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By Janet L. Yellen, President and CEO, Federal Reserve Bank of San Francisco
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The Outlook for Recovery in the U.S. Economy[1]

It's a pleasure to appear before a group of professionals who spend as much time trying to understand the financial markets and the economy as I do. It's fair to say that the last two or three years have provided all of us an education—a far-from-welcome one—of just how complex these subjects are. We have had to rethink old assumptions and question conventional wisdom in the face of a crisis whose dimensions few of us might have imagined.

I am hugely relieved that our financial system appears to have survived this near-death experience. And, as painful as this recession has been, I believe that we succeeded in avoiding the second Great Depression that seemed to be a real possibility. Much of the recent economic data suggest that the economy has bottomed out and that the worst risks are behind us. The economy seems to be brushing itself off and beginning its climb out of the deep hole it's been in.

That's the good news. But I regret to say that I expect the recovery to be tepid. What's more, the gradual expansion gathering steam will remain vulnerable to shocks. The financial system has improved but is not yet back to normal. It still holds hazards that could derail a fragile recovery. Even if the economy grows as I expect, things won't feel very good for some time to come. In particular, the unemployment rate will remain elevated for a few more years, meaning hardship for millions of workers. Moreover, the slack in the economy, demonstrated by high unemployment and low utilization of industrial capacity, threatens to push inflation lower at

[1] I would like to thank John Judd, Rob Valletta, and Sam Zuckerman for assistance in preparing these remarks.

a time when it is already below the level that, in the view of most members of the Federal Open Market Committee (FOMC) best promotes the Fed's dual mandate for full employment and price stability. As a result, monetary policy makers will continue to face a difficult task in the years ahead.

During the rest of my talk this afternoon, I will try to give a more detailed picture of the financial and economic landscapes. My comments are my own and do not necessarily reflect the views of my Federal Reserve colleagues.

As I noted, we've come a long way since last year when the financial system was teetering on the edge of collapse. To me, it's plain that the extraordinary and aggressive response of governments and central banks around the world saved the day—heading off the kind of financial meltdown that would have inflicted catastrophic damage on the economy. Some are skeptical about the effectiveness of emergency programs such as TARP, TAF, and TALF. But, in my view, these programs staved off disaster. And they have been keeping the patient on essential life support as little by little it begins to breathe again on its own.

While the worst was avoided, the financial shock that did hit the economy was awful enough. The economy finally fell into recession at the end of 2007 when, on top of an ongoing drag from a contracting housing sector, the ever-dependable American consumer—who had shrugged off one shock after another in years past—finally succumbed to the fallout from the financial crisis. Since the beginning of the downturn, real GDP has fallen by a bit short of 4 percent and the unemployment rate has jumped by nearly 5 percentage points. Few, if any, parts of the economy have escaped the devastation. In addition to the setbacks in housing and consumer spending, business investment, exports, and imports all fell off the table.

I’m happy to report that the downturn has probably now run its course. This summer likely marked the end of the recession and the economy should expand in the second half of this year. A wide array of data supports this view. However, payrolls are still shrinking at a rapid pace, even though the momentum of job losses has slowed in the past few months. The housing sector finally seems to be improving. Home sales and starts are once again rising from very low levels, and home prices appear to be stabilizing, even rising in recent months according to some national measures. Meanwhile, manufacturing is also beginning to show signs of life, helped particularly by a rebound in motor vehicle production. Importantly, consumer spending finally is bottoming out.

A particularly hopeful sign is that inventories, which have been shrinking rapidly, now seem to be in better alignment with sales. That’s occurred because firms slashed production rapidly and dramatically in the face of slumping sales. Recent data suggest that this correction may be near an end and firms are now poised to step up production to match sales. In fact, I expect the biggest source of expansion in the second half of this year to come from a diminished pace of inventory liquidation by manufacturers, wholesalers, and retailers. Such a pattern is typical of business cycles. Inventory investment often is the catalyst for economic recoveries. True, the boost is usually fairly short-lived, but it can be quite important in getting things going. Nowhere is this cycle more evident than in the auto sector. Production cutbacks this year have led to sharp reductions in inventories. Recently, sales of light vehicles have begun to rise, in part due to the government’s cash-for-clunkers program. As a result, auto manufacturing has picked up and, with inventories lean, prospects are good for further production increases.

In all of these sectors, improved financial conditions have played a vital part in stimulating greater activity. To be sure, the financial system is not yet back to normal and credit is still tight. But there have been notable improvements. The stock market rally has helped households recover some of their lost wealth and provided a much-needed psychological boost. Investors have regained some of their appetite for risk. Interest rates on corporate bonds—especially for less-than-prime firms—have dropped sharply and issuance has been brisk. Federal Reserve programs to support the mortgage market have helped push rates down. And other Fed programs have helped jump-start issuance of securities backed by consumer and small business loans. In the short-term wholesale funding markets, measures of stress have also diminished.

The fiscal stimulus program passed by Congress in February also deserves credit for helping the economy turn the corner. Its tax cuts have raised disposable income, and government spending is directly adding to payrolls, providing another source of household income. Much of the stimulus money remains to be spent and will add to growth as the year proceeds.

The normal dynamics of the business cycle have also turned more favorable. Some economic sectors are growing again simply because they sank so low. The inventory adjustment I just discussed is one factor, although the biggest part of those benefits usually is only felt for a few quarters. But other business cycle patterns can be longer lasting. Demand for houses, durable goods such as autos, and business equipment is beginning to revive as households and firms replace or upgrade needed equipment and structures.

I'd like to pause for a moment to make a few observations about the Bay Area economy. The recession has been felt keenly here. Employment is down about 6 percentage points from its peak in late 2007. The unemployment rate has risen by more than 6 percentage points to just over 10 percent from its low point in late 2006, outstripping the national increase.

A harsh slump in information technology, due to plunging business spending on tech equipment and services, has prompted extensive job cuts and been a key factor driving down the area economy. Employment has fallen especially steeply on the hardware side, although IT service providers have cut back as well.

Fortunately, IT seems to be on the mend. Sales of U.S.-made semiconductors are up substantially in recent months, prompting some prominent companies to bump up earnings outlooks for the remainder of the year. My local contacts have noted an uptick in venture capital investment, and they say that companies that received venture funding in the past are doing better at meeting performance benchmarks. Overall, the area's IT industry is in much better shape than it was following the dot-com bust of the early 2000s. Clearly, it has struggled during this downturn. But, this time around, it is not recovering from bubble-driven overexpansion, so it is well-positioned to take advantage of an economic upswing.

The area's housing market is also showing signs of life. Sales of existing homes have been rising since late last year. Of course, the pickup has been propelled in part by sales of foreclosed homes and widespread availability of properties at bargain-basement prices. As we all know, Bay Area home prices have been decimated. Estimates of the cumulative decline over the past few years range from about 15 percent to as high as 45 percent. Many local homeowners are under water, and that's helped feed the foreclosure wave. While it's too soon to be sure, this pernicious process may finally be coming to an end. Some recent data show price increases and a notable pickup in sales of higher-end properties over the past few months.

Returning to the national economy, the all-important question is how strong the upturn will be. With unemployment at 9.7 percent of the workforce and capacity utilization at its lowest level of the post-World War II period, the economy has an enormous amount of slack. That gives us plenty of room to grow rapidly over the next few years. Indeed, we need to grow robustly to alleviate the enormous human toll resulting from high unemployment and the waste of so much idle industrial capacity. At first glance, history suggests that a vigorous expansion could very well take place. Following previous deep recessions, the United States typically saw V-shaped recoveries. For example, the economy grew at an average rate of nearly 6 percent during the two years following the severe recession in 1981-82.

This time though rapid growth does not seem to be in store. My own forecast envisions a far less robust recovery, one that would look more like the letter U than V. And I'm not alone. The Blue Chip consensus forecast, reflecting the views of nearly 50 professional forecasters, anticipates by far the weakest recovery of the postwar era over the next year and a half. A large body of evidence supports this guarded outlook. It is consistent with experiences around the world following recessions caused by financial crises.[2] That seems to be because it takes quite a while for financial systems to heal to the point that normal credit flows are restored. That is what I expect this time. In the buildup to the recession, financial institutions became highly leveraged, a vulnerability compounded by investments in complex and risky assets funded with short-term debt. In an attempt to improve credit quality and reduce risk, banks have now tightened business and consumer lending standards. They have been doing so at the same time that rising unemployment and falling house prices have fed additional credit losses.

Unfortunately, more credit losses are in store even as the economy improves and overall financial conditions ease. Certainly, households remain stressed. In the face of high and rising unemployment, delinquencies and foreclosures are showing no sign of turning around. The

[2] See Reinhart and Rogoff (2009) for evidence on this issue.

delinquency rate on adjustable-rate mortgages is now up to about 18 percent, and, on fixed-rate loans, it's about 6 percent.[3] Delinquencies on both types of loans have increased sharply over the past year and are still rising. This trend is consistent across other major loan categories, and is affecting high- and low-quality borrowers alike. Even recent-vintage loans are experiencing rising delinquency rates.

While it is important for economic recovery that lenders provide credit to worthy households and businesses, they also must maintain enough capital to withstand losses—even if economic conditions turn out to be worse than anticipated. In the face of continuing credit losses, moves by lenders to shrink assets, reduce leverage, and conserve capital are restricting the provision of credit in the economy. For example, the Fed's Senior Loan Officer Survey on Bank Lending Practices conducted in July showed that, for consumer loans, far more banks are tightening standards than easing them, despite some improvements in this measure in recent months.

Normally, if credit flows were restricted by these types of financial headwinds, the Fed would ease the stance of monetary policy by cutting its federal funds rate target. But the funds rate is already at zero for all practical purposes, leaving the Fed's traditional policy tool as accommodative as it can be. In fact, many versions of the Taylor rule, a well-known policy benchmark based on the state of the economy and inflation, indicate that we should lower the funds rate well below this zero bound—if such a thing were possible. To provide more accommodation, the Fed has used unconventional policy tools. Collectively, these programs, which have provided us a slew of new acronyms, appear to be helping. But we have little

[3] These figures refer to mortgages that are delinquent for 60 or more days or are in foreclosure.

experience with them and the extent of their effectiveness is highly uncertain. So here's the bottom line: Financial conditions have clearly eased compared to the darkest days of the financial crisis. But the financial system is still far from healthy and tight credit is likely to put a damper on growth for some time to come.

A sputtering financial system is not the only challenge before us. The chances are slim for a robust rebound in consumer spending, which represents around 70 percent of economic activity. Of course, consumers are getting a boost from the fiscal stimulus package. But this program is temporary. Over the long term, consumers face daunting issues of their own. In fact, it's easy to draw a comparison between the financial state of households and that of financial institutions. For years prior to the recession, households went on a spending spree. This occurred during a period that economists call the "Great Moderation," about two decades when recessions were infrequent and mild, and inflation was low and stable. Credit became ever easier to get and consumers took advantage of this to borrow and buy. Stock and home prices rose year after year, giving households additional wherewithal to keep spending. In this culture of consumption, the personal saving rate fell from around 10 percent in the mid-1980s to 1½ percent or lower in recent years. At the same time, households took on larger proportions of debt. From 1960 to the mid-1980s, debt represented a manageable 65 percent of disposable income. Since then, it has risen steadily, with a notable acceleration in the last economic expansion. By 2008, it had doubled to about 130 percent of income.

It may well be that we are witnessing the start of a new era for consumers following the traumatic financial blows they have endured.[4] The destruction of their nest eggs caused by falling house and stock prices is prompting them to rebuild savings. The personal saving rate is

[4] See Glick and Lansing (2009).

finally on the rise, averaging almost 4½ percent so far this year. While certainly sensible from the standpoint of individual households, this retreat from debt-fueled consumption could reduce the growth rate of consumer spending for years. An increase in saving should ultimately support the economy's capacity to produce and grow by channeling resources from consumption to investment. And higher investment is the key to greater productivity and faster growth in living standards. But the transition could be painful if subpar growth in consumer spending holds back the pace of economic recovery.

Weakness in the labor market is another factor that may keep the recovery in low gear for a while. As I mentioned, payroll employment has been plummeting for a year and a half. While the August employment report offered more evidence that the pace of the decline has slowed, unemployment now stands at its highest level since 1983. My business contacts indicate that they will be very reluctant to hire again until they see clear evidence of a sustained recovery, and that suggests we could see another so-called jobless recovery in which employment growth lags the improvement in overall output. What's more, wage growth has slowed sharply. Over the first half of this year, the employment cost index for private-industry workers has risen by a meager three-quarters of one percent. Unemployment, job insecurity, and low growth in incomes will undoubtedly take a toll on consumption. When the array of problems facing consumers is considered, it is hard to see how we can avoid sluggish spending growth.

Putting the whole puzzle together, the main impetus to growth in the second half of this year will be inventory investment. The boost it provides will be a big help for a while, but we will need to look to other sectors to sustain growth. The fact that the largest sector of the economy—consumer spending—is likely to be lackluster implies a less-than-robust expansion.

Even the gradual recovery we expect will be vulnerable to shocks, especially from the financial sector. As I said, financial conditions are better, but not back to normal. And the likelihood of continuing losses by financial institutions will add new fuel to the credit crunch. In particular, small and medium-size banks could experience damaging losses on commercial real estate loans. Thus far, the largest losses have been on loans for construction and land development. Going forward, however, rising loan losses on other commercial real estate lending is likely because property values are falling, office vacancy rates are rising, and credit remains tight or nonexistent for those many property owners that will need to refinance mortgages over the next few years. Financial contagion from this sector is one of the most important threats to recovery.

The slow recovery I expect means that it could still take several years to return to full employment. The same is true for capacity utilization in manufacturing. It will take a long time before these human and capital resources are put to full use.

This brings me to the complex topic of inflation. In my career, I have never witnessed a situation like the one that exists now, when views about inflation risks have coalesced into two diametrically opposed camps. On the one hand, one group worries about the long-term inflationary implications of a seemingly endless procession of massive federal budget deficits. At the same time, others fear that economic slack and downward wage pressure are pushing inflation below rates that are considered consistent with price stability and even raising the specter of outright deflation. This dichotomy is on display among the participants in the Survey of Professional Forecasters. The lowest quartile of forecasters focuses on disinflation over the next five years. The top quartile is preoccupied with the possibility of rising inflation five to ten years out.

The fear of higher long-term inflation reflects, to a large degree, worries about Fed monetary policy. Our array of new programs to spur the economy have pumped up our balance sheet and created a huge quantity of bank reserves in the process. Some worry that we won't be able to shrink our balance sheet because of political pressures, and in the process we will end up monetizing the government debt. This fear is real, growing, and disruptive. That's why it's so important for me to say the following loud and clear: We at the Fed are and will remain fiercely independent from politics. We have the means—and we certainly have the will—to tighten policy when the time is right. In fact, by raising the interest rate that we pay on excess reserves we can tighten monetary policy even before our balance sheet shrinks. And we are, as always, steadfast in our determination to achieve both of our statutory goals of full employment and price stability.

My personal belief is that the more significant threat to price stability over the next several years stems from the disinflationary forces unleashed by the enormous slack in the economy. The 1980s provides a useful historical comparison. During that period, fears about burgeoning federal deficits and an unsustainable fiscal situation were widespread, as they are today. Moreover, the Fed was under significant political pressure, and some worried whether it would be able to safeguard its independence. But those circumstances didn't ignite a renewed bout of inflation. Unemployment nearly hit 11 percent in 1982 and oil prices were sinking. Core personal consumption expenditure (PCE) inflation—the Fed's preferred measure—fell about 6 percentage points during the first half of the 1980s.

Of course, that period differed from ours in one critical respect. Then, inflation was coming down from unacceptably high levels. Monetary policy was designed to be tight enough to bring inflation down to price stability, a goal we accomplished and have maintained for two-and-a-half decades. Today, we are starting with very low inflation. Core PCE price inflation has averaged just under 1½ percent over the past twelve months, which is already below the 2 percent rate that I and most of my FOMC colleagues consider an appropriate long-term price stability objective. With slack likely to persist for years, it seems likely that core inflation will move even lower, departing yet farther from our price stability objective.

From a monetary policy point of view, the landscape will continue to present challenges. We face an economy with substantial slack, prospects for only moderate growth, and low and declining inflation. With our policy rate already as low as it can go, it's no wonder that the FOMC's last statement indicated that "economic conditions are likely to warrant exceptionally low levels of the federal funds rate for an extended period." I can assure you that we will be ready, willing, and able to tighten policy when it's necessary to maintain price stability. But, until that time comes, we need to defend our price stability goal on the low side and promote full employment. Thank you very much.

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