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Jeffrey M. Lacker
President
Federal Reserve Bank of Richmond

What Does the Path to Full Recovery Look Like?

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Thank you for that kind introduction, Bruce. It's a pleasure to speak with you today, especially since this venue is air conditioned and it's 95 degrees outside. More importantly, though, this is an economically important and unique region within the Fifth Federal Reserve District. The fertile mixture of technology- and defense-related industries has, over the years, given rise to a strong and vibrant agglomeration of human capital that can serve as a powerful engine of regional growth going forward. Prospects for the path of economic growth in this area, as well as the northern Virginia region more broadly, look bright, in my view.

My topic today, though, will be growth at the national level. I'd like to start by saying that the U.S. economy is growing rapidly, jobs are becoming more plentiful and inflation is low. Unfortunately, as much as I would like to paint such a rosy picture, the reality is quite different; unemployment is high, inflation has risen and economic growth has been decidedly mediocre. These facts are behind us and there's nothing we can do about them. The more important question is what happens from here? What does the path to full recovery look like? That's what I'm going to talk about today. I should emphasize that these remarks are my own and the views expressed are not necessarily shared by my colleagues in the Federal Reserve System.[1]

I will begin with a bit of background on current economic conditions as a precursor to understanding where we might be headed. The Great Recession officially ended in June 2009. Since then, the rebound in economic activity has been disappointing. Over the last century or more, economic activity has fluctuated, but has shown a remarkable tendency to return to trend. To be more precise, real Gross Domestic Product (GDP), our best measure of total production in the economy, has fluctuated around a trend line corresponding to growth at a rate very close to 3 percent a year. In recessions, real GDP falls below that trend line. When coming out of a recession, real GDP has typically grown several percentage points faster than the 3 percent long-run trend rate. This time, real GDP has risen at a 2-¾ percent annual rate since the end of the recession. With growth at this rate, we are not reducing excess productive capacity and unemployment will remain high. So what accounts for this sluggish performance?

Most obviously, housing construction is severely depressed. Our prior 10-year boom in housing left us with too many houses, given our population. New housing fell by 79 percent before bottoming out in the spring of 2009. Since then, home construction has made virtually no contribution to economic growth. Following earlier recessions, though, housing often contributed significantly to the growth in overall activity. For example, following the recessions that ended in 1975 and in 1982, residential investment added 1-¾ percentage points to GDP growth. So, if we simply had a positive contribution from housing, this recovery would have looked noticeably better.

While housing has played a significant role, consumer spending has been even more important in explaining the weakness of this recovery. Consumer spending accounts for 70 percent of GDP, and thus healthy growth in this category is vital to a strong recovery. Normally that's the case; at the end of a recession consumers will see brighter times ahead and will boost spending even if incomes are temporarily depressed. But in this recovery, real consumer spending has been relatively sluggish, rising at only a 2 percent annual rate. This picture has not been improving because real consumer spending has risen at only a 1.1 percent annual rate over the last six months. There are ample reasons for consumers to be cautious in their spending plans. Household net worth dropped by over $15 trillion during the downturn and has not fully recovered.

An even more important reason for tepid consumer spending growth has been the condition of the labor market. The downturn in employment lasted for 25 months, and during that time the nation lost 8-¾ million jobs. We only began to add jobs, on net, in March of last year, and have only added 1-¾ million jobs in the 16 months that ended in June. At this slow pace, it will take more than another five years for employment to get back to the high point it hit in January 2008. Another facet of weak labor markets has been slowing growth in wages. In the last 12 months average hourly earnings grew by only 1.9 percent, less than inflation and less than half the growth rate we observed before the recession.

So far, I've focused on the gloomiest sectors of the economy – housing and consumer spending. These are partially counterbalanced by some sectors that have been turning in an above-average performance. Business investment in equipment and software has increased by 25 percent since the end of the recession, adding 1.1 percent to GDP growth. And exports of goods and services have increased 21 percent since the end of the recession, adding 2.4 percent to GDP growth. So for balance, it is necessary to keep these bright spots in mind.

The inflation outlook is one key aspect of the current situation that gets less attention than it deserves. Last year inflation, as measured by the price index for personal consumption expenditure, was a modest 1.1 percent. But the prices of crude oil and many other commodities increased sharply toward the end of last year and early this year, and naturally found their way into consumer prices. Inflation averaged over 4 percent at an annual rate over the first five months of this year. Clearly gasoline prices accounted for much of this inflation surge, but other prices have accelerated as well. The core inflation rate, which excludes food and energy prices, has risen at a 2.3 percent annual rate year-to-date, well above last year's core inflation rate. While oil prices have stabilized of late and have reduced overall inflation, this is likely to prove temporary and I expect inflation to average close to 2 percent over the coming year.

As I noted earlier, the pace of the recovery has been disappointing compared to historical experience. In the early stages of past recoveries, particularly those following sharp downturns, the economy typically expanded at rates well above the long run average of about 3 percent per year; GDP growth rates of 5 or 6 percent were not uncommon. While that hasn't happened, most economic forecasters continue to expect growth to pick up to over 3 percent. This outlook is largely driven by the U.S. historical data, which shows that for more than a century, economic activity, as measured by gross domestic product, has generally fluctuated within a tight band around a simple trend line that grows at a constant 3 percent per year. Periods during which growth slows and the economy falls below the trend line are soon offset by subsequent periods of faster growth in which the economy rises back above the trend.

The logic for such a consistent pattern is straightforward. Over time, the economy's capacity for producing goods and services expands with the growth of technological capabilities. While productive capabilities may suffer set backs from time to time – like the disruptions caused by a sharp rise in the price of energy – these tend to be temporary. They don't permanently impair growth in the economy's productive capacity.

In the current recovery, there are certainly reasons to expect that the most recent slowdown in growth could be temporary. These are reflected in most forecasters' outlooks for the second half of this year and beyond. For instance, second quarter growth was held down by supply-chain disruptions in the auto industry and elsewhere due to the Japanese earthquake and tsunami; those problems have eased and should contribute to a noticeable improvement in the third quarter. In addition, business investment in equipment and software is likely to remain robust, as technology continues to advance across a broad front and businesses find opportunities to improve efficiency. Technological progress also plays an important role in our nation's exports, which have made strong contributions to growth in this recovery. Many of our key exports are capital goods, and overseas growth is especially rapid in the emerging economies that are equipping increasing numbers of their workers with up-to-date capital goods. Thus growth in countries such as China, India and Brazil should support U.S. export demand for many years ahead.

Even the weaker areas of the economy are likely to be less problematic going forward. The slowdown in consumer spending growth this spring was attributable, in part, to the elevation in retail energy prices since last year. Energy prices seem to have plateaued, and as long as energy prices do not worsen significantly from here, consumer spending is likely to regain some momentum in the months ahead. Moreover, many households have been saving more and paying down debts, and a rising stock market boosted household wealth by $10 trillion over the last two years. Household balance sheets thus should provide further support to household spending.

In my view, the expectation that the economy will soon conform to historical norms and grow fast enough to begin returning us to the 20th century trend line is still quite reasonable. Indeed, a broad array of private forecasters, as well as many of my colleagues on the FOMC, embody this view in their baseline forecasts. The central tendency of the projections of FOMC participants, as reported following our June meeting, is for real GDP growth to rise to around 4 percent over the next two years, which closely aligns with my own forecast.

There is, however, a less promising scenario that now seems plausible as well – namely, that the economy is settling into a period of growth at roughly a trend rate of around 3 percent, without the period of faster "catch-up" growth we're accustomed to after a recession. In effect, this would mean that the economy has suffered a permanent (or at least very long lasting) reduction in the *level* of economic activity. The economy would track a new trend line, parallel to – but distinctly lower than – the long-term trend line around which we had previously fluctuated.

I do not think we can completely rule out such an outcome, although I should say that, at this point, I view it as less likely than my baseline forecast for gradually increasing growth. While there is no hard evidence for the lower-trend-line hypothesis, other than the disappointing nature of the recovery so far, some observers have pointed out that changes in tax and regulatory policy, both actual and anticipated, are capable of bringing about such a permanent effect on output and consumption growth. Some observers also emphasize significant uncertainty about such policy changes as a factor limiting hiring and investment. The list of significant recent and prospective policy changes should be familiar: It would include the health care and financial reform bills of the last two years, as well as wholesale shifts in environmental regulations. On the tax side, there remains considerable uncertainty as to how long-run fiscal balance will be achieved and the extent to which various marginal tax rates might change as a result. On top of all that, uncertainty about federal expenditures has a direct dampening effect on businesses that supply to and people who work for the federal government. The high level of extended unemployment benefits is also cited by many observers as a factor dampening labor supply and restraining employment growth.

Quantifying these effects is virtually impossible. But since early 2009, we have been hearing widespread anecdotal reports from business contacts in the Fifth District about the chilling effect of prospective regulatory and tax changes. Many say that projecting the need for and financial implications of hiring and investment commitments is exceptionally difficult in this policy environment.

In a much-publicized recent lecture, Nobel economist Robert Lucas has speculated about whether the policy mix in the U.S. is moving closer to that of other developed economies, especially many European countries.[2] These economies generally have higher tax rates, more generous social safety nets, and more regulated labor and goods markets than we've had in the U.S. They also generally employ less of their labor force and produce less output per capita than the U.S., although they tend to have roughly the same average rate of growth. Since recovering from World War II, measures of economic activity in those countries have converged to trend lines parallel to but significantly below the one the U.S. tracked prior to this recession.

These two possible paths essentially bracket the range of reasonably likely trajectories for the economy in the near and medium term. The growth rate could rise to 4 percent over the next two years and allow us to gradually make up the ground lost in the recession. Or growth could continue at around 2-¾ percent, keeping the level of economic activity persistently below the 20th century trend line. At present, I do not feel we face significant risk of growth much below that, or of an outright contraction. On the other hand, there is a possibility of an unexpected acceleration in growth to more robust rates – this has happened in past recoveries, though I view that as a good deal less likely than growth paths within the range bounded by 2-¾ and 4 percent.

What does this imply for monetary policy? I believe that which of these two possible recovery paths we realize is relatively independent of our monetary policy choices at this point. Professor Lucas's conjecture that the U.S. economy might not achieve more than 3 percent growth in the coming quarters is equivalent to saying that the path of our economy's productive capacity, given current tax and regulatory policies, will be lower than we thought. In this case, monetary stimulus can do little for real growth without creating appreciable inflationary pressures. Even in the more encouraging scenario, however, the factors that have held back growth this year – and seem likely to abate – are largely beyond the power of the central bank to offset.

More broadly, it seems unlikely that the forces limiting the pace at which U.S. growth is recovering are amenable to monetary policy. As evidence, consider the difference between the economic outlook now and at this time last year. In the summer of 2010, growth was sluggish but projected to rise gradually and inflation was running at or below 1 percent. Now, growth is still sluggish, but inflation is running at 2 percent or more. This circumstantial evidence suggests that the additional monetary stimulus initiated last November raised inflation and did little to improve real growth. Last year, raising inflation was a desirable policy objective, but that clearly is not the case today. Given current inflation trends, additional monetary stimulus at this juncture seems likely to raise inflation to undesirably high levels and do little to spur real growth.

For many, if not most people, real economic recovery means more improvement in labor market conditions than we've seen to date. But such improvement ultimately depends on the pace at which the economy's production and consumption of goods and services grows. Production has fallen well below the historical trend of the 20th century. When that has happened in the past, recovery has brought us back to the old trend. Whether and when this will happen in this recovery is becoming increasingly hard to predict, but the stakes are becoming increasingly high. While I remain cautiously optimistic that the path of our recovery will take us back to historical trends, the possibility of persistently lagging behind our 20th century trend is a pointed reminder that changes in an array of seemingly microeconomic policies could have macroeconomic implications that are highly consequential.

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[1] I am grateful to John Weinberg and Roy Webb for assistance in preparing this speech.

[2] Robert E. Lucas Jr., "The U.S. Recession of 2007-201?" Milliman Lecture, University of Washington, May 19, 2011, available at: http://www.econ.washington.edu/news/millimansl.pdf.