Prospects for an Economic Recovery

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Thank you for inviting me to join you this evening to talk about recent economic trends and prospects for recovery.[1] As you know all too well, the economy has been in the throes of a particularly long and severe recession. The national unemployment rate has more than doubled from its low of 4.4 percent before the "peak" of the business cycle. All of us in this room are well aware of the toll on individuals and households brought by job losses, so this is indeed sobering.

However, incoming data have been mixed of late – rather than solely negative – and the stock market has improved significantly from its low point in March. After two quarters where real GDP shrank by more than 6 percent,[2] I expect that the economy will contract by much less than that this quarter, and that we will begin to see positive growth – perhaps by the end of the year.

The severity of the recession has led both fiscal and monetary policymakers to implement aggressive responses. The Federal Reserve acted aggressively on the monetary front, and the Administration and the Congress on the fiscal front with the stimulus legislation. While these policies will still take some time to have their full impact, they are in my view part of the reason the rate of decline in the economy seems to be slowing.

Certainly any near-term recovery is predicated on continued healing of the financial markets and financial system that underpin the economy. This is an outcome that is hoped for, and that policymakers are working intently to ensure, but not yet a certainty.

Nonetheless I hope the debate will soon center on the nature of the recovery, rather than the severity of the recession. It is a positive sign that some analysts are beginning to speculate on the likely nature of an economic recovery – and, indeed, that a talk focused on aspects of recovery is now quite relevant.

Certainly a wide range of views have been expressed, with references to L, U, and V shaped recessions. While I am at heart very much an optimist, my own view of the situation is that due to some unusual features of this recession the economy is likely to experience a slow recovery. I'll mention these features briefly, and then explore them with you in a bit more detail.

- First, while the "financial freeze" has thawed quite a bit, it will take some time for complete normalization of financial markets and lending.
- Second, consumers' "balance sheets" have been under significant strain, in part due to a loss in household wealth, and improvements will take some time.

- Third, a related point: the very sharp decline in housing prices is likely to inflict some forms of "collateral damage." Labor market mobility is likely to be hampered, financing for homes is likely to be restrained, and the ability to use home equity to finance various projects will be limited.
- Fourth, the economic health of key trading partners remains somewhat fragile, so it would be unwise to expect much help in the form of foreign growth that would propel our export-led industries.[3]

Considering these issues and taking into account the current level of fiscal and monetary policy stimulus, my best judgment is that a rather slow recovery is likely. Unfortunately, such a forecast implies continued weakness in the labor market, and an unemployment rate that continues to rise through this year.

With significant growth in payroll employment unlikely until next year it will obviously and unfortunately be some time before we see labor markets return to what we think of as "full employment." And it is too soon to know when the trough of the recession will occur, although there are hopeful signs that we are nearing it.

The Employment Situation

Allow me to make a few observations on the employment situation. As **Figure 1** highlights, we are in the midst of a severe recession. Since the official onset of the recession in December 2007, on net, 5.7 million American jobs have been lost.[4]

While the 1973-75 and 1981-82 recessions brought peak unemployment rates above our current level, in these and other recessions it is important to consider not just the peak level of unemployment but also the level at the *beginning* of the recession, and thus the percentage point increase during the downturn. Consider **Figure 2**. From the official start of this recession in December 2007, the unemployment rate has risen by 4 percentage points – a percentage-point increase from the start of the recession that already exceeds what we saw in the last three recessions. And the unemployment rate is quite likely to continue to climb, although I hope at a much slower pace than in previous months.

Labor markets tend to be somewhat lagging indicators.[5] So the expectation that the economy will grow below its potential for the rest of this year suggests that the unemployment rate will likely rise through this year – even if we get to a state of slow positive growth in the economy later this year.

Figure 3 provides the peak-to-trough changes in several of the components of real GDP. Several patterns are apparent. First is the important role played by residential investment. While residential investment accounts for a relatively small share of GDP, it is a volatile component. In three of the past four recessions, residential investment has seen the sharpest decline of the components of GDP shown in the chart. Only the 2001 recession did not have declines in residential investment from peak to trough, primarily because that recession involved imbalances in corporate balance sheets partly triggered by the rapid investment in the "dot-com" boom.[6]

One reason residential investment is so volatile is that it is the component of GDP most sensitive to changes in interest rates. The housing sector tends to be disproportionately impacted by rising interest rates, which typically occur when monetary policymakers are working to prevent increases in the inflation rate.

However, this residential investment cycle has been different. Mortgage interest rates have remained relatively low, but residential investment has declined sharply as significant over-supply in some key areas has led to rapidly falling housing prices, which provide a strong incentive to postpone a home purchase. This time falling house prices, coupled with rising unemployment rates (rather than interest rate increases) have been the main housing drivers.

While the decline in residential investment from peak to trough has been much more severe during this recession than the previous three downturns, as shown in Figure 3, this actually understates the decline for two reasons. First, residential investment was falling well before the official start of the recession. The decline in residential investment began in the first quarter of 2006, while the official start to the recession was not until December 2007. Second, we remain uncertain about the date of the trough of the recession, although it seems that it most certainly will not be the end of the first quarter of this year.

Also notable in this recession has been the decline in business fixed investment. Particularly since the fall of last year, businesses have reacted quite aggressively to the slowdown in economic activity. Not only have they moved to reduce overall costs by reducing expenditures for labor, but they have also slashed their investment budgets.[7]

Further, exports have declined sharply during this downturn, as they have in three of the past four recessions. But once again, the decline in exports to date likely understates the ultimate size of the decline – because we have likely not yet reached the trough of this recession, and foreign economies have been weakening rather rapidly since the start of the year.

Economic Recovery

Figure 4 highlights the recovery in several components of the economy in the first year following the trough of a recession. Several interesting patterns appear. In the previous three recoveries, the housing sector has shown the largest percentage change among the components of GDP shown in the figure. This largely reflects that this interest-sensitive component is usually buoyed by the reductions in interest rates that are the normal monetary policy response to recessions. This is why many analysts have highlighted the importance of seeing the bottom of the housing market for the economy to begin a true recovery.

Another important point related to recovery is that consumption needs to grow. While the percent change in consumption looks small in the figure relative to some of the other components, it is important to remember that consumption is by far the largest component of GDP. Because consumption accounts for more than two-thirds of GDP, these percent changes are on a large base. In short, it is very difficult to have a recovery without consumers being willing to spend, which was a motivation for some of the fiscal stimulus being directed towards increasing consumption.

In contrast, business fixed investment is not usually the driver in the initial stages of the recovery, as businesses are hesitant to hire more workers and make further investments until the recovery is more firmly established. Government spending also plays a role in recovery, as you can see in Figure 4. Certainly in the current recession, policymakers hope the stimulus spending will play a role. Furthermore, exports normally grow during the initial stages of a recovery. This is why it is important to us that policymakers worldwide respond to a recession that is clearly global.

Impediments to a Recovery

Normally forecasters are slow to recognize a recovery. Just as economic models usually do not foresee the depth of economic problems at the onset of a recession, most models miss the speed of the recovery. Thus, while I do indeed expect the recovery to be slow, I am well aware of the perils in making such a forecast – given the forecast errors often made at this time of the cycle. Still, while every recession has its unique features, this recession has involved larger impacts on our economic and financial infrastructure than others – a fact that makes my outlook on the speed of this recovery rather subdued.

The first major impediment is the financial infrastructure. While we have seen some improvements in financial firms' stock prices, and a generally positive response to the banking industry's so-called "stress tests," financial institutions and financial markets are still recovering from recent turmoil. As is shown in **Figure 5**, despite recent improvements, bank stock prices remain well below their cyclical peak, and the decline in bank stock prices has been more severe in this recession than in the previous one.

Continued healing of financial institutions requires recapitalization and full recognition and disposal of problem assets. While there have been significant steps taken to recapitalize many financial institutions, there has been slower movement towards removal of problem assets from financial institutions' balance sheets (although the Treasury's Public-Private Investment Program is intending to address this). Unfortunately, countries that have experienced significant banking problems normally have a slower economic recovery, as bank lending improves only slowly while banks remain risk-averse and work to repair their balance sheets.

It is not only financial institutions that have been damaged; many short-term credit markets have been badly disrupted by recent events. While the commercial paper market and money market funds have shown some improvements – in part as a result of Federal Reserve lending facilities – short-term credit is still difficult to access for many firms. Similarly, while we are beginning to see some financing for securitization of assets, the securitization market is dramatically smaller than before the recession. A full economic recovery requires that financial markets as well as financial institutions return to their role of efficiently allocating financing.

A second significant impediment is the amount of wealth lost during this downturn, as shown in **Figure 6**. Not only has the decline in the stock market been particularly severe, with many people reluctant to look at their monthly 401K statements, but our housing wealth has also declined significantly as housing prices have fallen – making the real estate pages a section of the Sunday paper many want to avoid. Because of the large loss in wealth implied by these two dynamics, it is likely that consumers will be slower to spend during this recovery as they seek to balance their saving behavior to reflect their loss in wealth.

A ramification of this loss in wealth is less access to consumer financing. With home equity lower or gone, it is no longer a source of financing for many consumers. In addition, the financial stress created by this recession has impaired the credit rating of many consumers, making credit less available and more costly for many borrowers. In addition, many potential home buyers are finding that if they want to buy a house, lenders are requiring higher down payments, better credit ratings, and more income in relation to debt. While housing credit was by most accounts too readily available several years ago, the current environment is likely to be particularly challenging for first-time home buyers and those with modest incomes.

Furthermore, Americans have tended to be much more mobile than residents in many other countries. As a result, job seekers could move to those regions of the country most in need of additional workers during an economic recovery. This labor flexibility is important if different regions and different industries recover at different paces. However, during this recovery low house prices and low housing demand may make individuals reluctant to move, as it would require them to lock in losses on their houses – particularly if the selling price is likely to be below the value of the loan.

Concluding Observations

This recession has been long and severe. While we are beginning to see more mixed economic data, which are likely a harbinger of a trough in this recession, the economy and financial markets remain quite sensitive to additional shocks. While problems in financial institutions and financial markets have abated from last fall, the recovery is likely to be impeded until there is greater normalization in financing flows.

I believe the aggressive monetary and fiscal response to the crisis has no doubt helped provide the foundation for an economic recovery. While I expect in the absence of significant further shocks that we will begin to see positive economic growth towards the end of this year, that growth is not likely to be robust enough to provide much improvement in labor markets until next year.

I want to stress, however, that I anticipate that actions taken to stabilize financial markets and institutions, fiscal and monetary stimulus, and market forces will contribute to a gradual resumption of sustainable growth. Furthermore the Federal Reserve has been and will remain committed to employing all available tools to promote economic recovery and preserve price stability.

Finally, as the recovery begins, it will be critical to fully evaluate the lessons of this recession, so we can make our economy, our financial markets, and our regulatory environment more resilient and less susceptible to the shocks that have impacted us all. Hopefully the start of the recovery will be an appropriate time to begin that process, in earnest.

Thank you.

NOTES:

[1] Of course, the views I express today are my own, not necessarily those of my colleagues on the Board of Governors or the Federal Open Market Committee (the FOMC).

[2] These quarterly rates of decline are seasonally adjusted at annual rates.

[3] Although of late, while exports have dropped, imports have fallen even more – so the contribution of net exports to GDP has been positive.

[4] For reference, the situation in New England and Massachusetts is similar to that in the nation, although the unemployment rate is a bit lower. Job losses have not been quite as severe, but that is because the decline got started a bit later. Rhode Island currently has an unemployment rate that is the highest in New England, and sixth highest in the nation. However, at the end of 2008, Rhode Island was second highest, after Michigan. Since then, things have gotten worse in Rhode Island, but worse still in other states.

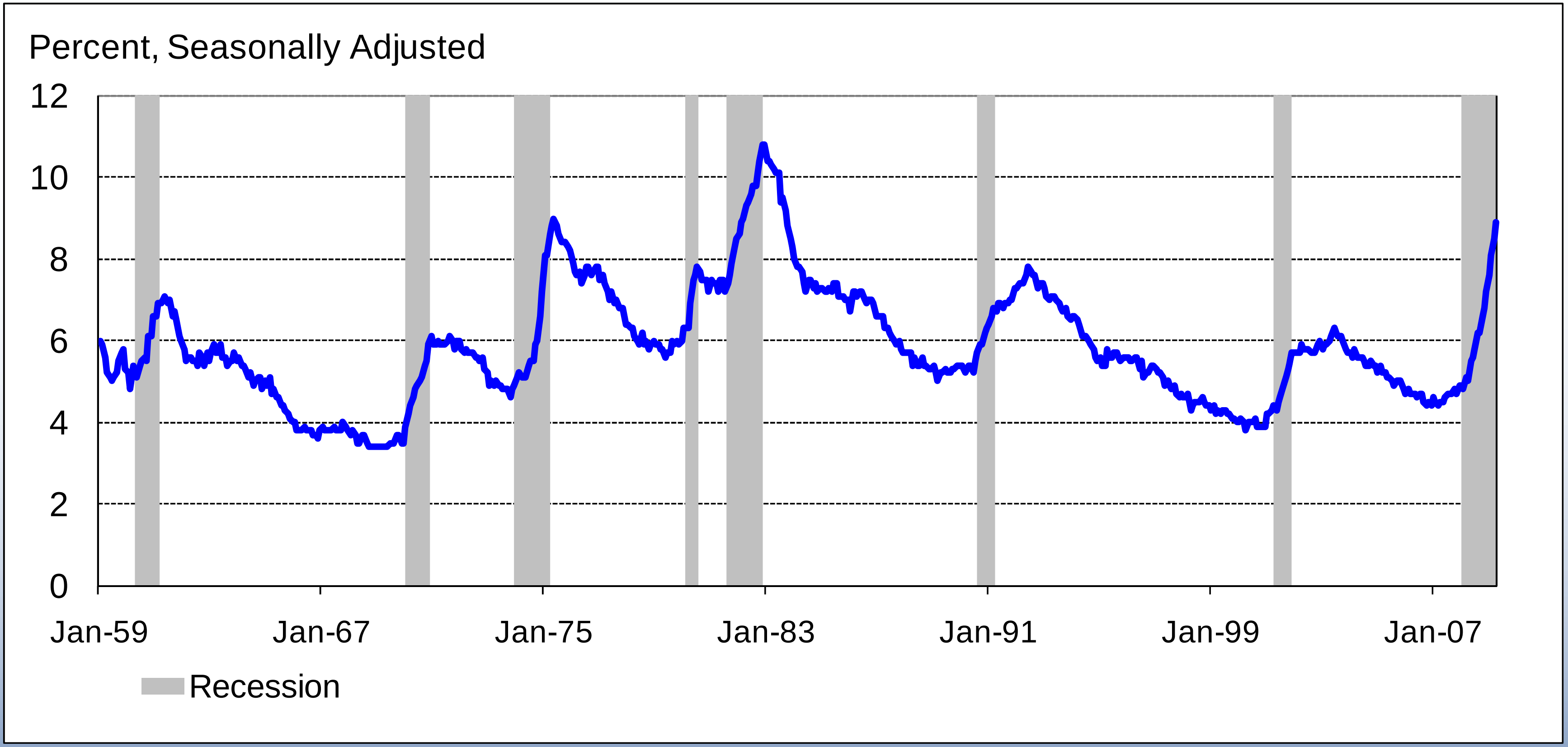
[5] The lag is very small for payroll employment – perhaps a month. Unemployment's lag is about three months.

[6] It was also one of the few times inflation was low going into the recession. The Federal Reserve was not trying to dampen inflationary pressures with higher rates.

[7] It could be that disruptions in credit flows to businesses stemming from the financial turmoil also played a role.

Figure 1
Unemployment Rate

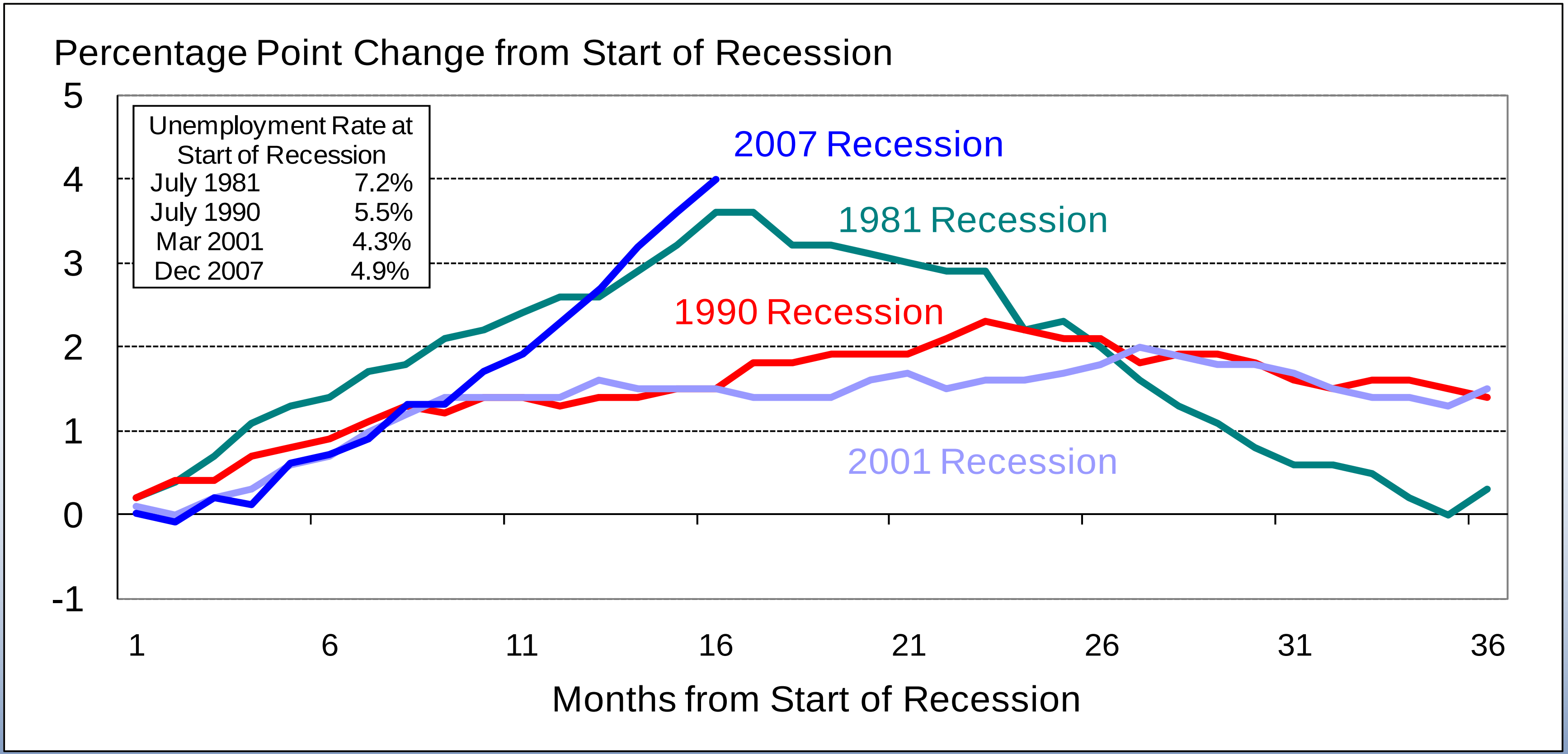
January 1959 - April 2009



Source: BLS, NBER / Haver Analytics

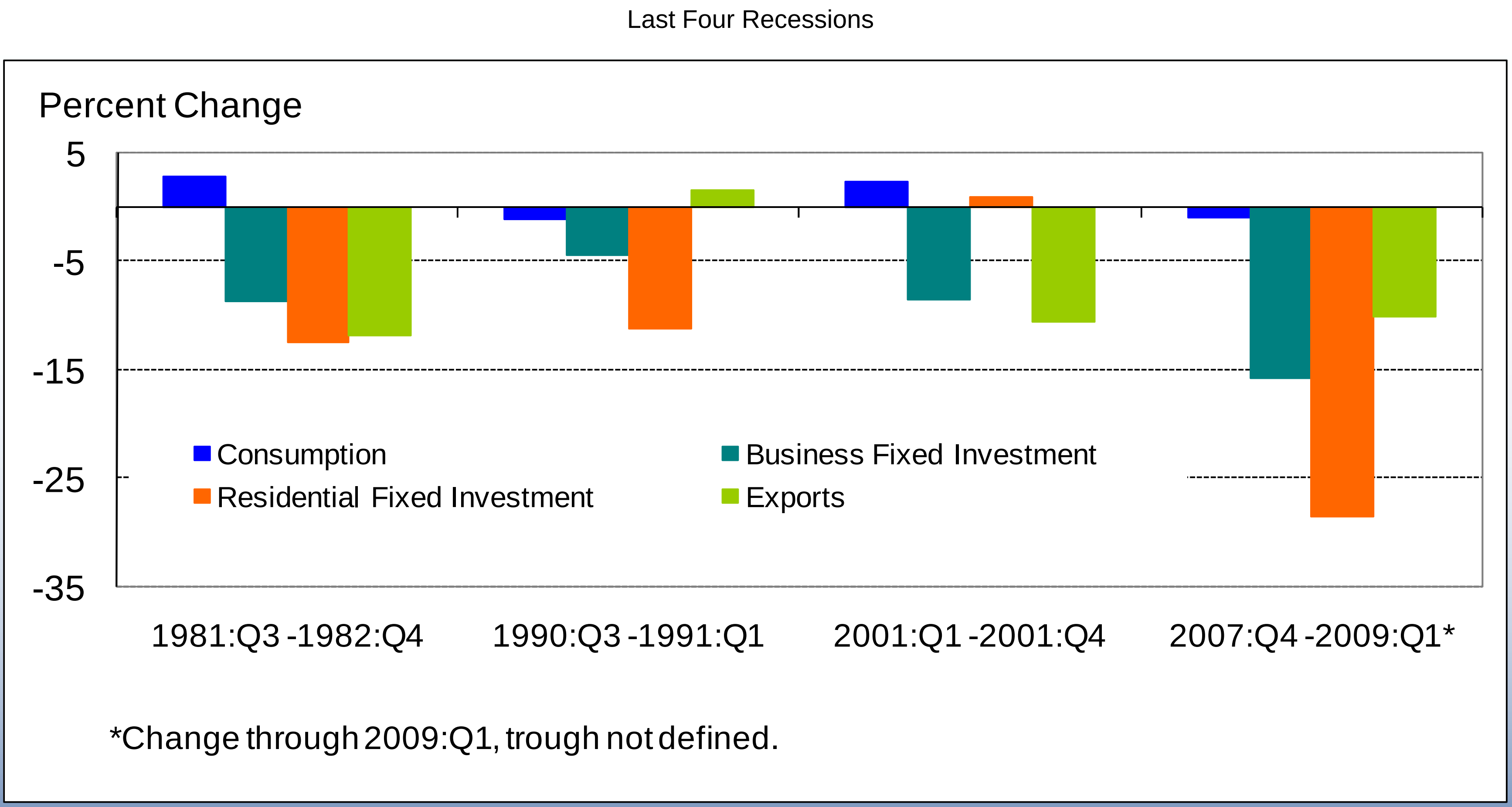
Figure 2
Monthly Change in Unemployment Rate from Start of Recession

Over Three Years Following Start of Last Four Recessions



Source: BLS, NBER / Haver Analytics

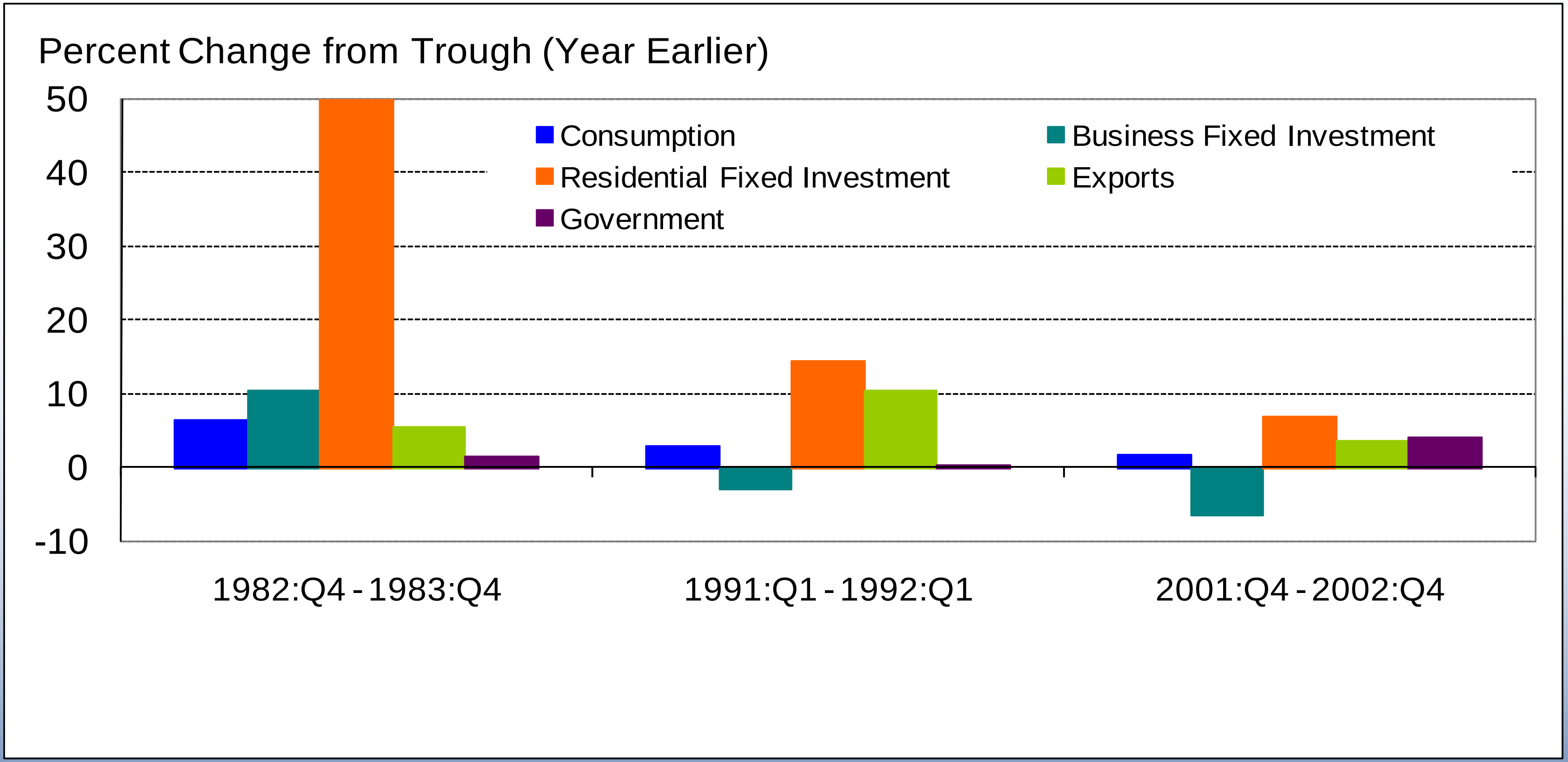
Figure 3
Peak-to-Trough Changes in Real GDP Components



Source: BEA, NBER / Haver Analytics

Figure 4
Recovery in Real GDP Components: Change 1 Year from Trough

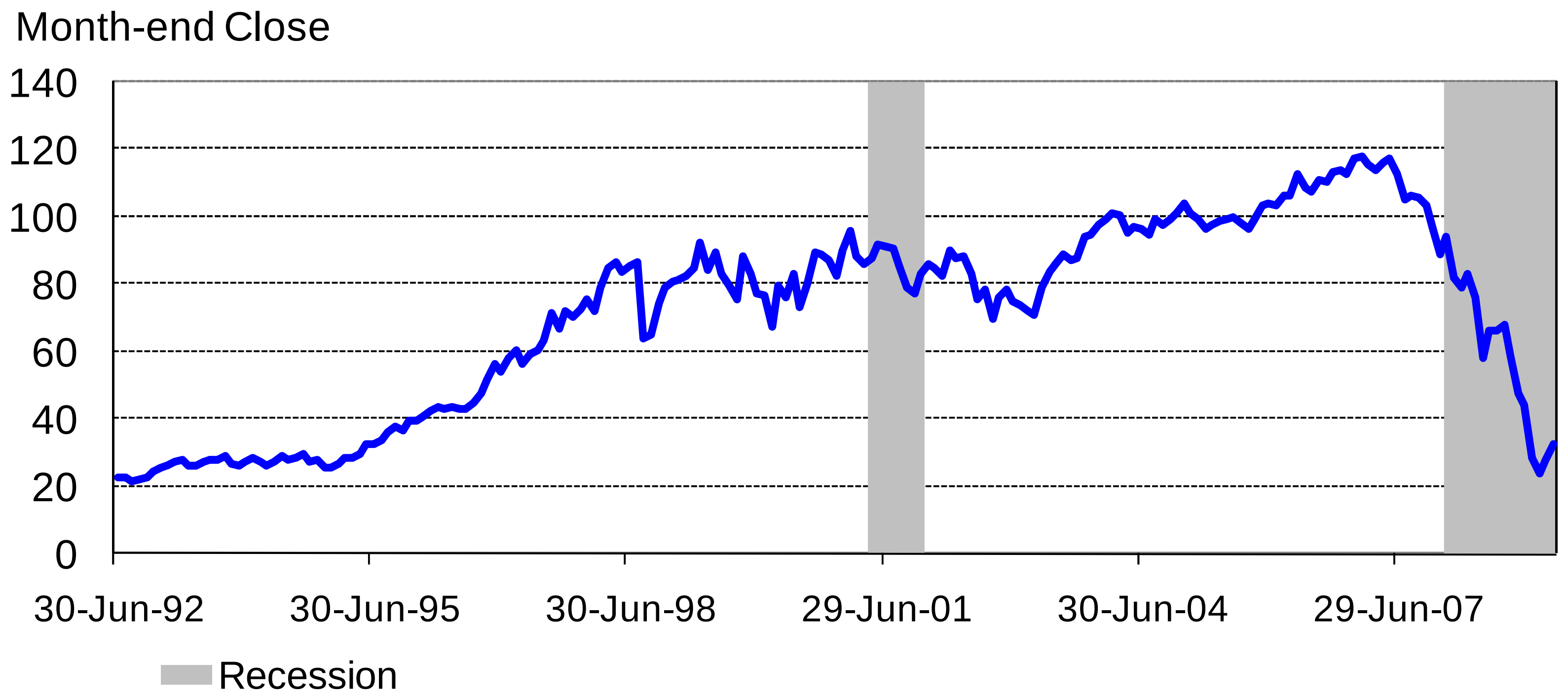
Last Three Recoveries



Source: BEA, NBER / Haver Analytics

Figure 5
KBW Bank Index

June 1992 - April 2009

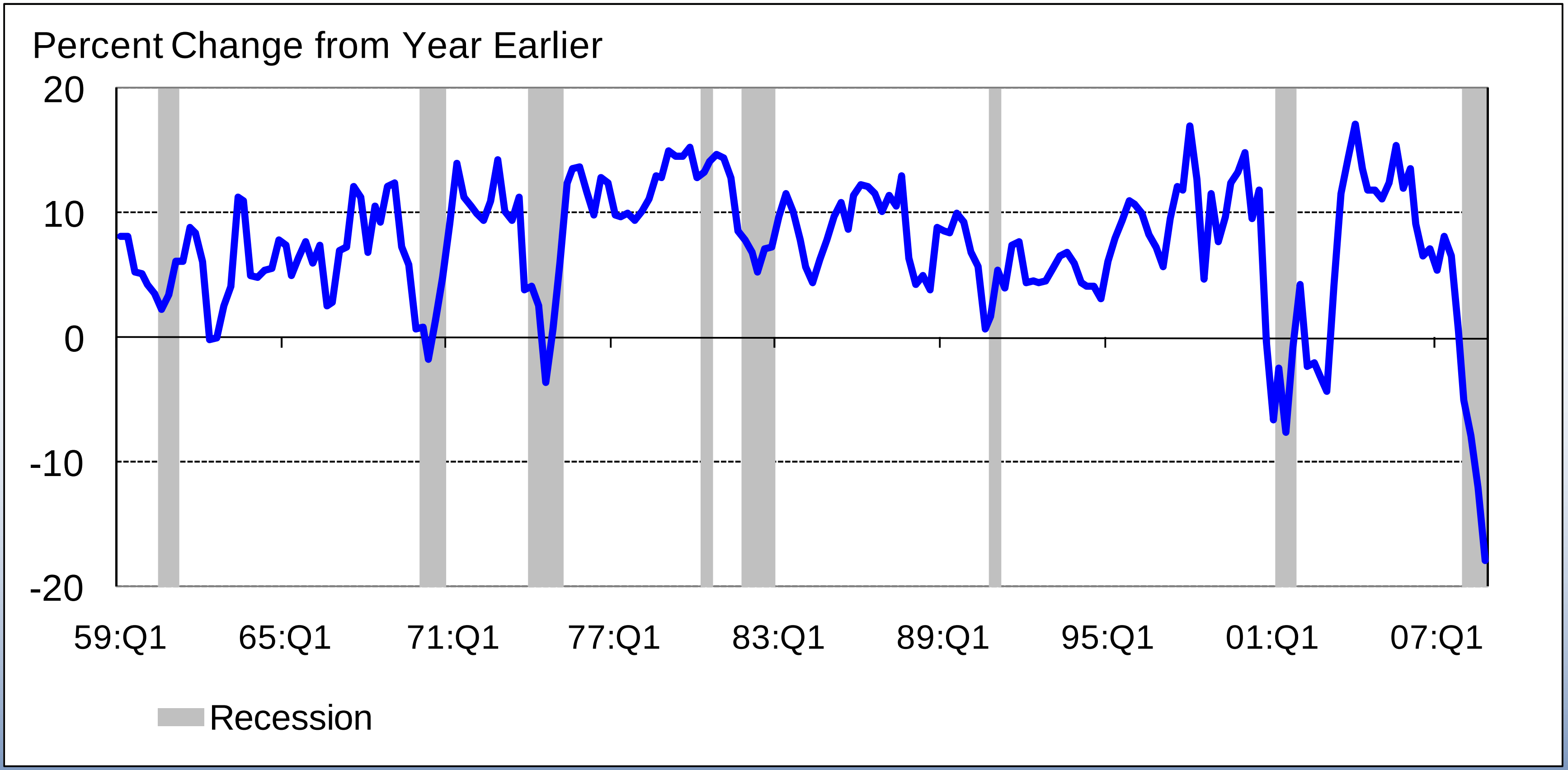


Note: The KBW Bank Index comprises 24 major banks (money center banks and leading regional banks) chosen to reflect the financial sector.

Source: Bloomberg

Figure 6
Household Wealth: Net Worth of Households and Nonprofit Organizations

1959:Q1 - 2008:Q4



Source: Federal Reserve Board / Haver Analytics