

The 2010 Outlook and the
Path Back to Stability

Thomas M. Hoenig
President
Federal Reserve Bank of Kansas City

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I am pleased to be back at the Central Exchange and appreciate once again having an opportunity to share with you my views on the economic outlook and the accompanying policy challenges that we face. When we met a year ago, conditions were bleak. The seizing-up of financial markets in the fall of 2008 turned what might have been a mild recession into a global financial crisis. In response, central banks and governments around the world dramatically lowered interest rates, directed emergency credit and liquidity to the financial system, and provided massive fiscal stimulus. Thus, by late spring of 2009, conditions began to stabilize, and, by summer, financial and economic distress had eased considerably.

Today, as we begin 2010, conditions continue to improve, and we appear to be in the early stages of economic recovery, both in the U.S and internationally. Economic growth has increased, labor market conditions have begun to stabilize, and housing shows signs of recovery. Even so, as with other recent recoveries, progress seems painfully slow and uneven. Uncertainty remains.

It is at this point, when conditions are mixed but pointing to improvement, that the questions facing central banks and governments are the most delicate. They must consider whether to scale back policy interventions, and how best to return to more normal settings, without hampering the recovery. This is no easy task. Many fear that weaning the economy off large amounts of stimulus will impede the return of self-sustaining growth and full employment. It is understandable in this environment that some prefer to focus exclusively on the immediate and wait until the recovery is clearly in full force before adjusting policy.

My view, however, is that we cannot afford to be short-sighted. We must more evenly weigh our short-run concerns against the longer-run costs. Experience, both in the U.S. and internationally, tells us that maintaining large amounts of stimulus over an extended period risks

creating conditions that lead to financial excess, economic volatility, and even higher unemployment at some point in the future.

In my remarks today, I would like to share my perspective on these economic risks and trade-offs, and the difficult decisions that lie ahead of us in 2010.

Current Conditions and the 2010 Outlook

Let me begin with a brief look at current economic conditions. As you know, last year began with a severe contraction in output and employment. In the first quarter of 2009, real GDP fell more than 6 percent and employment declined by nearly 700,000 jobs per month.

In recent months, however, we have seen clear signs of improvement, and many economists believe the recovery is underway. The U.S. economy grew at a 2.2 percent pace in the third quarter, the first increase in more than a year, and most forecasters anticipate the fourth quarter numbers will show even stronger growth. There has been improvement in both manufacturing and residential construction. Employment losses have diminished, and employment gains seem imminent. As we look forward in 2010, most economists expect GDP growth will increase at between 2.5 to 3 percent, with only modest improvement in labor markets and financial conditions.

I am more optimistic. I expect that GDP growth, at least through 2010, will exceed 3 percent. To begin, I would note that some expectations for annualized GDP growth in the fourth quarter of 2009 are now nearly 4 percent, after being revised up several times over the course of the quarter. Also, fiscal and monetary stimulus will continue to provide major support to the economy. Much of the fiscal stimulus package announced last year will have its impact in 2010, and it might well be more substantial than initially projected due to delays in implementing

spending programs. Residential construction is expected to continue to recover with the extension of the homebuyer credit program and low mortgage rates. In addition, even as the Federal Reserve begins the process of winding down its emergency credit facilities, the extreme amount of policy accommodation means that it will still be some time before monetary policy will return to a more balanced level.

The economy's self-correcting mechanisms also support recovery. For example, exports and inventories are expected to be sources of strength as foreign economies recover and manufacturers ramp up production to meet rising domestic and foreign demand.

As with other recent recoveries, a key element to the recovery in 2010 will be consumers, who have accounted for nearly 70 percent of total spending in recent years. Consumer confidence showed a rebound during the holiday season, with growth in retail sales exceeding 16 percent at an annual rate in November. Certainly, there are downside risks that could undermine consumer confidence and spending. Unemployment will likely remain elevated, and consumers must deal with lower home equity and high debt levels. However, attitudes have improved, and this should not be ignored.

I also would mention two additional elements that will affect the consumer in 2010 and represent an upside risk to the outlook. First, if the economy gains additional momentum from the various spending and stimulus programs, it will almost certainly spur a faster recovery in the labor markets. Second, if manufacturing and other business conditions continue to improve, it will encourage businesses to invest in equipment and software, strengthening aggregate demand. Either of these events would almost certainly further bolster consumer and business confidence and spending and thereby contribute to better overall economic performance in 2010. Both of these, I think, are realistic possibilities.

Those of you who have heard me speak previously, both here and elsewhere, know that I frequently point out that consumer debt levels are too high and that individuals must save more. So, how does that position align with my statements about the importance of consumer spending in the recovery and our broad economy? When I am asked this question, I think it is important to point out that for decades U.S. consumers consistently saved more than 10 percent of their incomes. However, in recent years, their savings levels have fallen dramatically, reaching rates as low as 1 percent in some years. If the U.S. is to reduce its dependence on other countries for credit and the support that its private and public investment demands, savings and consumption must return to more historical norms. But like the decline itself, the adjustment process must proceed gradually or we risk disrupting consumption to such an extent that we undermine the economy itself. The challenge is to establish the appropriate pace of change.

Policy Challenges Ahead

As I have indicated, a key contributor to the economic recovery is the extraordinary fiscal and monetary stimulus provided by governments and central banks around the world. In the U.S., we have seen the largest fiscal stimulus in history with tax cuts, spending increases, large transfers to state and local governments, and fiscal support to financial institutions. Additionally, as unemployment has risen above 10 percent, Congress has authorized further spending on enhanced jobless benefits.

While these policy actions have been instrumental in helping to stabilize the economy and financial system, they must be unwound in a deliberate fashion as conditions improve. Otherwise, we risk undermining the very economic performance we hope to achieve.

In the case of fiscal policy, the ballooning federal deficit must be controlled and reduced. If not, the federal debt will soon exceed national income. As the private sector recovers, increasing demand to finance both public and private debt will likely place upward pressure on interest rates. Eventually, there will be pressure put on the Federal Reserve to keep interest rates artificially low as a means of providing the financing. The dire consequences of such action are well documented in history: In its worst cases, it is a recipe for hyperinflation.

Addressing the deficit will be made all the more complicated by the fact that many of the stimulus programs are scheduled to wind down in 2011 at the very time the Bush administration tax cuts are also scheduled to expire. It will be an extremely abrupt shift in fiscal policy from stimulus to restraint that will cause the economy to weaken. Addressing the deficit under these types of circumstances will be controversial and desperately unpopular. For these reasons, it makes the development of a credible long-run plan to restore fiscal balance all the more critical. Moreover, if such a plan is to work, it will involve making some painful choices and important changes in the way we have operated both as a nation and as a society for some time. For the American people to accept such a transition requires equitable treatment and a sense of shared sacrifice.

In the case of monetary policy, the challenges are no less daunting. The Federal Reserve must curtail its emergency credit and financial market support programs, raise the federal funds rate target from zero back to a more normal level, probably between 3.5 and 4.5 percent, and restore its balance sheet to pre-crisis size and configuration.

The process of winding down financial support programs has already begun. Usage of these programs has declined considerably in recent months, and the Federal Reserve has announced plans to scale back and end many of these initiatives. However, normalizing

monetary policy and the Federal Reserve's balance sheet will be a far more contentious undertaking, and there are differing views regarding when this process should begin, how fast it should proceed, and what form it should take.

One view is that the Federal Reserve should delay interest rate normalization until there is more certainty that the economy and financial markets have completely recovered from this crisis. At that time, the accommodation can begin to be removed. Those who hold this view believe that high unemployment and low inflationary pressures due to excess capacity create considerable economic downside risks if the Federal Reserve removes stimulus. Their biggest fear is of the "double-dip" recession. In their minds, these immediate risks continue to outweigh concerns about long-term economic performance.

This is an appealing argument. The recovery is in its early stage, and weak data continue to emerge in some reports. State and local governments remain under severe fiscal pressures despite considerable federal assistance. Business investment spending for nonresidential construction and equipment remains weak. Additionally, those parts of the country heavily exposed to the subprime lending bust and to the auto industry remain depressed. Also, there is no denying the fact that despite improvements, labor markets and parts of our financial system remain under stress. Thus, while the economic and financial recovery is gaining traction, risks and uncertainty remain major deterrents to removing the stimulus.

Unfortunately, mixed data are a part of all recoveries. And, while there is considerable uncertainty about the outlook, the balance of evidence suggests that the recovery is gaining momentum. In these circumstances, I believe the process of returning policy to a more balanced weighing of short-run and longer-run economic and financial goals should occur sooner rather than later.

While I agree that unemployment is unacceptably high and short-term inflation risks are likely small, we must also recognize what monetary policy can and cannot do. Some of the current problems in the jobs market are cyclical and will respond to an accommodative monetary policy. However, we also have some structural issues related to the need to reallocate resources from manufacturing, construction, and finance to other parts of the economy. This will take time, and as much as we might wish it so, monetary policy is not an appropriate tool for dealing with structural unemployment problems.

As I have already said today, experience has shown that, despite good intentions, maintaining excessively low interest rates for a lengthy period runs the risk of creating new kinds of asset misallocations, more volatile and higher long-run inflation, and more unemployment — not today, perhaps, but in the medium- and longer-run.

Maintaining short-term interest rates near zero could actually impede the recovery process in financial markets. For example, with a low federal funds rate and small spread between the discount rate and rate paid on excess reserves, banks are more inclined to transact with the Federal Reserve instead of with each other. This prevents interbank markets from functioning effectively. Additionally, with short-term rates near zero, many types of money market funds have difficulty functioning because they cannot attract investors and cover expenses.

Low rates also interfere with the economy's ability to allocate resources and distort longer-term saving and investment decisions. Artificially low rates discourage saving and subsidize borrowers at the expense of savers. Over the past decade, we channeled too many resources into residential construction and financial activities. During this period, real interest rates—nominal rates adjusted for inflation—remained at negative levels for approximately 40

percent of the time. The last time this occurred was during the 1970s, preceding a time of turbulence¹. Low interest rates contributed to excesses. It would be a serious mistake to attempt to grow our way out of the current crisis by sowing the seeds for the next crisis.

Conclusion

One of the most important lessons to be learned from this crisis is the need for policy makers to properly balance short-run and long-run economic considerations. While we must be aggressive in our response to a crisis, and remain patient in the early stages of a recovery, we must also be resolute in the commitment to our longer-run mission and objectives if we are to properly fulfill our public mandate.

While I have focused my remarks today on the economic outlook and macroeconomic policy, there are certainly many other crucial lessons that need to be learned from this crisis.

For example, there are certainly important regulatory changes that are needed. In this regard, Congress needs to focus on developing firm rules that govern financial institutions. Rearranging regulatory agencies, which has found some support among policymakers, does nothing to improve the rules and standards to which financial institutions of any size must be held accountable. We must institute firm leverage ratios and basic underwriting standards. We must also limit the speculative activities that commercial banks with access to the safety net can engage in and limit investment banks' access to this same net. Institutions that operate with a clear mandate and focus, and with clear accountability for their actions, will be more competitive globally, not less.

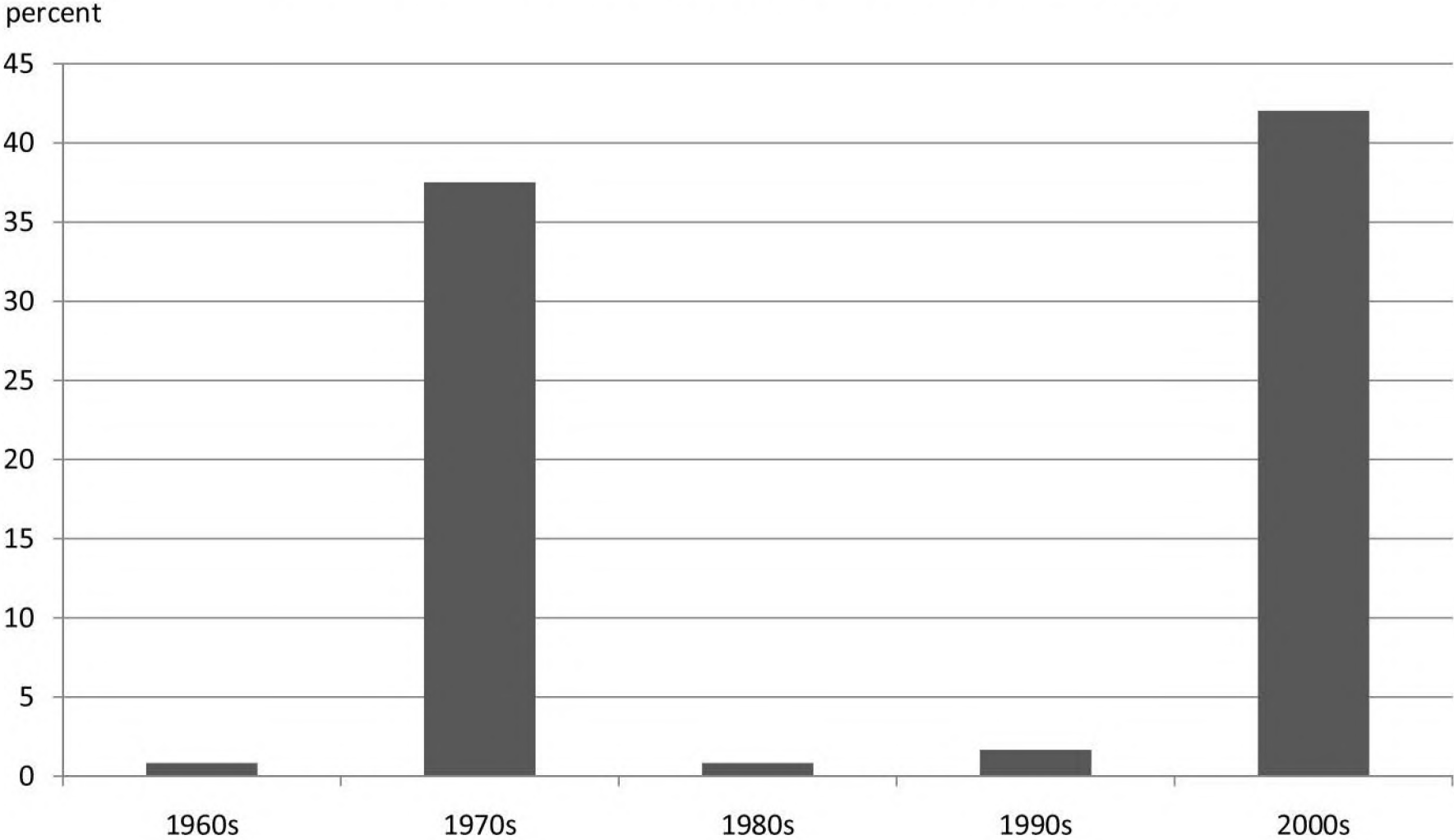
Once appropriate laws are in place, then Congress should hold any agency accountable for the quality of its regulatory oversight. If the regulations themselves are not strengthened, we

¹ See attached charts.

will have no one to blame but ourselves when the next crisis occurs. This would be a truly tragic, and unacceptable, turn of events.

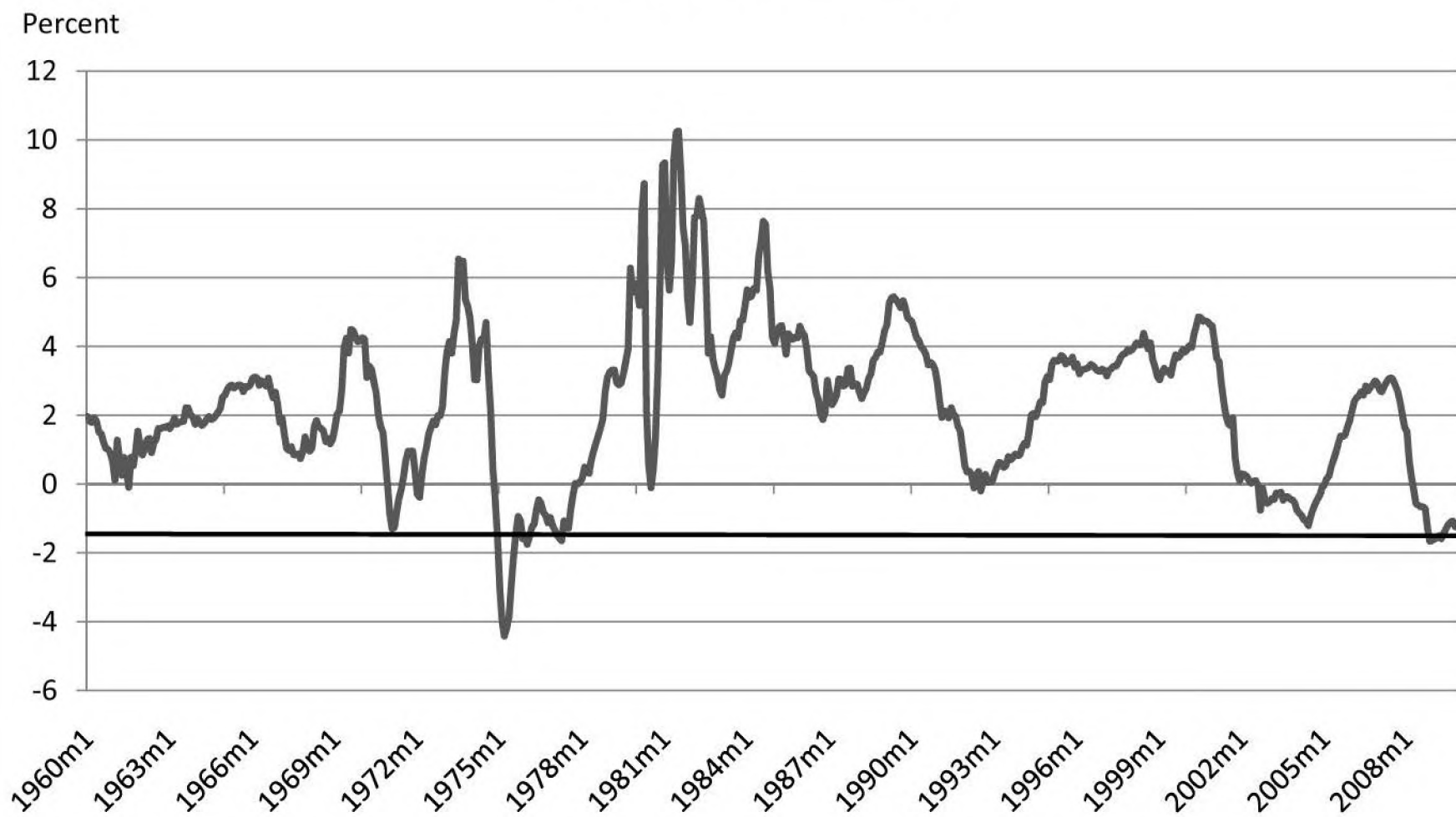
I would now be happy to take your questions.

Fraction of Time the Real Federal Funds Rate is Negative



Note: The real federal funds rate equals the nominal federal funds rate minus the core PCE inflation rate (measured from a year ago).

Real Federal Funds Rate



Source: Board of Governors of the Federal Reserve System and Bureau of Economic Analysis

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