Economic Outlook, May 2010

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It's a pleasure to discuss the economic outlook today. Before I begin, I should mention that these are my own views and are not necessarily shared by my colleagues on the Federal Open Market Committee.[1]

To start with the big picture, we're in the process of recovering from a very severe recession, and despite the unique causes of the contraction, this recovery resembles many that we've seen in the past. Signs of strength are particularly notable in manufacturing, business equipment investment, and consumer spending. As with other recoveries, other segments of the economy are lagging behind the broad pickup in activity, most notably employment and construction. Inflation has remained quite moderate. The most likely scenario is for the recovery to strengthen further in coming months. That's the broad-brush view; now I would like to fill in the canvas with some details.

A wide range of indicators show that economic activity has been expanding since the middle of last year. Real GDP, for example, has grown at a 3.7 percent annual rate over the last three quarters, which is a bit above its long-run trend. Granted, some of the increase was due to one-time factors. Last year's fiscal stimulus measures, for example, have been providing some boost to activity since the second half of last year, but the effect will largely fade away over the course of 2010. And the way GDP is calculated, it received an additional one-time boost from the completion in mid-2009 of the sharp inventory reduction that is typical of recessions. Demand since then has been met entirely from production, which is what GDP measures, rather than by drawing down inventories.

A look at the fine brushstrokes of the most recent GDP report, however, supports the idea that we're on a sustainable upward trajectory. Let's start by taking a look at consumers. Their spending accounts for more than two-thirds of total spending in the GDP, and it is now clearly on an upswing. During the recession – that is, in 2008 and the first half of 2009 – real consumer spending fell at a 1.2 percent annual rate. But in the last half of 2009, consumer spending *increased* at a 2.2 percent annual rate, and last quarter it increased at a 3.6 percent rate. That turnaround is likely to be durable, in my view. During a severe recession consumers tighten up on spending, in part due to job losses and the associated cut in current incomes, but also due to their weakening outlook for *future* income growth. Moreover, many households prudently defer major purchases when the headlines are alarming and jobs are threatened. But when the worst of the bad news begins to ebb, a growing number of households begin to sense that their jobs are in less jeopardy than they had thought. That improvement in expected income trends combines with the release of pent-up demand for big-ticket items and leads to a pickup in consumption spending. So while unexpected adverse shocks that disturb household income prospects have the potential, as always, to set this process back, the baseline outlook for consumer spending suggests growth at reasonably healthy rates in the months ahead.

The brighter picture is not limited to consumers. Business investment in equipment and software usually displays large swings in recessions and recoveries, and the latest experience fits that pattern very well. After falling at a 14.7 percent average annual rate during the recession, this investment category bottomed out in the third quarter and has risen at an average annual rate of 16 percent over the last two quarters. Again, prudent firms often defer capital spending in recessions, which creates a pent-up demand that boosts spending early in recoveries. And while sales may have fallen in many industries, technology continues to advance, and as a result there's an array of opportunities to deploy new capital to improve business processes and consolidate IT infrastructure. So I expect equipment and software spending to continue to rise this year and beyond.

This good news on spending has had a clear impact on the supply side of the economy. In manufacturing we have seen a sizable swing in activity. Industrial production fell almost 15 percent during the recession; since June of last year, it has risen every month, resulting in a cumulative increase of over 6 percent. That turnaround is evident in consumer goods, especially autos; business equipment; and raw materials; and even the production of construction supplies increased last quarter. Forward-looking indicators also are painting a brighter picture. An association of purchasing managers publishes information monthly on new orders for manufactured goods in the form of an index that takes on a value of 50 when the number of responding firms with rising orders equals the number of responding firms with falling orders. That index fell to a record low level of 22.9 in December, 2008, but has been above 55 every month since last July, and hit a sky-high level of 65 last month. This shows that a clear majority of manufacturers are seeing their order books expand, setting the stage for further increases in production this year.

Manufacturing also has been aided by the pickup in growth among our major trading partners since the first half of last year. A year ago, real exports were falling at nearly a 30 percent annual rate. In the first quarter of this year, however, real exports grew at an annual rate of 5.8 percent, for a third consecutive quarter of positive contributions to GDP. That increase in export demand is clearly visible on Virginia's waterfront. Nearly every measure of export activity for the Port of Virginia in the first quarter shows a year-over-year increase that surpasses the growth achieved over the past several years. While this activity is still below pre-recession levels, Virginia firms and workers are benefiting from this recent upward trend. Virginia's economy also benefits from the many internationally owned companies that call the commonwealth home and are helping to drive increased business investment as well as export activity.

I should put all this good news in the proper perspective, however. While the beginning of a recovery does mark the return of economic growth, it can take a while for that growth to make up all of the ground lost during the contraction in economic activity that marked the recession. Thus most observers expect a "full recovery" to take several years, and I see no reason to quarrel with that assessment.

In particular, take a look at the labor market, where we lost 7.3 million jobs during the recession. Then in the last half of 2009, while GDP and manufacturing production were increasing, we lost an additional 1.1 million jobs. That has raised the prospect of another jobless recovery such as the one that followed the 2001 recession, where employment fell for a 21-month period after the official end of the recession. This time, though, I think that employment is already on the path to steady growth. Payroll expanded by 162,000 jobs in the first quarter, and the pickup in demand that is already underway is likely to keep employment rising this year. It will take some time, however, to make substantial progress reducing the ranks of the unemployed. The loss of over 8 million jobs caused unemployment to surge from 4.6 percent in 2007 to 10.1 percent last October. Since then, unemployment has edged down slightly to 9.7 percent, but its elevated level is an indication of just how much ground remains to be covered.

In Virginia, the downward job trajectory was not as steep as for the nation, but the recession produced significant job loss here nonetheless. During the first half of 2009 the commonwealth experienced a net loss of 87,000 jobs, but with economic activity improving during the second half of the year, only 34,000 jobs were lost. More promising, during the first quarter of 2010, Virginia had a net gain of 3,700 jobs, with the most recent data for March placing Virginia among the fastest growing states in the nation. Another encouraging characteristic of the recent job gain is that we are seeing increased activity beyond education and health services and the government sectors – for example, professional and business services; trade, transportation and utilities; and leisure and hospitality, to name a few. Still, with many thousands of jobs lost since the recession began, the state needs strong and steady job growth over the coming months to recover lost income for workers and to help stabilize state and local government revenues. Virginia's unemployment rate has continued to climb from its pre-recession low of less than 3 percent, to an elevated current level of 7.4 percent. Increasing numbers of previously discouraged workers have re-entered the labor force in recent months, and this phenomenon will likely contribute to a stubborn unemployment rate, even as job growth gains more momentum.

Every recovery has its dark spots, and those dark spots are certainly evident today. Nonresidential construction spending – a category that includes stores, offices, warehouses, and other structures – has fallen 15 percent over the last seven quarters. Leading indicators for this sector, such as architectural billings and vacancy rates, suggest that nonresidential construction will continue to be very soft for an extended period.

And then there's residential construction, and everyone knows the background here. We had an incredible boom-bust cycle in housing – the number of new housing starts rose from 1.4 million in 1995 to 2.1 million in 2005 before falling to 554,000 last year. For perspective, it would take about 1.1 million starts per year to accommodate population growth with an unchanged homeownership rate. During the boom we built more houses – and bigger houses – than we ended up needing, and currently a large number of homes are vacant nationwide. While home prices may have stabilized, most observers see only a slow, uneven advance in home building for some time.

Virginia did not escape the boom-bust cycle in housing that caused several metropolitan areas of the commonwealth to experience annual price increases in excess of 20 percent at the peak in 2005, followed by a prolonged decline and eventual contraction in home prices during the recession. More recently, home prices appear to have stabilized, and existing home sales and building permits have improved relative to a year ago. Still, this sector of Virginia's economy remains soft and varies quite a bit across the state.

But even though there are still weak patches in this recovering economy, on balance, I believe consumer spending and business investment are going to be strong enough to drive growth in overall activity. We still haven't talked about the financial sector, though, and it's hard to imagine a solid recovery until financial markets signal expectations of a stronger economic environment. I would first note here that the worst is definitely behind us. A large volume of borrowing and lending transactions are completed every day, stock prices have risen significantly over the last twelve months, and risk spreads and borrowing rates have come down in most areas. The BBB corporate bond rate, for example, is representative for a wide range of borrowers and has fallen from 9-¼ percent in November 2008 to about 6-¼ percent now.

Still, we regularly hear complaints these days about firms being unable to borrow. It is certainly true that there are banks and other lenders who have experienced high losses and are now facing a higher cost of capital. Those lenders are now reducing their outstanding loans, and firms that have traditionally borrowed from these capital-constrained lenders may have difficulty getting new loans or even retaining existing credit lines. But the majority of banks appear to be ready and eager to lend to creditworthy customers – that's what banking is all about. So while more borrowers may need to shop around in this environment, I believe that credit market capacity is sufficient to support productive investment and allow a solid recovery to proceed.

The economic picture would not be complete without some comment on inflation. As recently as July, 2008, the 12-month inflation rate, calculated from the price index for personal consumption expenditure, was 4-½ percent. Of course the price of crude oil had just run up to $140 a barrel that spring. But the core inflation index, which leaves out food and energy prices, was 2.7 percent at that time, and to me even that lower number was unacceptably high. That episode was one of several unwelcome instances over the last decade of energy price surges spilling over into core inflation. This pattern suggests that monetary policymakers might need to reconsider the strategy of treating energy price gains as by-gones if the futures curve is flat. Given the broad upward trend in energy prices over the last decade, responding more aggressively would have kept overall inflation lower and closer to a rate I view as ideal.

Inflation has fallen since the surge of early 2008. In the last six months, the overall inflation rate was 1.8 percent and the core inflation rate was 1.1 percent. Those numbers are reasonable, and I would be happy if inflation remains about where it is. But the public expects to see higher inflation in the future. For example, the median inflation expectation from the University of Michigan's monthly survey of consumer sentiment is 2.9 percent, and other surveys yield similarly results. These readings on inflation expectations have been persistently high, and that's troubling, since they raise the possibility that people think the FOMC will be unable or unwilling to conduct monetary policy in a way that keeps inflation from rising significantly during this recovery.

Certainly monetary policy will be challenging in the period that lies ahead. Current policy settings are still at emergency levels, with the federal funds rate near zero and with our balance sheet 2 ½ times the size it was three years ago. These settings are currently providing substantial monetary stimulus. As a technical matter, whenever we decide to begin normalizing policy it will be straightforward to sell assets, shrink our balance sheet, and raise the level of short-term interest rates. The difficulty, of course, is that no one wants to tighten policy prematurely and needlessly dampen the recovery. So recognizing the right time to begin normalizing our monetary policy settings is going to be hard, and reasonable people can differ about this. For my part, I will be looking for the time at which economic growth is strong enough and well-enough established to warrant raising our policy rate. It may make sense, however, to begin normalizing our balance sheet in advance of raising rates. Normalizing our balance sheet means reducing its size, but also returning to our traditional Treasury-only asset holdings. My worry is that we will let the obvious slack in the economy lull us into a false sense of security regarding inflation, which could allow inflation pressures to build before we raise rates. That happened in 2004 and it could happen again, so we at the Fed will need to be careful to avoid waiting too long to raise rates.

As a longer-run matter the federal budget deficit implied by current and planned fiscal policies concerns me, and ought to concern every American, in my view. If economists can contribute anything to the policy process, it's our willingness to identify unsustainable trends and remind people that unsustainable trends don't go on forever. And clearly, our current fiscal policy is on an unsustainable path. The Congressional Budget Office estimates that under current legislation, by 2012 the federal debt as a fraction of GDP will have more than doubled in 10 years, with further increases occurring each year unless major changes are made in spending programs and taxes. Granted, our fiscal problems are not as severe at this point as those of Greece and some other European countries. But I don't think we want to find out how close we can get to a full-blown fiscal crisis before taking corrective action.

In broad terms, we all know what needs to be done – cut spending or raise taxes. If we don't, an adverse sequence of events will be set in train: investors will be increasingly reluctant to hold more Treasury securities, yields will consequently rise significantly, the cost of capital will increase for firms producing in the United States, capital formation will suffer, productivity growth will slow, and thus real household incomes will stagnate. In short, the well-being of future generations is at stake. My hope is that policymakers will find a way to move fairly quickly to make the adjustments needed to put the budget on a sustainable path. The sooner we make the necessary adjustments, the longer the period over which we can spread out the adjustment cost, and the more likely we are to avoid a fiscal crisis of the type Greece is now experiencing.

Despite these serious policy challenges, however, I remain fundamentally optimistic about the capacity of the American economy to generate sustained improvements in standards of living. Our country has repeatedly demonstrated an unsurpassed ability to generate technological and organizational innovations and deploy them to deliver improved products and services for consumers and businesses. While we have struggled from time to time with economic policy, and no doubt will continue to struggle in the years ahead, that should not distract us from our signal achievements, nor should it dim our hope for the future.

[1] I am grateful to Ann Macheras, Roy Webb and John Weinberg for assistance in preparing this speech.