Donald L Kohn: The economic outlook

Speech by Mr Donald L Kohn, Vice Chairman of the Board of Governors of the US Federal Reserve System, at the National Association for Business Economics, St Louis, Missouri, 13 October 2009.

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I'm pleased to be here at the National Association for Business Economics. Most of you are in the business of making or using economic forecasts to inform the strategies of your organizations as they try to meet their objectives. So am I, and I thought this would be a good opportunity to discuss my view of the outlook and the implications that I draw for monetary policy. I'll start with a brief overview of recent developments and the near-term outlook. Then I'll turn to a few of the issues that bear on the medium to longer-run outlook. I emphasize that the views you are about to hear are my own and not necessarily those of my colleagues on the Federal Open Market Committee.[1]

In broad terms, the data that we have in hand indicate that economic activity turned up in the third quarter. To some extent, the pickup in activity in recent months reflects the dissipation of some of the forces that had been exerting downward pressure on the economy during the preceding several quarters. Perhaps the most important of these downward forces was the turmoil in financial markets that began in late 2007, which not only tightened credit availability and reduced wealth, but also undermined confidence, especially when conditions took a decided turn for the worse in the fall of 2008. The stabilization, and more recently the improvement, in risk appetites and financial conditions, in part responding to actions by the Federal Reserve and other authorities, has been a critical factor in allowing the economy to begin to move higher after a very deep recession.

A turn in the inventory cycle is another key element in the recent firming in aggregate activity. During the second half of 2008, many firms were apparently surprised at the sharp falloff in demand. In response to a buildup of unwanted inventories, they began aggressively liquidating stocks by slashing production well below the level of sales. The pace of liquidation intensified through the middle of this year. More recently, however, with inventories now less burdensome, firms have begun boosting production to slow the pace of inventory destocking and bring output into closer alignment with expected final sales. This process is particularly evident in the motor vehicle industry, where the stock of cars and trucks on dealers' lots had become extremely lean, prompting increases in assemblies from the very low levels seen at midyear. More broadly, the slower pace of inventory liquidation likely provided an appreciable boost to manufacturing production in July and August, and should continue to push up factory output further in the near-term.

But, more importantly for sustained recovery, final sales began to stabilize earlier this year and have shown some tentative signs of picking up more recently. Improvement has been most evident in the housing sector. After three years of steep declines in residential construction, the recent news on housing has been encouraging, given the central role that this sector has played in the recession. Sales of new and existing homes have been on an uptrend since early this year, and the rise in sales has pared the inventory of unsold new homes substantially. As demand has strengthened and inventories of new homes have come down, construction of single-family homes has risen markedly in recent months. Meanwhile, several measures of house prices, after tumbling for the past two to three years, have increased in the past few months. Moreover, survey data suggest that an increasing number of potential homebuyers seem to think that house prices are near their bottoms and will

[1] Larry Slifman and Joyce Zickler of the Board's staff contributed to these remarks.

increase over the coming year. And, based on prices from admittedly thinly traded futures, financial market participants appear to have become more optimistic about house prices as well. In light of these developments, I expect housing starts to continue to improve gradually in coming months.

In the consumer sector, spending fell sharply in the second half of 2008 as households raised their saving in response to reduced net worth, tighter credit conditions, and increasing uncertainty about job and income prospects. Following the steep declines in spending late last year, outlays were essentially flat on average during the first half of this year, and the saving rate leveled out. Expenditures appear to have increased in the third quarter, boosted during July and August by the cash for clunkers program and by increased dealer incentives. In addition, the latest figures suggest that real outlays for other consumer goods and services rose considerably in August. The recent firming of consumer spending likely has been aided by the fiscal stimulus package, which lowered taxes and increased transfer payments. However, with the labor market still quite weak and income gains subdued, advances in consumption spending in the coming months likely will be muted.

In the business sector, fixed investment plummeted late last year and early this year as current and expected sales tumbled – the typical accelerator effect – and credit conditions tightened. Lately, however, real spending on equipment and software appears to be stabilizing. The improvement is particularly visible for business purchases of cars and trucks. But the demand for high-tech equipment also appears to have firmed, while demand for other types of equipment seems to have flattened out. New orders have been choppy, but, in sharp contrast to their plunge over the preceding year, they seem to have improved on balance since the spring.

In contrast to spending for equipment and software, the contraction in business outlays for most types of nonresidential structures – for example, office and commercial buildings – appear to have fallen sharply over the first three quarters of the year. The widespread weakness reflects high and rising vacancy rates, an extremely tight financing environment, and sinking property prices that reduce the expected profitability of new projects. Because of the lumpy nature of these investments and the long time that it takes to plan and develop new projects, movements in outlays for nonresidential structures often lag movements in overall output, and, given the strong headwinds in this sector, I expect that any recovery in this area will be particularly slow to emerge.

The recession was global, and so too have been the recent signs of recovery. As a consequence, the demand for U.S. exports has been increasing lately after falling sharply in the first half of the year. However, with the firming of domestic demand, imports have also begun to increase, and, on net, the external sector appears to be a roughly neutral influence on overall economic activity at present.

All told, I expect that the recovery in U.S. economic activity will proceed at a moderate pace in the second half of this year before strengthening some in 2010. As we move into and through next year, inventory investment is likely to play a smaller role in supporting the growth of output, and aggregate activity should increasingly be propelled by stronger gains in final demand for reasons that I will discuss shortly.

Recovery in the labor market typically lags that in output, and the employment situation remains quite weak. Although the contraction in payroll employment has lessened since earlier in the year, monthly losses in private-sector jobs still averaged more than 200,000 per month last quarter. And, while the unemployment rate has not been rising as rapidly since midyear as it did over the preceding year, it could well reach 10 percent by early 2010. The difficult conditions in labor markets and the consequent implications for household incomes are important reasons for my expectation that the recovery in overall economic activity moving into next year will be restrained.

The substantial rise in the unemployment rate and the plunge in capacity utilization suggest that the margin of slack in labor and product markets is considerable. The resulting

competitive pressures on workers and firms have contributed to a substantial decline in inflation, with both headline and core personal consumption expenditures (PCE) prices decelerating significantly over the past year. Although this year's backup in energy prices has boosted headline consumer price inflation, the levels of broad measures of consumer prices are still below where they were a year ago. Core PCE prices are estimated to have risen 1.3 percent during the 12 months ending in August, compared with an increase of 2.7 percent over the preceding 12 months. To be sure, this deceleration has probably been exaggerated by a sharp decline in the so-called nonmarket component of PCE prices, which tends not to be a reliable indicator of inflation trends. But market-based price increases have also moved lower in an environment of weak demand.

At the same time, businesses have been aggressively cutting costs not only by eliminating jobs, but also by cutting back increases in labor compensation. For example, the employment cost index – a broad measure of wage and benefit costs in private industry – rose at an annual rate of just 3/4 percent over the six months ending in June. An alternative measure – nominal hourly compensation for the nonfarm business sector – is reported to have actually fallen at an annual rate of 2-1/4 percent, on average, during the first half of 2009. Moreover, businesses have been so aggressive in cutting labor input that productivity rose noticeably in the first half of the year. As a consequence, unit labor costs fell sharply in recent quarters.

Meanwhile, shorter-term inflation expectations have risen and fallen with recent fluctuations in actual inflation. But longer-term inflation expectations – whether measured in surveys of households and economists or inferred from financial markets – have been quite stable.

Even as the economy begins to recover, substantial slack in resource utilization is likely to continue to damp cost pressures and maintain a competitive pricing environment. I expect that the persistence of economic slack, accompanied by stable longer-term inflation expectations, will keep inflation subdued for some time. Indeed, if inflation expectations were to begin to ratchet down toward the actual inflation rates that we have experienced recently, inflation could move appreciably lower.

Having done this quick tour of the recent economic news, I would now like to address a few broader macroeconomic questions. First, why do I expect a gradual strengthening of economic activity? The fiscal stimulus program enacted earlier this year is likely playing a role, and it will continue to do so for a while as the states spend their stimulus funds to pay for infrastructure projects, hire more teachers, and finance other types of spending. But what will support economic activity as fiscal stimulus wanes?

Most importantly, support for private demand should come from a continuation of the improvements we've seen lately in overall financial conditions. Low market interest rates should continue to induce savers to diversify into riskier assets, which would contribute to a further reversal in the flight to liquidity and safety that has characterized the past few years. As the economy improves and credit losses become easier to size, banks will be able to build capital from earnings and outside investors, making them more able and willing to extend credit – in effect, allowing the low market interest rates to show through to the cost of capital for more borrowers. A more stable economic environment and greater availability of credit should contribute to the restoration of business and household confidence, further spurring spending.

An encouraging aspect of the improvement in economic and financial conditions in recent months has been the firming in house prices that I mentioned earlier. House prices can affect economic activity through several channels. One channel is through the influence of house prices on the net worth of households and, thereby, on consumer spending. Another channel is through the effect of anticipated capital gains or losses from investing in residential real estate on the demand for housing. Finally, greater stability in house prices should help reduce the uncertainty about the value of mortgages and mortgage-related securities held on the balance sheets of banks and other financial institutions, which should have a positive

effect on their willingness to lend. This circumstance should nourish a constructive feedback loop between the financial sector and the real activity.

Given this possibility, another reasonable question might be, Why do I expect the economic recovery to be so moderate? To be sure, many times in the past, a deep recession has been followed by a sharp recovery. But, for a number of reasons, I don't think a V-shaped recovery is the most likely outcome this time around. First, although financial conditions are improving and market interest rates are very low, credit remains tight for many borrowers. In particular, the supply of bank credit remains very tight, and many securitization markets that do not enjoy support from the Federal Reserve or other government agencies are still impaired. Consumers as well as small and medium-sized businesses are especially feeling the effects of constraints on credit availability. Banks are still rebuilding their capital positions, and their lending will be held back by the need to work through the embedded losses in their portfolios of consumer and commercial real estate loans. Over time, as I already have noted, bank balance sheets should improve, and the supply of bank credit should ease. But the financial headwinds are likely to abate slowly, restraining the economic recovery.

In addition, I do not anticipate that the recovery in homebuilding will exhibit its typical cyclical pattern. Even though the decline in residential construction began well in advance of the overall contraction in real activity, the sector continues to have an oversupply of vacant homes. To be sure, by August, the inventory of unsold, newly built single-family houses had fallen appreciably from its peak level in the summer of 2006. Nonetheless, when compared with still low levels of sales, the supply of new houses remains elevated. In addition, the overhang of vacant houses on the market for existing homes is sizable, and the pace of foreclosures is likely to remain very elevated for a while, which should further add to that overhang. Thus, even with affordability quite favorable and house price expectations brighter, I anticipate a relatively subdued pickup in housing starts over the coming year.

In the business sector, the extraordinary amount of excess capacity is likely to be another factor tempering the rate of recovery. In manufacturing, the utilization rate currently is below 67 percent – noticeably less than the low points reached in prior post-World War II recessions. I expect that the wide margin of unused capacity, combined with the tight credit conditions faced by firms that have to rely primarily on bank lending, will lead many businesses to be quite cautious about the pace at which they increase their capital spending.

In part, the gradual pace I expect in the recovery of the economy toward full employment reflects the process of shifting the composition of aggregate demand and the way it is financed in response to the events of the past few years. In particular, consumers probably will do more saving out of their income, reflecting the likelihood that household net worth will be lower relative to income than over the past decade or so and that credit, appropriately, will be somewhat less available than during the boom that preceded the crisis. In addition, housing is almost certainly going to be a smaller part of the economy than it was earlier in this decade, as financial institutions maintain tighter underwriting standards that also more adequately reflect underlying risks. Such an increase in private saving propensities and a reduced demand for residential capital should prompt movements in relative prices and other factors that will, in turn, make room for a larger role for business investment and net exports in overall economic activity.

The transition to full employment and the complete emergence of this new configuration will take time, in part because the rebalancing of the economy involves repairs to balance sheets, the movement of capital and labor across sectors of the economy, and shifts in the global pattern of production and consumption – adjustments that are likely to be gradual under any conditions. Current circumstances, however, may slow the re-equilibration process more than might otherwise be the case because of the essential role of changes in the relative cost of finance in the adjustment process. But with the nominal federal funds rate essentially constrained at zero, and spreads in markets already having narrowed, reductions in the effective cost of capital will mainly take place as conditions at financial institutions

improve and lenders ease borrowing standards, which as I have already discussed I expect to happen gradually.

As noted earlier, I expect that inflation will likely be subdued, and that, for a while, the risk of further declines in underlying rates of inflation will be greater than the risk of increases. That outlook rests importantly on two judgments: First, that the economy will be producing well below its potential for some time, which will directly restrain production costs and profit margins; and second, that inflation expectations are more likely to fall than rise over time as the level of real activity remains persistently less than its potential and actual inflation remains low.

We can never directly observe the level of economic potential – it is largely inferred from the behavior of related variables, like output, productivity, costs and prices. In that regard, a widely discussed upside inflation risk is the possibility that as a result of the financial turmoil and deep recession, the extent of economic slack in the economy is not as great as is commonly estimated. One possibility is that the steep drop in investment has caused a decline in capital services that could damp the rise in productivity. Another possibility is that the needed reallocation of resources away from a number of sectors – including finance, construction, and motor vehicles – will have a restraining influence on potential output for a time. In addition, prolonged periods of unemployment could have adverse effects on the skills of workers and their attachment to the labor force.

The financial crisis may also have affected potential output by reducing the ability of financial markets to effectively lubricate the flow of credit throughout the economy – and to allocate capital resources to their most productive uses. The deterioration in the health of the financial system conceivably may have disrupted the credit allocation system enough to seriously impair the efficiency of business operations, and this impaired efficiency could show up at some point in more meager gains in productivity. And, some have argued, as governments seek to build more stable financial and economic systems, they may impede innovation and efficiency.

Each of these arguments contains a grain of truth, and they are worthy of further research. But in my view, the cumulative reduction in aggregate demand has been much greater than any possible cutback in potential supply. The unemployment rate has risen by 5 percentage points in a very short period, and capacity utilization in industry hovers just above its lowest level in the history of the series, dating back to 1948. The downward pressures on both prices and labor compensation reinforce my impression that our economy is operating well below its productive potential. And, if anything, productivity has been surprisingly strong, not weak, in recent quarters.

The improving picture for financial markets and the economy since last spring has meant that the Federal Open Market Committee (FOMC) has not undertaken any new initiatives to ease financial conditions and stimulate demand at its past several meetings. We have left the unusually accommodative posture of policy – in terms of our plans for our balance sheet and the level of our policy interest rates – in place. It's important to judge this posture against how the economy is likely to evolve against our objectives in the future. Importantly, our objectives in the Federal Reserve Act are in terms of levels – the level of inflation relative to effective price stability and the level of output relative to the economy's potential to produce over the long run. Right now, smoothing through the short-run fluctuations in energy prices, inflation seems to be running a little below the 2 percent objective for PCE prices that I have seen as best promoting our dual mandate of maximum employment and stable prices. And, as I indicated, employment and output seem to be substantially below plausible estimates of their potential.

But it's not the current level of inflation or of output that figure into our policy decisions directly – rather, it is the expected level some quarters out, after the lags in the effects of policy actions have worked themselves out. In that regard, the projection of only a gradual strengthening of demand and subdued inflation imply that that these gaps – of inflation and

output below our objectives – are likely to persist for quite some time. In these circumstances, at its last meeting, the FOMC was of the view that economic conditions were likely to warrant unusually low levels of interest rates for an extended period.

This assessment and my outlook do not mean that my colleagues and I will not also be looking carefully at any evidence that portends a potential pick up of inflation. Uncertainty about the course of the economy is a lot lower than it was just a few short months ago. But we cannot lose sight that this uncertainty remains quite high; we are still in largely uncharted waters when it comes to fully understanding how our economy will recover from the severe recession and financial disruptions of the past several years and how that recovery and inflation will be affected by the extraordinary actions we took. We need to base policy on our best estimate of the evolution of inflation and output relative to our objectives, but we also need to be ready to adjust our plans if events don't turn out as predicted in either direction. We have the tools to exit our unusual policies when the time comes. And we must act well before demand pressures or inflation expectations threaten price stability.

In circumstances like these, we will be carefully watching the forecasts and economic evaluations of people like yourselves – indeed, perhaps as carefully as you will be watching the evolution of our thinking. In that regard, I'm glad to have had the opportunity to share some thoughts on these issues with you today.