SPEECH

A Strategy for the 2011 Economic Recovery

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Joseph S. Tracy, Executive Vice President

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Good morning. It is a pleasure to be with you this morning to look back on the tremendous events impacting the economy over the past several years, and to assess the outlook for the economy going forward. Let me note that the views that I will discuss with you are my own and not necessarily those of the Federal Reserve Bank of New York or the Federal Reserve System.

On September 20, 2010, the National Bureau of Economic Research (NBER) determined that the "Great Recession" officially ended in June 2009. The Great Recession did not earn its moniker due to its length. At 18 months, the length of the Great Recession was only slightly longer than the average of 17.5 months for the 33 recessions tracked by the NBER since 1857. In fact, the longest recession was 65 months and lasted from October 1873 to March 1879.

The Great Recession distinguished itself from earlier recessions in terms of its severity rather than its length. There was a decline in real output relative to trend of $1.1 trillion or 8 percent (Chart 1). This contraction brought the level of real output back to its level in 2006. In most recessions, consumption growth slows but remains positive. In this recession, there was an actual decline in consumption rather than just a slowdown (Chart 2). When households need to cut back on their consumption, they typically do so first with durable goods—for example, by delaying the decision to replace a car or to trade up to a nicer house. It is no surprise then that auto sales dropped significantly (Chart 3). Housing starts had been declining since late 2005, and the decline continued during the recession (Chart 4). Producers reacted quickly to the sharp decline in consumer demand, but inventories still rose sharply relative to sales (Chart 5).

In order to realign production to the declining level of demand, firms quickly cut their staffing levels, which resulted in a rapid rise in unemployment across all age groups (Chart 6). From the peak in December 2007 to the end of the recession, private non-farm payroll employment declined by 7.3 million jobs—bringing employment below its level in January 2000 (Chart 7). The severity of the Great Recession is very apparent when you realize that an entire decade's worth of job growth was lost.

Household wealth declined sharply as well during the Great Recession due to losses both in equity and real-estate wealth. The household saving rate increased in reaction to this negative shock to household wealth (Chart 8). Several factors were likely behind the higher saving rate. First, as already noted, households likely increased their saving rate to begin to rebuild their wealth. Second, given the deterioration in the labor market, households would also have a strong "precautionary demand" for saving to help buffer their consumption in the event of a job loss. Finally, homeowners might react to falling house prices by increasing their saving rate in order to rebuild the capacity to make a down payment on a future trade-up house. In more extreme cases where house price declines have put owners in a negative equity position where the value of the house is now less than the balance on the mortgage, homeowners may increase their saving rate to have the capacity to pay off their mortgage to avoid a costly foreclosure.

At the same time that the real economy was contracting there was an on-going crisis in financial markets. The balance sheets of banks and securities firms were under severe strain and liquidity was drying up. A good barometer for problems in the financial sector is the price for credit default swap (CDS) contracts for financial firms (Chart 9). These CDS prices started to rise in 2007 as news of losses for subprime mortgages began to hit markets. There was a jump in CDS prices in March 2008 when Bear Sterns was taken over by JPMorgan Chase. For a brief period over the summer of 2008, CDS prices retreated. This was more evident for securities firms and may reflect the opening of the Primary Dealer Credit Facility (PDCF) that allowed primary dealers to obtain liquidity from the Federal Reserve on a collateralized basis. Following the bankruptcy of Lehman Brothers in September 2008, these CDS prices increased dramatically.

In response to the deterioration in the economy as well as to mounting loan losses, banks tightened their lending standards and credit spreads increased. This can be seen using data from the Federal Reserve's Senior Loan Officer Opinion Survey (Chart 10). Values above zero represent tightening of standards, widening of spreads and weaker loan demand. All three were taking place as the economy entered the recession. A consequence was a sharp contraction of lending activity (Chart 11). To the extent that the decline in lending was not completely due to lower loan demand, then this credit contraction exacerbated the decline in real activity—creating what is called an adverse feedback loop between the financial and real sectors of the economy.

The Federal Open Market Committee (FOMC) reacted aggressively in response to the recession and financial crisis. The FOMC quickly lowered its policy rate—called the federal funds rate—to essentially zero (Chart 12). The aggressive pace for lowering the fed funds rate reflected lessons learned from Japan's earlier experience dealing with a housing market boom and bust. At the same time, the FOMC increased its provision of liquidity to the financial system. Initially, liquidity was added through the traditional discount window, and later through a wide range of new liquidity facilities that were developed. Up until the Lehman bankruptcy, the FOMC provided this liquidity without expanding the size of its balance sheet (Chart 13). As the crisis intensified following the Lehman bankruptcy, the FOMC significantly escalated its support for the economy. The FOMC could not provide additional support to the economy in the traditional manner by reducing the fed funds rate since the policy rate was already at zero. Instead, the FOMC initiated the Large-Scale Asset Purchase (LSAP) program. The objective was to ease financial market conditions to provide more support to the economy. Central bank purchases of assets raise the price and therefore lower the yield on these assets. These purchases crowd out some investors who shift their purchases to other assets, which lowers the yields on these assets, as well. In this way, financial market conditions are eased more generally. A consequence of the LSAP program was a rapid expansion of the central bank's balance sheet.

The combined monetary and fiscal support for the economy helped to arrest the decline in economic activity. As final sales began to stabilize, firms were able to manage down their inventories. The aggregate inventory-to-sales ratio rapidly declined to its pre-recession level (Chart 14). With their excess inventory worked off, firms needed to meet demand by increasing production. Aggregate industrial production rebounded—especially for durable goods (Chart 15). Growth was also improving abroad, which increased the demand for our exports (Chart 16). In this chart, each business cycle is contrasted with real exports normalized to a value of one at the business cycle peak, which is dated as time zero on the chart. The chart shows the relative path of real exports during the contraction and recovery for each cycle. The recovery in exports for this cycle was quicker than for the prior recession in 2001. Firms reacted to the significant challenges presented by the recession by focusing on cost cutting and improved efficiencies. These efforts led to a rise in measured labor productivity (Chart 17). With labor compensation growth declining due to the weakness in the labor market, the higher labor productivity resulted in sharp declines in the costs of producing goods—unit labor costs. The decline in unit labor costs helped firms to restore their profitability.

As demand conditions improved, firms on net began to increase their employment and hours worked by their staff (Chart 18). It is important to note that improvement in the demand for workers will not necessarily lead to a steady decline in the aggregate unemployment rate. During the recession, many unemployed workers withdrew from the labor force and stopped actively looking for employment. This can be seen by the decline in the labor force participation rate (Chart 19). While there are around 15 million unemployed workers, there are also around 9 million workers who are working part time for economic reasons (as opposed to their own choice), and around 1.3 million "discouraged" workers who want a job but who are not currently actively looking for work—and therefore are not counted as unemployed. As firms decide to increase their total hours, some of this additional labor demand will take the form of firms restoring part-time workers to full-time status—an action that does not reduce the unemployment rate. In addition, as conditions begin to improve in the labor market, discouraged workers may decide to reenter the labor force and to renew their search for a job. This reentry pushes up the measured unemployment rate until these reentrants find new employment.

As the recession ended, consumption growth returned to positive, supported by improvement in disposable income growth and a leveling off of the household saving rate (Chart 20). Household wealth began to recover as equity markets improved and the deterioration in house prices abated, supported in part by demand created by the housing tax credit programs (Chart 21). As conditions in financial markets improved, banks ceased tightening their lending standards (Chart 22). Lending activity stopped contracting, and credit became more readily available for large firms that had access to the credit markets (Chart 23).

Midway through 2010, however, questions started to arise as to whether the economy was entering a "soft-patch" or heading toward a "double-dip" recession. Real gross domestic product (GDP) growth had slowed from 5 percent in the fourth quarter of 2009, to 3.7 percent in the first quarter of 2010 and to only 1.7 percent in the second quarter. Soft patches are common in expansions, but are difficult to distinguish from a more serious deterioration in an expansion. Examples of soft patches include the expansions of 1976 and 2002 (Chart 24).

Foreign risks also appeared on the radar screen with growing concerns about debt sustainability in Greece, Ireland, Portugal and Spain. This can be seen in the sharp rise in the sovereign risk spreads for these countries (Chart 25). At the same time, core consumer price index (CPI) inflation, which is used as an indicator of where overall inflation is heading, was low and trending downward (Chart 26).

Given the FOMC's dual mandate to promote price stability and maximum sustainable growth, the risk of a double-dip recession in 2011 was a concern. In more normal times, the FOMC could respond to this risk by deciding to reduce the fed funds rate. However, with the fed funds rate essentially at zero, other options had to be considered. At their November meeting, the FOMC decided to restart its large-scale asset purchases by announcing an intention to purchase an additional $600 billion in Treasury securities. Again, as with its earlier asset purchase program, the intent was to improve financial market conditions and thereby reduce the risk of the economy stalling. Subsequent to the FOMC's decision, a compromise was reached on extending the Bush tax rates in conjunction with additional fiscal stimulus measures for 2011. The flow of economic data as 2010 came to a close on balance indicated that the economy was in fact regaining its lost momentum. Economists began to mark up their forecasts for 2011 economic growth.

This recent improvement in the economic outlook is welcomed news. We should keep in mind, though, that there is considerable uncertainty associated with every economic forecast. There are both upside and downside risks that could cause actual economic growth this year to deviate from the consensus forecast. One important downside risk to the outlook is associated with housing markets. Following the end of the homebuyer tax credits, there was a sharp drop-off in home sales. In addition, the firming of house prices noted earlier has given way to renewed house price declines in many markets (Chart 27). There still remains a significant excess supply of housing that will exert downward pressure on house prices and new construction (Chart 28). Given the very low level of new home construction, the primary driver of this excess supply of housing is the on-going foreclosure process. The foreclosure pipeline continues to grow (Chart 29). How far along are we at resolving the foreclosure problem? Total completed foreclosures including short sales and deeds-in-lieu from the beginning of 2008 until the end of the third quarter of 2010 represent around 58 percent of all foreclosure starts over that same period. In addition, in each quarter the pace of foreclosure starts has exceeded the pace of completed foreclosures. At best, then, we are only halfway through the resolution process.

To conclude where I began, the name "Great Recession" is also appropriate in that it reminds us not only of the severity of what took place, but also of the travesty that was avoided—that is, the second Great Depression. This was only possible with the aggressive monetary and fiscal policy actions that were undertaken both domestically and abroad. Much was learned in the process about how to effectively deal with a financial crisis, and much remains to be learned about how to prevent them from recurring in the future.