After the Storm

Introduction

In Ohio, we have our snowstorms, and in Florida there are of course hurricanes to worry about. People in our states know a thing or two about storms and how they can disrupt daily life. But these past few years we've suffered through a different kind of storm.

It blew though Florida, and Ohio, and the rest of the country, and it wasn't high winds or drifting snow that caused the damage. Instead, a financial crisis that began in mid-2007 has left a path of destruction in its wake.

This morning, I'd like to share my views on the economic outlook as we emerge from this massive storm—this Great Recession. Despite early signs of recovery, the economy is still facing some significant headwinds that will limit the rate of growth we can expect for the next couple of years. I'm going to spend some time talking about two particular headwinds that I think illustrate the pressures confronting the economy. Then I will discuss how the Federal Reserve is conducting monetary policy to help navigate through these challenging times.

Please note that the views I express today are my own and not necessarily those of any of my colleagues in the Federal Reserve System.

Where the Economy Has Been and the Outlook for Restrained Growth

Like those moments just after a big storm, when people step outdoors to assess the damage, we are now looking over the economic landscape to get a better idea of the damage caused by this recession. We see that this has been a recession of historic proportions—of a magnitude we haven't seen since the Great Depression. Sometimes statistics fall short of capturing the magnitude of a moment or an event, but in this case I think the statistics do a good job of illustrating the impact this recession has had on all of us. Unfortunately, we set many post-Depression records.

To start, this has been the longest recession since the Great Depression. Officially, it began in December of 2007, and most economists believe it ended in the summer of 2009. We also recorded some of the sharpest and deepest declines in output since those dark days of the 1930s. Industrial production is down more than 14 percent in this recession—the largest decline since 1939. As of last summer, businesses were using just over two-thirds of their existing production capacity.

Payroll employment fell more than 6 percent, which is again a post-Depression record. While in the past we have seen higher overall unemployment rates than the current rate of just under 10 percent, today's unemployment rates for men, young adults, and people over the age of 55 are the highest since we began collecting detailed statistics in 1949.

The value of homes has fallen across the country. According to Robert Shiller, one of the leading researchers on real estate prices, we have now seen a 33 percent decline in the real value of housing since 2006, which is similar to the decline in the late 1920s.

Of course, banks have struggled in this storm as well. Bank profitability fell to a record low, and bank loan write-offs hit a post-Depression high.

When you listen to this litany of records, you can easily question how we can ever rebuild. But the economy has begun to recover. It's just a beginning, and it may not feel much like a recovery in your household or in your neighborhood yet, but gross domestic product, or GDP, which is a broad measure of economic activity, rose nearly 6 percent in the fourth quarter of last year. If we could sustain that growth rate, we would find ourselves in pretty good shape in just a few quarters. My forecast, however, is for a more gradual rate of growth, and I also expect the unemployment rate to stay above 9 percent until the middle of next year.

So why is my outlook for more gradual growth? After all, deep recessions have historically been followed by steep recoveries. This time, though, we're facing a different situation. This recession has left us with many problems to resolve. For example, there are over two million houses in some stage of foreclosure, we need to refinance more than a trillion dollars of commercial real estate loans over the next three years, and 41 states are struggling to keep their 2010 budgets balanced.

Recessions always bring an array of troubles, and this recession has exposed some pretty significant problems. However, this recession has also left us with some broader issues that are likely to slow our growth rate this year and next. These broader issues are sometimes referred to as headwinds.

Two Headwinds: Prolonged Unemployment and Heightened Caution

Let me focus on two particular headwinds that serve to illustrate why I believe our journey out of this recession will be a slow one. The first is the effect of prolonged unemployment, and the second is a heightened sense of caution on the part of consumers and businesspeople.

On the unemployment front, millions of people have lost their jobs, which often happens in a deep recession. But this time around, the impact was disproportionate compared to other recessions. Since World War II, whenever our gross domestic product has fallen by 1 percent, the unemployment rate has gone up by less than 1 percent—about seven-tenths of a percent. In this recession, the gross domestic product declined by 4 percent. So if the pattern holds true, you would have expected the unemployment rate in this recession to have gone up by a little less than 3 percent. In fact, it shot up by more than 5 percent, which means an extra 1.5 million people lost their jobs.

Staggering as the unemployment numbers are, what is even more troubling is how long people are remaining out of work. About half the people who are unemployed have been out of work for at least six months. In the 1982 recession, which was another severe recession, the average duration of unemployment peaked at 21 weeks, but today the average is already over 30 weeks. These long spells of unemployment can lead to some unfortunate consequences. Labor economists have repeatedly shown that the longer a person is out of work, the harder it is for him or her to find a job.

Research also tells us that workers lose valuable skills during long spells of unemployment that are not recovered until many years later. When workers do return to work after a downturn, they are generally most productive if they can go back to the same jobs they had. But in today's economy, that is unlikely to happen for many people. Some jobs simply aren't coming back. And some people returning to the workforce are forced to take jobs that pay less or aren't as well-matched to their skills as the ones they have lost. This has a direct impact on the productivity of both the employee and the employer, who may be faced with bringing workers aboard who need to be taught new skills before they can be fully productive. When this situation is repeated millions of times over in companies across the country, it can dampen overall economic productivity, potentially for years.

Another exceptional headwind in this recession is a heightened sense of caution, driven by a deep uncertainty about the direction of the economy and where the "new normal" or baseline might be. A whole generation who began their working careers in the mid-1980s had experienced only long periods of prosperity punctuated by just two very brief downturns. Those experiences encouraged an expectation for relatively smooth growth. Now everyone's expectations have shifted as a result of this long and deep recession.

Not surprisingly, people's attitudes have changed. For instance, in the past when Ohio's Xavier University's Institute for Politics and the American Dream surveyed consumers for its "American Dream Survey," people described their American dream as becoming richer and providing a better future for their children. In the most recent survey, people said their American dream is to be able to provide for themselves and their families. In fact, 60 percent of those polled believe attaining the American dream is harder for this generation than ones before. And nearly 70 percent think it will be even more difficult for their children.

Similarly, for decades, the University of Michigan's survey of consumers has been asking people about their expected income growth, and people have generally expected their incomes to rise by about 3 percent from year to year, even during recessions. But since March 2009, people are reporting that they don't expect their incomes to grow at all. These surveys, and many of the stories I hear personally, reflect profound changes in attitudes. At a wider level, perceptions like these can have a significant impact on the larger economy. In homes all over the country, even people who haven't lost their jobs fear that they could lose them. Households have also seen their wealth levels reduced through falling home prices and last year's stock market losses.

People are delaying major purchases until their circumstances are clearer. We have gone from well over two million new home sales per year before we went into the recession to just about 550,000 new homes sold last year. But this is not just a housing story. Car sales are down by about one-third, and everyone in the industry is still very unsure where the sales figures will ultimately settle when the economy recovers. Consumers remain uncomfortable making longer-term commitments, and they are saving more.

As a result, the household savings rate has risen from just over 1 percent in early 2008 to more than 4 percent late last year. Saving more is good for people and businesses in the long run. But in the short run, it tends to dampen the pace of economic growth.

We are also seeing the same kind of cautious behavior in large and small businesses. At the Federal Reserve Bank of Cleveland, we have been meeting with large numbers of business owners over the past couple of months, and they tell us they are not planning to hire many new workers, which just makes it more difficult for the unemployed to find work and keeps the unemployment rate high.

The same kind of caution goes into the decision-making process when companies consider whether to build or renovate a building, or buy a piece of equipment. Even well-established companies, with access to funding, are deciding in this uncertain environment to take a wait-and-see approach. I have heard from CEOs of small and large businesses alike who say that demand for their products and services is low and that there's a great deal of uncertainty in the United States right now, especially regarding policies relating to health care, energy, the environment, and taxes. This uncertainty has caused some businesses either to delay investment or to think about investing abroad—and these are the healthier companies. Many business owners are merely trying to hold on, or are trying to find ways to finance their businesses at a time when lenders are being more cautious.

When you take a look at the whole picture, it's not surprising that capital investment numbers are still down almost 20 percent from where they stood in 2006. With little demand for new commercial structures, this reluctance to expand is likely to keep investment numbers low for several quarters.

Now, if it sounds as though I've painted a pretty dire picture, I want to temper it a bit by saying I don't believe the caution that permeates the atmosphere at the moment will prevent us from sailing forward out of the storm. Every day there are companies that are taking advantage of opportunities and taking risks that will yield rewards down the road. But undeniably, the headwinds I have described will affect the speed of this growth. Frankly, this recovery has not been feeling much like a recovery and will, in my opinion, proceed more slowly than usual.

Monetary Policy and the Federal Reserve

Now let me turn to the actions that the Federal Reserve has been taking to help the recovery along. Our monetary policy role is guided by a dual mandate from Congress—to achieve price stability and maximum sustainable economic growth.

Given this mandate, the Federal Reserve responded aggressively to the escalating crisis. When economic activity weakens, the Federal Reserve typically lowers its short-term policy target, known as the federal funds rate, and this time was no exception. In September 2007, the Federal Reserve began lowering the federal funds rate target from 5 ¼ percent to where it stands today – which is effectively zero. But as the financial crisis deepened, causing financial markets to seize up, we had to do more than rely on interest-rate actions alone.

We implemented a number of unprecedented programs to provide liquidity to financial markets and to get credit flowing again. Collectively, these programs were crucial in helping revive the key financial markets, stabilize the housing sector, and extend credit to households and small businesses. One significant result of our actions is that our own balance sheet expanded enormously in the process--from roughly $900 billion before the crisis to approximately $2.2 trillion today.

The financial crisis created an environment in which the total failure of the economy was a possibility. The Federal Reserve is uniquely able to provide a backstop for the overall economy, and that is exactly the role we played. Today the economy is again growing, although at a restrained rate compared to past recoveries.

Let me now turn to our mandate for price stability. The current weak economic environment is altering firms' pricing decisions. Indeed, the incoming data on consumer prices already point to significant downward pressures. At the Federal Reserve Bank of Cleveland, we track two measures of inflation—what we call the "trimmed mean" and the median CPI series. Both of these series have been on a disinflationary path since the middle of 2008, and the prices of more than 40 percent of the items we track in our market basket of consumer expenditures have been declining over the past six months. In this economy, companies are really holding the line on prices to boost their sales, and they can do that profitably in part because labor costs are so restrained. At this point, I expect inflation to remain subdued, and inflation expectations in the financial markets are pointing to stable rates over the next two to three years.

Combining this inflation outlook with my outlook for a gradual recovery warrants maintaining exceptionally low levels of the federal funds rate for an extended period. Still, the time will come when it will be appropriate for us to begin removing some of our policy accommodation. It is always a challenge to get the timing right, because our policy decisions have to be forward looking. And the process will be more complicated than usual this time. The unprecedented actions we took to cope with the crisis have created conditions that make it harder to simply put the process in reverse. That is why the Federal Reserve has developed some new tools to carefully manage the size and composition of our balance sheet.

Due to the unusual nature of this process, it will also be important to communicate as clearly as possible both our outlook for the economy and inflation and our strategy for removing our policy accommodation. Clarity will help avoid adding monetary policy uncertainty onto the already large underlying economic uncertainties.

Conclusion

Our journey to a full economic recovery is really just beginning, and no one knows for sure what the path ahead will be. We do know there will be some bumps and difficulties along the way. There always are. But as Winston Churchill once said: a pessimist sees the difficulty in every opportunity; an optimist sees the opportunity in every difficulty. That's the challenge we must all rise to—to be optimists, so that we may find the opportunities that will lead to renewed economic growth. It has happened in every past recovery. It will happen in this one.