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The Economic Outlook: Moving Forward on a Bumpy Road

Thanks very much for coming today. The topic of my talk is the economic outlook. My remarks represent my own views and not necessarily those of my Federal Reserve colleagues. Recent economic data have been disappointing and there's no denying that the economy has hit a bit of a rough patch. Still, I believe that the recovery that has been in train for about a year is still on course, albeit at a more subdued pace. We economists keep a list of words we use to describe economic growth. It's very carefully calibrated from "torrid" at one end to "freefall" at the other. Unfortunately, after a period when it looked like the recovery was building up a head of steam, we lost some of that momentum this spring. We've been moving down that list of words from "rapid" for a brief time late last year to "moderate." And now we are getting close to merely "modest." The silver lining is that we're still better than "meager" and "anemic." And, thankfully, we are still several notches above "double dip recession."

As I just mentioned, recent data have been less than stellar. The upward trend in spending and consumer confidence that had appeared to be steadily building has dissipated. Consumer spending had grown smartly—another word on our list—through the spring. But, it appears that this surge was just a short-lived bounce from the very steep spending plunge that occurred in the wake of the financial crisis. In May and June, retail sales fell. Consumer confidence had likewise been on the mend. But bad news about the fiscal crisis in Europe, the volatility in the stock market, and continued weakness in housing and employment have taken their toll.

Auto sales are a telling barometer of households' reluctance to open their pocketbooks. Sales of motor vehicles have plateaued at about an 11.3-million-vehicle annual rate. That's well up from the trough of about 9 million seen in early 2009, but about 30 percent below the over 16 million we saw the previous decade. Perhaps not surprisingly, with unemployment and debt levels still high, ordinary Americans are weighed down by worries about the future. The old car in the garage is still going, the old washer still gets the clothes clean, so they're putting off big-ticket purchases and limiting spending mainly to essentials.

Housing, of course, was one of the main causes of our problems. So it was very encouraging many months ago when housing started showing signs of coming back. Sales volume picked up, home prices stabilized, and the mood of panic abated. More recently, though, housing has slipped back into the doldrums. The tax credit for first-time homebuyers provided a shot in the arm. But now that that program is winding down, sales have slid back to very low levels. Not many houses are selling, despite rock-bottom interest rates, very favorable home affordability, and improvements in the availability of credit. Given this weak demand, new construction is nearly dormant. So the harsh reality is this: In the aftermath of the worst housing

bust in over 70 years, it may take a long time before buyers will be able to get out of their heads the old rock-and-roll refrain “we won’t get fooled again.”

For commercial real estate, the situation is even worse. The weak economy has driven vacancies up. Nationally, the price of commercial real estate has fallen about 40 percent, greater than the decline in home prices of about 30 percent.

One of the things that brought us back to growth was fiscal stimulus from the federal government, which trimmed taxes and increased spending. That stimulus will play a smaller role going forward. On top of that, state and local government budgets across the country are under immense strain. Spending by these government units accounts for about 12 percent of the economy, and spending cuts and tax increases at these levels mean that this sector won’t contribute to economic recovery for some time.

Now, the ability of economists to forecast the economy is often compared—usually unfavorably—to the ability of meteorologists to forecast the weather. In our defense, economic forecasting faces hurdles meteorologists don’t have to deal with. As the Nobel prize-winning physicist Murray Gell-Mann quipped: “Think how hard physics would be if particles could think.” Well, in our field, the “particles”—men and women who work, shop, run businesses, and invest—do think, though admittedly not always coolly and calmly. And, in this sense, perception can matter as much as hard numbers.

Households, businesses, and investors have endured painful economic and financial trauma over the past few years. It will take considerable time for confidence and trust to heal. We know from past experience here and around the world that recoveries from financial crises take a lot longer than recoveries from “usual” recessions. Indeed, businesspeople and consumers today are extraordinarily cautious and averse to all kinds of perceived risks, whether from the economy, financial markets, or government policies. This caution is manifesting itself in a reluctance to invest or hire unless absolutely necessary.

The fiscal crisis in Europe provides a case in point of how confidence can turn on a dime. Fortunately, European governments and the International Monetary Fund appear to have acted effectively to stop the crisis from spreading. Therefore, I expect confidence to slowly rebuild after the recent stumbles.

Of course, eventually, housing, commercial real estate, and other hard-hit sectors will return. After all, the population of the United States grows by over 2½ million people a year and those people need roofs over their heads. And all of those old cars and washing machines will eventually start looking pretty creaky compared with the snazzy stuff in the showrooms. We’ve already seen just this process take place in technology where both consumers and businesses have overcome their hesitation to buy the latest gear. I don’t know how much confidence it takes to buy an iPad or an iPhone, but whatever it is, millions of people obviously have it.

Although discouraging, the recent softness in the economic data looks much more like a bump in the road of what we already thought would be a gradual recovery, rather than a swerve into the ditch. Importantly, monetary policy remains highly supportive of recovery. Interest rates are extraordinarily low. And we’ve seen a marked improvement in the willingness of investors to take on reasonable risks, as measured by interest rate spreads between corporate

securities and safe Treasury securities, as well as other metrics. At the same time, even though the bank loan market hasn't fully recovered, banks are somewhat more willing to extend credit.

Our forecast at the San Francisco Fed is for GDP growth of about 2½ percent this year. We expect growth to pick up steam next year to between 3½ and 4 percent. Such a growth forecast pales compared with past recoveries from deep recessions, for the reason I noted earlier: It takes a long time to bounce back from financial crisis. Still, if the economy expands at this pace, we should see some job growth over the next year and a half.

But that growth could be lackluster. Unless the economy picks up faster than I expect, unemployment will come down with agonizing slowness. The official June unemployment rate was 9½ percent. That's about half a percentage point below its recent peak, but still terribly high. And this figure masks how bad the problems really are. If you count all the people who want jobs but have given up looking and all those who are working part time for economic reasons, this broader measure of unemployment is 16.5 percent—enormously high by historical standards.

And there's more: The share of people who have been out of a job for more than six months has skyrocketed during the recession. In the past two recessions, this figure peaked at about 23 percent. This time, it's double that—46 percent. That's right. Nearly half the people we officially count as unemployed have been out of work for more than six months. Long-term unemployment is particularly troublesome because it erodes job skills and attachment to the labor market, and places tremendous hardships on families. This rise in long-term unemployment is a measure of how deep and prolonged this recession has been, plus the fact that we really have not seen much job creation yet. As the economy improves, most of the long-term unemployed are likely to find jobs in the industries in which they previously worked. However, a significant fraction of the jobs lost in the recession may never come back. Some workers will need to shift to other expanding sectors of the economy. That process will require retraining and time, and it means the economy will take that much longer to return to its potential.

Indeed, given the outlook for only modest growth through the end of the year, I expect unemployment to end 2010 at about its current level of 9½ percent. Once growth picks up to a more robust pace, the unemployment rate should gradually decline, but only to about 8½ percent by the end of next year. I expect it will take several years before it returns to more normal levels.

I'd like to switch now to a topic that's been hotly debated in recent months—inflation. For every expert who's convinced we're in danger of an episode of runaway prices, you can find another expert just as convinced that we're due for a sustained deflation, that is, continuously falling prices. I think these outcomes are highly unlikely. I expect inflation to remain low, dipping to around 1 percent, but not get stuck in negative deflationary territory. Then inflation should move gradually back to about 2 percent as the economy fully recovers.

Let's take a moment to examine the fear of higher inflation. Much of it is based on the view that the Fed has been creating huge amounts of money in recent years to boost the economy—"printing money," if you will. Now it's true that the Fed has taken extraordinary steps to get the economy moving. The monetary base—that is, the amount of currency in the economy plus the reserves held by banks at the Fed—has jumped to about \$2 trillion from about \$830 billion two years ago. In normal times, such an increase in the money supply would be

highly inflationary because too much money would be chasing too few goods, driving prices up. But, these are not normal times. Not at all. Simply put, the vast majority of this “money” isn’t getting out into the economy and circulating. Instead, it’s just sitting collecting electronic dust. In fact, the standard measure of the money stock in use by households and businesses is called M2. It includes currency and various types of bank deposits. Despite a more-than-doubling of the monetary base, this measure has risen only 11 percent over the past two years, significant, but hardly alarming.

Wage and price data show that inflation has been trending lower, rather than higher. The consumer price index, or CPI, has risen a little over 1 percent over the past 12 months. The most recent monthly readings on CPI inflation are even lower. This very low level of inflation illustrates just how much slack there is in the economy and matches what businesspeople say: in this weak economy, they have little pricing power. You can see it at many levels. Weak demand is reducing the ability of vendors to boost prices, which is lowering cost pressures on businesses. At the same time, businesses have little ability to impose price increases on their own customers. With unemployment so high, workers are happy to have jobs and not inclined to press for raises. Over the past year, private sector employee compensation has grown only about 1½ percent. With the economy recovering slowly, I don’t see this picture changing anytime soon.

Given this widespread weakness, should we be worried about deflation instead? There is a small risk of deflation, especially if it takes longer for the economy to recover than I expect. But I view a sustained period of deflation as unlikely for a couple of reasons. First, price trends aren’t nearly as sensitive to the state of the economy as they used to be. For example, core inflation, which strips out volatile food and energy prices, was running at about an annual rate of 2.6 percent at the onset of the recession, higher than the rate of about 2 percent that most members of the Fed’s policymaking committee have said is appropriate. That inflation rate has dipped to 1.3 percent today, two-and-a-half years into arguably the worst recession since the Great Depression. In other words, despite such an awful downturn, we’re now only about as far below the desired rate as we were above it before the recession started.

One reason for the relatively muted response of inflation to the recession is expectations. The public is pretty confident that the Fed will do what it takes to eventually return to and maintain a low, positive rate of inflation. In the jargon of economists, inflation expectations are well anchored. The Fed earned this credibility over decades during which it kept inflation low and stable. We see evidence of this anchoring in survey responses of the general public and economic forecasters, as well as in the prices that financial market participants pay for securities that protect against inflation. This anchoring of expectations helps tame inflationary swings, putting both a floor on how low inflation will go and a ceiling on any potential rise.

What all of this means is that the economy is still on a recovery path, with moderate growth, and that inflation will remain very low. But we face significant risks to this outlook and need to remain vigilant. Thank you very much.