Donald L Kohn: The economic outlook

Speech by Mr Donald L Kohn, Vice Chairman of the Board of Governors of the Federal Reserve System, at the Federal Reserve Bank of San Francisco community leaders luncheon, San Francisco, 8 April 2010.

* * *

The United States has been through a severe recession – a consequence of the correction of excesses that had accumulated in the economy and financial markets. Today, I would like to take stock of where we are in that correction by discussing the outlook for the economy. To summarize in a sentence: We have worked through a lot of the problems that initiated and deepened the downturn, but not all of them, and thus the pace of the recovery is likely to be restrained.

I last spoke on the economic outlook in October, and my views since then remain largely unchanged – though, I should hasten to add, not because I am too lazy to update my forecast! Rather, the data since last fall have been broadly in line with my earlier expectations and suggest that a moderate recovery is under way, accompanied by low inflation. Of course, things could well have turned out differently: Given the extraordinary events of the past few years, by now we could be experiencing a relapse into recession or, alternatively, a strong rebound. The fact that conditions evolved largely as had been expected last fall suggests that the future may, just may, be a bit less uncertain than before. Even if that is the case, considerable uncertainty about the outlook remains, and at the conclusion of my remarks I will touch on some of the implications of that uncertainty for monetary policy.

Before proceeding, I should emphasize that my remarks today reflect my own views and not necessarily those of my colleagues on the Federal Open Market Committee (FOMC).[1]

Recent developments

After declining for a year and a half, economic activity bottomed out in the middle of last year and subsequently turned up. A number of factors have fostered the recovery. The steps taken in the United States and abroad to stabilize financial markets and end the panic so evident in late 2008 and early 2009 helped steady the economy. In addition, extraordinary monetary and fiscal stimulus, both here and around the world, have supported the upturn. These actions helped the financial markets to turn around, and they set the stage for recovery in combination with reductions in the inventory overhangs of houses and a broad range of other goods. Real gross domestic product (GDP) expanded at an annual rate of about 4 percent in the second half of last year. The gain was especially large in the last quarter of 2009, although a sizable chunk of that increase reflected a marked slowing in the pace of inventory liquidation. The most recent data on spending and production from the first few months of this year have been encouraging and suggest that the recovery remains on track. I expect the expansion to be sustained by continued increases in private final demand, even as the temporary boost from inventories passes and the contribution of fiscal stimulus to growth likely wanes later this year.

On the positive side, consumer spending has been expanding at a solid pace, supported by low interest rates, improving household wealth, recovering confidence, and fiscal stimulus. Business outlays for equipment and software appear to be rebounding appreciably, consistent with improved financial conditions and business sentiment.

[1] Peter Tulip and Daniel Sichel of the Board’s staff contributed to these remarks.

Exports are another bright spot. International trade tends to be highly sensitive to the business cycle, and foreign demand for U.S. products fell sharply during the global slump. But with economic conditions improving abroad, export volumes have rebounded since the middle of last year. At the same time, however, a sizable increase in imports has accompanied the upturn in our economy, and the effect of exports and imports on GDP growth has been roughly offsetting.

On the negative side, some sectors of the economy remain quite weak. Home sales, which seemed for a time last year to be starting to slowly recover, have stalled recently, and housing starts are only a little above last year's low. Moreover, nonresidential building continues to contract amid rising vacancy rates, plunging property prices, and strained financing conditions. And, as I'm sure you are only too aware, difficult fiscal conditions have restrained spending by state and local governments. The latest data on employment and construction suggest that spending by state and local governments has continued to decline this year.

Signs of recovery are just beginning to emerge in the labor market. Private payrolls appear to have bottomed out earlier this year and to have posted a noticeable increase in March, and the unemployment rate is down a bit from its recent high. Despite that good news, the labor market remains extremely weak. Businesses, facing considerable uncertainty and under pressure from weak sales and tight financial conditions, have been reluctant to hire even though output has begun to recover and instead have found ways to boost worker efficiency. Indeed, output per hour in the nonfarm business sector is reported to have risen almost 6 percent during 2009. But such outsized productivity gains are not likely to continue. If labor productivity growth slows to a more normal rate of increase, then further increases in demand and production should lead to additional increases in hiring. However, if economic growth remains moderate, as I anticipate, employment gains are likely to lower the unemployment rate only slowly.

An ongoing concern in this recovery is whether unemployed workers may experience unusual difficulties in re-entering the workforce. The duration of unemployment has been exceptionally long in this business cycle, a development that could erode worker skills and decrease re-employment probabilities. In addition, it may take some time for those who are unemployed to move or retrain for the new jobs that the recovery will bring. For these and other reasons, part of the increase in unemployment over the past two years may be structural, and this part would tend to reverse only slowly.

Even if a portion of the rise in unemployment is structural, however, most appears to be cyclical, suggesting that the economy is operating well below its productive potential. This conclusion is supported by other measures of slack, such as capacity utilization in manufacturing, and by the ongoing deceleration in wages and prices.

Although headline consumer price inflation has been boosted in recent quarters by an increase in energy prices, a substantial deceleration has been observed in measures of prices that exclude such volatile elements. For example, the price index for personal consumption expenditures (PCE) excluding food and energy rose 1.3 percent over the 12 months to February, down 1/2 percentage point from a year earlier and down more than a full percentage point from the start of the recession in late 2007. Other measures of underlying inflation trends also show substantial deceleration; for example, the Federal Reserve Bank of Dallas's trimmed mean measure of PCE inflation, which excludes the most extreme price changes in a month, was only 1.0 percent in the 12 months to February, compared with 2.4 percent in the preceding 12-month period.

Labor costs have also decelerated. The employment cost index – a broad measure of wage and benefit costs in private industry – rose only 1.2 percent in the 12 months to December after hovering around 3 to 4 percent for most of the preceding two decades. Other measures of labor compensation show comparable slowdowns and, when coupled with the acceleration in productivity, imply the largest four-quarter drop in unit labor costs in decades. This development also should work to restrain price inflation.

The shape of the recovery

Often in the past, very steep recessions, such as the one we have been through, are followed by sharp recoveries. As I noted at the beginning of my talk, I don't expect that outcome this time; instead, I think the most likely scenario is a gradual pickup in economic activity as the forces that got us into this difficult situation slowly fade away.

First, although financial conditions are improving and capital markets are open for larger firms, credit remains unusually tight for many borrowers, especially consumers and smaller businesses that are dependent on banks. Banks are still rebuilding their capital, and their lending will be held back as they work through the embedded losses in their portfolios, particularly for consumer and commercial real estate loans. Beyond this challenge, some securitization markets are still impaired.

As the economy improves and credit losses become easier to estimate, banks should be able to build capital from earnings and outside investors, and they will have greater confidence in the prospective profitability of lending. They will become more able and willing to compete for new business – in effect, allowing low market interest rates to pass through to more borrowers. These developments will induce more borrowing and spending, further improving the economy, but this process will take time.

Second, I do not expect that the recovery in housing construction will boost growth substantially this year, in contrast to its usual pattern early in economic recoveries. A large overhang of vacant homes is likely to weigh on new construction for some time, even though residential construction activity has declined dramatically since its peak in 2005 and inventories of unsold new homes have fallen to very low levels. In addition, the pace of foreclosures is likely to remain elevated for a while, adding to the stock of homes for sale. On the positive side, housing affordability is quite favorable, in part reflecting low mortgage rates, and house prices appear to be stabilizing. Still, problems persist in housing, and I anticipate a relatively subdued pickup in housing starts over the coming year.

Third, households need to continue rebuilding wealth. They became too indebted and too dependent on housing wealth to finance current purchases and provide for future events like the education of their children and their retirement. Now they need to repay debt and save more out of current income. In addition, restraints on consumer credit continue to hold down spending, and high unemployment and uncertainty have weighed on consumer confidence.

Again, these constraints will fade as consumers adjust to the shocks they have been dealt. Indeed, the effects on spending of past reductions in wealth are receding, and household net worth is rising again. And as employment continues to pick up, income will rise more rapidly and households will presumably become more confident about the future – and thus more willing to spend. But they are unlikely to return to the spending patterns of old, and we cannot expect outsized gains in consumer outlays to provide an extra push to the economic expansion.

Last, business investment spending has been depressed by a weak and uncertain sales outlook, tight credit conditions, and significant unused capacity. However, signs are growing that confidence is returning as the outlook for sales brightens and bond spreads narrow. Moreover, spending on equipment and software is likely getting a boost from replacement demand. Gross investment in equipment and software has fallen so low that it is not even covering estimated depreciation, meaning that further spending increases are needed just to prevent the capital stock from continuing to shrink, let alone to foster a modest expansion of the capital stock as the recovery proceeds. So this sector has the potential to be a source of strength for the economy.

With only a moderate recovery likely on tap, I expect unemployment to come down only slowly from its currently elevated level. Although the persistent high level of unemployment will tend to restrain inflation further, the effect of resource slack on inflation does not appear to be as great as some previous episodes might have led us to expect. The difference is that inflation expectations now appear to be much more firmly anchored than they once were, probably reflecting the extended period of low inflation that we have experienced and a credible monetary policy directed at sustaining this performance. I anticipate that inflation will remain low for a while, with core PCE inflation not likely to fall much further from the subdued pace I cited a few minutes ago.

Longer-run rebalancing

The U.S. economy should emerge from this episode stronger, more resilient, and on a more sustainable growth path than before the recession. This outcome will entail a gradual long-run shift in both the composition and financing of aggregate spending. In particular, as I already noted, consumers probably will save more than in the past, reflecting the likelihood that household net worth will be lower relative to income than it was over the past decade or so and that credit, appropriately, will be somewhat less available than during the boom. In addition, housing is almost certainly going to be a smaller part of the economy than it was when lax credit standards encouraged overbuilding and overborrowing. Increased private saving and reduced demand for housing 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. In addition, households that have worked down debt levels will be less vulnerable and better able to withstand shocks in the future.

As I have been emphasizing, the transition to full employment and the emergence of this new configuration of spending and production, and borrowing and saving, will take time. This rebalancing 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. Moreover, the re-equilibration may be slower than might otherwise be the case because tight credit will limit the ability of some households and firms to make the necessary adjustments.

Government policies will be essential to supporting the smooth transition to more-sustainable economic growth with greater investment and exports. We must ensure that changes in taxation and regulation do not blunt incentives for business investment. In addition, although fiscal policy has provided important support for the economic recovery, it will need to be put on a more sustainable path in the medium term. Failure to do so risks a market reaction that could increase longer-term interest rates; economic growth would be hindered if government borrowing boosts the cost of capital and diverts resources away from private investment.

Reducing the deficit and avoiding a continuing buildup in government debt relative to income will be essential for bringing national production and spending into better balance. That balance, in turn, is necessary so that we are no longer so reliant on borrowing from other nations. Heavy dependence on foreign borrowing by the United States is not a solid foundation for long-term economic growth either here or in those countries extending us credit. The actions of U.S. authorities and private parties to bring about a better balance of saving and investment must be matched by action overseas in chronic surplus countries. While we reduce demand relative to our productive potential, the surplus countries must increase their domestic demand if the global economy is to thrive.

Finally, as has been so painfully demonstrated over the past few years, sustained growth requires a financial system that is much more resilient and thus better equipped to continue to supply funds to creditworthy borrowers when the unexpected happens. To this end, banks and other lenders must hold capital and liquidity to cover more of the risks they are taking, and they must have the capability to know what those risks are and to manage them effectively. Critically, the financial regulatory structure needs to be modernized to bring oversight and market discipline to bear much more effectively on our rapidly evolving financial system and to give regulators more tools to deal with problems as they arise. At the Federal Reserve, we are improving our supervision and regulation to incorporate a broader view of emerging risks in the financial system and to become more effective at translating identified risks to supervisory oversight and, if required, remedial actions by the banks.

Monetary policy

The picture I've drawn today – of a gradually improving economy, bolstered by better functioning financial markets and rising asset prices, but also still held back by the effects of the previous imbalances and corrections – has had important implications for monetary policy. Because the economy and financial markets have improved, we have been able to wind down our special liquidity facilities and complete our purchases of long-term assets, like mortgage-backed securities. But because the recovery looks as though it will be gradual, and because it started with the economy in a deep hole, with large margins of underutilized labor and capital resources and low inflation likely to persist well into the future, the Federal Open Market Committee has stated that the current exceptionally low level of interest rates is likely to be required for "an extended period" to make progress toward our legislative goals of maximum employment and stable prices. The exceptionally low rates help offset the lingering restraining effects on economic activity and prices discussed earlier.

In due course, as these restraints abate and the expansion matures, we will need to withdraw monetary stimulus to prevent the development of inflationary pressures. As in past cycles, our decision to begin tightening will be based not on a particular indicator or small set of indicators, but rather on forecasts of economic activity and inflation that take account of all available information. We will want to make sure the economy has enough forward momentum to continue absorbing the unused resources and to limit disinflationary pressure. But we will also want to be sure that we haven't left highly accommodative policy in place so long that economic and financial conditions become conducive to future inflation. Given the lags in the effects of monetary policy, that means we will not be able to wait until the unemployment rate is down close to its long-term level.

We will be watching inflation and inflation expectations carefully. Inflation expectations have been stable, and I expect them to remain so. Still, one risk is that, in line with past behavior, expectations could follow actual inflation down, imparting additional downward momentum to actual inflation. However, another risk is that expectations could increase, perhaps reflecting concerns about the Federal Reserve's balance sheet or the federal budget deficit. For the moment, the public seems confident that the Fed will keep inflation stable over time. We do not take that trust for granted: We monitor inflationary developments closely and stand ready to respond quickly and vigorously should the need arise.

Although the framework for deciding when and how fast to tighten monetary policy will not differ conceptually from the framework used in the past, our decision this time has some added complexities. In particular, our assets and the corresponding bank reserves are far larger than anything in our experience. We are developing the tools to manage our enlarged balance sheet in support of policy tightening when the time comes, and we will need to deploy them in ways that reinforce our ability to achieve our macroeconomic objectives. That won't be easy since we've never had so many levers to manipulate before, but the FOMC has been giving considerable thought to this issue, and I'm confident that we will find the right balance and sequence of actions to support our basic policy decisions.

Some implications of uncertainty

As this last point illustrates, we are still in the midst of a very unusual period in U.S. economic history and therefore in the conduct of monetary policy. Policy always operates in an environment of uncertainty. The events of the past three years have highlighted to me yet again our limited knowledge of the dynamics of the financial system, the economy, and the interactions between them.

I can be reasonably certain of only one point: My economic forecast is highly likely to be wrong – but I don't know how. One implication of this pervasive uncertainty is that any statement about the future path of monetary policy must be conditional – dependent on the economy following the expected path. Although the FOMC has stated that the federal funds rate is likely to remain exceptionally low for an extended period, this statement explicitly depends on an economic outlook similar to the one I have given today. We cannot provide a precise timetable for when short-term interest rates will begin to return to normal because that depends on the evolution of actual and projected activity and inflation.

Another implication of uncertainty is that policymakers need to be open to alternative views about how best to set policy over time to stabilize prices and achieve maximum employment. All models of the economy are flawed to some degree, and a policymaker cannot dismiss a risk simply because it is improbable in his or her favorite model. I don't know of any formal model that predicted what we have just been through. Rather, policymakers need to weigh the predictions of competing models in light of both theory and empirical evidence. They also need to be prepared to adjust these weights or even abandon some models when the incoming data are inconsistent with the view of the world embodied in the particular model.

In my experience, these and other considerations put a premium on flexibility. The need to learn from and respond to news means that policy should have a substantial discretionary component. We have certainly needed to innovate over the past several years to contain the damage from unprecedented events in financial markets. But discretion has its limits as well. We must be able to explain and justify our actions within a coherent framework – even if the elements of that framework are adjusted from time to time as experience dictates. And to the extent that we can act predictably, households and businesses will be able to anticipate our actions, reinforcing their effects. Finally, we must not be flexible about our objectives. The goals of monetary policy – price stability and maximum employment – are stable and well known. The flexibility relates to the actions we take to get there.

Conclusion

The economy appears to be moving in the right direction, though not as quickly as we all would like. As I prepare to step down from my current position, I recognize that I am leaving Janet and my other colleagues with some formidable tasks. But I am confident that under the leadership of Chairman Bernanke, the Federal Reserve will be able to foster the restoration of prosperity and stability for the U.S. economy over the years to come.