Five key questions are often asked about current economic and financial conditions: Has the financial crisis ended? Is the recession over? Will the economy return to full employment and normal conditions anytime soon? Is inflation going to jump too high? Does the Federal Reserve have an “exit strategy” to undo its extraordinary policy actions of the past two years? The answers, respectively, are: Mostly, Almost certainly, No, No, and Yes.

The financial crisis has eased. In particular, financial market conditions have improved, with lower liquidity and risk spreads in the interbank lending, commercial paper, and corporate debt markets. Also, although banks remain reluctant to lend, large financial institutions generally appear more secure—buttressed by the acquisition of new capital. At the same time though, prospects for many smaller banks appear bleak, with losses in the offing, especially on commercial real estate loans.

The recession that began in the fourth quarter of 2007 appears to be over. Technically, recessions are periods when broad measures of production, employment, real income, and real sales are falling. Since the summer, many measures of overall economic activity have been slowly growing, despite continued job losses. However, even if the recession is over, the level of production is very low. And the pain this produces in the form of low income, sales, and employment remains acute.

Although growth has returned, the economy will remain in a deep hole with high unemployment and underutilized productive resources for some time. So, even though the recession is over, production, income, sales, and employment will persist at subpar levels. A large amount of unemployed or underutilized labor and capital remains in the economy, and it will take a sustained period of growth for the economy to return to its normal or potential level.

It appears highly unlikely that inflation is going to jump too high. In the short run, excess supply is pushing inflation lower. Unemployment is holding down wages and labor costs, housing vacancies are holding down rents, and ample unused production capacity limits pricing power. In the long run, the Federal Reserve controls inflation. For the past thirty
years, the Fed has taken difficult actions to lower inflation. After finally achieving effective price stability, the Fed will do whatever is necessary to maintain it.

- Although the recession and the associated economic slack have already lowered core price inflation by about a percentage point, two scenarios cause some to worry about higher inflation. First, some fear that a sharp drop in the dollar could cause inflation to jump. This seems unlikely. A precipitous dollar depreciation would be associated with global financial instability, but such instability would also probably foster significant safe-haven capital flows back into dollar-denominated assets. Such safe-haven flows appear to have boosted the dollar during the 2008 financial panic, and they would similarly play a countervailing force supporting the dollar during any exchange rate disarray. Second, expansionary federal fiscal policy has also caused many to worry about inflation. (See, for example, FRBSF Economic Letter 2009-31, Disagreement about the Inflation Outlook.) The outlook for federal fiscal deficits is indeed grim—driven by an aging population and rising per capita health care costs. But higher inflation would not solve this problem, since the additional spending is essentially indexed for inflation.

- To achieve its goals of economic and financial stability, the Fed took two broad actions to ease financial conditions: It lowered short-term interest rates to near zero and it doubled the size of its balance sheet. The Fed has many options for a successful exit strategy to return monetary policy to normal. However, given current conditions and the economic outlook, such a renormalization appears to be a considerable period away. A rough benchmark for calibrating the stance of monetary policy explains the level of the funds rate in terms of inflation and unemployment. Currently, this simple rule of thumb, which has captured the broad contours of policy over the past two decades, suggests that the funds rate will be near its zero lower bound for several years. (Further discussion can be found in FRBSF Economic Letter 2009-17, The Fed's Monetary Policy Response to the Current Crisis.) The Fed likely will have more than ample time and opportunity to shrink the size of its balance sheet and raise the funds rate when economic conditions require. In particular, the Fed can shrink the amount of liquidity and monetary stimulus by taking any one or more of the following actions: selling off securities, boosting liabilities other than bank reserves (such as reverse repos or term deposits), and paying a higher interest rate on bank reserves (so banks are less willing to lend out these funds).
Industrial production has started to rise

Index of Industrial Production
Seasonally adjusted; 2002 = 100

Enormous pool of unemployed workers

Unemployment Rate
Seasonally adjusted

Real GDP is expected to grow

Real GDP
Percent change at seasonally adjusted annual rate

A large output gap will likely persist

Real GDP
Seasonally adjusted chained 2005 dollars

The recession has lowered core inflation

PCE Price Inflation
Percent change from four quarters earlier

Inflation risk from exchange rate?

Exchange Rate Indices
January 2007 = 100
1. The financial crisis and financial conditions have eased, but we still must lower future systemic risk.

2. The longest postwar recession appears over.

3. Although growth has returned, the economy will remain in a deep hole with high unemployment and underutilized resources for some time.

4. The Fed remains completely committed to preventing inflation from surging too high.

5. The Fed has many options for a successful exit strategy to return monetary policy to normal.