Economic Outlook, May 2011
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It's a pleasure to speak to you today about the outlook for the economy and economic policy. It was nearly two years ago, in the spring of 2009, that the U.S. economy hit bottom, and though our economy has recovered since then, the pace of expansion has been disappointingly slow. Unemployment remains high, and many sectors of the economy remain in the doldrums. While I don't want to minimize the extent of lingering weakness in economic activity, we should not lose sight of the fact that the economy has been expanding at a significant pace and the fundamentals for future growth are strong right now. Before we look at the economic outlook in more detail, I would like to emphasize that these remarks are my own and the views expressed are not necessarily shared by my colleagues in the Federal Reserve System.[1]

Let me set the stage by reviewing how we got here. In 2008 and through the first half of 2009, we experienced the worst recession since the Great Depression. We saw growth turn positive again in July 2009. Our best measure of overall economic activity, gross domestic product or GDP, increased at a modest 2.8 percent annual rate over the next seven quarters. Many observers have been disappointed with this modest growth, which was barely above the long-run trend rate that results from population growth and productivity growth. But at least real GDP *has* improved, and its level is now above its previous peak in the fourth quarter of 2007. Other important indicators of growth have not recovered. The number of employees on nonfarm payrolls has risen by 1.8 million persons in the last 14 months, but that increase is dwarfed by the 8.7 million jobs that were lost in the previous two years. It's fair to say that we have a way to go before we make up all of the ground lost during what many are calling the Great Recession.

The disappointing nature of this recovery can be seen in comparison to the recoveries from the other two deep recessions in the postwar period, the recessions of 1981-82 and 1974-75. In the first seven quarters after those recessions ended, real GDP growth averaged a 5.9 percent annual rate – twice as fast as the current recovery. Accompanying that output growth, job growth averaged 4.5 million persons in those two recoveries.

Two factors account for much of the sluggishness of this first stage of the recovery. The most obvious is the collapse of housing construction. We built too many houses in the boom years from 1995 to 2005. Many of those houses are now vacant and make pretty good substitutes for new construction. As a consequence, residential investment fell by 57 percent from the end of the housing boom to the end of the recession, and has fallen further in this recovery. In contrast, residential investment increased an average of 40 percent in the first year of recovery following the two recessions I mentioned earlier.

While housing is the most obvious factor dampening this recovery, residential investment accounts for only 2.2 percent of GDP at this point, down from 6.3 percent of the economy at the peak in 2005. A much larger factor is consumer spending, which accounts for over 70 percent of GDP. In the first year of this recovery, consumer expenditures increased less than 2 percent. This is in contrast to the two other recessions, where household spending grew by an average of 6-½ percent in the first year of expansion.

Thus, a key to the outlook is consumer behavior. At over two-thirds of GDP, the recovery will not be robust without sustained gains in consumer spending. And it is easy to understand why consumers were cautious at the beginning of the recovery. A large number of households experienced unemployment during the recession, and many more were uncertain about their job security. On top of that, wage growth fell during the recession. The decline in housing prices, which was unusually large in this downturn, significantly reduced the value of housing equity on the consumer balance sheet. In addition, stock prices declined sharply during the recession. Consumers responded to the drop in their net worth and current income the way they typically do, by deferring nonessential spending and rebuilding their balance sheets.

The fundamentals underlying household spending plans have improved significantly since the recession's end. Most importantly, a number of indicators make it increasingly clear that the labor market is headed in the right direction. The unemployment rate has fallen by over 1 percentage point from its peak, and employers have added an average of 232,000 jobs per month on net over the last three months. Household balances sheets are looking better as well, on the whole. The stock market has more than doubled from its recession low point, and the net worth of households has increased by $8 trillion since early 2009. And even though home prices have been fluctuating lately, they are no longer in a virtual free fall as they were in 2008. As these fundamentals have improved, so has consumer spending. Retail sales rose 5.2 percent in the first year of recovery, and in the next nine months improved at a 10 percent annualized growth rate. Because this expansion is solidly grounded in improving fundamentals, I expect robust growth in consumer spending to persist, as households see continuing improvements in job markets, incomes and wealth.

While consumers are critical to the recovery, there are other sources of strength as well. Exports of goods and services have risen nearly 20 percent since the end of the recession, adding 2.2 percent to real GDP growth. The key fundamental factor for export demand is growth abroad, and here the prospects are excellent. Although growth in the highly industrialized economies has been similar to our growth, many less developed economies are growing very rapidly. Especially notable are the two most populous countries; China's GDP grew 9.7 percent last year and India's GDP grew 8.3 percent. Such exceptional growth is driven mainly by the rapid movement of large work forces from pre-industrial sectors into enterprises that use up-to-date capital goods, a process that generates sizable productivity gains for workers making the transition. Japan's growth miracle following World War II was similarly propelled, and lasted for several decades, suggesting that the current crop of rapidly growing economies can look forward to several decades on the fast track. So I believe that export demand is likely to contribute strongly to U.S. growth for the foreseeable future.

Business expansion also should make a significant contribution to growth this year. Investment in equipment and software has grown over 25 percent since the end of the recession, despite the moderate rate of growth in demand. Opportunities to streamline business processes and reduce costs through productivity-enhancing investments appear to be widespread. And as demand growth picks up, it will provide yet further encouragement for capital spending plans. All told then, the economy has a lot going for it.

At the same time, there are still substantial challenges ahead. Housing activity remains depressed. Given the extraordinarily large inventory of vacant homes and the ongoing wave of foreclosures, home prices are likely to remain under pressure, and the best case for residential construction would be a slow, uneven advance.

Another challenge stems from the recent run up in energy prices. The world price of crude oil has risen more than 60 percent since last summer, and the economy is facing large increases in the prices of gasoline and other petroleum products. Consumer spending growth is likely to be somewhat restrained for a time, as households adjust to the bigger bite these higher prices take out of their take-home pay. I would be concerned if I expected substantial further price increases, but at this point, futures markets are pricing in modest declines in petroleum products. If the markets are right about that, the effect of energy prices on consumer spending should only be temporary. Having said that, our experience over much of the last decade demonstrates that a flat futures curve does not preclude further price hikes.

A longer-run challenge is fiscal policy. The trajectories of federal government spending and taxes have diverged, leaving us with a budget deficit that was above 10 percent of GDP last year. The amount of government debt therefore is rising more rapidly than GDP, with no relief in sight under current legislation. Of course, the national debt cannot grow faster than our ability to repay forever. That is simply not feasible and will not happen. The real question is whether our elected officials make timely adjustments to the paths of spending and taxes, or whether a crisis forces hasty decisions. The array of efforts underway, just over the Potomac, to address our fiscal challenge is encouraging. But until credible changes are made to align spending and taxes, an overhang of uncertainty will make long-term planning more difficult for households and firms.

Despite these challenges, most forecasters predict that overall economic activity will grow over the next few years at a solidly above-trend pace; emerging market growth and innovation opportunities continue to drive business demand and spending, and consumers continue to regain confidence in their future income prospects. Under that forecast, unemployment would continue to decline and income growth would improve. I would sign on to that projection, although as always, actual outcomes may lie either above or below that forecast. It also is worth emphasizing that the rate of growth may well fluctuate from quarter to quarter around that projected trend, and we should be careful not to read too much into every month's little data jiggle.

One reason that the consensus of forecasters is so positive about the national economy is that they believe that the inflation environment will remain benign. Granted, inflation has surged to more than a 4 percent rate over the last few months in response to large upswings in energy and commodity prices. But there are good reasons to believe this surge is temporary. The prices of energy futures indicate that market participants generally expect spot prices to decline gradually over time going forward. In addition, surveys and financial market prices indicate that market participants generally expect overall inflation to decline this year. So in the absence of further energy price increases, we are likely to see inflation subside to a rate closer to 1-½ percent.

We should not take that outcome for granted, however. Input price increases have squeezed profit margins for many firms, and we are increasingly hearing that some are looking for an opportunity to raise prices. If firms see robust demand growth, they will be increasingly willing to pass input price increases through to their customers. Such increases can be common in this stage of the business cycle. In late 2003 and early 2004, for example, non-food non-energy inflation ratcheted up rapidly to over 2 percent, and overall inflation averaged 3 percent over the following four years. This may not have been the worst of all possible outcomes, but I do not consider it a success. With the pace of expansion clearly picking up now, we should strive to do a better job this time of preventing an excessive rise in inflation.

The responsibility of the Federal Open Market Committee (FOMC) is to conduct monetary policy in a manner that confirms expectations that inflation will remain low over time. Next month the FOMC will complete the $600 billion asset purchase program announced last November. Barring significant unexpected developments, this should be the high-water mark for monetary stimulus in this cycle, with the focus going forward on the timing and pace of stimulus withdrawal. While timing and pace will depend upon how the economy behaves, I believe it will be important to remember the lesson of the last recovery – namely, that inflation is capable of rising even if the level of economic activity has not returned to its pre-recession trend. To prevent that, it may be necessary to initiate policy tightening well before the unemployment rate has fallen to a rate we would expect to see over the long run.

While our economy faces significant macroeconomic policy challenges, constructing a more effective regime of financial regulation may ultimately prove more difficult. In my view, the crisis we just experienced resulted largely from a mismatch between a regulatory structure designed for the explicit financial safety net (consisting mainly of deposit insurance) and the extent of moral hazard induced by a much broader implicit safety net. Given precedents dating back to Continental Illinois in the 1980's and beyond, market participants made inferences about what government protection might be forthcoming in future instances of financial distress – that is, which institutions were likely to be viewed by authorities as "too big to fail." This lack of clarity about the federal safety net grew in the decades leading up to the crisis – and came about because policymakers hoped that a policy of "constructive ambiguity" would dampen the markets' expectations of bailouts, but preserve their option to intervene if necessary. Researchers at the Federal Reserve Bank of Richmond have estimated, based on conservative assumptions, that the federal financial safety net now covers 62 percent of the financial sector, compared to about 45 percent a decade earlier.

Last year's landmark financial reform legislation – the Dodd Frank Wall Street Reform and Consumer Protection Act of 2010 – seeks to close the gap between the scope of prudential regulation and the scope of the implicit safety net. Dodd-Frank gives regulators new tools to constrain private risk-taking, and seeks to limit the implicit safety net by empowering the Federal Deposit Insurance Corporation (FDIC) to liquidate troubled nonbank firms and by placing new constraints on the Fed's lending powers. But the FDIC and the Fed retain considerable discretion to use taxpayer funds to limit losses to some creditors. This creates continued uncertainty about possible rescues, as well as gaps in our ability to provide clear, credible constraints on the safety net.

In the near term, I believe regulators have a firm grasp on the industry, and are taking strong steps to tighten risk management at regulated firms. But firms will continue to have an incentive to by-pass regulation to take on excessive risks and still enjoy some degree of implicit protection. This desire to operate just outside the perimeter of regulation, but within the implicit safety net, will present ongoing supervisory and regulatory challenges – and may make it difficult to prevent or limit the magnitude of future crises. Ambiguity about the extent of federal financial support would make such by-pass virtually inevitable. Unless we establish clear expectations about the federal financial safety net and live up to our commitment to limit government rescues, our financial system will continue to pose a significant risk to economic growth.

In conclusion, let me say that we've come through an extraordinary period in our nation's history. Despite all the challenges, there are good reasons for an affirmative view of the future, as long as policymakers follow coherent, sustainable, long-term policy plans. I look forward to working with my colleagues in the Federal Reserve to meet the unique policy challenges we face in the years ahead.

[1] I am grateful to Roy Webb for assistance in preparing this speech.