faster than households' incomes. But starting in 2003 this trend accelerated, with households' debt growing nearly 5



percent faster than their incomes. All together, household debt rose from 35 percent of household income in 1952 to over 130 percent in 2007.<sup>3</sup>

In large part, households felt comfortable taking on more debt because their household net worth had increased dramatically. Generally speaking, the stock market had performed well, home prices had gone up, and living standards had risen. What's more, everyone expected these trends to continue well into the future. Confidence reached new heights just before the financial crisis. Household debt surged from 2003 to 2007, and 85 percent of the jump came from home mortgages. The increase in the use of home equity lines of credit enabled people to pull some of the newly created equity out of their homes and use it to purchase additional goods and services. We also saw higher growth in credit card debt, car loans, and other consumer debt.<sup>4</sup>

Now that housing prices have collapsed, millions of homeowners owe more on their homes than their homes are worth. In response to their loss in wealth and large debts, households are rebuilding their balance sheets by paying down their debt and saving more.

There is no hard-and-fast rule as to the level of debt that is appropriate. It depends on many factors, the most important one being how much you expect your income to grow. For example, young households whose wages are likely to rise more quickly are typically willing and able to borrow more.

Today, households are not expecting much income growth. According to the University of Michigan's consumer sentiment survey, for the first time in the survey's history, the median household is expecting no income growth. Before the financial crisis, households had reported that they expected their incomes to grow around 2 to 3 percent per year.

This expectation that incomes will not grow is leading consumers to feel concerned about their financial positions. According to the Ohio State University's Consumer Finance Monthly survey, before the recession hit, almost half of the households surveyed felt better about their finances than they did in the year prior. In 2010, only about a quarter of households felt better than they did in 2009, which was a terrible year for the U.S. economy. What is striking is that regardless of their income, more households reported that their financial situation had deteriorated.

With expectations that incomes are not going to grow and with weaker financial positions, we have seen unprecedented declines in household borrowing levels. Home mortgage credit outstanding is 7 percent less than it was in 2008. Outstanding credit card debt is down by more than 5 percent, and new borrowing on credit cards has declined by far more. In fact, overall consumer borrowing has been declining even as the economy has been gradually recovering. This is quite exceptional because the amount of borrowing itself has never declined on a year-over-year basis since the 1950s, when we started to track this data.<sup>5</sup>

The decline in borrowing has begun to make a dent in the total amount of debt that households owe, which is a positive development for their longer-term financial health. The level of total household debt has declined somewhat during the past few years, from 130 to 114 percent. Part of this reduction can be attributed to the rise in foreclosures and bankruptcies, but there is also strong evidence that many households have consciously made the decision to reduce their debt levels.

The number of lines of credit, outstanding balances, and inquiries for

new credit are all lower. My staff confirmed that this trend was true for not just those individuals with credit problems, but also for individuals with high credit scores--exactly the customers to whom banks would be happy to extend credit.<sup>6</sup>

Low interest rates are helping many households whether or not they are not actually reducing the total amount of debt they owe, by lowering their interest payments. In fact, the debt service ratio,<sup>7</sup> which is essentially the monthly payments that households are making on their debt relative to their income, has declined even more sharply than the total amount of household debt outstanding. It is now back to its 1990s level. The net result is that many households have an increasing amount of money left over after paying their creditors--extra cash available for spending, saving, or investing.

With their debt service expenses down so sharply, households could return to more typical rates of borrowing and spending. In a typical recovery, consumer spending would be expanding at rates of at least 3 to 4 percent. But consumers appear to be taking their financial conditions quite seriously, and they are focused on debt repayment and saving. In this recovery period, consumer spending has been growing closer to 2 percent, slightly slower than the economy's overall rate of growth. My analysis of the situation leads me to expect that today's historically low rate of consumer spending will continue for awhile. Given the considerable importance of consumer spending in our economy--recall that its share is about 70 percent--you can see why I expect growth for the overall economy to remain at a moderate rate.

## Monetary Policy

Let me take us down the home stretch and share my views on monetary policy. Laws governing the Federal Reserve require us to promote low inflation and low unemployment over time. These objectives are more formally referred to as our dual mandate for price stability and maximum employment. During the financial crisis, the Federal Reserve took unprecedented steps to avoid another Great Depression, and we have continued to act aggressively to promote economic growth while maintaining price stability.

Our highly accommodative policy is designed to help lower interest rates for consumers and businesses to encourage new borrowing, to help facilitate the refinancing of loans, and to reduce the interest costs associated with variable-rate loans. It is an important reason why mortgage rates are near historic lows. These and other interest rates, which are far lower than typical, have played a critical role in lowering consumer debt service levels. Our policy is appropriate in this economic environment; it is supporting a stronger recovery while ensuring that inflation remains consistent with our mandate.

Monetary policy is well suited for controlling the average inflation rate over the medium to longer run. Inflation has averaged about 2 percent over the last three years, right in line with my definition of price stability. My inflation outlook is for inflation to remain around 2 percent for the next few years as well. Two key factors support that view: labor costs have been moderate and productivity growth has been solid.

While inflation has been running slightly above 3 percent this year as a result of higher commodity and energy prices, inflation was well below 2 percent the prior two years. I expect this year's higher inflation rate to be temporary, and in fact, I am already seeing signs that energy and other commodity price pressures are abating. I'm not the only one with this view. The inflation expectations of financial market participants, who stand to lose real money, remain at or



below 2 percent well into the future.

In contrast with inflation, trends in employment over the medium and longer term are not predominantly a monetary phenomenon. They are subject to other forces, including demographics, productivity, and technology. As I've already mentioned, unemployment remains stubbornly high. I think it could take a quite a few years for the unemployment rate to fall to the neighborhood of 6 percent, which corresponds with my current estimate of what we will see when the economy attains a state of maximum sustainable employment growth. It would be great if we could attain this outcome sooner, but I don't expect overall economic growth to be strong enough to pull the unemployment rate down faster for the reasons I have already explained.

## Conclusion

In closing, it should be clear from my remarks that policymakers, including those of us at the Federal Reserve, are dealing with an economy that is struggling to recover from a recession that was far from ordinary. We have suffered severe losses in wealth, output, and jobs. Households have been stressed and are doing what they can to improve their balance sheets by paying down debt and saving more. While this is a positive development in the long run, it does restrain growth in the short run.

Monetary policy must do its part, and has been doing its part, to spur the pace of growth while staying consistent with our mandate for price stability. But in this economy, monetary policy alone cannot cure all of the economy's ills. Federal Reserve actions to lower interest rates are supporting the recovery, but the usual impact of our policies has been somewhat blunted. Lower interest rates have benefited many households, but the financial crisis was so large and so pervasive that far fewer households than usual have been able to take advantage of the lower interest rates.

Beyond monetary policy, our economy would benefit from policies that help distressed households and from policies that give businesses greater clarity about taxes and regulations.

I'm confident that by working together we can get our economy back on track.

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1. Data from Bureau of Labor Statistics, Household and Establishment Employment Surveys.
  2. Murat Tasci, "[This Time May Not Be That Different: Labor Markets, the Great Recession and the \(Not So Great\) Recovery.](#)" Economic Commentary, Federal Reserve Bank of Cleveland, September 2011.
  3. Ratio calculated using outstanding household debt from the Federal Reserve Board's Flow of Funds over disposable personal income from the Bureau of Economic Analysis.
  4. Data from Federal Reserve Board, Flow of Funds.
  5. Data from Federal Reserve Board, Flow of Funds.
  6. Data from Federal Reserve Bank of New York, Consumer Credit Panel, and Equifax.
  7. Data from Federal Reserve Board.

