

The Current State of the Economy and a Look to the Future

***(With Reference to William ‘Sidestroke’ Miles, W. Somerset
Maugham, Don Ameche and Kenneth Arrow)***

Remarks before the Austin Headliners Club



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The views expressed are my own and do not necessarily reflect official positions of the Federal Reserve System.

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Thank you, Tom [Granger], for that kind introduction.

Coming in from the airport, I again saw that fabled bumper sticker calling on local voters to “Keep Austin Weird.” It reminded me of the old saw that Washington is 10 square miles surrounded by reality.

Austin might be justly proud to consider itself 272 square miles surrounded by normality. But I know better. When I made my hapless run for the U.S. Senate in 1994, I managed to visit every nook and cranny of this state. I know from personal experience that, thankfully, there is nothing normal about Texas.

Take my wife’s family, for example. Her great-great grandfather was William Miles. He hailed from Nip ’n Tuck, a little town near what is now Longview in East Texas. He served gallantly in the Mexican Wars and then, after a substantial interlude, joined the 14th Regiment of the Texas Unmounted Cavalry—they had no horses but they were proud Texans and called themselves “cavalry” nonetheless—and went off to fight for the Confederacy. He had his arm shot off in battle, was discharged and sent home. To get back, he swam across the Mississippi—no small feat for a one-armed man. He is memorialized by the nickname “Sidestroke” in the family annals. Old “Sidestroke” then walked back to Nip ’n Tuck to become a dirt farmer.

He arrived home broke; he could not immediately afford a mule, so until he could, he hitched a plow to his six daughters—there was a seventh but she got smart, married a Yankee and was promptly disowned. William Miles never spent a dime; he saved every penny he earned and prospered handsomely. He died in 1910. His will instructed his executor to auction off all he had accumulated—his house, his equipment, the works—so his net worth could be calculated in hard currency.

All this is captured on his tombstone in the Gum Springs graveyard near Longview. His stone records the dates of his and his wife Nancy’s births and deaths, and the dates of his service in both the Army of the U.S.A. and the Army of Jefferson Davis. On the back of the stone, for all the world to see, are carved the words “Value of my estate \$44,378.34.” That’s nearly \$1 million in today’s dollars. That’s the good news. He died a rich man. The bad news is that his will required his daughters to buy everything back that was sold in his estate sale.

You cannot tell me that Austin has a corner on the market for being “weird.”

Interesting as all of that is, I know you didn’t ask me to return tonight to regale you with the legends and lore of my wife’s family. You asked me here to provide insight into something even more resilient and more “weird” than William “Sidestroke” Miles—our economy. So let’s get down to business.

As you all know, the Federal Reserve's principal monetary policymaking group, the Federal Open Market Committee (FOMC), met last Tuesday and Wednesday. Our statement—released like clockwork at the conclusion of every FOMC meeting precisely at 1:15 p.m. Central time—summed up our collective wisdom: With a host of caveats, we noted that activity in the American economy has continued to pick up and appears to be on the mend. Despite this progress, however, we remain vigilant.

Let me explain why.

Just this spring, economic conditions were drastically different than they are today. We were engaged in battle against an attack that ravaged our economy on four fronts. First: a collapse in home building, the worst we'd seen since the Great Depression. Second: a reversal of wealth—the worst decline in real or nominal terms that we can find in data that begin in 1952. Third: a financial panic, complete with extreme risk aversion and a credit contraction in securities and direct credit markets. And last but not least: a bank credit crunch.

A severe contraction had taken root beginning in the fall of 2008, and the Federal Reserve, as the monetary authority of the United States, was duty-bound to do everything within its power to mitigate the damage. Our task was no less than to drag the global economy abruptly and forcefully from the edge of the abyss.

I believe we will be judged by history as having done so. Time will tell, of course. But this much I know: The policy actions taken by the Federal Reserve, combined with the inherent resiliency of the American economy, have helped us reverse the onslaught on three of those four fronts. Despite deterioration in nonresidential construction, the housing sector appears to be stabilizing. With regard to wealth, after plunging 24 percent in inflation-adjusted terms from mid 2007 through the first quarter of this year, net worth across all American households rose slightly in the second quarter and will likely be found to have risen in the third. And, after surging to incredibly high levels, interest rate spreads have returned to near-normalcy in the commercial paper and mortgage markets and are returning to Earth in the bond market.

Efforts to free up bank credit have helped slow the pace at which banks have tightened their credit standards. The latest reports we have received from bank lending officers, released just yesterday, confirm this. However, with the lagging effects of loan quality problems, difficulties in the commercial real estate market and uncertainty over regulatory reform, a full resuscitation of bank credit has yet to take place and will take considerable time.

The progress we've made on each of these fronts is most certainly a welcome relief, but questions remain. Where are we headed, and when will we get there?

As we closed out the summer, I pointed out in an interview with the *Dallas Morning News* that there were good reasons to expect fairly strong output growth—what an economist would call “above trend growth”—in the second half of this year.¹ The reason? I like to call it the “Johnny Mercer effect,” after the great Hollywood lyricist of the 1940s: Growth follows almost automatically if you “ac-cen-chu-ate the positive and e-lim-i-nate the negative.”²

¹ “Recession Over, Dallas Fed Chief Says, But Jobs Lag,” by Brendan Case, *Dallas Morning News*, Aug. 26, 2009.

² “Ac-Cent-Tchu-Ate the Positive,” lyrics by Johnny Mercer and music by Harold Arlen, 1944.

That's essentially what we saw in the third quarter. Fixed investment flattened out and ceased to be a drag on the economy, eliminating an important negative from the GDP calculus. Consumer spending, which was neutral in the first half, became a strong positive. And exports and inventory investment did a 180, flipping from sources of weakness to sources of strength.³

Now, I've often thought that economic forecasters seem to be cursed—or maybe blessed, I suppose, dependent upon your point-of-view—with a short-term memory: They tend to extrapolate only the most recent trends into the future. As if goosed by the more optimistic tone of the latest GDP release, many now believe that solid output growth will extend into the first half of next year. The latest Blue Chip survey, for example, shows that professional forecasters expect GDP growth averaging 2.8 percent in the first half of 2010.

I am wary of the consensus view. For a good while now, I've suggested that we are more likely to see a more uneven recovery—not a “V”-shaped recovery but something more akin to a check mark, where the elongated arm of that check mark inclines at a slope that is less than desirable and might possibly be repressed by an occasional pause or several quarters of weak growth.

Why a check mark?

Several recent sources of strength are likely to wane as we head into next year. Cash-for-clunkers and the first-time-homebuyer tax credit have both shifted demand forward, increasing sales today at the expense of sales tomorrow. Neither of these programs can be repeated with any real hope of achieving anywhere near the same effect: The more demand you steal from the future, the less future demand there is for you to steal. The general tax cuts and government spending increases included in this year's fiscal stimulus package won't have their peak impact on the *level* of GDP until sometime in 2010, but their peak impact on the *growth* of GDP has come and gone; the fiscal stimulus continues to drive GDP upward, compared with what it would otherwise have been, but the increments to GDP are beginning to shrink. And, as we all know, the shot in the arm that our economy is receiving from inventory adjustments is, while welcome, inherently transitory.

What about growth in the longer term—the second half of 2010 and beyond? American households have finally come to realize that they've been playing the part of the grasshopper in Aesop's fable: They see that our previous spending boom was financed by somewhat reckless disregard for tomorrow by over-eager creditors feeding their desire for unsustainable leveraging of their income and balance sheets and, for the nation as a whole, by increases in overseas borrowing. That reality has been largely absorbed, and consumer spending is growing again—albeit from a lower base and at a slower pace. I doubt it will recover its previous vigor for some time to come. I expect that the strong bounce-back in consumer demand that we've come to expect in recoveries past will be absent this time around as Americans recalibrate the proportion of their income and wealth that they need to save versus what they need to consume. We need

³ Exports did contribute almost 1.5 percentage points to growth in the third quarter, reversing a recent string of four consecutive negative contributions—but net exports remained a drag.

not become a nation as parsimonious as William Miles, but we are going to have to be more ant-than grasshopper-like in our behavior.⁴

With a likely subpar showing from household spending, one other candidate as a source of growth is government spending. We should be hesitant to become overly dependent on it. As consumer credit conditions gradually improve, any boost the economy gets from growth in government purchases will increasingly be offset by reductions in household spending—people will save to meet a higher prospective tax burden.

Unfortunately, this prospect of an uneven and comparatively weak recovery—in combination with excess capacity and uncertainty about the impact of new government initiatives and regulation—is taking its toll on business confidence. Firms are hesitant to add plant and equipment. In my surveys of corporate CEOs with significant capex wherewithal—a personal survey I conduct religiously before every FOMC meeting—it appears that those who are beginning to budget expanding plant and equipment are less inclined to do so here at home and more interested in doing so abroad in areas they consider to have greater risk-adjusted profit potential.

Most painfully, they remain hesitant to add labor. I'm sure you all saw the headlines last Friday—despite a continuing decline in payroll losses and initial unemployment claims, the jobless rate in this country has officially reached a 26-year high of 10.2 percent, not counting those who have given up looking for work. Far fewer of you likely saw the latest numbers on labor productivity: According to the Bureau of Labor Statistics release last week, nonfarm labor productivity increased at an annualized rate of 9.5 percent in the third quarter. That is the highest quarterly increase we've seen in six years.

What does this tell us? After a prolonged period of payroll growth, firms are using this downturn to reorganize and retool. To control costs and preserve margins that can cushion the top line, employers are learning to do more with less. They are squeezing all the productivity they can from their employees. You can get a snapshot of this in the recent round of earnings releases by the 453 of the S&P 500 companies that have reported third quarter performance thus far: Earnings for these companies were down 10 percent year-over-year. But top-line growth—total revenue growth—was down 14 percent. As long as this condition obtains, companies can hardly be expected to add to payrolls.

This is not surprising if you think about it. Before the crisis, we had a long period of economic expansion and easy access to money. Historically, the longer the expansion or period of prosperity, the more complacent businesses become. A growing economy, like sailing in a following sea and pleasant weather for days on end, weakens the discipline to run a tight ship. But once a storm strikes, captains of industry have no choice but to batten down the hatches and reef their sails. The more intense the storm, the longer it takes for the inefficiencies incurred during the previous expansions to recede from memory, even after fair weather returns. I would think that in this recovery period the willingness to rehire or expand capital expenditures will be

⁴ Of course, there are alternative versions of Aesop's fable. In 1924, W. Somerset Maugham wrote a story titled "The Ant and the Grasshopper" about two brothers: one a hard worker and a saver and the other not. In the end, the "grasshopper" brother marries a rich widow who ups and dies and leaves him a fortune. In the 1988 film *Things Change*, the character played by Don Ameche recites a version where the grasshopper eats the ant.

long in coming. Chastised by recent experience, businesses will continue to run tight ships, with all resources, including labor, being driven to maximum efficiency.

It may be some time before significant job growth occurs and even longer before we see meaningful declines in the unemployment rate.

So we have a mixed picture for economic growth down the road, despite the pickup we've seen lately. What are the implications of all this for monetary policy?

With financial-market conditions normalizing—if not yet fully normal—most of the special programs that the Federal Reserve introduced last winter to backstop bank and nonbank credit have either already unwound or are rapidly doing so. For example, the special facility we put in place to revive the commercial paper market when it succumbed to paralysis last year—a facility that expanded our balance sheet by \$350 billion at its peak usage level—has fallen to under \$10 billion as the market has been restored. As to the longer-lived asset purchases we have made, now that mortgage-finance spreads have narrowed, our purchases of mortgage-backed securities (MBS) are tapering off. We expect those transactions—which will total up to \$1.25 trillion—to be executed by the end of next year's first quarter.

A legacy of MBS acquisitions is a Fed balance sheet that has more than doubled in size. This expanded balance sheet has as its counterpart a greatly elevated level of bank reserves. Banks, seeking liquidity and avoiding risk, have so far been content to let their reserves sit at the Federal Reserve, earning a modicum of interest. Ultimately, as confidence returns, these funds will be used to support an expansion in bank lending, increasing the velocity of base money in our economy. That would not necessarily be a bad thing, within limits, given all the idle resources in the economy at present. Of course, the Fed must be wary that velocity does not explode and create inflation pressures resulting from too much money chasing too few goods and services. If credit growth at some point threatens to become excessive, we have the tools to rein it in, ranging from selling the assets we have acquired so as to suck up excess money, to adjusting the rate we pay on excess reserves, to utilizing other techniques such as large-scale reverse repurchase agreements, or “repos,” to even raising the Fed funds rate.

The press and the markets are eager to know when we might undertake a tightening in policy. The answer to this question is ... “It depends.” Our mandate is to pursue the maximum level of employment consistent with long-term price stability. So, when and how rapidly we reduce our accommodative policy must depend on fine judgments about how quickly the real economy gets back on track without jeopardizing our longer-run price-stability goal. As noted in our most recent statement, the FOMC will consider a variety of economic indicators—including resource slack, inflation trends and inflation expectations—when making this decision. But for the foreseeable future, the FOMC considers policy to be appropriately calibrated to the times.

My own judgment—based partly on available estimates of slack, but also on the behavior of prices, and informed by the anecdotal input I receive monthly from business leaders as to their intentions—is that inflation is likely to remain subdued for some time, and thus our current policy is appropriate. Of course, I recognize that our measures of slack and our understanding of the determinants of inflation are uncertain. And agile business leaders can change plans on a dime. Being what some believe to be the most hawkish member of the FOMC, I am very Reagan-esque in my evaluation of inflationary potential: I trust but continually seek to verify that

inflation is not raising its ugly head. So, as I've always done, I will keep a close eye on price developments as they unfold.

Right now, I see more immediate deflationary pressures than inflationary ones. Yet I am fully aware that the law of unintended consequences is always lurking in the shadows. For instance, having spent a few years early in my banking career as a foreign exchange advisor to investors and corporations, I am particularly mindful of the risks we run by stating in FOMC statements that we expect to maintain the Fed funds rate at "exceptionally low levels" for "an extended period." This could fuel the "carry" trade, whereby speculators—assuming U.S. rates will remain unchanged over a reasonable time horizon—can borrow plentiful amounts of dollars cheaply and invest them in securities denominated in other currencies that yield more or offer greater returns, in the process driving those securities and currencies to prices beyond their equilibrium levels. Were this to become a disorderly influence, I would expect the FOMC and other authorities to craft an appropriate remedy.

Tom, here is the bottom line: The Federal Reserve has done what it can to prevent Depression 2.0 and the deflation that one would have expected might accompany economic collapse. It will take some time, in my opinion, to get back on a steady pathway to a pace of growth that will result in significant job creation. We are in for a long slog. We had a snapback in growth in the third quarter and can expect that will continue in the current quarter. But looking into 2010 and perhaps to 2011, the most likely outcome is for growth to be suboptimal, unemployment to remain a vexing problem and inflation to remain subdued.

Mind you, you should take economic forecasts—even my own—with a big grain of salt. Jamie Galbraith's dad, John Kenneth Galbraith, may have been more right than econometricians like to think when he said that "the only function of economic forecasting is to make astrology look respectable."

Nobel Prize-winning economist Kenneth Arrow has his own perspective on forecasting. During World War II, he served as a weather officer in the U.S. Army Air Corps and worked with individuals who were charged with the particularly difficult task of producing month-ahead weather forecasts. As Arrow and his team reviewed these predictions, they confirmed statistically what you and I might just as easily have guessed: The Corps' weather forecasts were no more accurate than random rolls of a die.

Understandably, the forecasters asked to be relieved of this seemingly futile duty. Arrow's recollection of his superiors' response was priceless:

"The commanding general is well aware that the forecasts are *no good*. However, he needs them for planning purposes."

Tom asked me to provide you tonight with my forecast for the economy. This evening, I have done as asked, drawing upon the models and judgment of the Federal Reserve, which are among the most complex and comprehensive in the world. But we cannot lose sight of the unfortunate fact that, despite our best efforts, no one can precisely predict the future. While we know where the economy has been and believe we understand the gearing of the economy as well as anybody can, we cannot know with certainty where it's headed. That said, I hope my musings this evening have been better than "*no good*" and are of some assistance to you for your planning purposes.

Thank you for listening. Now, in the tradition that is hallmark of Federal Reserve officials, I would be happy to avoid answering any questions you might have.