Presentation to the Greater Phoenix Chamber of Commerce
Phoenix, AZ
By John C. Williams, President and CEO, Federal Reserve Bank of San Francisco
For delivery on November 15, 2011

The Economic Outlook and Monetary Policy

Thank you. Itøs a pleasure to be with you in Phoenix this morning. I must tell you though that I am a fervent San Francisco Giants fan, and I am still smarting from the way the Diamondbacks snatched the Western Division championship from us this year. But you invited me here to speak about the economy and the Federal Reserve. So I promise Iøll stick to my assigned subject for the rest of my remarks. I should note that these remarks represent my own views and not necessarily those of others in the Federal Reserve System.

The title of my talk is õThe Economic Outlook and Monetary Policy.ö Iøll sketch for you my sense of where the economy is now, where it is going, and what the Fed is doing. As I see it, the story is one of slow recovery from an especially severe financial crisis and recession, painfully gradual progress on unemployment, and receding inflation. It is a story that calls for continued action by the Federal Reserve to support a fragile economy.

Iøm happy to say that the most recent economic data offer signs that the recovery is on slightly firmer ground than it was earlier this year. Both consumers and businesses are increasing their spending at a moderate pace. This firming can be seen in the performance of gross domestic product, or GDP, which is the total output of goods and services in the economy. It was heartening to see that, in the July-through-September quarter, inflation-adjusted GDP grew at a rate that began with a twoô 2.5 percent to be exact. That growth rate was moderate at

best and a far cry from the rapid expansion weøve often seen after recessions. But it was significantly better than the number for the first half of 2011, which began with a zero.

Yet Iøm afraid that this recent improvement doesnøt change the basic story. The recession of 2007 to 2009 ended nearly two-and-a-half years ago. But the recovery since then has been notably lackluster and seems likely to continue in that vein. In fact, for many people, the recovery hardly seems real at all. Unemployment has declined only about one percentage point from its peak, millions of homeowners have lost their homes to foreclosure, and many millions more are currently underwater.

When we look at income, things are particularly tough. Personal income fell roughly 1¾ percent in the July-through-September period after adjusting for inflation and taxes. So, if you or people you know are feeling squeezed, thereøs good reason. The fact is, even with recovery, tens of millions of people are facing real hardship in the form of lost jobs, stagnant incomes, and a harder struggle to make ends meet. One person told me recently that the fact the recession is over is immaterial because so many people are acting as if we were still in one.

The sluggishness of this recovery is distressing, but itøs not entirely unexpected. When we study economies around the world, we find that recoveries are weak when they follow recessions caused by financial crises.[1] Now, we had a whale of a financial crisis in 2008. So itøs not surprising that we have not had the sort of robust recovery that followed most other severe recessions in the post-World War II period.

[1] Reinhart and Rogoff (2009).

Iød like to look now at two factors holding back the recovery: slow growth in consumer spending and a depressed housing market. First off, and not to put too fine a point on it, consumers feel lousy. Anxiety about the economic outlook has taken a heavy toll. Surveys of consumers show pervasive gloom and confidence near record lows. One major consumer confidence index has dropped to the levels posted in the depths of the recession.

Thereøs no shortage of reasons for consumers to feel anxious. The volatility in the stock market and the uncertainty in Europe have put many on edge. A large number of households are also overloaded with debt, in part because home prices have crashed. And the lack of jobs leaves those looking for work discouraged, and even makes those who are employed feel insecure. Indeed, only about one in ten households expect their income to rise over the next six months, which is near the all-time low in the 30 years people have been asked this question. With Americans so demoralized, itøs not surprising that consumer spending has not played its usual role in kick-starting a recovery. This year, inflation-adjusted consumer spending has been growing at just under a 2 percent pace. Thatøs well below the more normal recovery pace of about 3 percent or more.[2]

The moribund housing market isnøt just a psychological blow to consumers. It is itself a major reason for the weak recovery. Past recoveries typically got a significant boost from a rebound in home construction and spending on home-related goods such as furniture, new carpeting, appliances, and the like. Not this time though. Over the past three years, the pace of construction and sales of new homes have been stuck at the lowest levels recorded since the early 1960s.

[2] See Glick and Lansing (2011) and Mian and Sufi (2011).

As of September, over 3 million existing and new single-family homes were on the block. Thatøs a big number. But to get a sense of how much of a weight is dragging down the housing market, we need to factor in what might be called a õshadow inventory.ö This consists of another 4 million or so homes either in foreclosure or whose owners are seriously delinquent on their mortgages. Many of those houses could come on the market soon.

At the same time, potential buyers arenøt buying for several reasons, even though mortgage rates are at record low levels. Millions of families are underwater on their current mortgages, making it hard for them to get out of their homes. Then too, credit is tough to get as lenders and regulators try to avoid the excesses of the boom years. Potential buyers face much higher down payment and credit requirements than before the downturn. Finally, even some of those who qualify for a mortgage may lose their nerve when they think about the steep drops in house prices in recent years.

This is a somber picture. But the housing market will eventually recover. Already, some positive trends are laying the groundwork. Home prices have dropped so much that theyøre roughly in line with historical norms. We can see that in the relationship of the cost of buying a house versus renting one. The number of seriously delinquent mortgages in danger of foreclosure has begun to ease. And the recently announced federal initiative to make it easier for underwater homeowners to refinance could trim monthly payments for some households. That could reduce foreclosure ratesô and eventually provide a modest boost to consumer spending.

As these factors fall into place, the housing marketøs long-term dynamics should kick in. The U.S. population continues to grow, which eventually will fuel housing demand. As demand

recovers, home construction will return to more normal levels. I expect that process will take several years.[3] But any pickup in construction will add momentum to the recovery.

Phoenix is all too familiar with the miseries of the housing market. Arizona has been one of the states hit hardest. Foreclosures in the state peaked at a rate about double the national average. And home prices in the Phoenix area have fallen by just over half since their 2006 peak. Thatøs a remarkable collapse, without precedent in the more than 30 years that records are available for the Phoenix area.

Fortunately, the Arizona market is doing somewhat better this year. The pace of existing home sales was up noticeably during the first half of 2011. Meanwhile, since late 2009, the foreclosure pipeline has declined by nearly half. Housing starts remain at historically depressed levels, but they ticked up in the third quarter. Iøm hopeful that we have reached bottom and can move up from here.

Iød like to turn briefly to the business side of the economy. Manufacturing has continued to grow. And, after plunging during the recession, business investment in plant and equipment has been a source of strength recently. Business investment surged in the third quarter, growing at just over a 15 percent annual pace. In addition, export growth has been relatively strong since the recession ended.

At the same time though, surveys show that credit availability remains an obstacle for many small businesses. To get financing, many business owners used to mortgage their business

---

[3] See Hedberg and Krainer (2011).

property. But this source has largely dried up since the crisis.[4] Thus, there is a split between larger corporations that can raise funds cheaply by tapping the capital markets and smaller businesses that rely largely on banks.

Iøll finish my survey of the economy with a look at one of the most troubling aspects of the recoveryô the weakness of the job market. Job growth has been averaging only about 125,000 a month this year, barely keeping up with the expansion of the labor force. The unemployment rate has been stuck around 9 percent, a level that can fairly be described as a national calamity. Approximately 14 million people are classified as unemployed. Nearly a third of them have been out of work for at least a year. This is a disturbing break from past downturns, when spells of unemployment typically were short. I worry about what happens to people who are out of work for such long periods. Not having a paycheck is bad enough. On top of that, they face an erosion of their job skills and a weakening of their attachment to the world of work.

At least three factors are keeping employers from hiring in earnest. First, and most important, businesses are reluctant to add many jobs until they feel more secure about the recovery. Second, job creation at small businesses has been unusually slow, reflecting tight credit and weak demand for their products and services.[5] Finally, governments at all levels are aggressively cutting spending, which means layoffs and hiring freezes. Total government employment is down by about 700,000 since early 2009 and prospects are for more of the same.

---

[4] Wilcox (2011).
[5] See, for example, Haltiwanger (2011).

I’d like to move now to my outlook. My forecast projects that the growth we saw in the third quarter will continue in the months ahead. The sharp slowdown during the first half of the year was at least partly due to temporary factors. The big run-up in global oil and commodity prices held back consumer spending and business investment. In addition, the Japanese earthquake and tsunami disrupted U.S. auto production by making it harder to get parts. More recently though, commodity prices have retraced some of their gains and the auto supply chain situation has improved.

I anticipate that real GDP will grow in 2012 at about a 2¼ percent pace and pick up a bit in 2013 to around 3 percent. Unfortunately, such growth will not be enough to make significant progress on unemployment. I see the jobless rate dropping only a bit from its current level of 9 percent to around 8¾ percent by the end of 2012 and reaching 8 percent at the end of 2013.

My forecast of sustained moderate growth stems in part from improving financial conditions, which seem likely to continue. Interest rates are at historic lows and corporations are flush with cash. Lenders are gradually relaxing their grip on credit. Meanwhile, those strained household finances I spoke of are improving as consumers save more and pare down debt. And the housing market has nowhere to go but up.

Still, this is by no means an upbeat forecast. An important reason is that I think our ability to produce goods and services isn’t growing at the rapid rate it was a few years ago. Of course, economies around the world have a natural tendency to expand as new technology is introduced and workers become better educated. But there is evidence that, at this juncture, the growth of the productive potential of the U.S. economy has slowed.

Research at the San Francisco Fed has identified a number of factors behind this slowdown. The late 1990s and early 2000s saw impressive gains in the productivity of U.S. businesses, reflecting the spread of information and communications technology.[6] Those gains started slowing in the middle of the past decade, even before the recession. Then, during the downturn, businesses slashed investment in more efficient plants, equipment, and technology. Investment has been recovering, but weøre still feeling the aftereffects of earlier cutbacks. Meanwhile, high unemployment has caused the skill set of the workforce to deteriorate. Taken together, these factors have at least temporarily held down the economyøs natural tendency to expandô and thatøs reflected in my very moderate growth forecast.

I should point out that there are risks that could cause growth to be even less than this forecast. The biggest risk comes from Europe, which has been facing a serious financial crisis. Several countries that use the euro as their currency have been struggling to make payments on government debt. Greece in particular appears unable to meet its obligations. Whatøs more, worries about Greece have forced countries such as Spain and Italy to pay high interest rates on their borrowing. Some European financial institutions hold large quantities of Greek government bonds and could face serious losses if the Athens government defaulted. The danger is that losses from a Greek default could spread to other euro area countries, possibly triggering the kind of financial panic we saw in 2008.

The recent agreement by European leaders to write down Greek debt, recapitalize European banks, and back up vulnerable economies has raised hopes that the crisis can be managed. However, there are still many political and economic obstacles to implementing an

---

[6] Basu and Fernald (2008).

effective plan. The outcome matters very much to the United States. A financial panic in Europe would probably cause serious disruptions in U.S. financial markets. Indeed, a San Francisco Fed analysis indicates that the probability of another U.S. recession over the next 12 months increases significantly when the European situation is factored in.[7]

Let me turn to inflation. The Fedøs preferred measure of inflation has picked up markedly in 2011 to nearly a 3¼ percent annual rate through September. At the end of 2010, the rate was about 1¼ percent. The current inflation rate is well above the objective of about 2 percent that most Fed policymakers indicate they prefer.[8] However, the spike in inflation largely reflected temporary circumstances, which have already receded. I expect the inflation rate to ease to around 1½ percent in both 2012 and 2013.

Higher inflation earlier this year stemmed largely from a run-up in oil and other commodity prices, as well as higher prices for some imported goods. The impetus came largely from developing countries such as China, which have enormous appetites for raw materials. More recently though, downshifts in U.S. and European growth have reduced commodity price pressures. Since the spring, these prices have dropped noticeably. Meanwhile, there is no sign in the United States of upward pressure on wages. Nor have we seen any evidence that the public or financial market participants expect inflation to move to a higher plane. In this kind of environment, high unemployment and weak consumer demand should keep prices in check.

---

[7] See Berge, Elias, and Jordà (2011).
[8] See the longer-run projections for PCE inflation at http://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20111102.pdf..

So what is the Fed doing now? Over the past few years, faced with an economy that is performing far below its potential, the Fed has taken extraordinary action to boost growth. That effort is ongoing. Let me put it in context.

Congress has assigned the Fed two goals: maximum employment and price stability. As Iøve said, I expect inflation to subside somewhat below the level most consistent with price stability. And clearly, with unemployment at 9 percent, we are falling far short of maximum employment. During the recession, Congress and the White House increased federal spending and trimmed taxes to stimulate the economy. The emphasis has now shifted to controlling spending and reining in the federal budget deficit. Controlling the federal deficit over the long run is vital to our economic health. But, at this point, government austerity means that we are unlikely to see much economic stimulus from fiscal policy at this juncture. Under these circumstances, itøs vital that the Fed use a full range of tools to achieve its mandated employment and price stability goals.

The Fed affects the economy by influencing short- and long-term interest rates. Our usual tool is the federal funds rate, which is what banks pay to borrow from each other on overnight loans. It serves as a benchmark for other short-term interest rates and indirectly influences longer-term rates as well. We have had the federal funds rate close to zero since late 2008, so there is not much more we can do with it now. But that doesnøt mean that we have nothing left in our toolbox. The Fed has put in place several so-called unconventional monetary policy tools over the past three years. These include large purchases of longer-term securities issued by the U.S. government and mortgage agencies such as Fannie Mae and Freddie Mac. In

addition, weøve made explicit statements laying out future Fed policy. Such statements can themselves be effective tools at influencing interest rates and broader financial conditions.[9]

Our unconventional policies are aimed at reducing longer-term interest rates. For example, when we buy large quantities of Treasury securities, we increase demand for those securities. That boosts their price and lowers their yield. As the yields on Treasury securities come down, other longer-term interest rates also tend to fall, reducing the cost of borrowing on everything from mortgages to corporate debt. We started buying longer-term securities during the financial crisis in late 2008 and early 2009. And we followed with another round of securities purchases beginning late in 2010. Longer-term interest rates are measurably lower because of these programs.

After our August policy meeting, the Fed announced our expectation that we would keep the federal funds rate at exceptionally low levels through mid-2013. Such announcements can affect financial market expectations of where interest rates will be in the future, which in turn affects interest rates today.

At our September meeting, we put in place another unconventional policy. Under this program, the Fed will buy $400 billion in Treasury securities maturing in six years or more and sell an equal amount of Treasuries maturing in three years or less. The program should provide additional help in bringing down longer-term interest rates, and it wonøt increase the overall size of our securities holdings.

[9] Williams (2011).

To summarize, the Fed has already pushed short-term interest rates about as low as we can. Our unconventional policies are aimed at creating additional economic stimulus by pushing down longer term rates as well. None of these are cure-alls for our economic ailments. But they are helpful. Growth is faster and unemployment lower than they would be without these programs. And we have so far avoided an outbreak of deflationô that is, falling pricesô that would have made an already bad situation even worse.

Looking ahead, our monetary policy actions will depend on how the outlook for the economy and inflation develop. If economic conditions improve much more rapidly than expected or if inflation shows signs of taking off, we have the tools to tighten monetary policy as needed. But, I fear the more likely situation is one of continued moderate growth, persistently high unemployment and undesirably low inflation. In that case, additional monetary policy accommodationô either in the form of additional asset purchases or further forward guidance on our future policy intentionsô may be needed to bring us closer to our mandated objectives of maximum employment and price stability. Thank you very much.

References

Basu, Susanto, and John Fernald. 2008. õInformation and Communications Technology as a General-Purpose Technology: Evidence from U.S. Industry Data.ö *FRBSF Economic Review* 2008, pp. 1ó15. http://www.frbsf.org/publications/economics/review/2008/er1-15.pdf

Berge, Travis J., Early Elias, and Òscar Jordà. 2011. õFuture Recession Risks: An Update.ö *FRBSF Economic Letter* 2011-35 (November 14). http://www.frbsf.org/publications/economics/letter/2011/el2011-35.html

Glick, Reuven, and Kevin J. Lansing. 2011. õConsumers and the Economy, Part I: Household Credit and Personal Saving.ö *FRBSF Economic Letter 2011-01* (January 10).

Haltiwanger, John. 2011. õJob Creation and Firm Dynamics in the U.S.ö Unpublished manuscript, May. http://econweb.umd.edu/~haltiwan/c12451.pdf

Hedberg, William, and John Krainer. õWhen Will Residential Construction Rebound?ö *FRBSF Economic Letter 2011-23* (July 25). http://www.frbsf.org/publications/economics/letter/2011/el2011-23.html

Mian, Atif, and Amir Sufi. 2011. õConsumers and the Economy, Part II: Household Debt and the Weak U.S. Recovery.ö *FRBSF Economic Letter 2011-02* (January 18).

Reinhart, Carmen M., and Kenneth S. Rogoff. 2009. *This Time Is Different: Eight Centuries of Financial Folly*. Princeton, NJ: Princeton University Press.

Wilcox, James A. 2011. õSecuritization and Small Business.ö *FRBSF Economic Letter 2011-22* (July 18). http://www.frbsf.org/publications/economics/letter/2011/el2011-22.html

Williams, John C. 2011. õUnconventional Monetary Policy: Lessons from the Past Three Years.ö Speech to the Swiss National Bank Research Conference, Zurich, Switzerland, on September 23. http://www.frbsf.org/news/speeches/2011/john-williams-0923.html