Economic Outlook, *October 2011*
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Thank you for inviting me to speak with you tonight. I will be discussing the economy — both current economic conditions and what the future might hold. Before I begin, I would like to emphasize that these remarks are my own and the views expressed are not necessarily shared by my colleagues on the Federal Open Market Committee (FOMC).[1]

My views about the economy are shaped by the ongoing analysis of national and regional data by staff in the Federal Reserve System, particularly at the Federal Reserve Bank of Richmond. But they are also influenced importantly by the wealth of information that we glean from regular contacts with businesses and consumers around our district. There is no good substitute, in my mind, for talking with economic decision makers about their particular situation and hearing their concerns for the future. Indeed, what brings my Richmond Fed colleagues and me to this region is a desire to learn more about some of the key drivers of the Eastern Shore economy. Before coming to tonight's dinner, a group of us visited various businesses involved in the poultry and seafood industries. Tomorrow, we'll learn about state-of-the-art technology that is transforming the space and defense industries. Making sense of these developments and incoming economic data would be much more difficult without the perspective derived from our contacts around the Fifth District. The Fed's ability to gather such information is greatly enhanced by the decentralized, federated structure of the System, a subject to which I will return later in my remarks.

Economic Conditions and Outlook

Current economic conditions are to a large extent still being shaped by the process of recovering from the recession of 2008 and 2009. This was the worst contraction in economic activity since the 1930s. Real GDP, our best estimate of total output in the economy, fell by more than 5 percent from the end of 2007 to the second quarter of 2009, but that figure may understate the damage. New housing starts fell by nearly 80 percent from peak to trough.[2] We lost 8.5 million jobs, causing the unemployment rate to more than double by the time it topped out at over 10 percent.[3] And household wealth fell by over $16 trillion in less than two years.[4] It's no exaggeration to call it the Great Recession.

As we emerged from the recession, many economists were cautiously optimistic. As a nation we have proven to be extraordinarily resilient at times, and we typically exit from a recession growing at a fairly rapid clip. That hasn't happened this time. Output increased by only 3 percent last year, and, in the first half of this year, growth slowed to an anemic 0.8 percent annual rate, well below the longer-run growth trend that is commonly estimated to be between 2-½ and 3 percent. Unemployment has remained stubbornly high, at 9.1 percent according to the latest reading, because job growth has been sluggish. So here we are, more than two years after the recession officially ended, having a hard time making up the ground lost during the Great Recession.

What accounts for this mediocre performance? Most obviously, housing construction is depressed. In earlier recessions housing often fell sharply but rebounded quickly and made a significant contribution to real growth during the recovery. This time, however, the housing boom that preceded the recession left us with a large oversupply of vacant homes, and these continue to weigh on many local markets, dampening new construction. Since the end of the recession, housing starts have averaged less than half the rate of the mid-1990s.

While housing has played a significant role, consumer spending has accounted for even more of the weakness of this recovery. Household spending normally contributes strongly to a recovery; while consumers cut spending during a recession, when the recession comes to an end they anticipate brighter times ahead and restore spending even if incomes are temporarily depressed. In this recovery, though, real consumer spending has grown at a pace that is fairly modest and not strong enough to generate the rapid overall growth we have seen in other recoveries.

The cautious pace of consumer spending is understandable, though. Growth in employment and real income has been sluggish, and the large decline in household net worth during the recession gave consumers ample reason to focus on paying down debt and building up savings.

While housing and consumer spending account for a good part of the sluggishness of this recovery, other sectors have done much better. Business investment in equipment and software has increased substantially since the end of the recession. Many firms apparently continue to find cost-effective ways to improve processes, increase quality and enhance efficiency through new capital outlays, despite the modest pace of overall demand growth. Exports of goods and services have also contributed positively to the recovery. Many emerging economies are experiencing sustained periods of rapid growth as their economies modernize and need durable goods embodying state-of-the-art technology. This is where the U.S. has a strong comparative advantage. So, for a balanced picture of the economy, it’s important to keep these bright spots in view.

Many analysts began this year expecting growth to pick up, even after accounting for consumer caution and housing oversupply. Pent-up demand would overcome residual caution for many households, and housing construction would return to more normal levels. Several temporary factors intervened, however. The earthquake and tsunami in Japan had severe consequences for their economy and disrupted supply chains across many global industries. And crude oil prices ramped up starting late last year, as the outlook for global demand picked up. Further increases were driven by conflicts in oil-producing states in the Middle East and North Africa. Retail gasoline prices here in the U.S. rapidly followed suit, further dampening consumer spending.

As this year has unfolded and the effects of these temporary factors have ebbed, it has become apparent that there are more persistent factors impeding growth in this recovery. While a number of candidate explanations are plausible, pinning down their quantitative contributions is quite challenging. A broad range of observers have pointed out that changes in tax and regulatory policy, both actual and anticipated, are capable of dampening output and consumption growth and limiting hiring and investment. The list of significant recent and prospective policy changes should be familiar and includes the enactment of far-reaching health care and financial reform bills in the last two years, as well as significant shifts in environmental and labor regulations. We have heard many anecdotal reports in our district of uncertainty about the direct impact of such changes discouraging firms from making new hiring or investment commitments.

The federal budget outlook is another source of uncertainty that plausibly could be dampening growth now. The federal deficit is currently almost 10 percent of GDP, and realistic projections under current policies show federal debt outpacing our national income for decades to come, with no bound on debt-to-GDP ratios. This simply is not feasible, and the experience of southern Europe demonstrates that the real world ultimately will place caps on our debt if our own government fails to do so. The list of those who would be affected by potential repairs to our broken fiscal accounts covers virtually the entire economy: from taxpayers vulnerable to higher marginal tax rates, to program beneficiaries exposed to cuts, to government employees and suppliers, to government agencies. In fact, the cloudy outlook for federal spending is having a noticeable effect on economic activity in the greater Washington area. I should note that our business contacts complain less about the effects of potential policy changes than they do about the lack of clarity about the rules of the game.

Another factor that appears to be impeding recovery is the magnitude of the mismatch between the unemployed and the needs of a growing economy. All recessions and recoveries involve shifting resources from some economic sectors to others because the composition of the expansion seldom perfectly mirrors that of the contraction. Many of the workers that exit declining industries in the downturn eventually find work in newly expanding industries in the recovery. That process can take some time and perhaps retraining, since the skills required in the expanding sectors may not line up with the skills of those released from the contracting sectors. This process of sectoral reallocation could be a more prominent feature of this recession and recovery than in the past, resulting in greater skill mismatch than in past recoveries. While various indicators, such as the historically large pool of long-term unemployed, are suggestive, the mismatch hypothesis has been hard to pin down empirically.[5]

Pulling together all of these threads, my assessment of the economic outlook is not terribly different from the conventional view. The central tendency among professional forecasters is that overall activity will continue to grow at a modest pace over the near term, somewhere between 2 and 3 percent, and I would agree. Like most forecasters, I believe the most likely scenario is for the rate of growth to gradually strengthen during the next two years. But I would not be surprised if instead growth remained fairly modest over that horizon; there is enough uncertainty in my mind regarding the current impediments to growth that I cannot rule out a less robust path.

Inflation

I may part company with some forecasters on the inflation outlook, however. Last year, inflation, as measured by the price index for personal consumption expenditure, was 1.4 percent. In my mind that’s just where it needs to be over time. This year, however, inflation has averaged 3.3 percent at an annual rate. The surge in energy prices has played an important role, and as I noted earlier that surge was temporary; indeed, crude oil prices have declined substantially since April. But inflation in other categories has risen as well this year. Core inflation has averaged 2.2 percent at an annual rate this year, compared to only 1.5 percent for last year. I agree that we have probably seen the worst monthly readings for overall inflation this year, due to the recent declines in crude oil and gasoline prices, but I doubt inflation will fall much below 2 percent for a sustained period. Moreover, experience coming out of past recessions suggests that the risks to inflation lie to the upside, so I do not believe we should relax our vigilance on inflation at this time.

Monetary Policy

I have yet to mention monetary policy, and for good reason. My reading of the evidence is that the strength of this recovery is going to be relatively independent of our monetary policy choices from here on out. The factors likely to be restraining growth — from empty houses to prospective tax rates — are nonmonetary and largely beyond the power of the central bank to offset through easier monetary conditions. History has repeatedly demonstrated that if a central bank attempts to add monetary stimulus to offset nonmonetary disturbances to growth, the result is higher inflation that can be difficult and costly to eliminate. This is why I opposed the Maturity Extension Program — popularly known as “Operation

Twist" — in which the Fed will buy long-term Treasury securities and simultaneously sell short-term Treasury securities. The effect of these operations is uncertain, but likely to be relatively small. My sense is that the main effect will be to raise inflation somewhat rather than increase growth.

At the September meeting, the FOMC also decided to reinvest principal payments from holdings of agency debt and agency mortgage-backed securities (ABMS) in agency mortgage-backed securities, rather than in Treasury securities. This means that the Fed's portfolio of agency securities will be maintained at its current size rather than reduced over time to return the Fed's balance sheet to an all-Treasury composition. I also was unwilling to support this decision. I recognize the potential value of reducing retail mortgage rates by reducing the spread between AMBS and Treasuries. But doing so will cause an offsetting increase in the rates charged to other borrowers, and it's not obvious whether the net effect on borrowing or growth will be positive or negative. More broadly, it's simply inappropriate, in my view, for a central bank to attempt to channel credit toward some economic sectors and away from others.

The Federal Reserve

Before closing, I would like to share a few thoughts about the Federal Reserve. Many observers have commented on the fact that three members dissented at the last two FOMC meetings — the first time that has happened since the early 1990s. This is, in my view, no cause for alarm. Economists can reach different conclusions, based on legitimate scientific uncertainty about the structure of the economy and current economic conditions. Reasonable economic policymakers thus can disagree, just as reasonable Supreme Court justices can disagree. In my experience as an FOMC participant since 2004, the Committee has functioned with an exceptional level of collegiality. Differences have been aired candidly and respectfully, and the give and take of our debates has strengthened the FOMC's collective understanding.

The fact that diverse and independent views are brought to bear on important policy questions is attributable in part to the unique federated structure of the Federal Reserve System. When the Fed was founded in 1913, Congress deliberately rejected the monolithic model of the European central banks of the time. By chartering 12 distinct banks, each with a board of directors that appoints their Reserve Bank president (subject to approval by the Board of Governors), they deliberately sought to insulate policymaking from election-induced swings that can distort decision-making by diminishing the focus on long-run considerations. And while the Reserve Bank presidents are subject to oversight from both their own boards of directors and the Board of Governors in Washington, their distinct policy views are informed by both regional economic information and the independent research of Reserve Bank economists. This is why legislation that aims at stifling dissent by removing the presidents from the FOMC would be so harmful. By limiting the diversity of independent views around the table, such measures would undermine the historic strength of the System.

While the governance structure of the Federal Reserve is somewhat unique within the array of U.S. government entities, at the same time the Fed is highly transparent and strongly accountable to the American people. Through the semi-annual Monetary Policy Report to Congress, as well as testimony and speeches, Federal Reserve officials discuss and assess macroeconomic conditions and provide the public with the opportunity to scrutinize the results of past policy actions. And in case you were wondering whether the Fed gets audited, the answer is "yes." We publish externally-audited financial statements and are regularly audited by the Government Accountability Office.[6]

Conclusion

In closing, I want to leave you with one final thought about the economic outlook. I recognize that the prospect of continued modest growth over the near term may be uninspiring, particularly to the extent that unemployment is likely to remain elevated. But at the same time, the modest rate of growth in aggregate economic measures masks the very significant economic dynamics that are going on at ground level. Opportunities continue to arise for individual firms to innovate and grow and for individuals to expand their talents. These are the dynamics that in the past have ultimately restored long-term growth after economic disruptions. I remain confident that these same creative forces will do so once again.

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[1] I am grateful to Roy Webb, John Weinberg and Laura Fortunato for their assistance in preparing this speech.

[2] Housing starts peaked in January 2006 and reached a low point in March 2009.

[3] Payroll employment reached its low point in February 2010.

[4] Household net worth fell by about 25 percent, from over $65 trillion to less than $50 trillion.

[5] Andreas Hornstein and Thomas A. Lubik, "The Rise in Long Term-Unemployment: Potential Causes and Implications," Federal Reserve Bank of Richmond 2010 Annual Report.

[6] Finding out more about these audits is easy. Just go to www.federalreserve.gov and click on the button in the upper right corner that says "Does the Fed get audited?" There you will find links to a trove of information and data.