Some Thoughts on the Current Economic Situation

Remarks for the

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Charles L. Evans

President and Chief Executive Officer

Federal Reserve Bank of Chicago

FEDERAL RESERVE BANK

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Thank you, Madlyn, for that kind introduction and very warm welcome. I'd also like to extend a special thank you to Greg O'Leary for helping to arrange my visit to the University Club and the Civic Affairs Society Breakfast Forum. I'm especially pleased to be here this morning to explain what I see happening in the economy and express my views on some of the key issues we face today. Over the past couple of years I have been asked many times to speak about the Federal Reserve’s role in addressing the financial crisis. Usually, at the end of the talk, when I open the floor for discussion, I find myself being asked the same sorts of questions over and over again. So I’d like to address some of those questions in my remarks today and then give you an opportunity to follow up with questions of your own.

Let me emphasize that the views that I am presenting today are my own and not necessarily those of the Federal Open Market Committee (FOMC) or my other colleagues in the Federal Reserve System.

Let’s begin with the question I hear most often: What are the prospects for the economy?

In short, the economy is recovering from the recession, and I am optimistic that it will continue to do so. My forecast is that real gross domestic product (GDP) will grow about 3-1/2 percent this year. In fact, we have been hearing many more upbeat business reports over the past several months, and have nudged up our outlook accordingly.

That said, we still need to experience a good deal of growth before we return to the more normal pace of economic activity and levels of unemployment that we enjoyed in late 2007. And the 3-1/2 percent pace of growth I anticipate is quite moderate given the severity of the recession. To offer some perspective, in the first year and a half following the deep 1981 to 1982 recession, growth averaged nearly 8 percent.

Let me give you some of the details underlying this assessment of the economy.

First, consider the recent GDP numbers, which measure the value of all of the goods and services produced in the economy. GDP fell sharply—3.7 percent all told—during 2008 and the first half of 2009. But GDP has increased in each of the past three quarters, with growth averaging a 3.6 percent annual rate.

Where did this growth come from? Some of it reflected the federal government stimulus package passed in 2009. This raised economic activity a good deal in the second half of last year, and should be a continued solid boost to spending through much of 2010.

But government stimulus is hardly the whole story. Unmistakably, private spending has been reviving. One area is inventory investment by businesses. During the recession, firms aggressively cut inventories to very lean levels. By avoiding an overhang of excess stocks, they are now increasing orders for newly produced goods to meet incoming demand—and we've seen manufacturing production increase accordingly. We have also seen an increase in business spending on capital equipment, most notably on high-tech items, as firms replace and upgrade their IT systems and other equipment in order to maintain competiveness and profitability.

Consumers also have increased spending. Job worries and losses in household wealth had caused consumers to cut back on spending appreciably during the recession. But they have now begun to reopen their pocketbooks. During the first quarter of 2010 total personal consumption expenditures increased at a 3-1/2 percent annual rate. Significantly, these increases were distributed across many different types of goods and services. Even in the hard-hit automobile sector, sales have averaged over 11 million units annual rate so far this year—up over 17 percent from a year ago, though still well below the pace of 16.6 million units that prevailed before the recession.

In contrast, housing continues to struggle. During the second half of 2009, both sales and new construction lifted off from the recession low points seen around the turn of last year. But sales fell back after the expiration last November of the first round of tax credits for first-time home buyers, before receiving another boost this spring, as buyers rushed to beat the end-of-April expiration date for the extension of the home buyer tax credits. The increase in housing starts also stalled later in 2009 before showing some modest renewal during the past several months. Still, the rates of sales and starts are far below historical norms. Fundamentally, supply conditions continue to weigh on real estate markets, and they could for some time as foreclosures add to the overhang of unsold homes. But with the improving economy, low mortgage rates, and more attractively priced homes, housing market conditions will get better as we move further into the expansion.

What about labor markets? In general, many measures of economic activity show improvement early in a recovery well before the jobs picture starts to get better. This was especially true following the two previous recessions. I am concerned that this may be the case during this expansion as well. As the economy entered the most recent recession, businesses quickly cut their work forces. And even as the economy grew during the second half of 2009, job destruction outpaced the extremely low levels of hiring.

More recently, there has been a modest improvement in the jobs picture. Over the first five months of the year, excluding temporary hiring for the U.S. Census, on average about 86,000 jobs per month were added to the economy. Last Friday's data were disappointing, but they are only one month's numbers.

Businesses are being cautious about adding permanent staffing. They continue to strive to produce more with fewer people. But they can increase output for only so long without adding to payrolls. As the recovery progresses and businesses become more confident in the future, employment will increase on a more consistently solid basis.

Indeed, there are signals that we currently are near such a turning point. There is the modest pickup in the jobs numbers I just noted. Underlying those recent employment numbers, layoffs are down substantially. Some of those businesses that cut employment most aggressively at the beginning of the recession have begun to rehire. And others that are taking a more wait-and-see attitude are hiring temporary workers to fill their staffing needs. In fact, temporary worker employment has increased solidly in each of the past eight months.

Nonetheless, even after more solid employment gains materialize, unemployment may remain stubbornly high. Discouraged workers will resume searching for jobs, adding to the number of those already looking for work. In addition, the number of long-term unemployed is extremely high, and such workers typically have a more difficult time finding a job. Consequently, the outlook for these workers is challenged. So I anticipate that the rate and length of unemployment will improve relatively slowly.

With consumer spending accounting for roughly two-thirds of GDP, the economic forces at work here are key factors underlying the moderate projections for overall growth. Households entered this recession with high net worth but also with low levels of savings and high levels of debt. When faced with a temporary loss of income, households can maintain spending only by drawing down assets, borrowing more, or reducing savings. But as the recession took hold, households faced mounting job losses, stark reductions in the value of their housing and equity assets, and little in the way of liquid savings. So it is little wonder that consumers sharply retrenched on spending.

The need for households to repair their balance sheets will moderate growth in consumer spending going forward. In addition, we are seeing reduced availability of household credit. And, importantly, muted gains in employment will hold back growth in wages and salaries. All of these factors contribute to an outlook for relatively modest growth in consumer spending, which, in turn, restrains the forecast for overall GDP growth.

In addition to consumer lending, the availability of bank credit remains a significant headwind for many small- and medium-sized companies. Both supply and demand considerations are at work here. Some of the decline in bank lending last year reflects weak demand for loans by businesses wary of taking on new debt burdens in an uncertain economic environment. But at least some of the reduced lending arises from banks' tighter lending standards. These tighter standards appear to reflect concerns of banks about their own capital levels and also the credit quality of borrowers. More generally, credit flows are being reduced because both borrowers and lenders are still dealing with losses from the recession, especially the busts in residential and commercial real estate. I expect banking conditions to improve and better support growth, but this is likely to take some time.

While I've mentioned a number of factors that we think will dampen growth, we could be surprised on the upside. Increases in confidence could turn into higher spending sooner than we now think. And productivity growth has remained strong. Technology continues to advance, and firms continue to create new products and find new ways to produce more efficiently. These factors will lead to higher incomes in the longer term. And even over the shorter term, the higher profits and incomes generated by productivity can help restructure balance sheets and support spending.

Well, that was a long answer to a short question. The second question I'm often asked is a two-parter concerning inflation. The first part is: Isn't inflation about to explode? The second part is: Are you concerned about deflation? The answer is no in both cases: I think inflation will remain relatively stable.

Both camps have clear arguments. The current low rates of resource utilization strongly point to lower inflation. At 9.7 percent, the unemployment rate is quite high. Similarly, manufacturing capacity utilization is quite low. Such resource slack reduces cost pressures and makes firms less able to push through price increases. These factors have contributed significantly to lower inflation. The Fed's preferred measure of core inflation—the deflator for Personal Consumption Expenditures, or PCE, excluding food and energy—has fallen from 2.7 percent in August 2008 to 1.2 percent in April 2010. That is a large decline for a relatively stable data series.

Those who press me on higher inflation point to the Fed's accommodative policy and expanded balance sheet. We all know that too much money chasing too few goods eventually will generate inflation. But, currently, most of the funds used to increase our balance sheet are sitting idly in bank reserves. And because banks are not lending those reserves, they are not yet generating spending pressure. But, of course, leaving the current highly accommodative monetary policy in place for too long would eventually fuel such inflationary pressures.

With core inflation at 1-1/4 percent, I see the opposing forces of resource gaps and accommodative monetary policy as roughly balancing out over the medium term. As resource slack abates in a recovering economy, I expect inflation to move up to about 1-3/4 percent by 2012.

What does all of this mean for monetary policy? Currently, policy is, appropriately, very accommodative. But, eventually, we will have to return to a more normal stance. Judging the appropriate timing and pace for reducing accommodation poses a significant challenge for policymakers over the next couple years. On the one hand, removing too much accommodation prematurely could inhibit the recovery. On the other hand, as I noted, if the Fed leaves the current level of accommodation in place too long, inflationary pressures will eventually build. The Fed's decisions will be based on careful monitoring of business activity and keeping an alert eye out for signs of changes in the inflation outlook. In addition, the FOMC is making sure that it has the technical tools it will need when it decides to reduce monetary accommodation. Overall, I am confident that monetary policy will both support economic growth and bring and keep inflation near my guideline of 2 percent over the medium term.

As you can imagine, the crisis and recession have kept us busy. And we are constantly alert to issues that may cause us to reassess our outlook. With this in mind, I'd like to address a question that I have been asked a lot lately: How will recent events in Europe affect the U.S. economy?

There are a few channels through which the European sovereign debt problems could influence us here. European efforts to lower debt will likely weigh on their economic growth over the medium term. This will translate into less demand by Europeans for U.S. products. In addition, the dollar already has appreciated relative to the euro. This means that European consumers find our products to be relatively more expensive than before. At the same time, prices for European goods in terms of the dollar have fallen, boosting our demand for European imports. All of these channels work in the direction of lowering U.S. net exports, which, all else being equal, would tend to reduce the outlook for U.S. GDP growth.

However, a couple of factors suggest that these trade effects of the European fiscal situation on the U.S. economy are likely to be limited. Although the euro-11 economy is large, it represents only about 15 percent of U.S. exports. In comparison, our single largest trading partner, Canada, accounted for over 19 percent of domestic exports last year. And while the dollar has appreciated almost 18 percent relative to the euro since late November, the broad dollar exchange rate that is a trade-weighted average across all currencies has appreciated only 5.1 percent over the same period.

Nonetheless, if events in Europe evolve so that they have a more severe and broad impact on financial markets, then the scope of the problems for the U.S. could be magnified. Fortunately, our direct exposure to European debt is limited. But an intensification of liquidity or solvency problems in Europe and some related spillover losses in U.S. markets could cause a marked increase in investor risk aversion. More lenders could pull back on intermediation, restricting the flow of credit to fund worthy spending projects of U.S. firms and households.

To date, though, this doesn't seem to have occurred. Notably, the spreads between riskier and safer assets have risen some, but they are still nothing at all like the spreads we observed during the height of the financial panic. But this is a risk to monitor carefully.

Indeed, recognizing the importance of providing liquidity to stressed financial markets, the Fed recently re-opened currency swaps with the European Central Bank (ECB) and other major central banks. This step seems prudent as the events in Europe have the potential to create dollar funding pressures in world markets. As we did earlier, the Federal Reserve today offers dollars in exchange for foreign currency collateral—*at a fixed exchange rate* and a penalty rate. In this way foreign central banks can extend dollar liquidity support to creditworthy financial institutions facing temporary liquidity strains in foreign credit markets. To date, these lines have not been tapped much.

I'd like to conclude at this point, but I hope you'll recall that the answers to our three questions about future growth, inflation, and the European debt crisis were three-and-a-half, no, and probably not much, but we are being vigilant. Of course, the details behind these short answers are key to understanding how we put the pieces together to create a picture of the economy. I hope I have been able to convey some of that to you today.

I look forward to your questions.