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Sailing into Headwinds: The Uncertain Outlook for the U.S. Economy

Thank you very much for coming today. This afternoon I'll be talking about the economy—where it's headed and my thoughts about why it hasn't done better. I should stress that my remarks represent my own views and not necessarily those of my Federal Reserve colleagues.

My title is "Sailing into Headwinds: The Uncertain Outlook for the U.S. Economy." You'll notice that I use the word "sailing," not "sinking." Given the very real economic disappointments we've experienced lately, it's important to keep in mind that we *are* making forward progress. Our economy continues to expand, even if the pace is slow. For those of you who are familiar with sailing, it's like beating to the windward with a very stiff breeze in our face. You don't get there fast and the voyage is rough, but eventually you do reach safe harbor.

I am confident we will find safe harbor, even if we feel a little seasick right now. Certainly we have experienced lackluster growth over the past several months and we face significant risks that could hold back the tempo of recovery. But the situation is much improved from the depths of the recession. The private sector is adding jobs and a truly terrible financial crisis is largely behind us. To keep things in perspective, think back to where we were just two years ago, when the financial system was on the brink of collapse, banks were fighting for their lives and some of Wall Street's most prominent names disappeared. We've come a long way since then. Meanwhile, Federal Reserve policies remain highly supportive of growth, our trading partners are recovering, and the confidence of businesses and consumers is gradually returning.

I won't pretend that some very serious problems aren't still with us, but I see a double dip into recession as highly unlikely. Instead, I expect the recovery to gradually gain momentum, which will fuel a slow return to health of the job market. Inflation should remain subdued and I think that both unacceptably high inflation and sustained deflation are very unlikely.

I'll talk about the economy in greater depth shortly. But first I'd like to try to demystify for you if I can the institution I work for—the Federal Reserve. You undoubtedly know that we are part of the government and that we conduct monetary policy. But, beyond that, there's much confusion about who we are, and what we do and don't do. The Fed is the nation's central bank, which means that we control the amount of money in the economy. In practice, we do this by adjusting the money supply to make the overnight interest rate that banks charge each other for loans what we want it to be. This, in turn, influences other interest rates and financial conditions more generally. And interest rates are one of the keys to how much people will spend and invest, which directly affects how fast the economy grows. All else equal, when rates are low, consumers and businesses are more willing and able to finance consumption and investment. High interest rates have the opposite effect, damping consumption and investment.

In the world of central banks, the Fed is a unique institution. When Congress created it in 1913, lawmakers wanted to make sure that it remained close to the communities it served. The Washington, D.C., Beltway didn't exist then, but you might say that Congress wanted to ensure that the Fed didn't get caught up in the inside-the-Beltway mentality. So, in addition to creating the Federal Reserve Board in Washington charged with overseeing the Federal Reserve System, it also chartered 12 regional Fed banks in cities across the country. The Reserve Banks are hybrid public-private institutions, with private-sector boards of directors. In fact, I and my colleagues at Reserve Banks are not government employees, but instead part of the private sector. Bank employees perform a variety of functions, including the supervision of banks, distribution of currency to financial institutions, and administration of the payments system. This structure allows the Fed to maintain close ties with local businesspeople and community leaders.

Monetary policy, which includes the setting of short-term interest rates and the amount and composition of the assets that the Fed holds, is set by a body called the Federal Open Market Committee, or the FOMC, which meets once every six weeks in Washington. The committee consists of all seven governors and five of the twelve reserve bank presidents, who serve on a rotating basis. The other seven presidents participate in meeting deliberations, but do not vote on policy decisions. Our president in San Francisco, Janet Yellen, was recently appointed by President Obama to be governor and vice-chair of the Federal Reserve Board under Chairman Ben Bernanke. So, pending confirmation, she'll be switching seats at FOMC meetings. All seven governors, including the chairman and vice-chairman, cast votes on monetary policy.

The Fed is unique among central banks in one other respect. Many other central banks are charged with keeping prices stable—that is, making sure that inflation stays in check and that deflation doesn't occur. The Fed too is tasked with maintaining stable prices. But Congress also assigned us the mission of promoting maximum sustainable employment. This means that the Fed is often engaged in a balancing act—trying to set interest rates at a level that encourages strong sustainable growth while keeping the inflation rate low and stable.

Finally, the Fed is independent, which means that we set monetary policy on our own, based on our analysis of the economy, and are shielded from interference from other arms of the federal government. That distinguishes us from the Treasury Department, which is part of the executive branch and is under the authority of the White House. Fed Governors are appointed by the President and confirmed by the U.S. Senate to 14-year terms. Reserve Bank presidents are picked by the Reserve Bank boards of directors subject to Board of Governors approval.

This degree of independence permits the Fed to set policy based strictly on economic considerations, not short-term political considerations. However, we are accountable in the sense that the Fed Chairman must report twice a year to Congress and Fed officials can be called before Congress to answer questions.

I should emphasize a few things the Fed doesn't do. It doesn't set taxes or make decisions on government spending, except for the costs of its own operations. Such fiscal policy actions are properly the domain of elected officials and would be inconsistent with the independence of the central bank.

I'd like to turn now to the outlook for the economy. As I hinted at the start of my talk, economic data have been disappointing for the past several months. The housing sector, which had been boosted by temporary government programs, has turned south, with both sales and construction falling sharply. Growth in consumer spending has remained modest. And, private-sector job gains have also been modest, with only about 80,000 private jobs added per month during the past three months. There are a few sectors that are doing well. Business investment in equipment and software has rebounded and the manufacturing sector continues to expand at a good clip.

The recovery is now in its second year. It appears that the recession ended in mid-2009. Even before the recent slowdown, the pace of recovery had already fallen well short of rapid recoveries from deep recessions in the past. Then, this spring, the economic ship sailed into the doldrums. Growth of real gross domestic product, or GDP, the broadest measure of the economy's total output of goods and services, slowed to a 1.6 percent annual rate in the second quarter of this year, after increasing at a 3.7 percent rate in the first quarter. The most recent data point to growth of only about 2 percent in the current quarter.

Economists like to be precise in their descriptions. In a talk a month ago I described the pace of growth as "moderate," bordering on modest. Well, since then, we've clearly moved well into modest territory. Yet, despite this loss of momentum, the recovery continues to tack forward, fighting stern headwinds. Why has the pace of economic recovery been so underwhelming? Real GDP grew about 3 percent over the past four quarters. This pales in comparison to the 7¾ percent growth seen in the first year of the recovery from the last very deep recession, the one that occurred in 1981 and 1982. It's more like the two most recent recoveries, the ones that occurred at the beginning of the 1990s and after the 2001 recession. These were far more muted, giving rise to the unhappy phrase "jobless recovery."

Some of the recent weakness is surely due to temporary factors that will end. But, others are likely to endure. Economists have identified several major factors contributing to the weak recovery. Perhaps most notable is the fact that the recession followed the worst global financial crisis since the Great Depression. Research has clearly demonstrated that economic recoveries that come in the wake of banking and financial crises tend to be slow and painful.[1] This pattern

[1] See Reinhart and Rogoff (2009) and Reinhart and Reinhart (2010) for discussions of the evidence on banking and financial crises in history.

reflects the critical role that credit plays in greasing the wheels of economic activity. Following a severe crisis, the process of rebuilding the health and confidence of borrowers and lenders alike is a long, drawn-out affair. Second, U.S. households are straining under mountains of debt accumulated during the housing boom and for years before. We had become a nation of borrowers, not savers, and we are now having to make painful adjustments. Consumers, normally reliable participants in recoveries, are standing on the sidelines. They feel compelled to repair their finances in lieu of cruising the auto showroom or shopping for 3-D TVs. Meanwhile, businesspeople have been left extraordinarily cautious and averse to all kinds of perceived risks, whether from the economy, financial markets, or government policies.

On top of that, the construction boom of the mid-2000s created an enormous overhang of houses and other structures that will take years to work off. Finally, monetary policy has reached the limit of what it can do by conventional means. The Fed's benchmark policy interest rate is already effectively at zero, the lowest it can go. The Fed can't reduce short-term interest rates any more than it already has. That constrains Fed policy and has prompted us to turn to unconventional programs to stimulate the economy, such as buying mortgage securities in order to lower long-term interest rates.

These are all reasons to expect a slower-than-normal recovery.[2] One way to think about it is to recognize that low interest rates, although helpful, can't fully offset the headwinds that we are facing. Lenders have become unusually strict in doling out loans and potential borrowers have become unusually cautious in taking on debt. In such an environment, even low rates can't

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[2] Weidner and Williams (2010) quantify the different influences that have slowed the current economic recovery relative to past experience.

convince people to buy a lot of homes and autos. Similarly, in the face of uncertainty, businesses may prefer to accumulate cash rather than borrow for expansion.

Still, as I stressed at the onset, things are not all gloomy. Although the pace of growth is frustratingly slow, the economy continues to expand. We see steady improvement in the availability of credit, which should improve conditions in the housing and auto markets. We've also seen a marked improvement in the willingness of investors to take on reasonable risks, as measured, for example, by the gap between interest rates on corporate securities and safe Treasury securities. Some of the major downside risks to the outlook have receded as well.

In particular, the very frightening European fiscal crisis that erupted this spring, although far from over, has been very well contained. European governments, the European Central Bank, and the International Monetary Fund acted quickly and effectively to stem a full-blown meltdown. Several countries have instituted aggressive actions to control their ballooning government debt and have undertaken reforms aimed at improving economic efficiency and competitiveness. These actions have so far stopped the crisis from spreading a contagion across the continent.

Our forecast at the San Francisco Fed is for real GDP growth of about 2½ percent this year. We expect growth to pick up steam next year to between 3½ and 4 percent. Unfortunately, this growth forecast implies only a very gradual decline in unemployment from its current 9.6 percent rate. I don't expect the unemployment rate to start to fall until next year. And I expect it to remain above 8 percent until sometime in 2012. It will likely take several more years for it to return to more normal levels. That is the main reason why this recovery doesn't feel a whole lot better than recession. Growth itself doesn't provide great relief if the unemployment rate stays high and so many families still are suffering.

Finally, I'd like to discuss the outlook for inflation. The measure of inflation I follow closely is the core personal consumption expenditure price index, released each month by the Commerce Department. Over the past year, it increased 1.4 percent, somewhat below the 2 percent level that most FOMC members view as consistent with price stability and about 1 percentage point below its level at the start of the recession. The fact that inflation declined after a severe recession is no surprise. In most recessions, slack in labor and goods markets reduces inflationary wage and price pressures, resulting in downward movements in inflation.

Actually, the surprise isn't that inflation has fallen. The surprise is that it's fallen so little, given the depth and duration of the recent downturn. Based on the experience of past severe recessions, I would have expected inflation to fall by twice as much as it has. What explains the muted response of inflation this time around? Economic research shows that inflation has become much less persistent in the past two decades.[3] That's a dramatic break from the wage-price spirals and escalating inflation of the 1970s. The key to this change in the behavior of inflation is that, following the Fed's successful reduction of inflation starting in 1979, people have come to expect that prices will be stable. We call that anchoring of inflation expectations. Unlike the 1970s, when people lacked confidence that the Fed would move aggressively to control rising inflation, today people expect the Fed to do its best to keep inflation low and stable. As a result, people expect that movements in inflation related to the business cycle or other influences will be temporary and not lead to permanently higher or lower inflation.

[3] See Williams (2006) and Stock and Watson (2010) for analysis and discussion of the change in inflation dynamics.

This fundamental transformation of the behavior of inflation has important implications for the inflation outlook. First, we expect inflation to dip a bit lower to about 1 percent, reflecting the continued weakness of the economy. But, with expectations well anchored, the risk of slipping into a sustained period of falling prices, or deflation, is very small.[4]

In sum, recent data have dimmed somewhat the near-term outlook for growth, but over the next year or two I expect the wind to begin to fill the economy's sails and for unemployment to fall slowly. Inflation remains subdued and the risks of sustained deflation or unacceptably high inflation appear remote. In any voyage, storms are to be expected, even terrible gales like the one we've been through. But, with any luck, the sailing will gradually become smoother as the recession recedes behind us.

[4] See Williams (2009) for a discussion of the risk of deflation and its relationship to the anchoring of inflation expectations.

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