The Great Rebalancing

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The conference organizers suggested a number of questions we could address in our remarks. The gist of these questions is 1) What has changed after the recession and the financial crisis? and 2) What is new?

This is a pretty big canvas on which to paint for a mere 10 minutes. My stock-in-trade is an economic outlook speech, but today I will exploit the opportunity presented by these questions by stepping back and trying to discern the broader historical themes of the “before and after” of the recent recession and financial crisis. These themes are likely to at least partially define the environment for business in coming years.

I almost always begin formal remarks with a disclaimer. It goes like this: my remarks today are my personal views and may not be shared by my colleagues on the Federal Open Market Committee and in the Federal Reserve System.

The Great Moderation

Here is the basic thrust of my argument today: over the last quarter century, American economic history can be divided into three periods. A long period leading up to the recession that began in 2007 has been called the Great Moderation. The recession itself was the most severe downturn we have experienced since the Great Depression. For that reason, it has been called the Great Recession—not a depression, but still very ugly. I would like to suggest that the period we are now in—beyond being a recovery from recession—can be thought of as the Great Rebalancing. This phrase has been used to describe the adjustment process underway in Britain. I believe it’s also appropriate to the United States.

Historical periods are more easily labeled with hindsight and, obviously, the story is not yet told. Take this discussion, therefore, as a device to frame some of the big economic issues as we look ahead.

During the Great Moderation, from about 1984 to 2007, the volatility of output growth and the level of inflation declined markedly. There were two recessions during this period, but both were relatively shallow and short-lived.

The Great Moderation was a period of sustained growth and low unemployment. Lower and more stable inflation created the conditions for the improved functioning of financial markets and made planning easier for both businesses and households.

Economists have attributed the Great Moderation to a variety of factors. These factors include better macroeconomic policy (including monetary policy), various structural changes in the economy, and some good fortune as well.

However, the seeming stability brought on by the Great Moderation masked growing imbalances and excesses as time went on. The household savings rate, for example, steadily declined. Consumers took on a lot of debt, especially mortgage-related debt. Asset prices—notably house prices—increased much faster than their historical average.

Rising domestic imbalances were growing in tandem with global imbalances. These imbalances were manifested in large current account deficits that began to build in the late 1990s. Surpluses abroad resulted in outsized capital flows to the United States that lowered the cost of borrowing, encouraged leveraging, and increased returns on many assets.

Toward the end, investors began to assume that past hefty gains guaranteed future results and took on more and more risk. But in 2007, the Great Moderation came to an end.

The Great Recession

The Great Recession that followed was the deepest and most prolonged of the 13 recessions since the Great Depression. The financial crisis brought the country close to financial collapse. It caused more than 8 million job losses and brought a painful level of unemployment and underemployment that persists today.

The Great Recession lasted seven quarters and turned to recovery in the summer of 2009. Since then, the economy has expanded for seven quarters, as of last Thursday (the end of the first quarter). With each quarter, the recovery is increasingly well established.

However, underlying the recovery there remain serious imbalances that have not been corrected. Work on correcting these has only recently begun. This is a very familiar story to all of you, I know.

The Great Rebalancing

In my introduction, I mentioned what I called the Great Rebalancing. Today, I see three rebalancing processes now underway. They are 1) the rebalancing of consumption and savings, 2) fiscal rebalancing, and 3) regulatory rebalancing in the financial sector.

Let me elaborate a bit more on the forces that I think will define this period of rebalancing.

First, the deleveraging of the household sector is rather well advanced and continuing. Households are repairing their balance sheets by reducing debt and rebuilding savings. The savings rate has hovered around 6 percent for many months now, more than triple the level that prevailed at the end of the Great Moderation. Consumer spending has been growing more slowly relative to income than it did before the recession. I expect that this more measured consumption behavior is likely to persist.

A less consumption-dependent economy will help rebalance the country's external accounts—the trade and current accounts. It's unlikely and even undesirable that there be a drastic shift away from consumption, so less American consumption will not fix the global imbalances. But a stronger savings and investment economy here and its mirror image—a less consumption-driven economy—should temper the dangerous tensions that are characteristic of international imbalances.

Stronger savings by U.S. consumers won't be enough to correct our external imbalance without significant reduction of the country's public borrowing.

The public sector in the United States must stabilize its finances and reverse the accumulation of debt that has accelerated in recent years. This process of public sector deleveraging—an element of fiscal rebalancing—is mostly ahead of us.

Spending cuts have begun at all government levels, and some improvement in revenues is now being reported. The extent of cuts is being discussed, quite literally, as we speak.

Public pension reform is a necessary element of fiscal correction. Again, this is mostly ahead of us. In the private sector, the process of migration from a defined-benefit world to a defined-contribution world is well underway. And observed from a very high level, I think there is evidence of a broad shift of some of the burden for providing for one's retirement from a combination of government and employer to the individual. The context is, of course, the baby boomer retirement wave that is just beginning, with those born in 1946 now reaching 65 years of age.

The third major domain of rebalancing, in my view, is bank and financial system regulation. We are in a period of re-regulation. In many ways, this re-regulation is a natural reaction to the financial crisis and constitutes a commitment to the public to prevent a recurrence.

Some of this re-regulation is wholly new—especially in the financial sector. As required by the Dodd-Frank Act, a new dimension of financial oversight is in the early stages of implementation. This oversight is variously called "macroprudential supervision" or "systemic risk oversight." The intent is to identify and preemptively neutralize sources of systemic risk and eliminate the too-big-to-fail problem.

In banking and a number of other industries, many contacts across the Southeast region of the country are increasingly giving voice to claims that this re-regulation is overreaching and potentially destructive. I frequently hear—across a range of industries—that the growing cost of compliance will drive out investment and hiring. As a current banking supervisor who has a background in the private sector, I see both sides of this concern. Let me just say that, to maximize the economy's potential, I believe that in the coming years we need to strike the right balance in all regulated sectors.

I see rebalancing of certain fundamentals that underpin the country's economic performance and prospects as a prerequisite of long-term growth and full employment. I'm confident that the Fed, through its monetary and regulatory policies, is helping to shape and support conditions that allow these rebalancing processes to proceed.

Our hosts here today asked, what has changed? What is new? I would like to think some profound changes are underway that, once the perspective of hindsight has been achieved, might appropriately be dubbed the Great Rebalancing.

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