Christine M Cumming: Macro overview of the United States

Remarks by Ms Christine M Cumming, First Vice President of the Federal Reserve Bank of New York, at the European Economics and Financial Centre, London, 15 February 2011.

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It is a great pleasure to be here to speak to you today about recent developments in the U.S. economy. I'd like to thank Professor Hannah Scobie and the European Economics and Financial Centre for organizing the seminar in this beautiful historic setting, and thank the Member of Parliament, Geoffrey Clifton-Brown, for presiding over and sponsoring this meeting. The views I will express are my own and do not necessarily reflect the views of the Federal Reserve Bank of New York or the Federal Reserve System.

I have organized my talk into six observations about the U.S. economy.

First, in considering the nature of the recovery from the financial crisis and recession, which many call the "Great Recession," it is important to take note of the severity of the downturn from which we are recovering. Even though the United States has experienced six consecutive quarters of positive growth of real gross domestic product (GDP) since the official end of the Great Recession, the level of output remains well below the business cycle peak. The economic history of such combined financial crisis and recession experiences is that recovery is often slow and protracted; this one seems no different.

- Hours worked, closely tied to overall economic activity, and personal income excluding transfers (Charts 4–5) illustrate both the depth of the economic decline and the highly unusual nature of the recovery so far compared with all others in the post-World War II period.
- The unemployment rate has declined, but to a large extent this reflects the decline of the labor force participation rate (Chart 6). Ranges of estimates of unemployment including discouraged workers run as high as the high teens.
- Had the participation rate remained at its business cycle peak level, the unemployment rate would be about 10.5 percent.
- Core inflation (excluding energy and food prices) has declined to a very low level, well below the range of 1 percent to 2 percent that market participants have associated with the Fed's desired, "mandate consistent" range. Low rates of core inflation are of concern because economic research suggests that this is an important indicator of long-term trend headline inflation (Chart 7).
- Economic history also suggests that recoveries from financial crisis and recession are fragile. Indeed, one disappointment in 2010 was that an initially strong recovery weakened considerably in the second quarter, in part due to renewed concerns about financial fragility in the wake of the sovereign debt concerns in parts of Europe. The recovery remained restrained, eventually prompting the Federal Reserve in November to embark on a second round of large-scale asset purchases, often called quantitative easing.

Second, a wide array of recent indicators suggest that the U.S. economy entered 2011 with substantial forward momentum.

- Real personal consumption expenditure (PCE) grew 4.4 percent (AR) in 2010Q4, led by spending on durable goods (Chart 9).
- The one-year, 2 percentage point payroll tax cut, part of the December 2010 tax package extending the Bush-era tax cuts, is likely to give a significant boost to real PCE over the first half of 2011, perhaps as much as $120 billion.

- Real exports have grown rapidly of late; growth has been strong among much of the emerging market world, and growth prospects among our major trading partners is promising (Chart 10).
- Growth of business investment in equipment and software has been well maintained and is likely to get an added boost in 2011 from the “full expensing” provision enacted late last year as part of the tax package. This and the export strength is reflected in high levels of orders and shipments of capital goods (Chart 11).
- Business investment in nonresidential structures, such as office buildings and hotels, hard hit by the recession, is still declining but at a much reduced rate (Chart 12).
- Business inventories are in good balance with sales, after a very pronounced inventory cycle (Chart 13). Reflecting these developments, measures of business activity in both manufacturing and nonmanufacturing have reached substantial highs and measures of consumer confidence have stabilized (Charts 14–15).

Third, substantial progress has been made on the large adjustment of financial positions in the household and financial institution sectors necessary after the substantial leveraging of households and financial institutions that occurred in the run-up to the financial crisis. Confidence is increasing that conditions are now in place to support sustained above-potential growth, when it occurs.

- Aided by the second installment of Large-Scale Asset Purchases (LSAPs), financial conditions have improved. After equity prices, interest rates and inflation expectations fell with the apparent slowing of the economic recovery in the summer, they began to move up again shortly after Chairman Bernanke’s speech laying out potential responses to the slowdown in late August in Jackson Hole, Wyoming (Charts 17–20).
- The personal saving rate has risen to a level that is consistent with the historical relationship between that rate and household net worth relative to disposable income, reflecting the very large drop in household net worth from the combined impact of financial crisis and severe housing downturn (Charts 21–22).
- The household financial obligation ratio has declined to the level that prevailed in the mid 1990s, reflecting a combination of debt repayment, debt charge-offs and lower interest rates (Chart 23). Households in all credit-quality quintiles are continuing to reduce their overall debt (Chart 24).
- Banks tightened lending standards during the financial crisis and recession. Bank lending standards, while tight in level terms, have begun to ease (Chart 25).
- Commercial and industrial (business) loans on bank balance sheets and consumer credit (nonmortgage) have begun to expand (Chart 26).

Fourth, the U.S. economy still faces painful structural adjustments in the housing and government sectors that pose significant downside risks.

- The excess inventory of vacant homes, particularly single-family units, remains substantial (Chart 28). As a result, the number of housing starts has fallen to essentially frictional (replacement) levels and remain there (Chart 29). A large pipeline of loans in foreclosure and loans seriously delinquent still exists (Chart 31). The ratio of foreclosures to delinquencies over 90 days has fallen substantially, under the combined impacts of efforts to work out loan modifications with borrowers, decisions by lenders to slow foreclosures to avoid the deleterious impact of property vacancy, and the sheer volume of foreclosures relative to the legal and financial infrastructure designed to handle them.

- Home prices have come under renewed downward pressure, a concern because of its impact on household net worth and spending (Chart 30). Some signs that the market for distressed housing (short sales and foreclosures) is separating from the main housing market may be a positive indication that market forces are starting to work through the housing oversupply in a process similar to that usually seen for distressed real and financial assets.
- State and local governments have been cutting employment and will likely continue to do so over the year ahead (Chart 32). The federal fiscal stimulus sustained state and local governments through the severe revenue drops triggered by the recession. With the ebbing of the fiscal stimulus program, many state governments are taking actions to make long-term structural reductions in spending.
- Federal fiscal policy is widely acknowledged to be on an unsustainable path for the long term and must be addressed (Chart 33). For example, the expiration of the Bush-era income tax cuts and legislated cuts in Medicaid, if they went into effect, would stabilize the debt to GDP ratio at around 80 percent; if, however, their effective date continued to be deferred, the debt to GDP ratio could move toward 100 percent fairly rapidly. The proposed budget delivered by the U.S. Administration on February 14 begins the process of adjusting the fiscal trajectory.

Fifth, the challenge for monetary policy has been to provide stimulus and support in the wake of the combined financial crisis and recession. As noted at the outset, economic history suggests that such a combined financial and economic shock can drive the economy down very deeply. Strong, forceful policy – both monetary and fiscal – is necessary to stem the contractionary forces in the economy. The Federal Reserve responded by lowering interest rates to near zero, to provide substantial liquidity support to the economy and to conduct the first large-scale asset purchase program, more than doubling the Federal Reserve's balance sheet. History also suggests that the recovery from a combined financial and economic shock can be fragile. The Federal Reserve responded to the slowing of the recovery in mid-year 2010 by beginning a second round of large-scale asset purchase programs. Those purchases are resulting in a rough tripling of the Federal Reserve's balance sheet (Chart 42).

- U.S. economic conditions are currently quite far away from levels consistent with the Federal Reserve's dual mandate of the pursuit of the highest level of employment consistent with price stability. I've discussed the high unemployment and unused productive capacity in the United States. Let's turn to inflation.
- While trend inflation is quite low at the moment, we see it likely to be near the low point of this cycle. The rate of inflation for nonenergy services is beginning to increase, led by faster increases in apartment rents (Chart 36). A firming of demand along with a decline of the exchange value of the dollar should begin to put upward pressure on nonfood, nonenergy goods prices.
- However, underlying inflation fundamentals suggest relatively low trend inflation for some time:
  - A substantial amount of slack in the economy, reflected in the sharp deceleration of core services prices – and the United States is a services economy (Chart 35).
  - Relatively wide profit margins, so that firms facing very competitive output markets are able to absorb changes in energy and commodity prices. Moreover, unit labor costs are still falling (Chart 37).
  - Inflation expectations remain well anchored (Chart 38).
- Rising commodity prices are an indicator of strengthening demand around the globe.

- Higher energy prices likely to boost overall inflation in the near term. Whether energy and commodity prices raise inflationary levels for the medium term depends on the persistence of the commodity price rises.
- Because commodity price changes have shown less persistence over the last 20 or more years, economists have seen little evidence of pass-through of higher commodity prices into underlying inflation (Chart 39). In the past, sustained rising prices for energy and commodities have been tempered over time by business and household adopting more energy-efficient practices, as well as investment in and adoption of substitute sources.

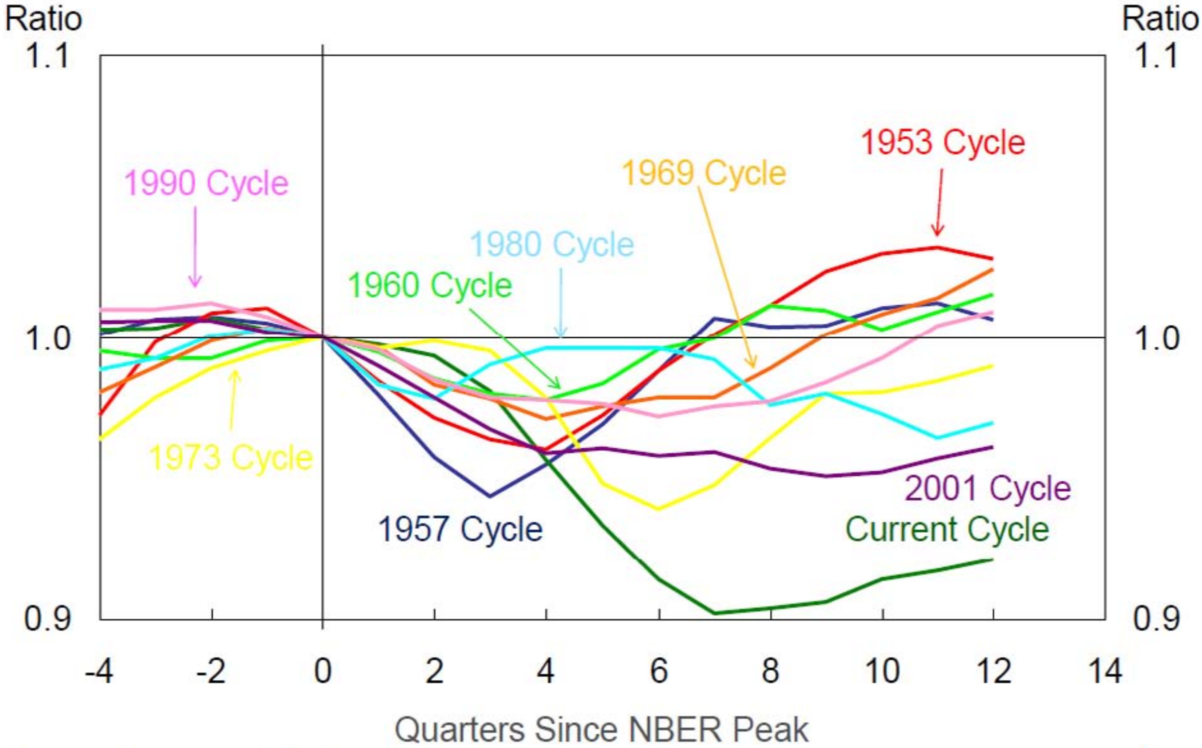
Sixth, what does the market expect the Federal Reserve to do in the near-term? The last statement of the Federal Open Market Committee said:

- The Committee…continues to anticipate that economic conditions, including low rates of resource utilization, subdued inflation trends, and stable inflation expectations, are likely to warrant exceptionally low levels for the federal funds rate for an extended period.
- Current market expectations, inferred from the federal funds (overnight interest rate) futures curve, are that:
  - The Fed will purchase the full $600 billion of Treasury securities by mid 2011.
  - The Fed will begin to raise the federal funds rate in the second half of 2011 (Chart 41).
- The Committee has stressed that policy is conditional on the performance of the economy. As the fed funds chart shows, market expectations for monetary policy are very sensitive to changes in the economic setting – consider the shifts in the shape of the federal funds over time.

Thank you for your attention.

Nonfarm Business Sector: Hours Worked of all Persons

(Series Set to 1.0 at NBER Peak)



Source: Bureau of Labor Statistics

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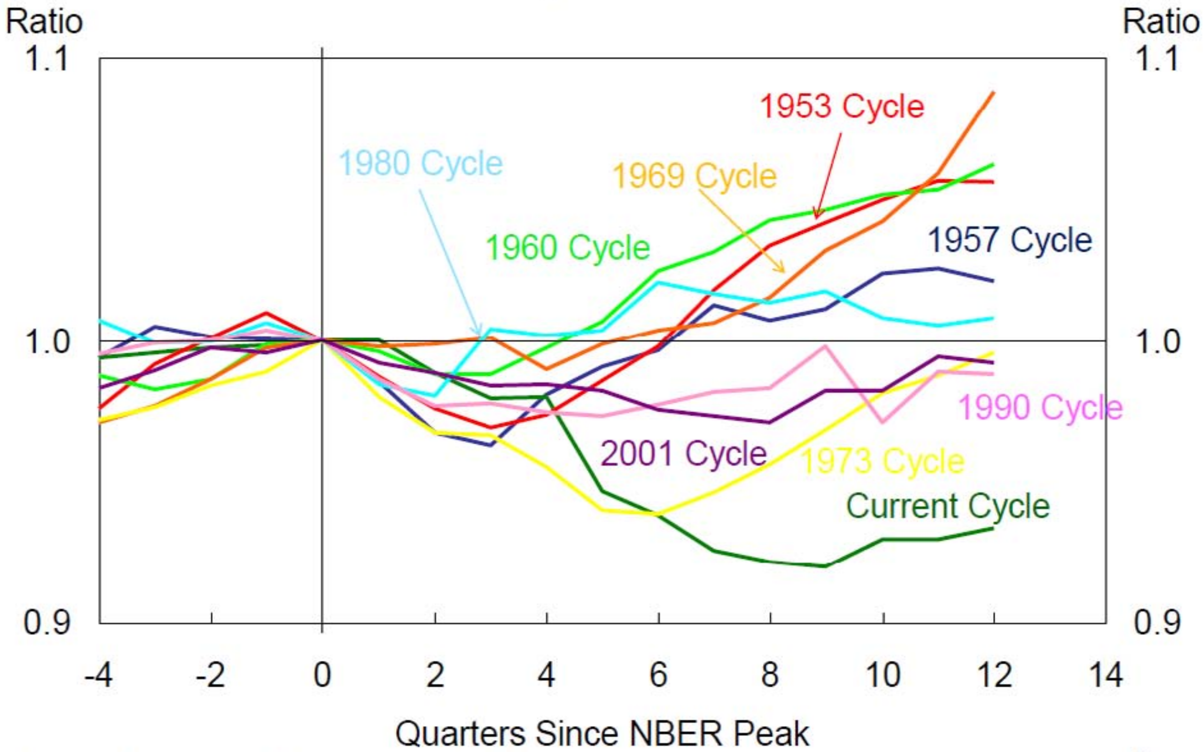
Personal Income Excluding Current Transfer Receipts Per Capita

(Series Set to 1.0 at NBER Peak)



Source: Bureau of Economic Analysis

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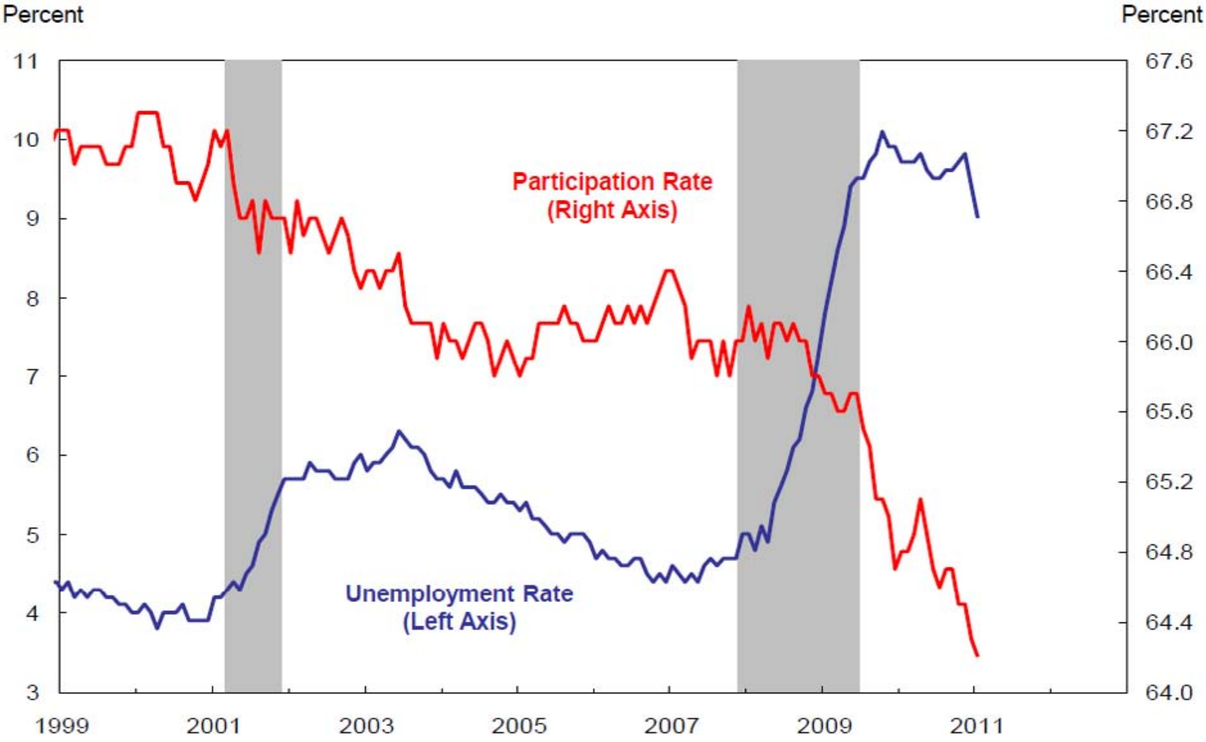
Unemployment and Labor Force Participation Rates



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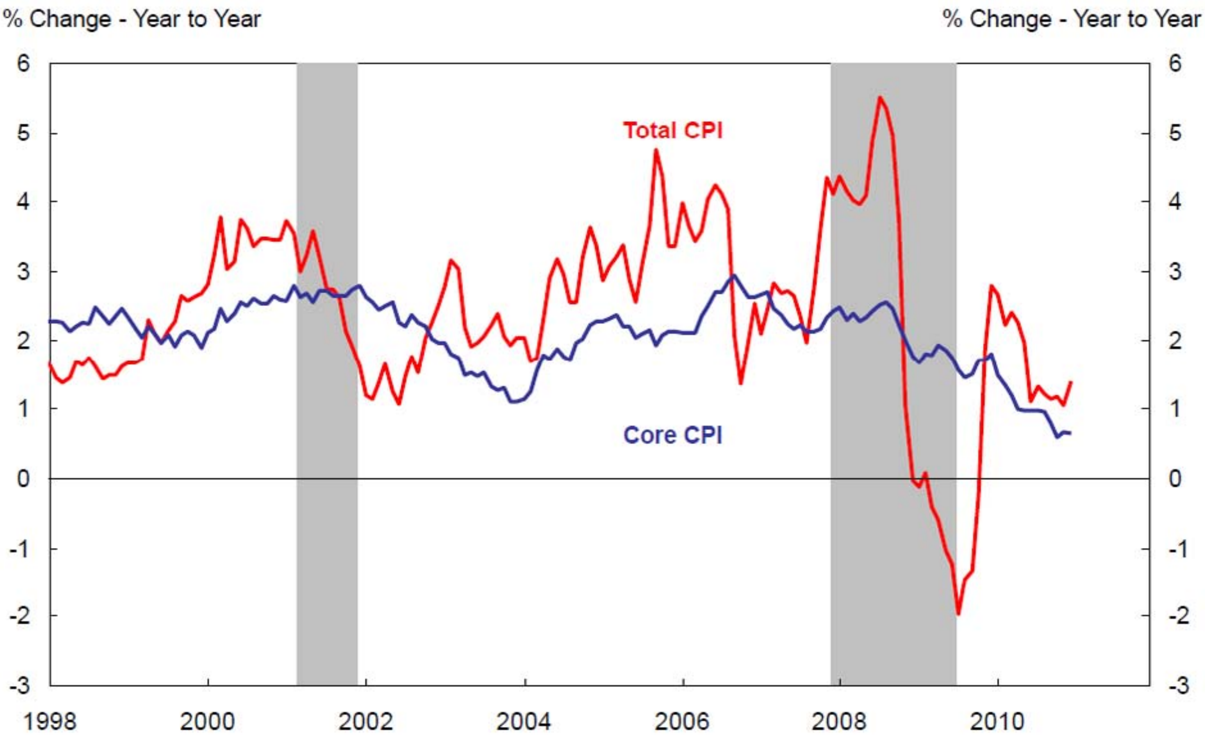
Source: Bureau of Labor Statistics

Total and Core CPI



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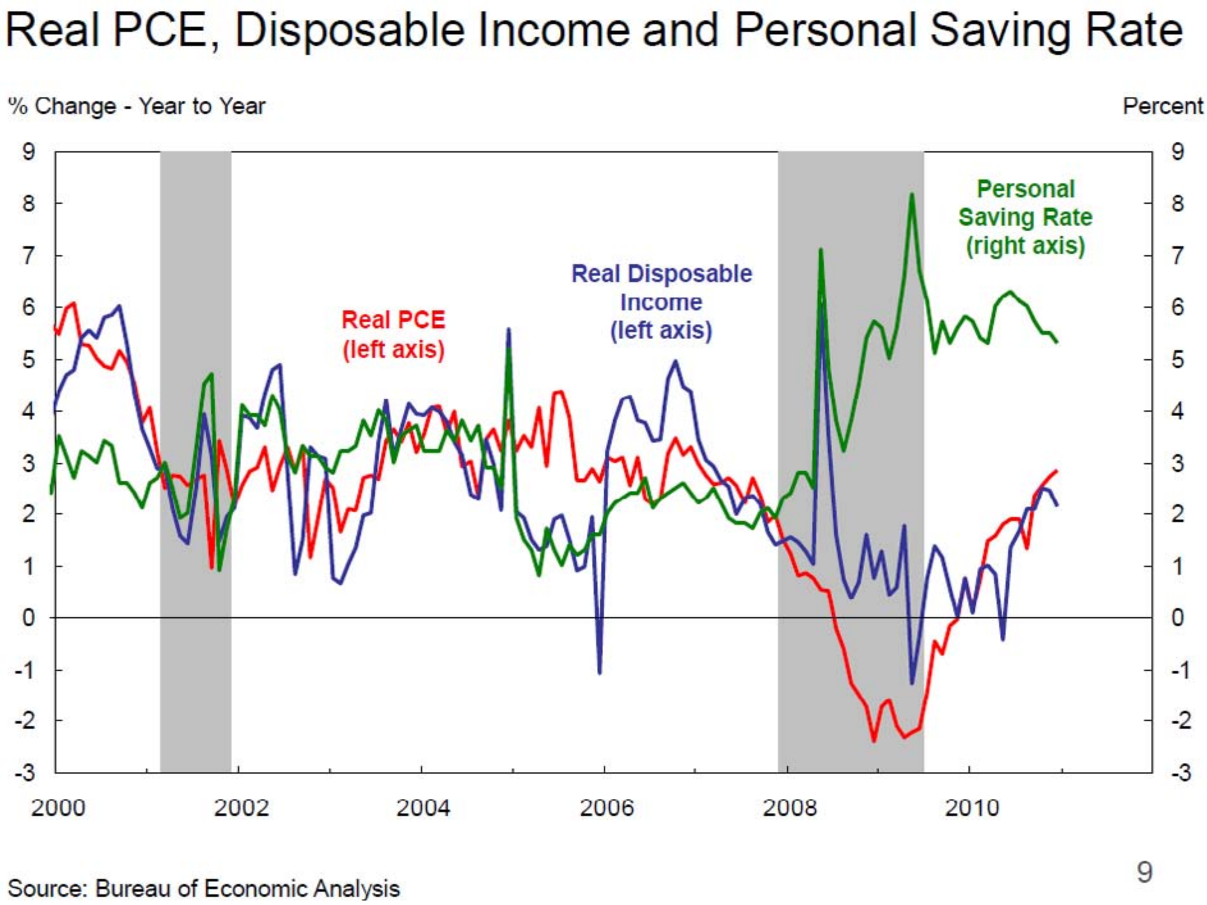
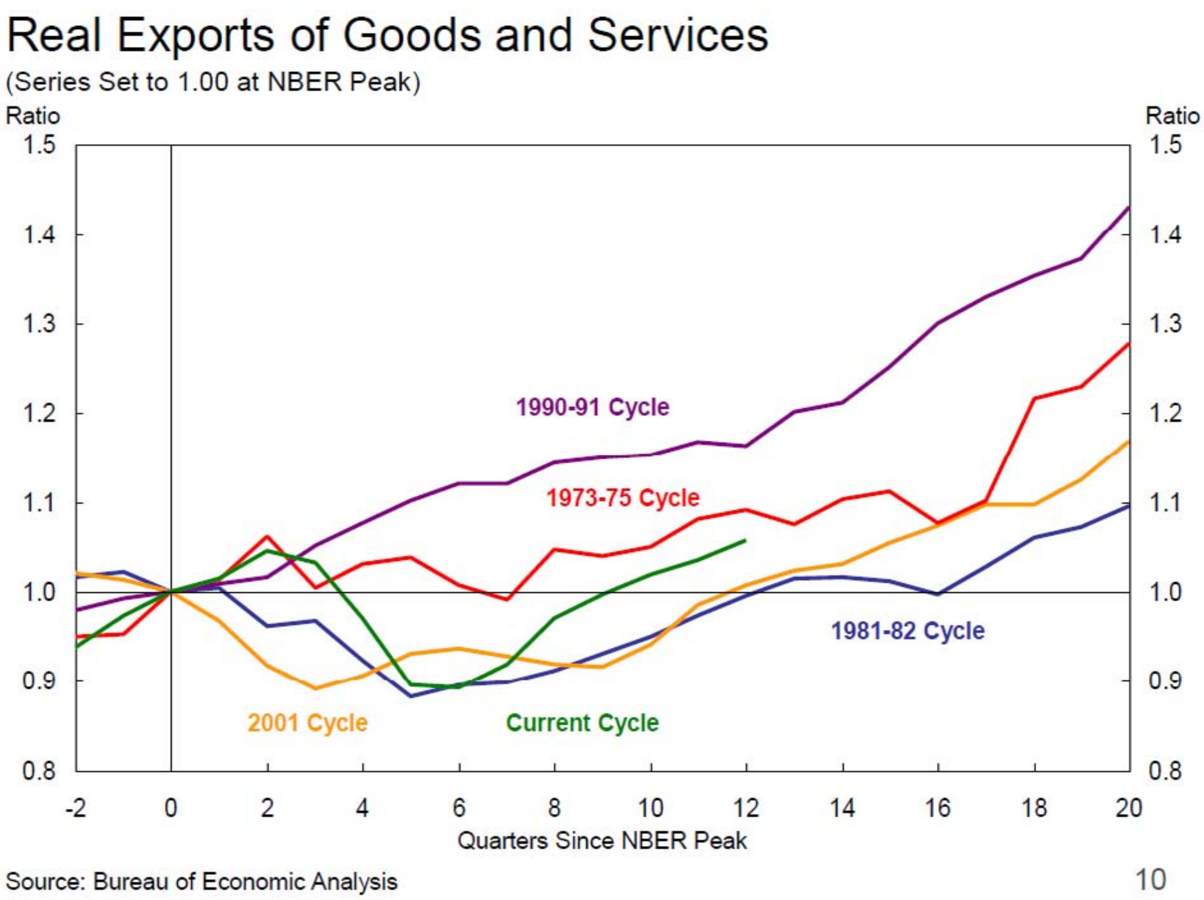
Source: Bureau of Labor Statistics

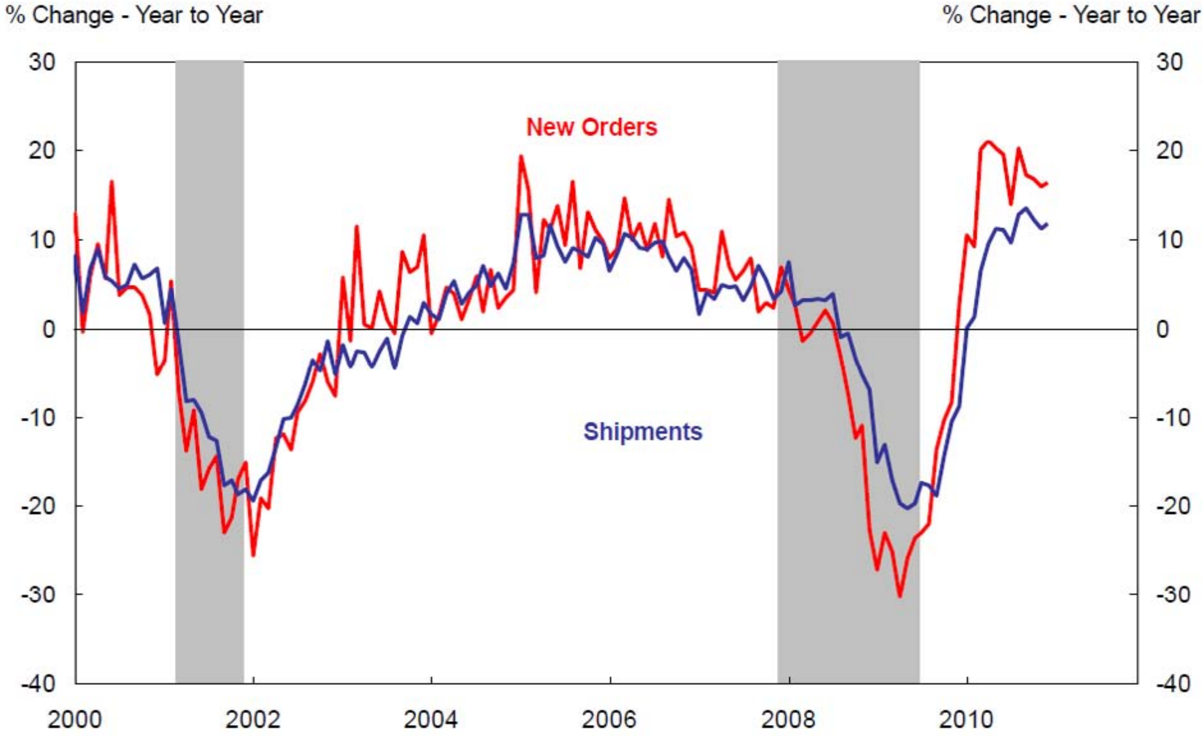


Real PCE, Disposable Income and Personal Saving Rate
% Change - Year to Year
Percent
Personal Saving Rate (right axis)
Real Disposable Income (left axis)
Real PCE (left axis)
9
8
7
6
5
4
3
2
1
0
-1
-2
-3
2000
2002
2004
2006
2008
2010
Source: Bureau of Economic Analysis
9



Real Exports of Goods and Services
(Series Set to 1.00 at NBER Peak)
Ratio
Ratio
1.5
1.4
1.3
1.2
1.1
1.0
0.9
0.8
1990-91 Cycle
1973-75 Cycle
1981-82 Cycle
2001 Cycle
Current Cycle
-2
0
2
4
6
8
10
12
14
16
18
20
Quarters Since NBER Peak
Source: Bureau of Economic Analysis
10

Nondefense Capital Goods Excluding Aircraft



Source: US Census Bureau

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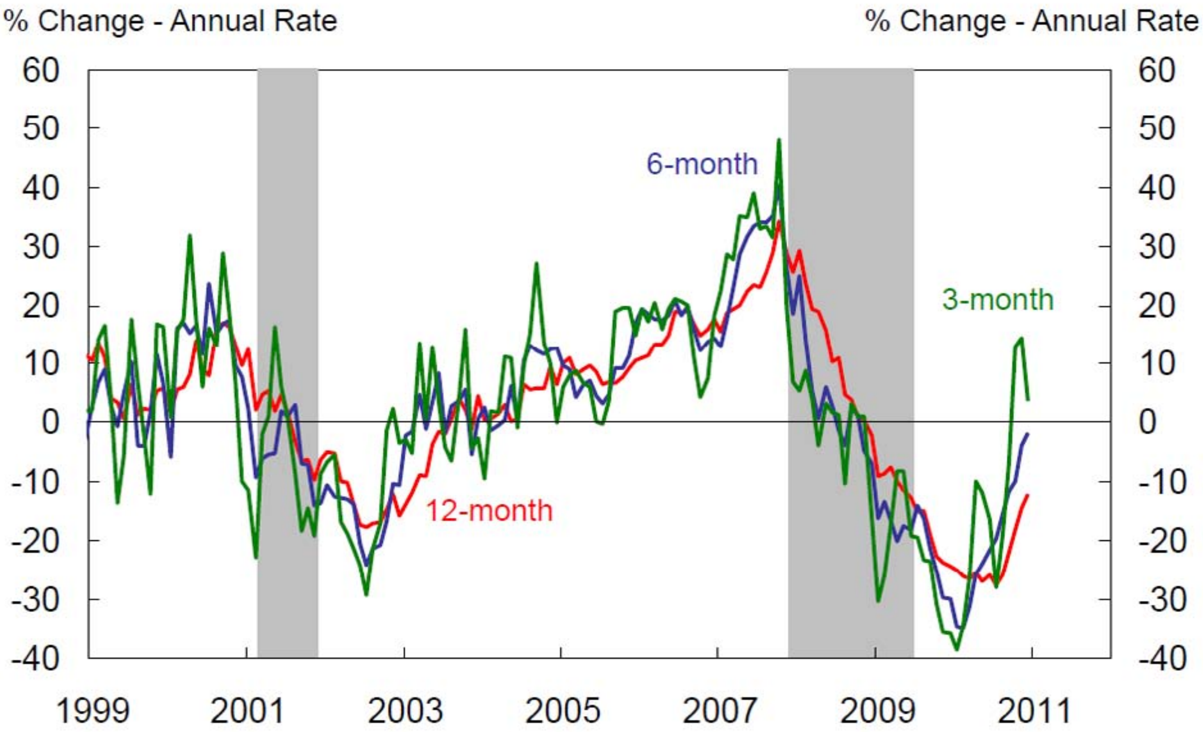
Private Nonresidential Construction over Various Horizons



Source: US Census Bureau

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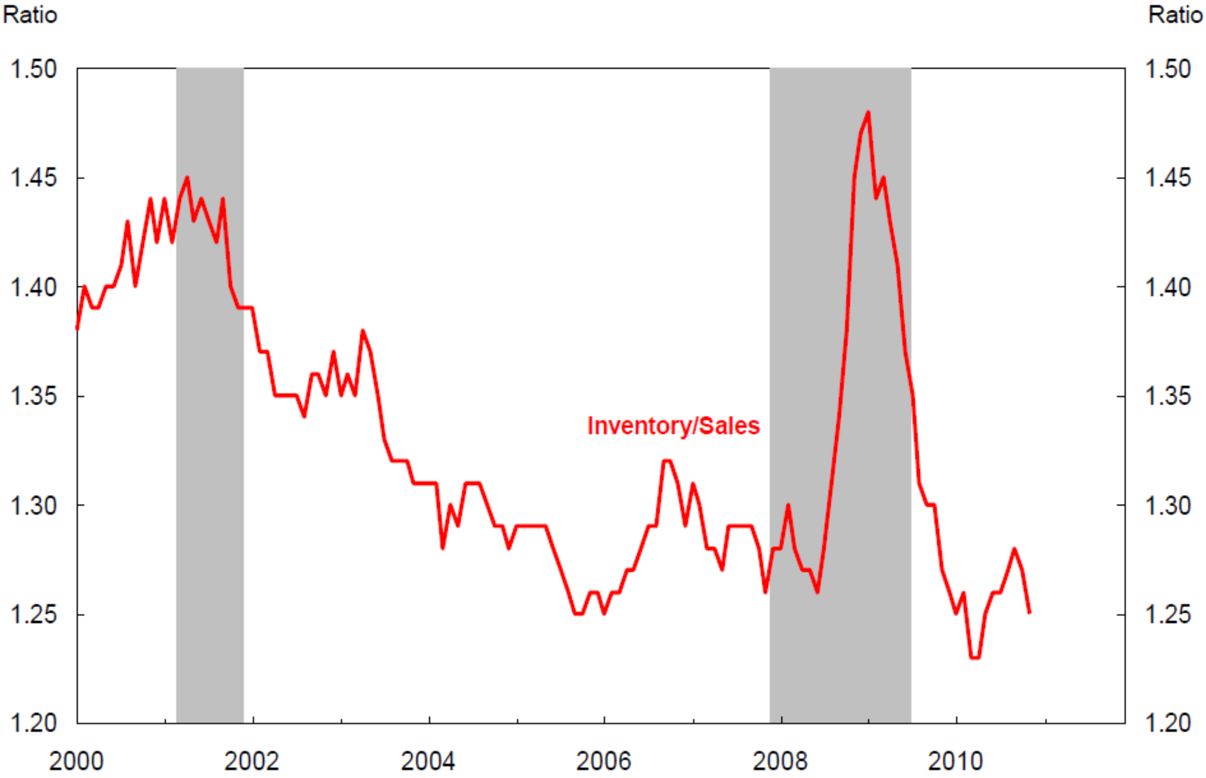
Inventory/Sales Ratio: Total Business



Source: US Census Bureau

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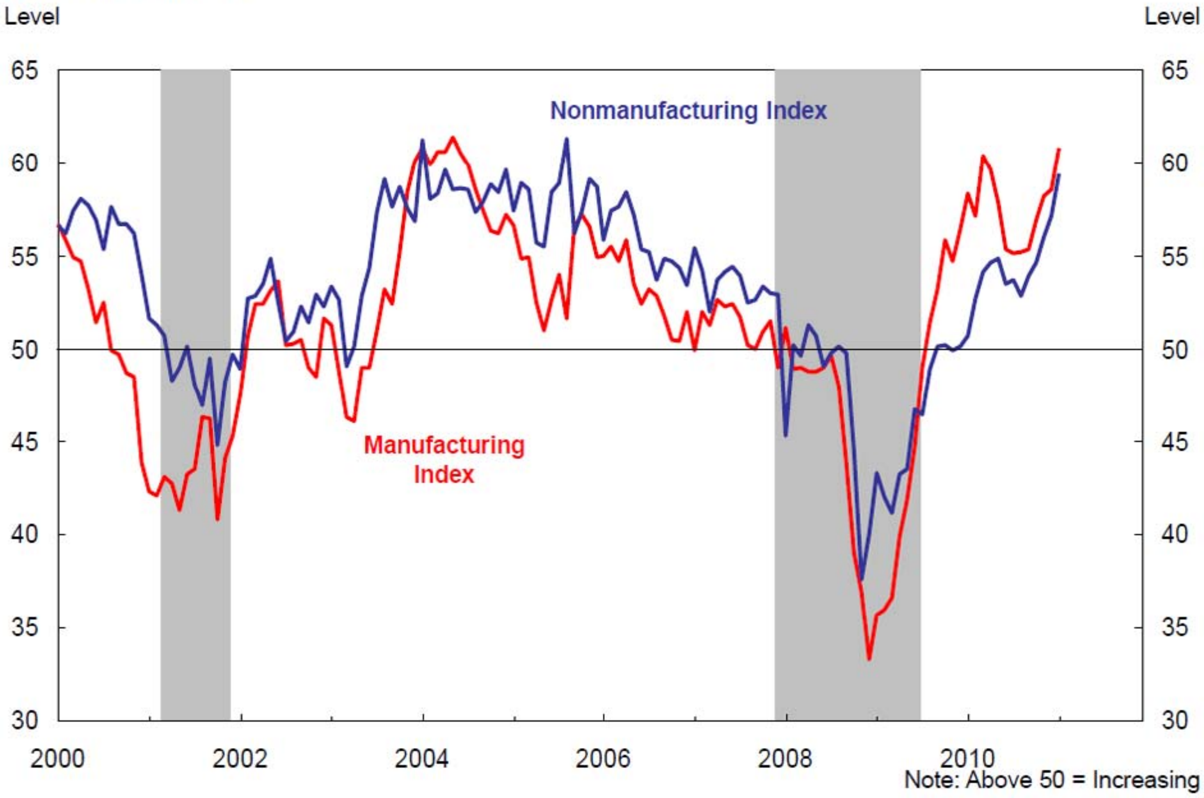
ISM Indices



Source: Institute of Supply Management

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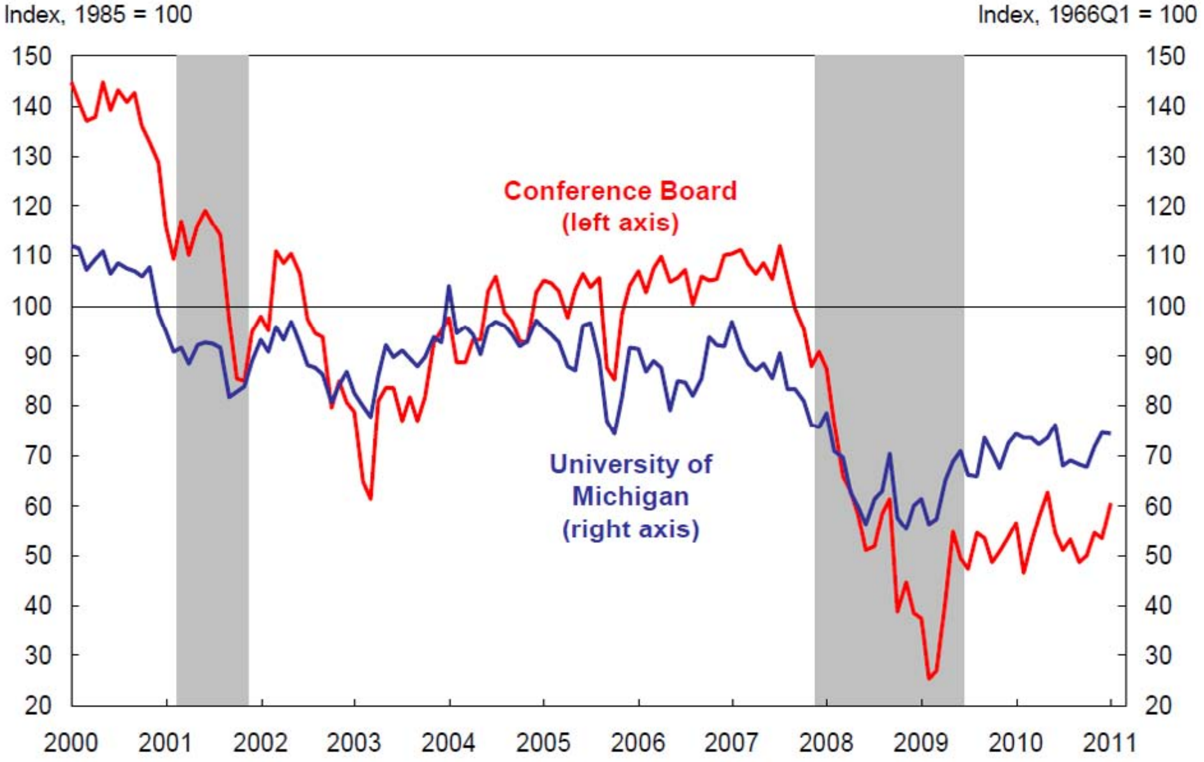
Consumer Confidence



Source: Conference Board and University of Michigan

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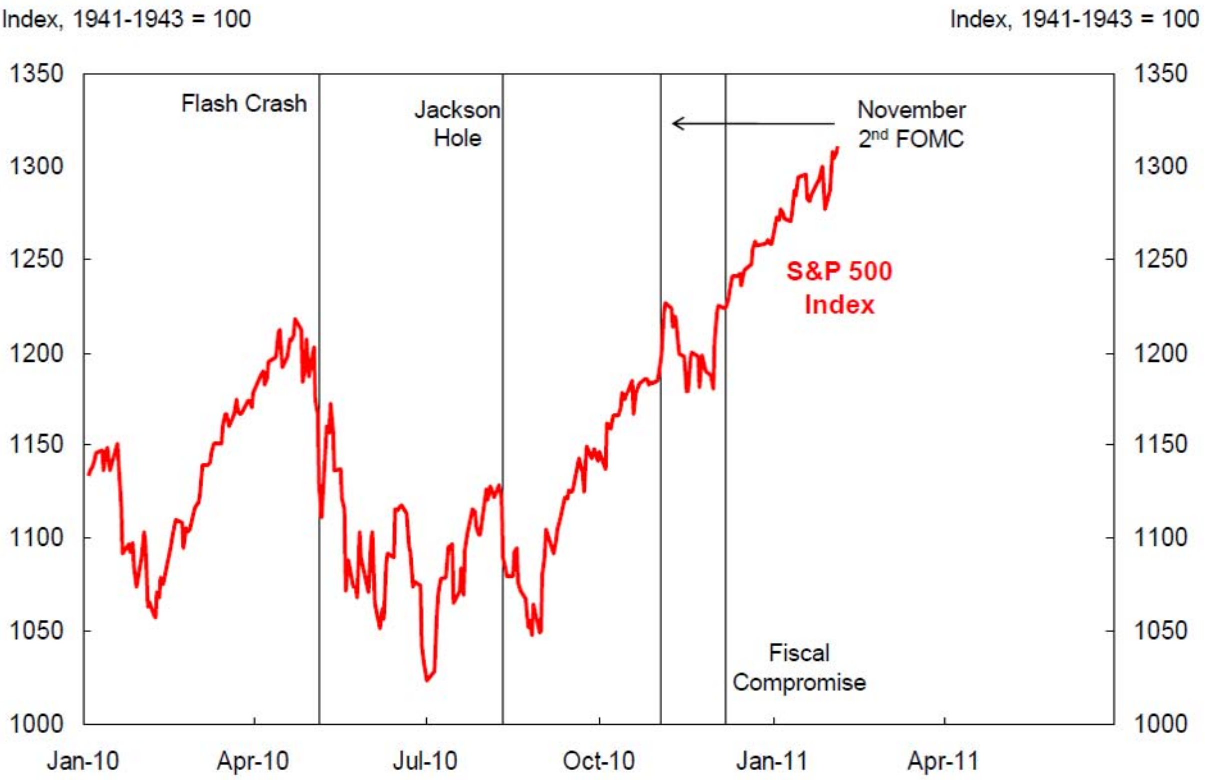
S&P 500



Source: New York Times

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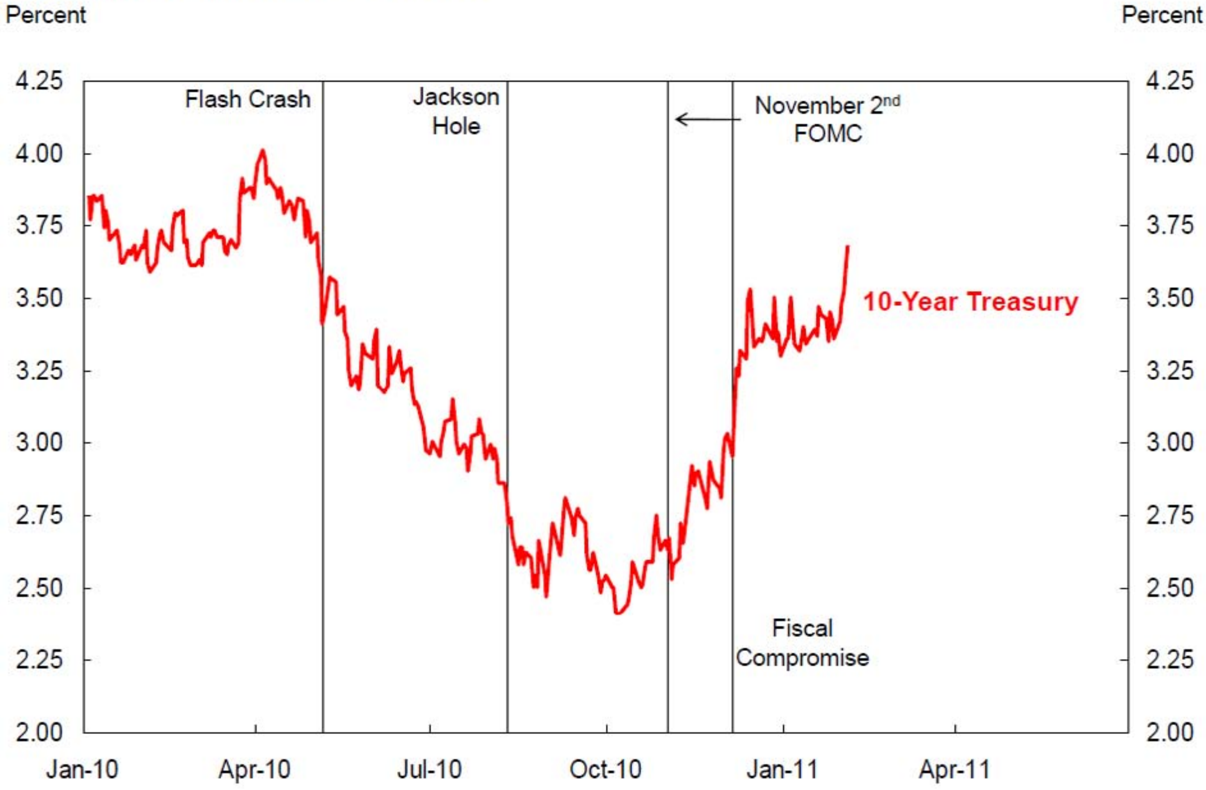
Nominal Interest Rates



Source: Federal Reserve Board

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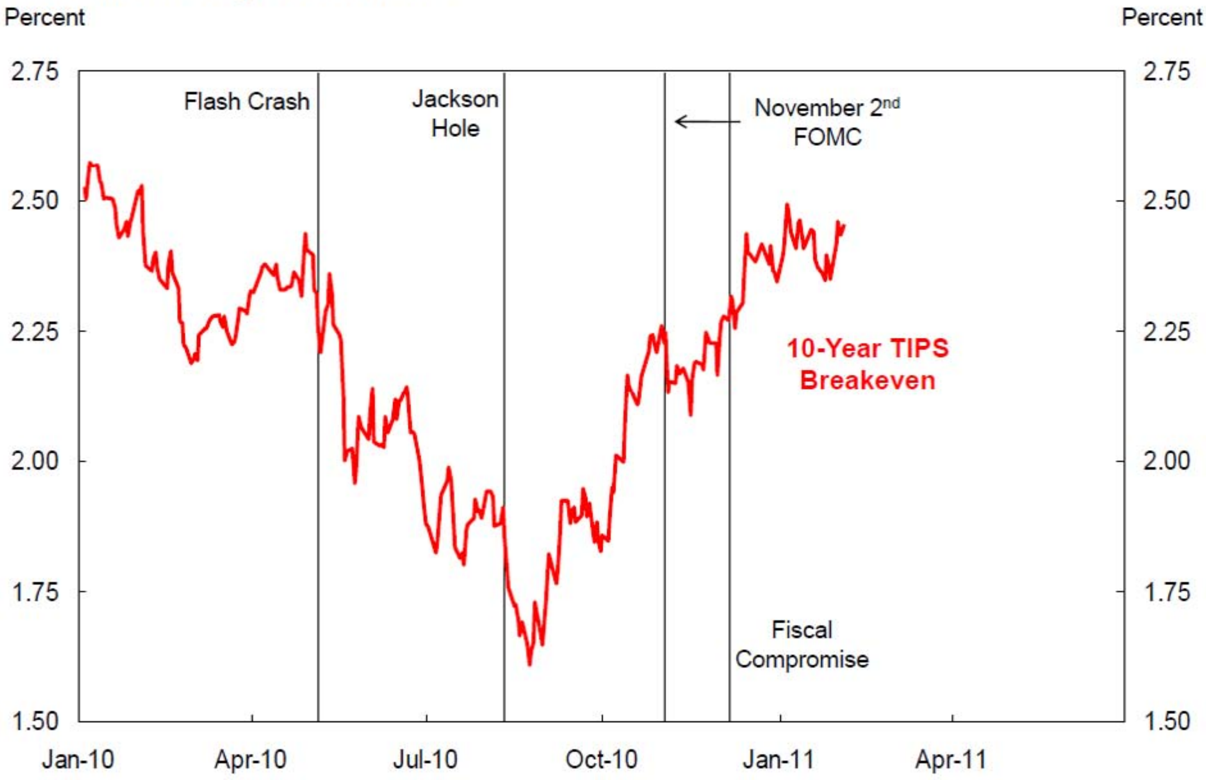
Inflation Expectations



Source: Federal Reserve Board

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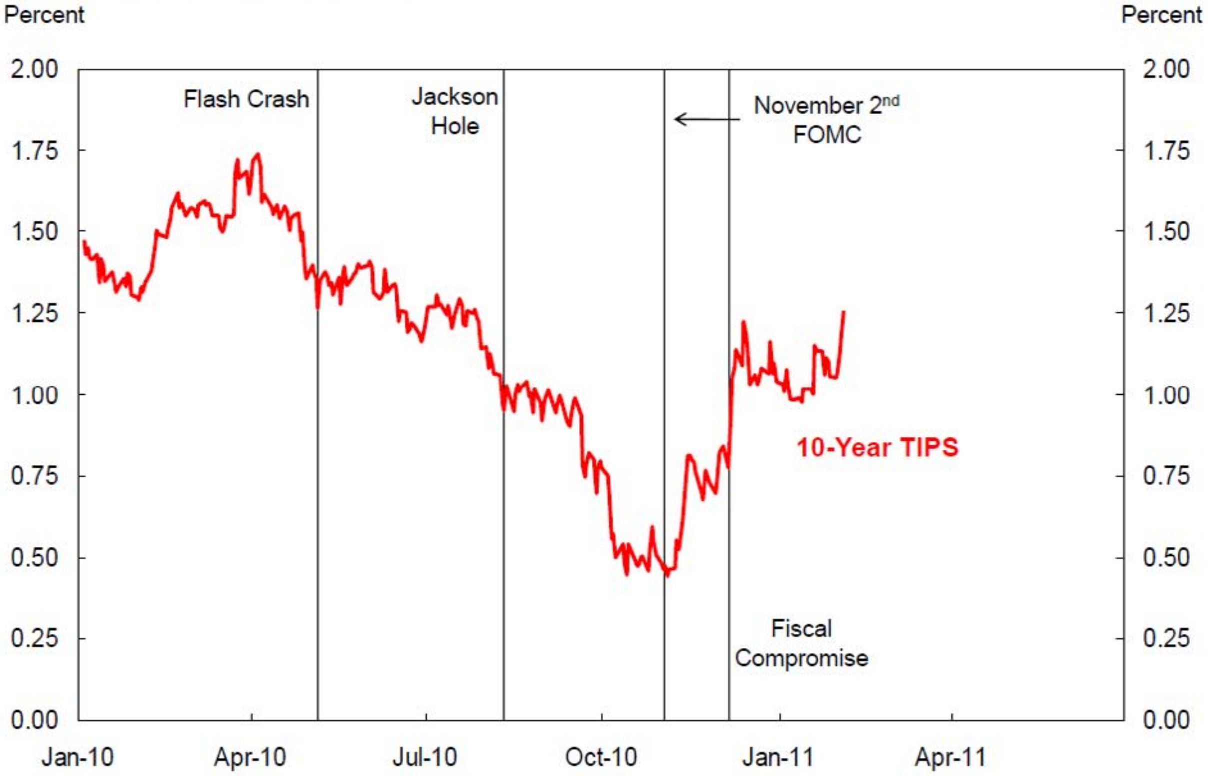
Real Interest Rates



Source: Federal Reserve Board

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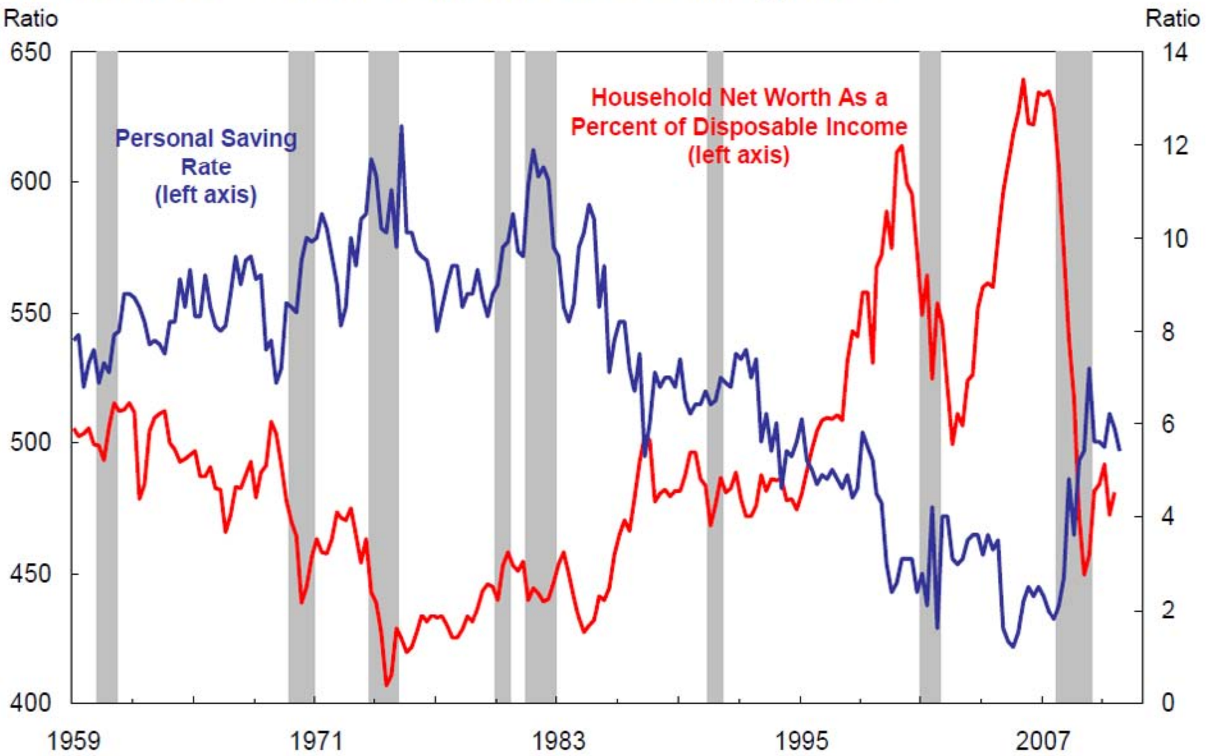
Household Net Worth and the Saving Rate



Source: Federal Reserve Board and Bureau of Economic Analysis

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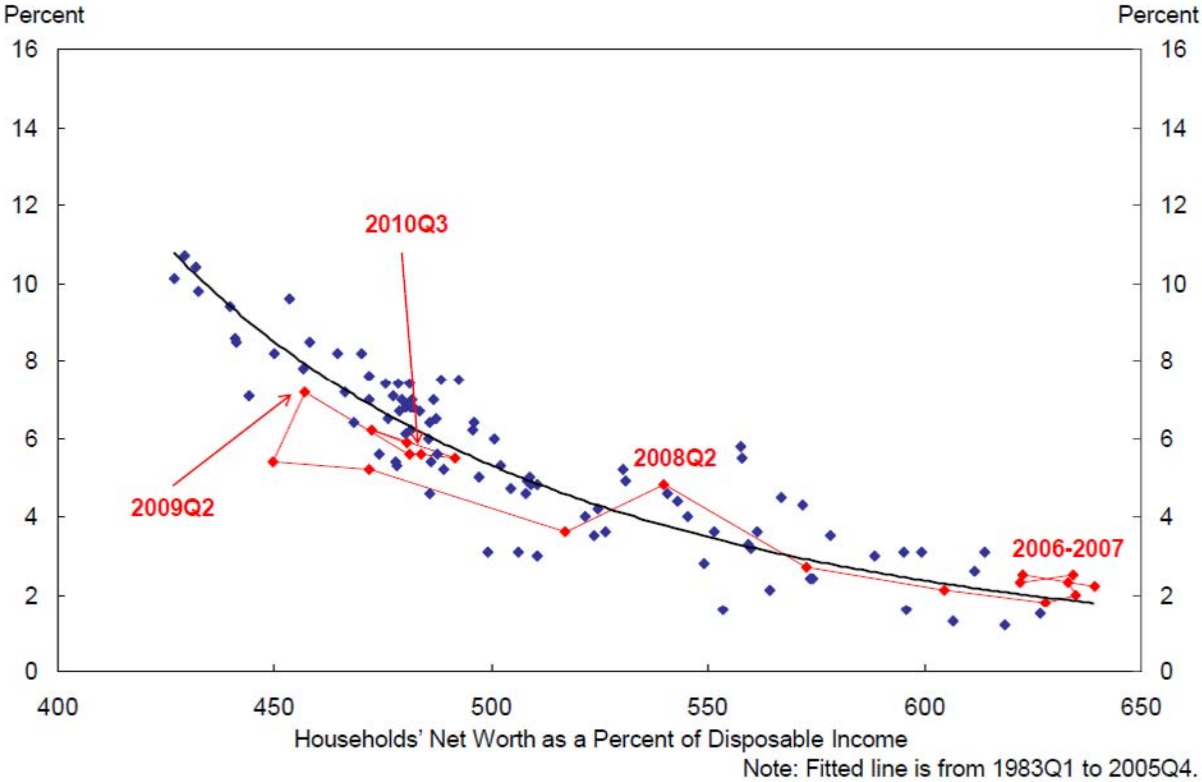
Personal Saving Rate and Household Net Worth



Source: Bureau of Economic Analysis and Federal Reserve Board

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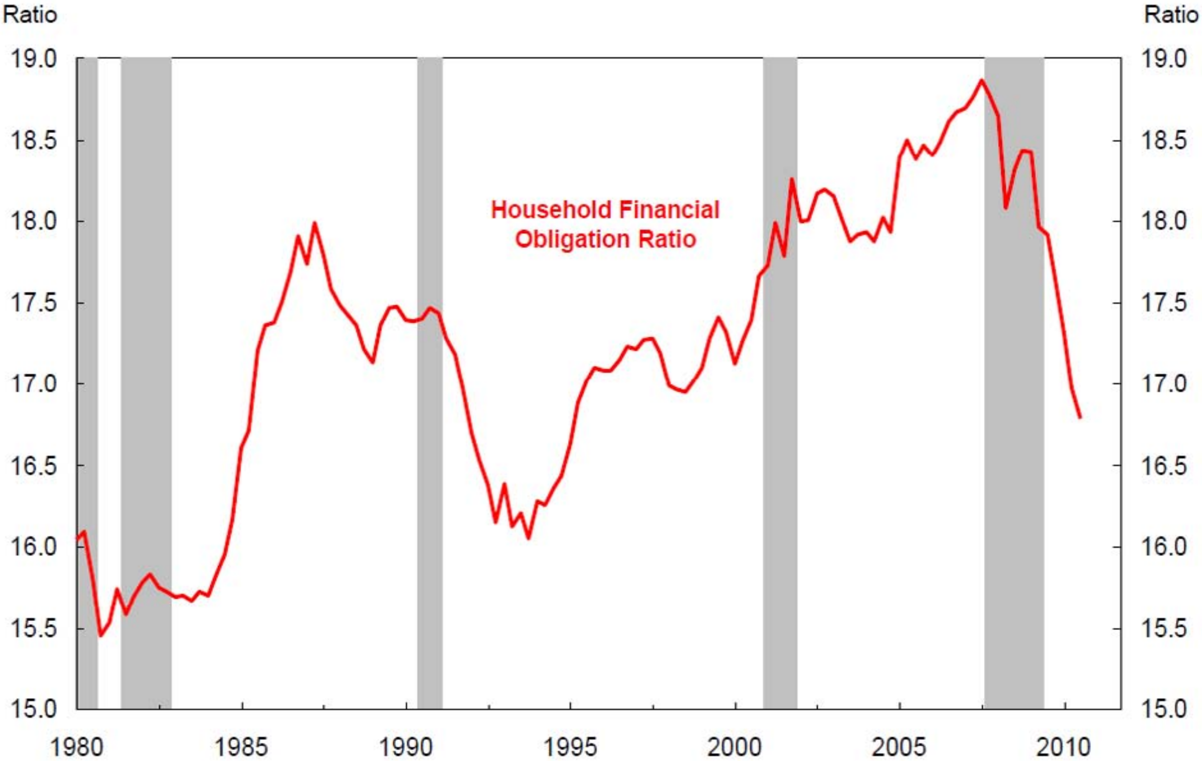
Household Financial Obligation Ratio



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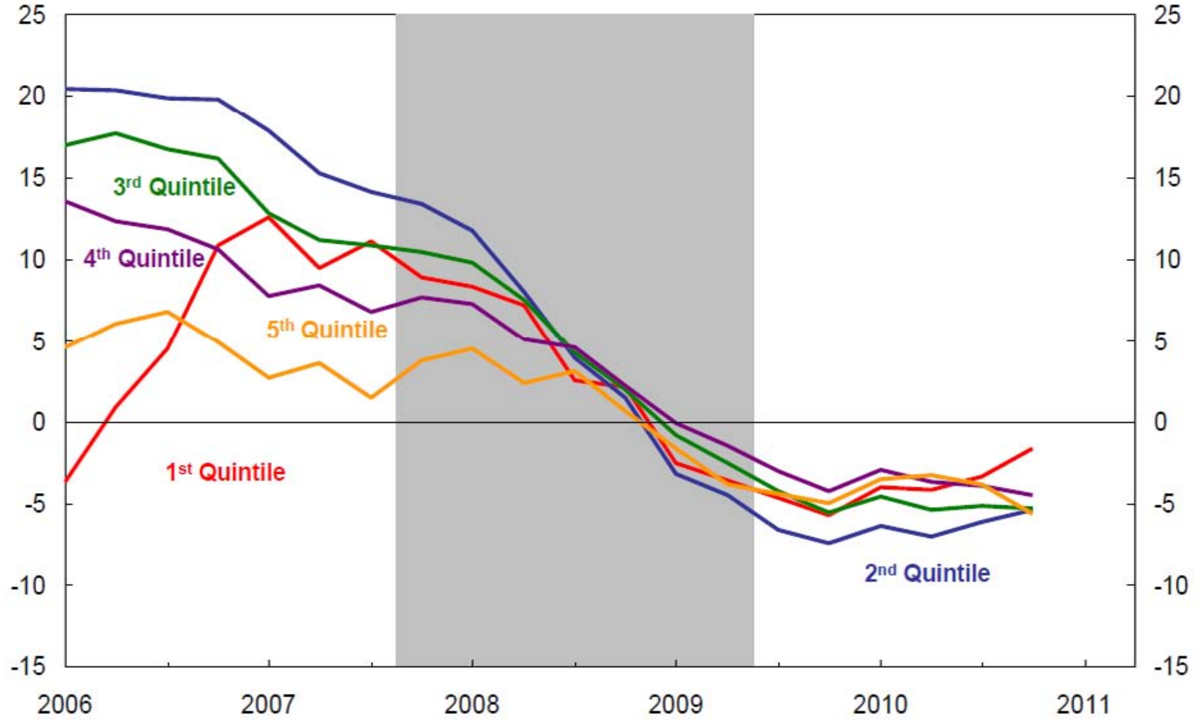
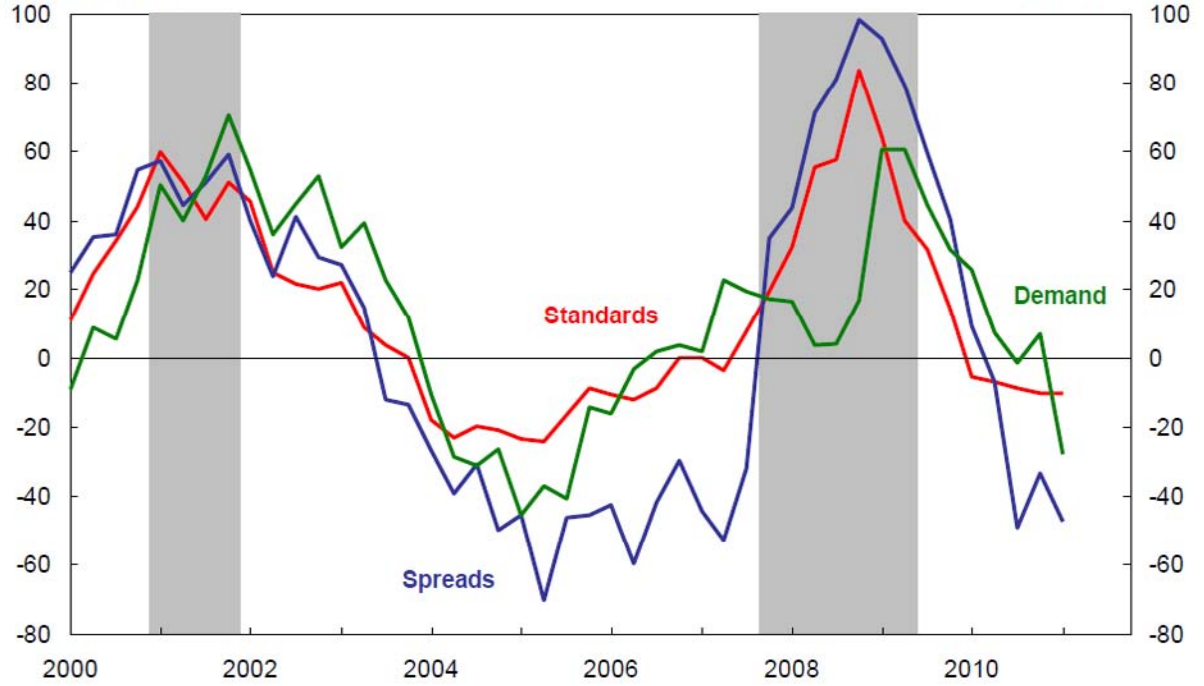
Source: Federal Reserve Board

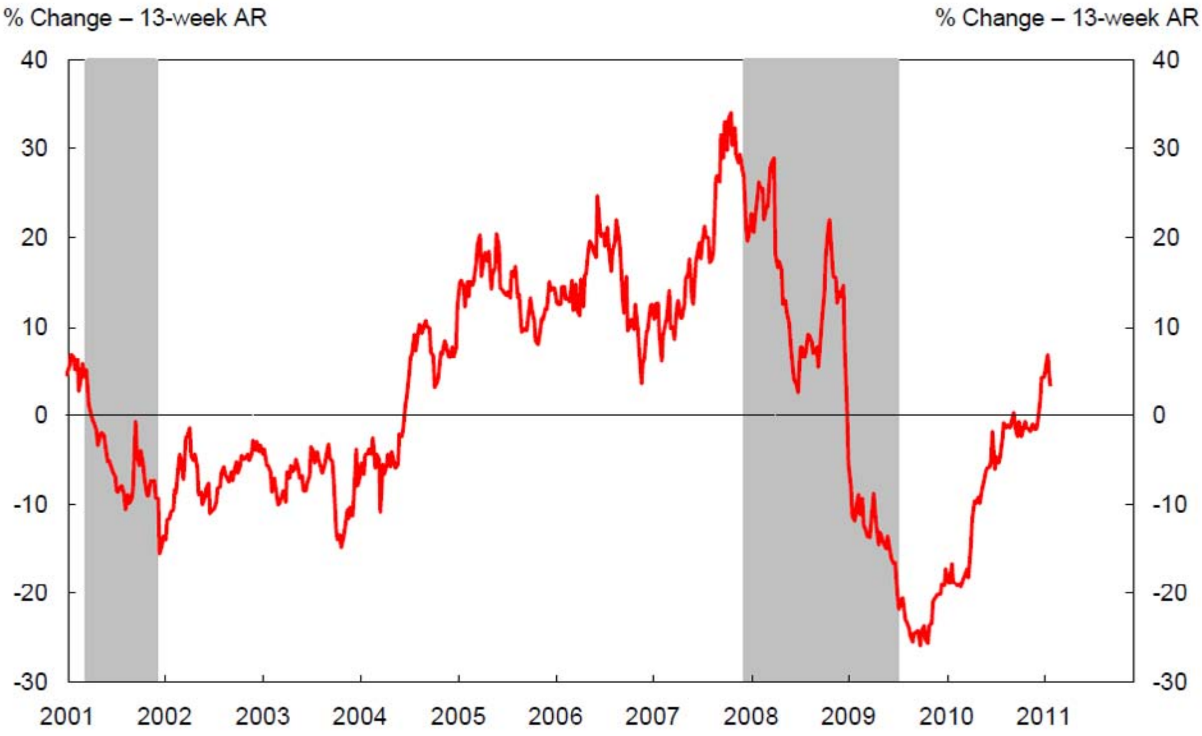


Source: FRBNY Consumer Credit Panel



Source: FRB Senior Loan Officer Opinion Survey

C&I Loans: All Commercial Banks



Source: Federal Reserve Board

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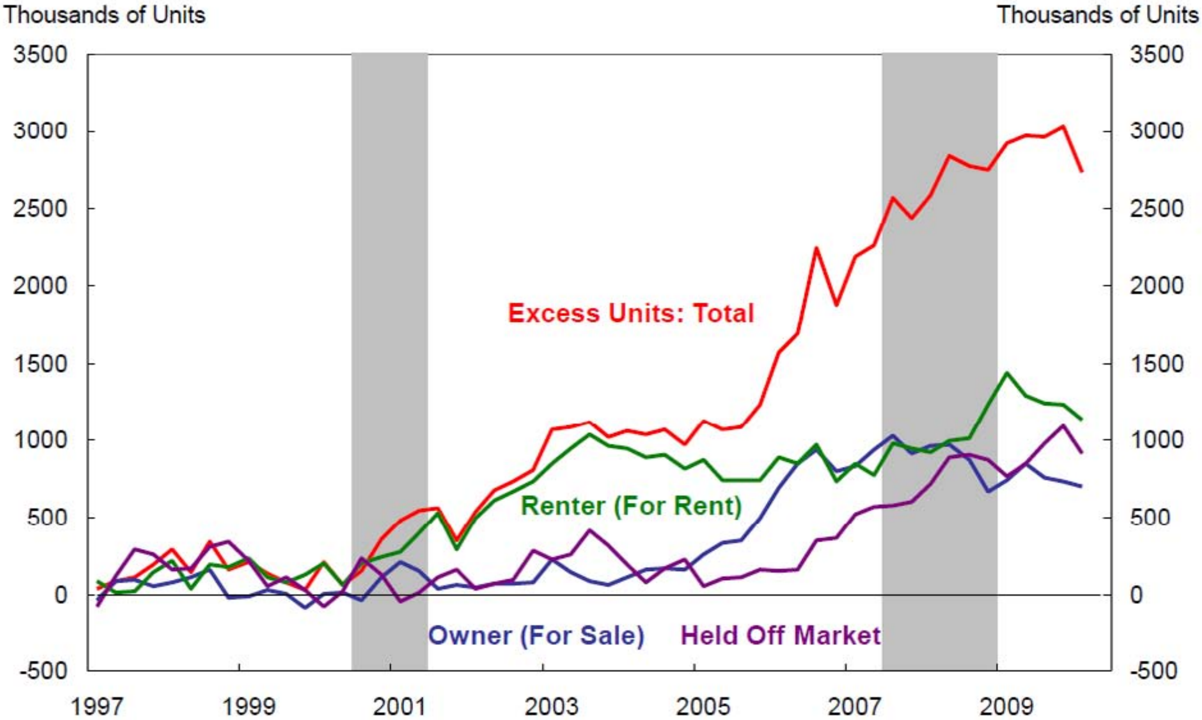
Excess Supply of Housing



Note: Shading represents NBER recessions.

Source: US Bureau of the Census; calculations by the Federal Reserve Bank of New York.

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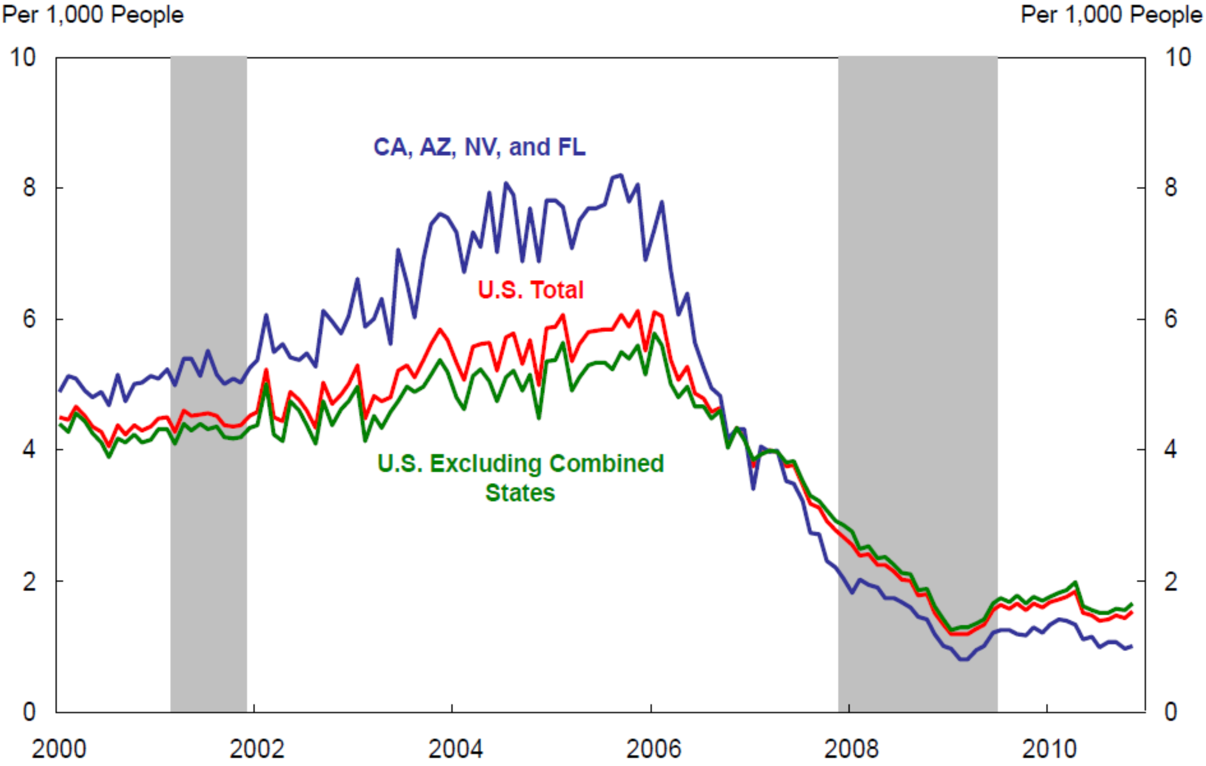
Housing Starts



Source: U.S. Census Bureau

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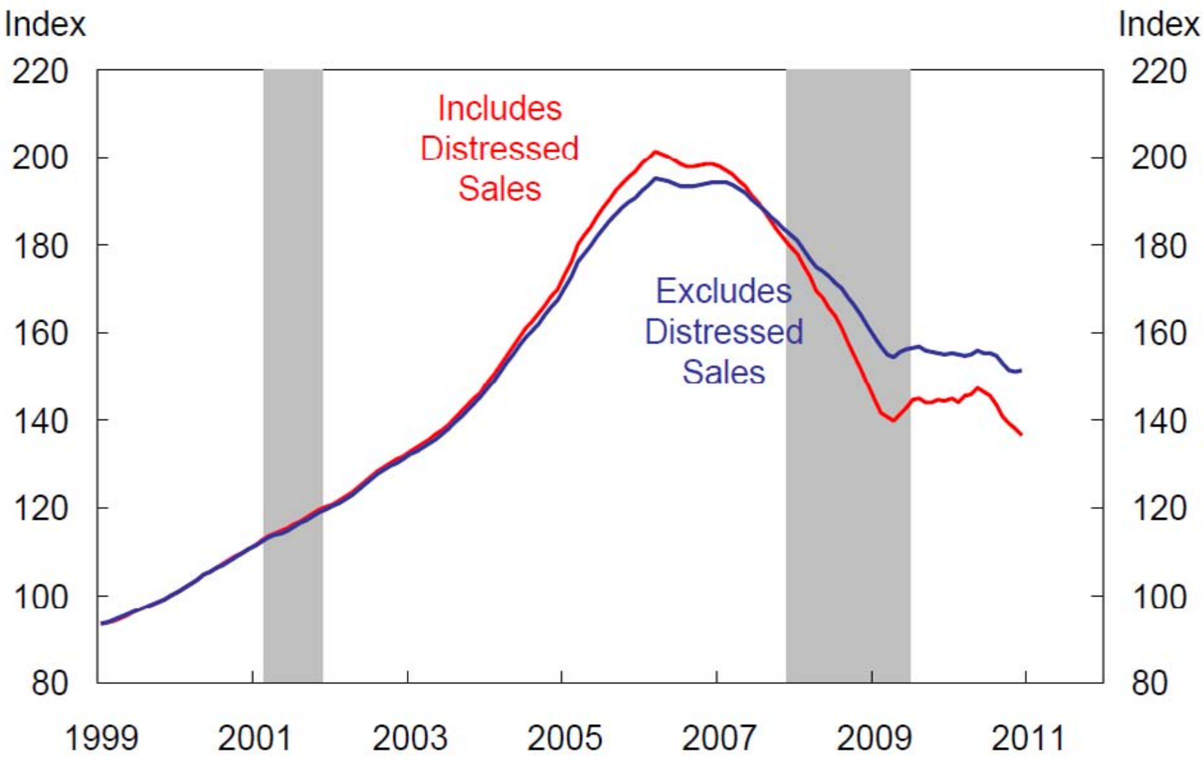
CoreLogic National Home Price Index



Source: CoreLogic/Haver Analytics

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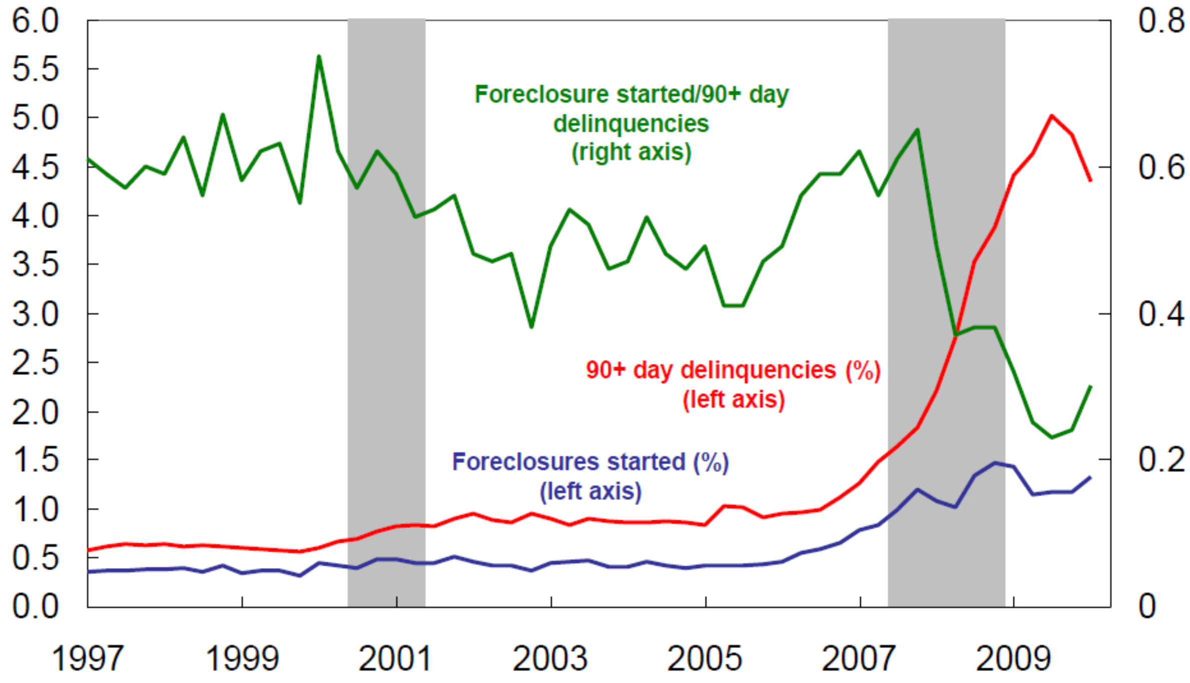
90+ Day Mortgage Delinquencies and Foreclosures Started



Source: Mortgage Bankers Association of America

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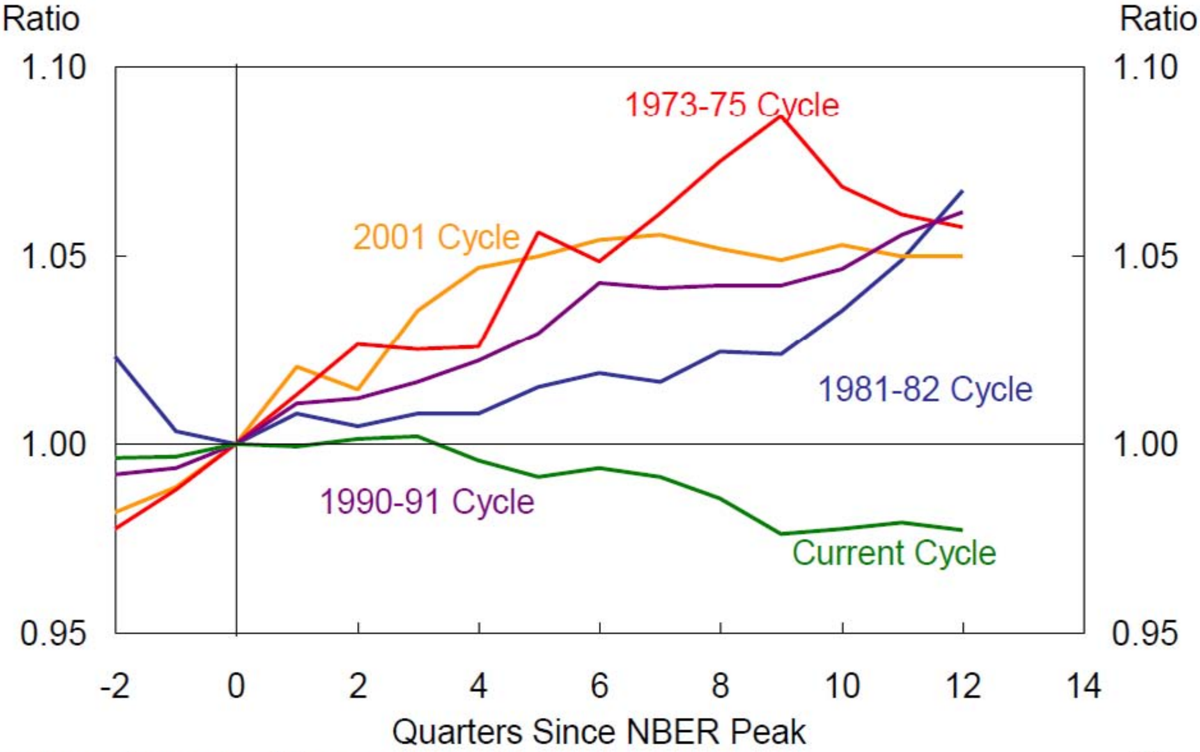
Real State and Local Government

(Series Set to 1.00 at NBER Peak)



Source: Bureau of Economic Analysis

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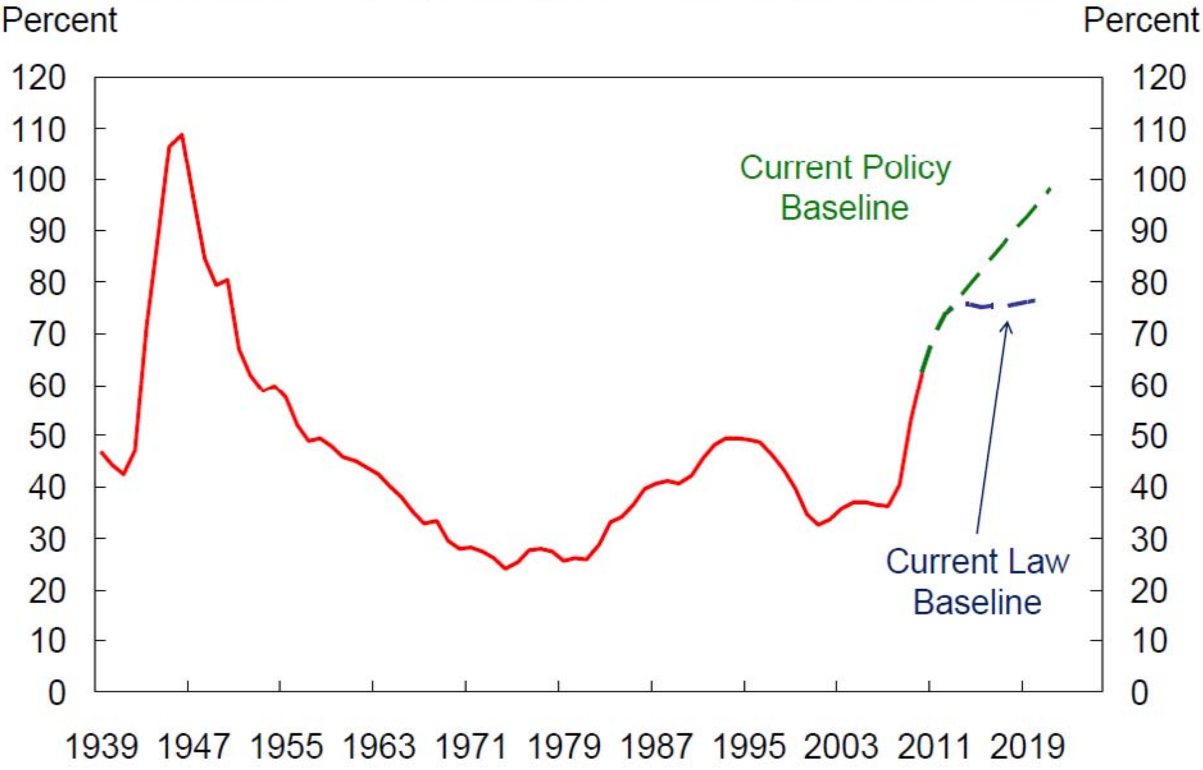
Federal Debt Held by the Public as a Percent of GDP



Source: Congressional Budget Office

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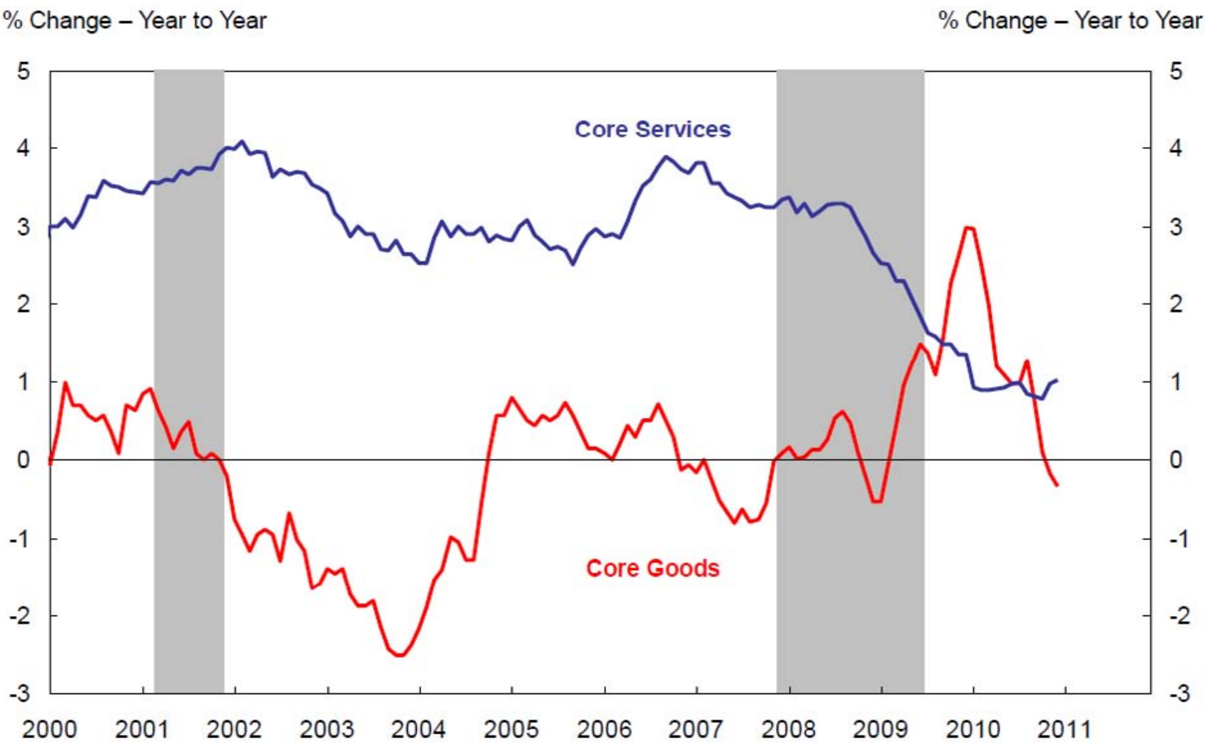
CPI: Core Goods and Core Services Inflation



Source: Bureau of Labor Statistics

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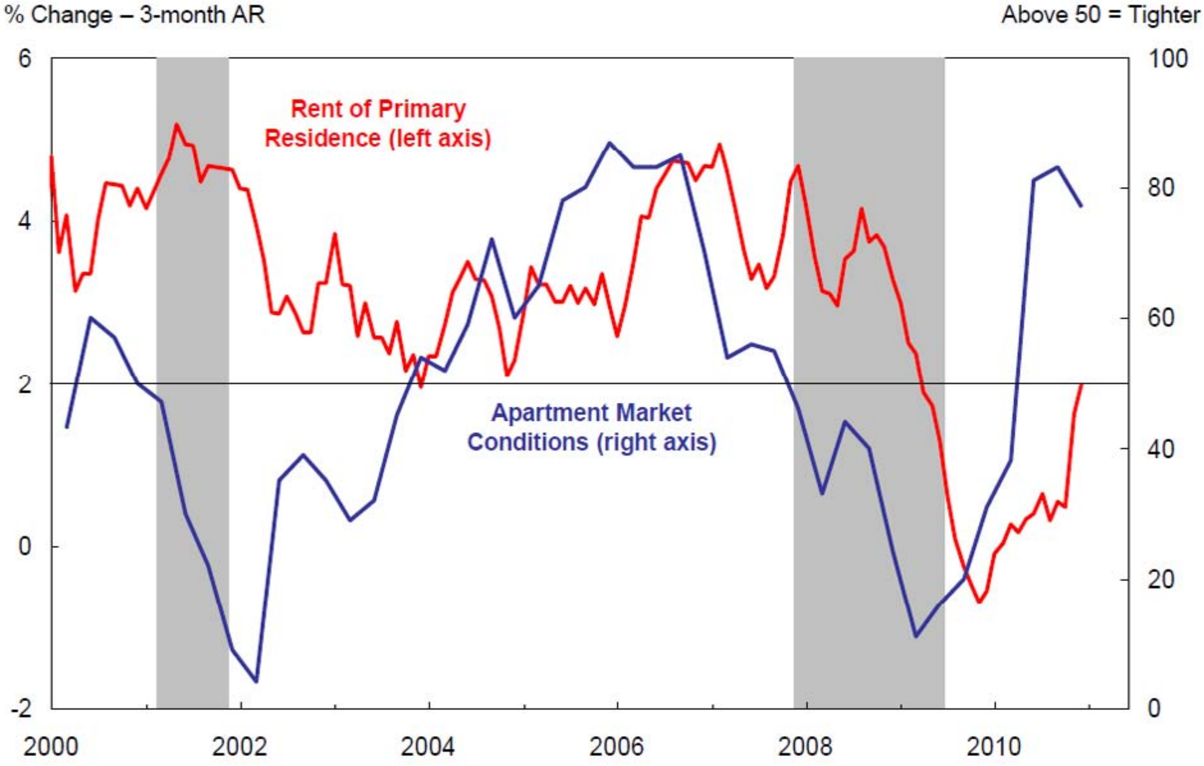
Rental Market Conditions



Source: Bureau of Labor Statistics, NMHC

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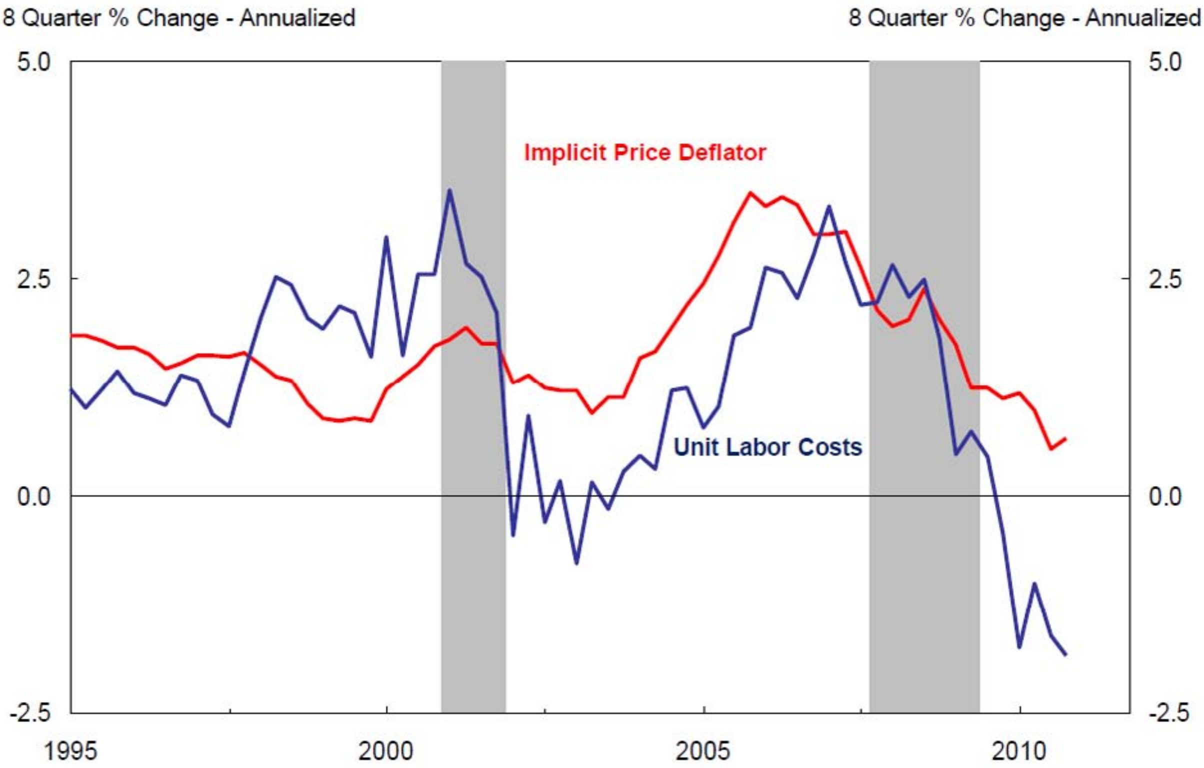
Implicit Price Deflator and Unit Labor Costs



Source: Bureau of Labor Statistics

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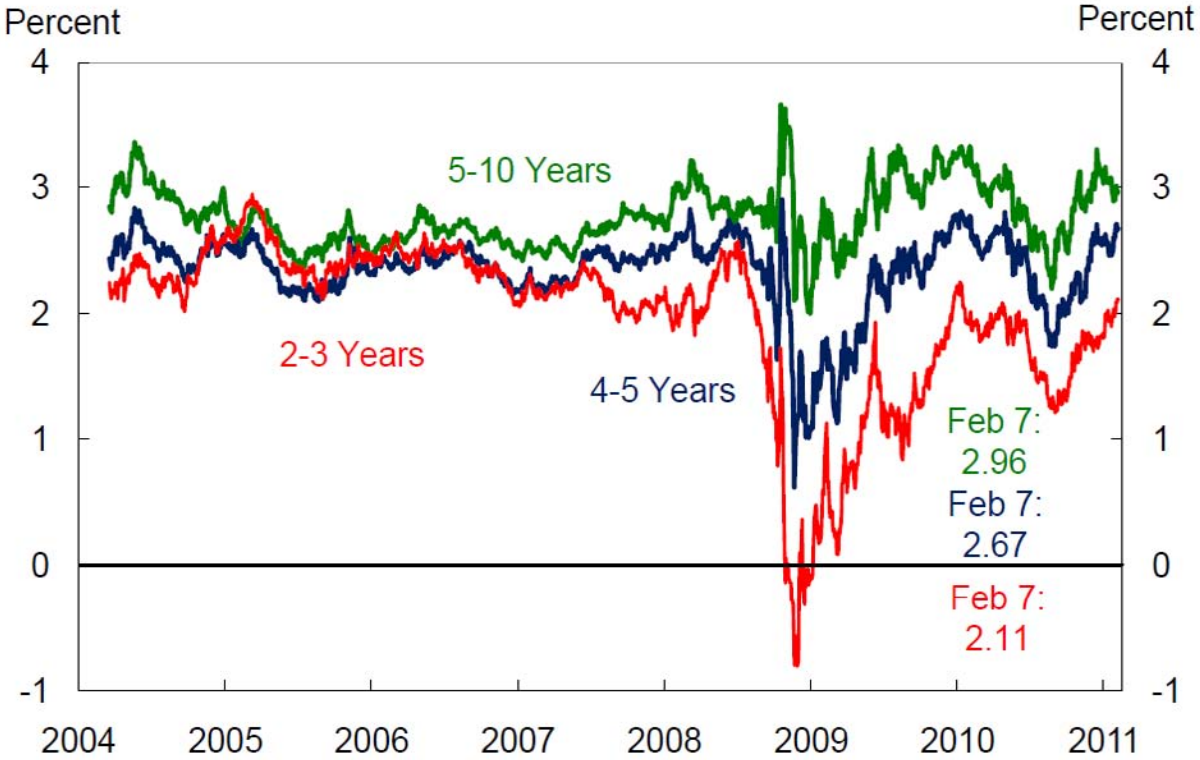
TIPS Implied Inflation: 2-3, 4-5, and 5-10 Year Horizons



Source: Federal Reserve Board

Note: Carry-adjusted.

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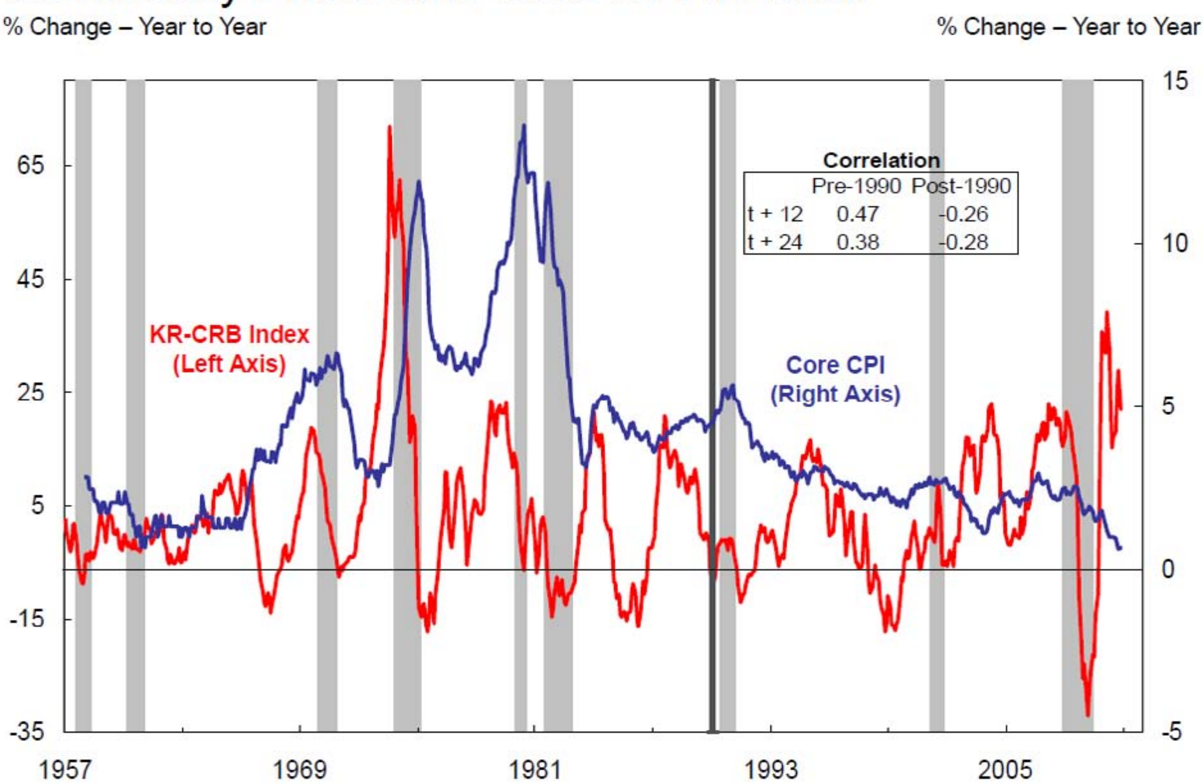
Commodity Prices and Core CPI Inflation



Source: Commodity Research Bureau, Bureau of Labor Statistics

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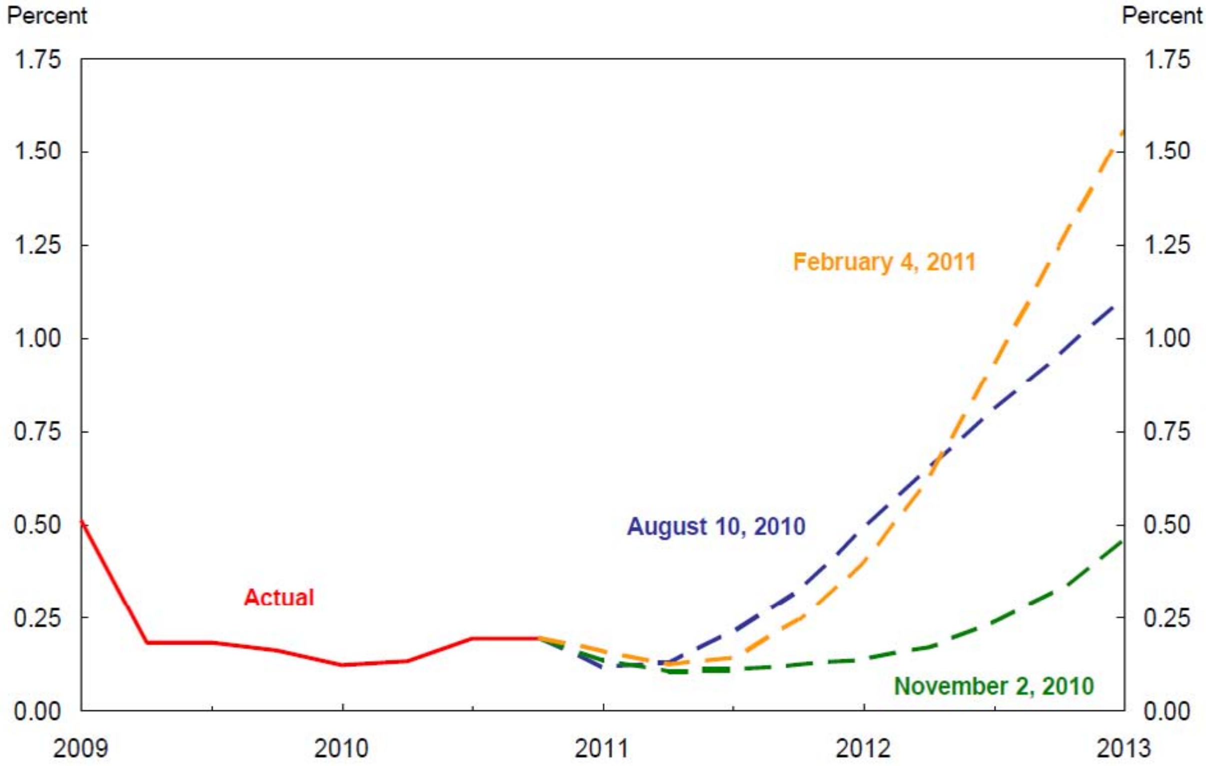
Actual and Expected Fed Funds Target



Source: Federal Reserve Board

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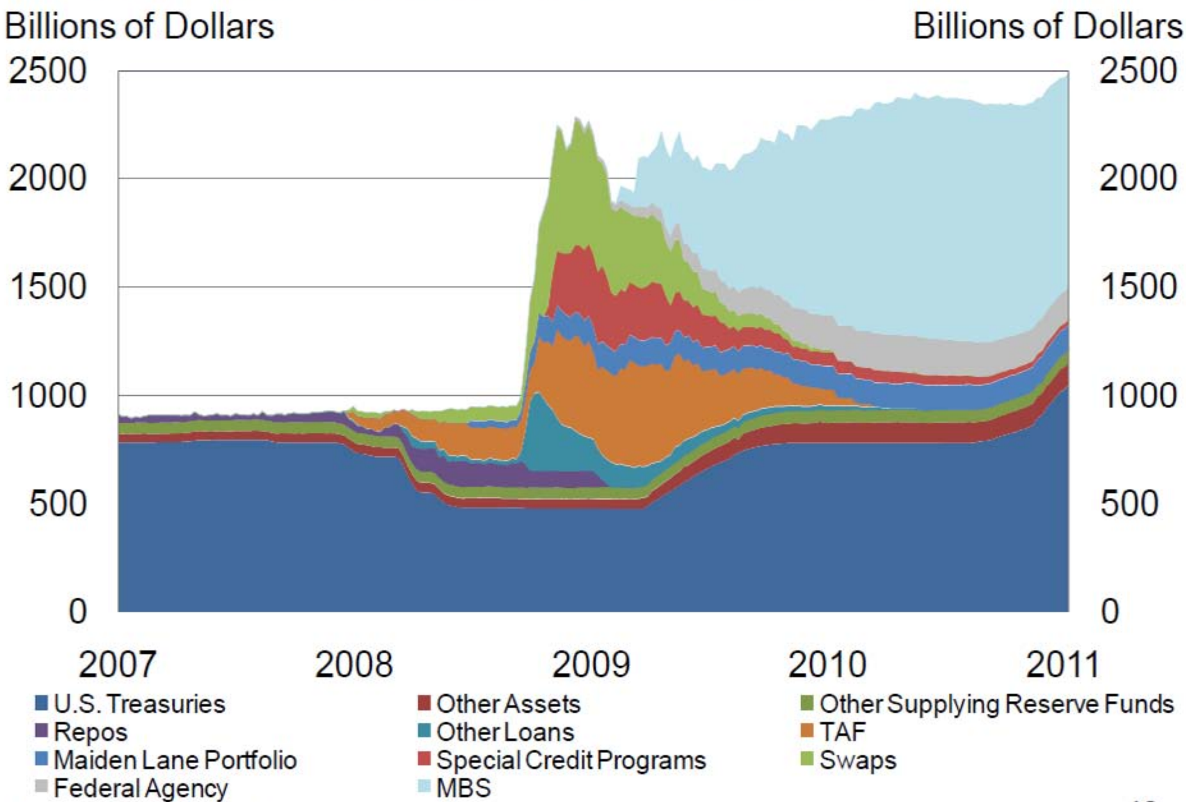
Federal Reserve Balance Sheet: Assets



Source: Federal Reserve Board

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