Presentation to Community Leaders
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By John C. Williams, President and CEO, Federal Reserve Bank of San Francisco
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The Outlook for the Economy and Monetary Policy[1]

Thank you very much for coming today. It's a pleasure to be here in Salt Lake City. You've got nearly everything here—mountains, desert, and, of course, the lake. In fact, as a native Californian, I would say the only thing that's missing is the ocean.

My subject today is the outlook for the economy. We are now two full years into the economic recovery, yet progress on restoring the economy from the damage caused by the financial crisis and ensuing Great Recession remains discouragingly slow. The news from the jobs front has been particularly disappointing, with the unemployment rate—currently 9.2 percent—stubbornly high. This afternoon, I'll give my perspective on why economic growth has been so modest and offer my outlook for the future, which anticipates some improvement during the second half of this year and next year. I'll also talk about inflation, which has seesawed in recent months. Finally, I'll explain what the Federal Reserve is doing to promote maximum employment and price stability. As usual, my remarks represent my own views and not necessarily those of my Federal Reserve colleagues.

Before I go any further, I should say a few words about the budget and debt limit situation in Washington, which is going down to the wire. I'll refrain from commenting on politics, but a few economic points are worth making. There is no question that we are currently on an unsustainable long-run path of federal fiscal deficits. It is essential that budget deficits over the next decade be brought under control. The costs of not doing so are enormous. First,

[1] I want to thank John Fernald, Glenn Rudebusch, and Sam Zuckerman for their assistance in preparing these remarks.

uncertainty about future fiscal policy and doubts about whether Uncle Sam will pay his bills are likely damping consumer and business confidence. Second, heavy government borrowing pushes up interest rates for businesses and consumers, which tends to reduce capital spending and long-term productivity. That's a recipe for long-run economic decline and lower American living standards. Sooner or later, we'll have to deal with the deficit, and we should get our house in order sooner rather than later. Finally, the lessons from the events in Europe are clear—unsustainable deficits can cascade into a crisis. If that happens, policy options are limited and the damage to the economy can be severe.

However, I need to stress, even as the nation must come to terms with its fiscal problems, a federal default must be avoided. Make no mistake—the Federal Reserve doesn't have a magic wand that will allow the economy to get through a crisis of this magnitude unscathed. Fortunately, the key players in Washington seem to understand the risks, which may be why financial markets have stayed reasonably calm—at least so far.

So then, assuming a way will be found to raise the federal debt ceiling, where do things stand with the economy? Since the middle of 2009, the economy has been steadily growing. That's no small accomplishment when you consider that less than three years ago we lived through the most severe financial crisis since the Great Depression. The critical question is why the recovery has been stuck in second gear. In particular, the pace of growth has been insufficient to make much of a dent in unemployment. During the downturn, we lost nearly 9 million jobs outside the farm sector. Since job growth resumed, payrolls have expanded by less than 2 million jobs. Moreover, the pace at which we're creating new jobs has slowed to a crawl. In May and June, we added on average just over 20,000 jobs per month. Not only are 14 million

people unemployed, but about 45 percent of them have been out of work for six months or more, a sobering reminder of how deep and prolonged this downturn has been.

Fortunately, some of the disappointing performance this year reflects events that should have only a transitory influence on the economy. These included unusually destructive weather—virtual plagues, if you will, of blizzards, tornadoes, and floods. Then, there was Japan's disaster, which caused supply-chain disruptions in several industries, especially autos. Probably the biggest blow came from the spike in energy costs, which undermined confidence and damped consumer spending. All the same, the main effect of high energy prices on the economy's rate of growth should prove temporary. Consumers have had to reduce their spending on non-energy goods and services. But if energy prices hold steady, households don't have to keep cutting their spending by more and more. In fact, oil prices have fallen substantially since April on net, which means more income is available for discretionary purchases.

While these transitory factors depressed first-half growth, it would be wrong to suggest that we are only swimming against a temporary tide. The problem is that some persistent and deep currents are restraining our progress.

Housing and the Recovery

One of the most important currents holding back recovery has been housing. The collapse of the housing market touched off the financial crisis and recession. In most recessions, housing construction falls sharply, but then leads the economy back when growth resumes. As you well know, that snapback hasn't occurred this time. Before the crisis, residential investment as a share of the economy was at its highest level since the Korean War. Today, housing

construction remains moribund and residential investment as a share of the economy has fallen to its lowest level since World War II.

On one level, that's not surprising. We simply built too many—in fact, millions too many—houses during the boom and we are still feeling the effects of this overhang. Consider housing prices. From their peak in 2006 until early 2009, home prices nationwide fell by nearly a third. When you exclude distressed sales, prices appeared to bottom out in 2009 and early 2010. New housing starts also appeared to stabilize in 2009, after plummeting some 75 percent during the housing crash. I'm happy to report that Utah has done better than the nation as a whole, and certainly the housing market here is not as depressed as in such neighboring states as Arizona and Nevada. Prices here are down only about 20 percent from their peak, and foreclosure and delinquency rates are also lower.

The $64,000 question is when will the housing market finally recover? One daunting challenge for such a recovery is the huge number of homes in foreclosure. Almost 7 million homes have entered into foreclosure since the first quarter of 2008 and some 2 million are still in the foreclosure process. In addition, there is a shadow inventory of homes currently owned by delinquent borrowers. When you add up unsold new houses left over from the boom, homes for sale by owners, foreclosed residences for sale by lenders, and the shadow inventory of houses at risk of distressed sale, you come up with a massive supply overhang.

Over time, more reasonable prices and an improving economy ought to bring buyers off the sidelines and set the stage for recovery. But high unemployment and anemic wage gains are leaving people worried about their income prospects and cautious about buying homes. Also, the dramatic plunge in home valuations since 2006 has made some first-time homebuyers wary about entering the market because of worries that prices might fall further.

Credit conditions

A second current we've been swimming against is tight credit conditions. Let's take small business, for example. It's harder today for small businesses to get credit and some of the reasons aren't immediately obvious. The usual image of the small business owner is the man or woman who goes to a Main Street bank looking for a loan. However, it turns out that small businesses depend indirectly on global capital markets for funding. Indeed, the ultimate lender to small businesses in the United States may be in Frankfurt or Hong Kong. One of the most important ways small businesses are tied to global capital markets is through commercial mortgages on their business properties. Before the financial crisis, lenders sold many of those loans to investment banks, which then pooled them as commercial mortgage-backed securities in a process similar to the way residential mortgages were packaged. This commercial mortgage-backed securities market has been depressed since the crisis, and that's made commercial mortgages harder for businesses to get.[2]

Credit is also an issue for consumers. Before the crisis, it seemed you could always count on free-spending Americans to bail the economy out. But now consumers are keeping a firm grip on their wallets and purses. Inflation-adjusted consumer spending rose during the first five months of 2011 at an anemic 1 percent annual rate. Tight credit is one reason people aren't loading up at the mall, and why they aren't buying houses and cars in anywhere near the numbers we saw in the recent past. Households have gone from unusually easy access to credit during the housing boom to a period of unusual tightness. Lenders are stricter with credit cards, and home equity loans are no longer the instant source of cash they were a few years ago. To qualify for a mortgage these days, you need a strong credit score and the resources to come up

[2] See Wilcox (2011).

with a substantial down payment. By contrast, to qualify for a mortgage in 2005, it seemed like all you needed was a pulse.

Restraints on consumer spending

Credit is far from the only factor keeping consumers and businesses in check. The weak job market and slow income growth limit what households have to spend. At the same time, households have been trying to repair their finances after years of taking on too much debt and setting aside too little in savings. Americans have come to realize the dangers of running up debt and they've rediscovered thrift. A key impetus has been rebuilding wealth lost when house prices collapsed and the stock market tanked. The combination of high unemployment, stagnant incomes, lower debt levels, and more saving is a recipe for feeble consumer spending gains. Research at the San Francisco Fed suggests that monthly consumer spending per person is running at a rate about $175 below where it would be if pre-recession trends had continued.[3]

One other current I should mention is government. Local, state, and now the federal government are aggressively cutting spending to balance budgets or trim deficits. Total government employment is down by almost half a million since the recovery began. Budget reform is good medicine for the long run. But, in the short run, government belt-tightening means that the private sector will have to do even more to keep the recovery on track.

Outlook for growth

Up to this point, I've focused on some of the factors holding back growth. On the plus side, there are important areas of strength in the economy. Manufacturing has been expanding thanks in part to a rebound in the auto industry and solid demand for U.S. exports, two sectors that were especially hard-hit during the recession. Corporate profits have been healthy, which has helped fuel rising business investment in equipment and software. Information technology

[3] See Lansing (2011).

has been on a roll, and there are even signs of a mini boom in public offerings and private share sales for Internet and social networking companies.

Looking ahead, I expect the pace of economic growth to pick up. First, the financial sector's health and access to credit is improving. In addition, the trend toward thrift means that consumers also seem to be in better financial condition. Second, pent-up demand should help the sale of durable goods as households finally replace beat-up cars and outdated appliances. And, third, the drag from housing should slowly diminish. It's only a matter of time before we work off the inventory overhang and construction picks up. How much time it takes will depend in part on what happens with foreclosed properties. If we begin making progress on working down the foreclosure inventory, then single-family housing starts could plausibly rise from their current level of about 400,000 per year to an average level of perhaps 1.1 million per year in three or four years, according to research at the San Francisco Fed.[4] To put this in perspective, such an increase would boost real gross domestic product, or GDP, by at least 1 percent.

Let's look more closely at real GDP, which measures the total output of goods and services adjusted for changes in prices. In the first half of the year, real GDP was held down by all the transitory factors I mentioned and appears to have expanded at an annual rate of about 1½ percent. As these temporary influences on growth wane and even reverse, I expect real GDP will grow at a pace a bit faster than 3 percent in the second half of this year and in 2012. Meanwhile, the unemployment rate should edge down to about 9 percent by the end of this year and 8¼ percent next year. This is still a very high unemployment rate, but at least the trend should be in the right direction.

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[4] By contrast, if we can't work down the foreclosure inventory, then a return to normal construction levels could be delayed several more years. See Hedberg and Krainer (2011).

Inflation

Let me turn now to a subject that's been the focus of a lot of attention lately—inflation. In the past few years, we've had some sizable swings in inflation. There are several measures of inflation, but the one the Fed follows most closely is the price index for personal consumption expenditures, or PCE, which is compiled from the same data used to calculate GDP. Last year, by this measure, inflation was low, just a bit more than 1 percent. But in the first half of this year, prices rose much more quickly. We don't have the June data for this measure yet, but the annualized price increase in the first half of this year looks to have been more like 3½ percent. This increase in inflation reflected sharp rises in many commodity prices, especially gasoline and other energy items. Gas prices peaked in April and have come down quite a bit since then. In fact, the PCE inflation rate was probably negative in June.

This sharp volatility in energy prices is not all that unusual. Because of these big ups and downs, economists look beneath the surface of the overall inflation number for a better indicator of underlying inflation trends. When we do that, we find that there has been a clear upswing in the inflation rate for non-energy goods and services this year compared with the very low levels seen in the latter part of 2010. What's behind this rise in inflation? In part, higher prices for energy, certain other commodities, and some imported products have worked their way into the prices of other goods. For example, my business contacts have repeatedly stressed the pressures they are facing from higher costs for raw materials, energy, and transportation. In addition, the prices of goods from China have been rising. Autos represent a special case in which supply bottlenecks after the Japanese earthquake created scarcity that allowed retailers to charge more.

Importantly, these are factors that are likely to provide only a temporary boost to inflation, rather than harbingers of an ongoing inflationary trend. In fact, with energy prices

falling and forecasts for economic growth in the United States and elsewhere coming down, it's probable that inflation will subside, rather than continue to rise. With an unemployment rate of over 9 percent, we still have a great deal of slack in the economy, and that limits the ability of workers to demand higher wages or businesses to raise prices. At the same time, there is little sign that financial market participants or the broader public expect inflation to accelerate in the medium term.

Looking ahead to next year, I see inflation settling in at around 1½ percent, somewhat below my long-run preferred level of around 2 percent. Of course, this is just a forecast and forecasts can be wrong. I want to stress though that we need to keep a watchful eye on inflation to make sure that recent increases aren't ongoing.

Federal Reserve policy

I'd like to shift gears now to talk about what the Federal Reserve is doing. By law, the Fed has two policy objectives: promoting maximum employment and price stability. In the face of this subdued recovery and an outlook for relatively low inflation, we are keeping in place our highly stimulatory monetary policy. We pushed down our target for the federal funds rate close to zero late in 2008 and have kept it there since. The fed funds rate is the rate banks charge each other for overnight loans and is a benchmark for many other interest rates in the economy. We continue to believe that economic conditions warrant keeping the fed funds rate at exceptionally low levels for an extended period.

In addition, to hold down longer-term interest rates and provide added stimulus, the Fed has carried out large-scale purchases of Treasury and mortgage-related securities. Last month, we completed—on time and on budget—the most recent round of $600 billion of longer-term Treasury securities purchases, which the financial press dubbed QE2. The Fed now holds close

to $2.7 trillion in securities and debt instruments. As these holdings mature and mortgages underlying the mortgage-backed securities are prepaid, we reinvest the principal in Treasury securities to keep the total quantity of our overall securities holdings steady. Research suggests that maintaining our holdings puts downward pressure on longer-term interest rates, even if we don't enlarge our portfolio.[5]

It's clear that these measures have not been enough to usher in a robust recovery. That said, it's important to ask though where we would be if monetary policy hadn't been so stimulatory. Longer–term interest rates would be perhaps half a percentage point higher, according to recent research.[6] Mortgages would be less affordable, and the housing market would be in even worse shape than it is, if that's imaginable. Other interest rate-sensitive sectors would also be worse off. This stimulus also probably helped prevent the U.S. economy from falling into a sustained period of deflation.

Looking ahead, we at the Fed will keep a very close eye on incoming data and adjust our policy as needed to work towards our two policy goals. If the recovery stalls and inflation remains low or deflationary pressures reemerge, then we may need to keep our very stimulatory policies in place for quite some time or even increase stimulus. On the other hand, assuming growth picks up and inflation doesn't fall too low, then at some point we'll need to start gradually removing stimulus.

A great deal of thought has gone into designing the proper ways to unwind the measures now in place. As outlined in the minutes of the June meeting of the Federal Open Market Committee, our policymaking body, our exit strategy would likely begin with a move to stop reinvesting principal payments on our securities holdings, which would gradually shrink our

[5] Chung et al. (2011).
[6] Chung et al. (2011), and Gagnon et al. (2011).

balance sheet.[7] We will be very careful to communicate our plans in advance, most notably in the statements we issue after policy meetings. When appropriate, we will begin to raise the fed funds rate and return to more normal policy, in which moving the fed funds rate is our main tool for influencing the economy. In addition, likely sometime after the first increase in the fed funds rate, we will start selling assets gradually to bring the size of our balance sheet to more normal levels. As always, the direction of policy, and the timing and pace of any policy actions, will be dictated by the evolution of the economy. Thank you very much for your attention and I would be happy to take your questions.

[7] For more discussion of exit strategy, see Board of Governors (2011).

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