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The Economic Outlook

Thank you very much for your invitation to speak today. I'm going to offer my thoughts about the economy—where I think it's going and what the Federal Reserve is doing to promote economic recovery and price stability. The sluggish pace of growth that we've seen over the past year or so has been deeply frustrating to all of us. Nevertheless, I have some encouraging news to report. We at the San Francisco Fed found a striking new indicator that is sending an unambiguous signal that the economy could surge next year. It comes from a field that is even more obsessed with statistics than economics is. I'm referring, of course, to baseball.

You know how excited we in the San Francisco Bay Area were about the Giants World Series win. It turns out that what was exciting for us was also good for the nation. In our research at the Fed, we found that inflation-adjusted gross domestic product—GDP, the most fundamental measure of the overall performance of the economy—grew by a phenomenal 10.2 percent average in the years immediately following a Giants Series victory. That's more than five times faster than the estimated 2 percent GDP growth rate registered in this year's third quarter. In fact, over the past 100 years or so, the slowest growth recorded after a Giants World Series win was a very robust 6 percent. I'm only sorry that we've had to wait since 1954 for this particular indicator to turn positive. And one other thing: Thanks for sending us Tim Lincecum.

Unfortunately, in my career following the economy, I've learned not to rely too much on one indicator, even one as important as the World Series. Instead, I'm going to base the rest of my remarks on more traditional and mundane tools of economic analysis, and they present a decidedly more mixed picture. I should stress that my comments represent my own views and not necessarily those of my Federal Reserve colleagues.

I'll lay out some key points regarding the economy's current performance and I'll present our forecast for the next few years. I will focus in particular on what I think is one of the most important headwinds keeping the recovery from taking off—that is the lackluster growth of consumer spending. I'll then spend a little time talking about the current low level of inflation and the remote risk of a period of Japanese-style deflation, in which wages and prices actually fall. Finally, I'll explain how the Fed is responding and describe the reasoning behind the program of Treasury securities purchases announced two weeks ago.

In trying to understand the economy's performance, the central question is why the pace of recovery is still so slow. The Business Cycle Dating Committee of the National Bureau of Economic Research, the group that calls when recessions begin and end, determined that the recession ended in June 2009. By some measures, this was the worst recession since the Great Depression. During the recession, the economy shed over 7 million jobs, inflation-adjusted GDP fell by over 4 percent, and household net worth declined by 13.7 trillion—that's trillion with a "T"—dollars.

It's now nearly a year and a half since the economy started expanding again, but, in many respects, it feels like we're still mired in recession. After an initial surge out of the starting gate, the economy lost momentum and now seems stalled at a growth rate of about 2 percent. The statement released after the Fed policy meeting November 3 described this performance as "disappointingly slow." It's below our estimate of the growth of potential output and it's well off the pace of typical recoveries after bad recessions, when growth tended to be 5 percent or better. This is not just a matter of dry statistics, either. With such a subpar recovery, job growth has proceeded at a snail's pace and the unemployment rate has been stuck at about 9.6 percent all year. Indeed, according to a September CNN/Opinion Research Corporation Poll, more than 70 percent of those surveyed thought the economy was still in recession.

That said, it's important to stress that the economy *is* recovering. Employers added over 150,000 jobs in October. Consumer spending and business investment are rising, and the manufacturing sector has been on a solid uptrend. The information technology sector has been doing quite well and Internet businesses are posting strong gains, as those of you who follow Microsoft and Amazon well know.

As we look ahead, we expect that the recovery will gradually pick up speed, although it will continue to be a long, drawn-out affair. Neither consumers nor businesses seem to be in position to power rapid growth. Meanwhile, federal fiscal stimulus is winding down, while state and local governments are cutting budgets. In other words, there's no sector of the economy—not consumers, not business, and not government—that's waiting to surge ahead and drive a strong recovery. Instead, I expect spending by consumers and businesses to gain momentum only gradually over the next few years as we put the financial crisis behind us and confidence returns.

In terms of hard numbers, I expect real GDP growth to rise from this year's 2½ percent pace to about 3½ percent next year and 4½ percent in 2012. The unemployment rate will probably still be around 9 percent at the end of 2011 and won't reach 8 percent until late in 2012. I don't expect the unemployment rate to get back to a normal level of between 5 and 6 percent for at least four more years.

This disappointing performance can be traced back to the forces that triggered the recession in the first place. The recession was the result of the most catastrophic banking and financial crisis since the Great Depression. An excess of risky lending and investing—especially in the housing market—led to the near collapse of the financial system, which sowed fear and starved the economy of credit. Research shows that when recessions are caused by financial crises, recoveries are weaker and slower.[1] That's because it takes time for the financial system to heal and for households and businesses to repair their finances, which were damaged by the crisis.

This bears directly on one of my main themes this afternoon—the tepid growth of consumer spending, which represents about 70 percent of the nation's economic activity. Recoveries are typically supported by stronger growth in consumption as households regain both the will and the wherewithal to spend. But, in the aftermath of the burst credit and housing bubbles, consumers don't have much of either of those things. They've been hit hard by a number of factors that have prompted them to tighten their purse strings.

First, the crash of housing and the stock market's retreat destroyed trillions of dollars of household wealth, as I noted. The loss of wealth causes people to save more in order to rebuild their retirement and college fund nest eggs. The first figure shows the ratio of net wealth to

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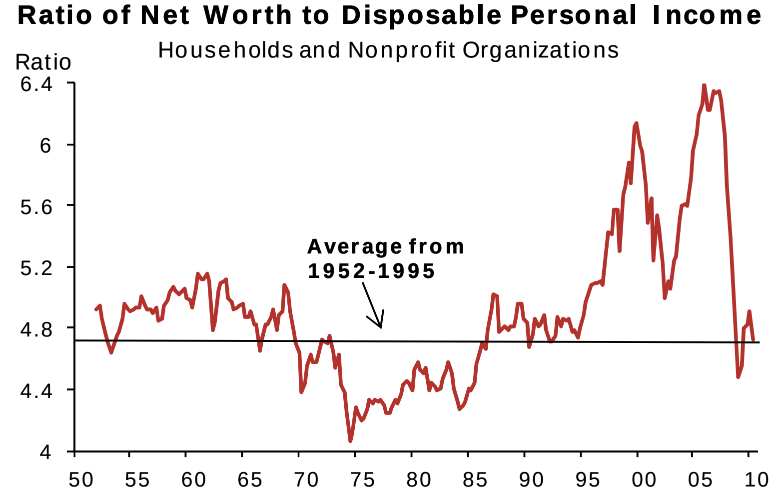
[1] See Reinhart and Rogoff (2009) and Reinhart and Reinhart (2010) for discussions of the evidence on banking and financial crises in history.

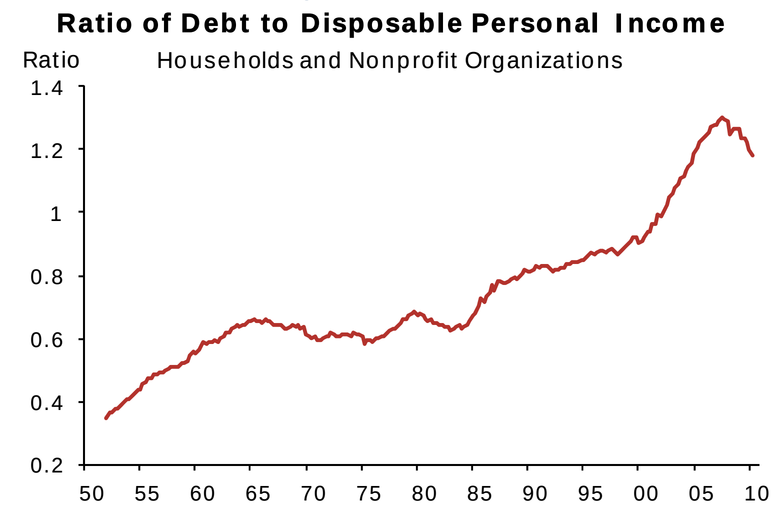
disposable personal income. At the peak of the housing bubble, it reached nearly 6.4. We're now back to a historically typical value for this ratio of about 4¾. According to standard estimates of the so-called wealth effect, which is the tendency of accumulated assets to encourage consumption, the decline in net worth since the start of the recession will reduce consumer spending by about $430 billion, or 4½ percent, relative to its pre-recession level.

Figure 1
The Bubble Decades



Second, adding insult to injury, consumer debt reached unsustainable levels during the bubble years. The second figure shows the ratio of household debt to disposable personal income. You can see a clear upward trend in this ratio over the second half of the 20th century. But, what is even more striking is the explosion during the housing boom, when households piled on debt, bringing the debt-to-income ratio to an all-time high of 1.3. Well, the party is over and we are in

Figure 2
Household Debt Hangover



the midst of a long hangover. Families are paring back spending in an effort to get out from under this mountain of debt.[2]

Third, the easy credit of a few years ago has given way to an environment in which it's tougher to get a revolving credit line, a mortgage, or other loans. Certainly it's hard to use home equity to fund consumption when the value of your home is flat or declining. The ATM called home just won't give out cash any more. Fourth, slow income growth is also limiting the ability of households to spend more.

Finally, high unemployment, stagnant wages, and a fragile economy have sapped consumer confidence and made people cautious about spending. If you're uncertain whether you'll have a job next month, you think twice about buying a house or car.

Put it all together and you have a recipe for consumer spending growth significantly below what is typically seen in recoveries. Growth in consumer spending has been running at about trend for the past few quarters. I don't see anything on the horizon that will dramatically change this picture in the near term. And the housing market is likely to remain in the doldrums for even longer.

I'd like to turn now to inflation, or, I should say, the lack of inflation. The measure of inflation we follow most closely is the core personal consumption expenditures price index. These prices have been rising at a 0.9 percent rate so far this year. This is the lowest nine-month inflation rate recorded in the over 50 years that this statistic has been compiled. Our forecast is that inflation will come in about 1 percent for the year as a whole and stay at that rate next year.

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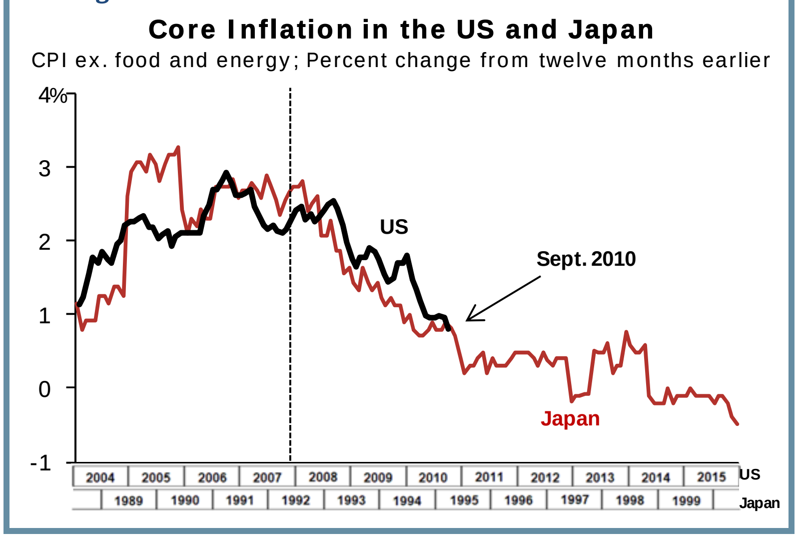
[2] See Glick and Lansing (2010) for a discussion of the accumulation of debt, housing bubbles, and subsequent declines in consumption in several countries.

That's about 1½ percentage points below where it was at the start of the recession and well below the level of around 2 percent that most Fed policymakers have said is consistent with stable prices.

It's hardly a surprise that inflation is so tame. There is a great deal of slack in the economy and workers are in no position to demand sizable wage increases. And both consumers and businesses have learned to wait for bargains before making purchases. Our retail contacts speak of a brutal sales environment in which heavy discounting has become the norm and holiday sales start around Halloween.

To me, the danger is that weak demand and excess productive capacity could cause inflation to fall further, taking us perilously close to deflation. That's what happened to Japan in the 1990s, a painful period for them characterized by slowly sinking prices and alternate bouts of slow growth and recession. I want to show you a sobering chart that overlays the recent U.S. core consumer price index inflation trend line with that from Japan's lost decade. Although there are many differences between the economies of the two countries, there are some important parallels between Japan's situation then and that of the United States today. Japan was also mired in an extended period of subpar growth. Like in the U.S.A., Japanese consumers and businesses were reluctant to spend.

Figure 3
Rising Risk of Deflation



Few of us have experienced an extended period of deflation, but it's not pretty. The *New York Times* recently ran an article about how ordinary Japanese citizens coped with deflation. It described how people stopped buying homes, cars, and other discretionary items because they could be had for a cheaper price in the future. Businesses postponed investments because the returns from holding cash were better than what they could reliably expect to earn by expanding operations. The article conveyed a pall of gloom that hung over the Japanese economy, sapping confidence and further fueling a deflationary hesitance to spend.

The good news is that I firmly believe that we can avoid a pernicious bout of deflation here. I described the similarities of our situation with Japan's, but there are also some critical differences, which makes the chances of prolonged U.S. deflation quite low. One of the most important of these concerns financial conditions. When Japan's banks found themselves with enormous portfolios of bad real estate and commercial loans, regulators allowed the banks to kick the can down the road. So-called zombie banks were incapable of lending on the scale needed to revive Japan's economy. By contrast, U.S. policymakers shut down failing institutions and forced remaining banks to recapitalize. While lending hasn't fully recovered, there's no question that U.S. financial institutions are far healthier today than Japan's were in the 1990s.

In addition, following the Fed's successful reduction of inflation starting in 1979, research shows that Americans have come to expect that inflation will be low, but positive. In economics jargon, inflation expectations are well anchored. That means that people expect the Fed to take action to keep inflation low and stable, and do everything in its power to prevent deflation. The anchoring of expectations helps us avoid the onset of a deflationary mindset that could create conditions for a downward spiral in wages and prices that would be highly damaging to the economy.

Finally, and perhaps most importantly, we're also different from Japan in monetary policy. One lesson from Japan's experience is the need to act aggressively before deflation becomes firmly entrenched. In contrast with Japan, the Fed has adopted proactive measures to head off a deflationary spiral before it can take root. This brings me to current Fed policy and, in particular, the recently announced program to purchase Treasury securities.

By way of background, it's important to understand that by law Congress has charged the Fed with two objectives: maximum employment and price stability. Currently, the Fed is falling short on both counts. Unemployment obviously is unacceptably high. And, as I've explained, inflation is somewhat below the level that is consistent over the long run with stable prices. In other words, the Fed would like to kick the recovery into a higher gear and nudge inflation up a bit, avoiding further disinflation.

The Fed's traditional policy tool is the federal funds rate, which is the overnight interest rate banks charge each other for loans. We've had our federal funds target set near zero for almost two years now and obviously that's as low as it can go. So, to provide additional stimulus to the economy, we've used unconventional policy tools, most notably beginning nearly two years ago a program to purchase up to $1.75 trillion in Treasury securities and agency mortgage-backed securities and debt. This program has helped push down mortgage and other long-term interest rates, thereby supporting the housing market and the economy overall at a time when it desperately needed a boost. The Fed's latest program involves purchases of a further $600 billion of longer-term Treasury securities, which will be carried out at a pace of about $75 billion per month. The idea is the same as before–to push medium and longer-term interest rates down further, giving added support to economic activity. So far, the responses in financial markets show that this program is working.

Like all monetary policy decisions, there are risks associated with this action. I would like to talk about the concern that we may see a return of high inflation because of the large amount of monetary stimulus. Although I take this concern very seriously, I see the risk of high inflation as remote. First, there are no signs of the kind of overheated economic activity that triggers inflation. Indeed, all measures of slack I know of show the economy is running well below its potential and inflation is trending down, not up. Second, the inflation expectations of households, investors, and economists point to low, not high, inflation in years to come. In the 1970s, the last time we saw runaway inflation, inflation expectations had clearly become unmoored. Third, the Federal Reserve has the means and, most importantly, the will to reduce monetary stimulus when appropriate. As it has for the past three decades, and as it affirmed in the November 3 policy statement, it will monitor the economy carefully and adjust the stance of monetary policy to preserve price stability.

In summary, although I wish the Giants win portended a quick acceleration of growth, I think we need to realize that the economy is digging itself out of a very deep hole and will take quite a while to get back to "normal." This disappointing performance in large part stems from the nature of the housing crash and financial crisis. Monetary policy is doing what it can to promote recovery and price stability, and I am confident that with time we will once again attain maximum sustainable employment with low stable inflation.

Thank you very much.

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