Crisis, Recession, and Recovery: 2007–16

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Key points

- Atlanta Fed President and CEO Dennis Lockhart, in a January 9 speech at the Rotary Club of Atlanta, looks at the economic story of the past decade.
- Lockhart says the complete narrative of the last 10 years involves a story of slow, but satisfactory, cyclical recovery.
- Lockhart states that some underlying fundamentals, including productivity, business investment, and labor force trends, have been restraining the pace of growth.
- Lockhart notes that many close observers of the economy have lowered medium- and longer-term expectations for long-run potential GDP growth, actual GDP growth in the nearer term, and the neutral policy rate setting.
- Lockhart continues to expect a gradual pace of interest rate increases.
- Lockhart believes the economy today is well positioned for moderate growth and steadily improving conditions.

This is my 10th and final appearance at our Rotary Club in my capacity as president of the Atlanta Fed. I am stepping down effective February 28, 10 years to the day of my arrival. These last 10 years have been an extraordinary period economically for all Americans and certainly for me as a Federal Reserve Bank president.

Today I will observe tradition and offer my views on the outlook for 2017 and a bit beyond, but I would like to preface my look ahead with a look back at the economic story of the last decade. This retrospective will coincide almost exactly with my time in office as a Fed policymaker. I'll present only my personal reflections and views. I'm not speaking for the Federal Reserve or the Federal Open Market Committee.

I promise this won't be just a trip down memory lane. I'll look back at the events and forces that have shaped our collective economic experience, but also push the narrative into the present. The relevant question, I think, is, how is our national economy positioned for the future?

The storyline has plenty of drama early in the decade of my tenure. There was the financial crisis—it's fair to say "panic"—in 2007 and 2008. This scary period involved bank failures, bailouts, interventions to stabilize markets, government capital forced on banks, and political and public outrage.

Starting in 2007 and through 2009, virtually all key economic indicators took a dive (or the inverse—rose dramatically when that was a bad thing). I came on the scene just before the crisis hit. I know what you're thinking. In my defense, I'll point out—as economists often say—correlation does not equal causation.

The complete narrative of the last 10 years involves a story of slow, but satisfactory, cyclical recovery. After a deep and damaging recession—officially dated from December 2007 to June 2009—the economy got on a recovery path that has lasted to today. Let me back that up with some details.

- Real gross domestic product, or total output, now stands at 111 percent of the 2007 level.
- In a two-year period during the recession, the economy lost more than eight-and-a-half million jobs. Over 15 million jobs have been added since

the labor market hit bottom, almost seven million above the level before the crisis.

- The net worth of U.S. households and nonprofits fell by more than $12 trillion during the recession. Household net worth has rebounded by more than $34 trillion since then and is now approximately a third higher than prior to the crisis.
- A big share of the growth of household wealth came from recovering house prices. After falling 27 percent during the crisis, house prices in the aggregate have fully recouped those losses plus a little more.
- Perhaps as a result, measures of consumer confidence are at their highest levels since 2007.

Have we returned to normal? I feel some need to resist calling this recovery a return to normal. Even though the economy has been through what looks like a full cycle, the economy is "returning" to a new place. In that sense, there is no return to normal. I think of "normal" as code for a desired state of the economy—in equilibrium, at full employment, with annual inflation running at 2 percent, and all this sustainable. That's what "normal" means to me.

Four subplots

As I said, this cyclical recovery is a satisfactory story, but it is a subplot, not the whole story. The deeper story of the economy includes three other subplots.

There's a policy subplot. The policy response to the financial crisis and ensuing recession was unconventional. The Fed's policy interest rate—the rate that highly influences all other interest rates—went from 5 1/4 percent on the day I started in March 2007 to zero, in effect, by December 2008. The policy rate stayed there for eight years. Today—after only two quarter-point increases over the past 13 months—the policy rate rests at 3/4 percent or a little lower.

When interest rate policy goes as low as it can go, central banks sometimes resort to unconventional measures to add stimulus to an ailing economy. One aspect of unconventional policy was a controversial measure known as QE, or *quantitative easing*, in central bank jargon. The Fed created new money and bought longmaturity Treasury and mortgage-backed securities, and did this three times. The aim was to put downward pressure on long-term market interest rates to make mortgages, car loans, business term loans, and bond financing cheaper. As a consequence of these policy actions, the balance sheet of the Federal Reserve grew from $900 billion before the crisis to around $4.5 trillion today, a quintupling.

There is a secular trend subplot. It underlaid the cyclical behavior of the economy and the policy reaction that accompanied it. Secular trends are important economic dimensions that did *not* swing back cyclically. Many predated the 10-year period of my story. Some of these may reflect ongoing structural changes in our society and economy.

The distinction between secular and structural trends in economics is not always crystal clear. Secular trends may amount to deep-seated structural problems. Or they may not. They may be reversible. Or they may be irreversible. I'll simply say such trends tend to move persistently in one direction for a long while, sometimes in an unhelpful or undesirable direction.

To illustrate, I'd like to contrast certain secular trends that had the effect of offsetting, to an extent, economic indicators that carved cyclical trajectories. I do this to make the point that, while the economy has recovered in many respects, it has also evolved to a different place today. This is the point I made earlier when talking about what "normal" means.

I'll start with employment. Employment has recovered substantially. I think we're close to a state of full employment. At the same time, we've seen a secular decline in labor force participation.

Employment-related secular trends are highly affected by demographics. It's well known that the United States has an aging population distribution. The baby boom generation is reaching retirement age, and the number of retirees is growing. Age demographics, and demographic trends broadly, affect the economy in a number of ways. I'll cite just a few: consumption patterns including health care consumption; wealth distribution, savings levels, and investment patterns;

and workforce growth, composition, and labor market dynamism. The concept of labor market dynamism captures worker geographic mobility, job creation and destruction, and worker churn. While employment has recovered, labor market dynamism has been declining for some time.

Also, while employment has returned, wage growth fell and then stagnated for much of the decade until recently. In addition, income and wealth inequality have increased.

The employment recovery can be attributed to the resumption of growth of gross domestic product, or GDP. Think of GDP as total output or total economic activity. GDP growth has averaged just over 2 percent since the recession officially ended in the summer of 2009. The recovery has been slow compared to earlier post-recession episodes. Yet, GDP has regained all the ground lost during the recession and more.

However, for much of the recovery period, productivity growth has languished. Growth of productivity is a key driver of overall economic growth. And, it is a basis of wage growth. Productivity growth has been extremely weak, and the reasons are a matter of debate.

Also, while the economy overall has recovered, business investment spending has been weak through most of the recovery period to date. To generalize, the private sector has been spending to maintain and replace capital equipment and software, but not to build capacity for a rosier future. Business leaders have not been ready to place those kinds of bets. I think this is one of the reasons for weak productivity growth.

Along with weak capital spending, business dynamism has been in secular decline starting before the recession and throughout the decade. A good indicator of business dynamism is new business formation.

I'll provide one more example that contrasts the cyclical and the secular. The housing sector has made a nice comeback—as indicated by housing starts, house prices, multifamily residential development, and sales activity. At the same time, household formation seems to be in secular decline. This is about your grown kid living in your basement. I'm told that the number of grown children living with parents is at the highest level since the 1940s.

My final subplot is about headwinds. Headwinds, by my definition, are temporary developments that suppress activity. Such episodes may partially explain the weakness in business capital investment. What headwinds do I have in mind? I'm referring to events and developments such as fiscal crises (government shutdowns, the fiscal cliff), uncertain effects of the Affordable Care Act, the Greek debt saga, European fiscal strains and bank weakness, the slowdown in China, oil price volatility and decline, and recently, Brexit and the U.S. presidential election. Each of these, in its time, raised concerns about what the future held and evoked caution. These kinds of concerns influenced decisions to defer investment, hiring, and major household purchases. They shortened planning horizons and rattled financial markets.

Current position of the economy

The economic story of the past decade—with its four subplots of cyclical recovery, the path of policy, secular trends, and temporary headwinds—is prologue to what we all today care most about—our economic future.

I'll offer my views on the outlook in a moment, but let me first add some context. The experience of the past decade—with growing recognition of fundamental factors weighing on the economy—has caused many close observers of the economy to lower medium- and longer-term expectations. Over the last two or three years, many Fed economists—among them, my team at the Atlanta Fed—have progressively lowered estimates of three critical forecast elements. First, we have dropped our estimate of *long-run* potential GDP growth to reflect both demographic effects on the labor supply and a slower pace of structural productivity growth. Second, we have reduced our forecasts of actual GDP growth *in the nearer term*, reflecting the negative impact of the slow business-investment recovery I referenced earlier.

The third critical adjustment to our projections is a little arcane, but very important as a working assumption or estimate. It relates to where we think interest rates will settle out in a cycle of rising rates. It's where the Fed would stop. You may have heard the terms "neutral rate" or "equilibrium rate." This is the policy rate setting where monetary policy can be judged to be neither accommodative nor restrictive, neither purposely applying stimulus nor tightening. This policy setting would fit an economy humming along at steady state—an economy operating at full employment and registering an inflation rate around 2 percent.

Based on our changing assessment of potential growth, we have lowered our estimate of the neutral rate, and along with it, the anticipated path to this terminal point. Knowing what I know today, I continue to expect a gradual pace of interest rate increases.

In general terms, the downward adjustment of these forecast elements is analogous to a lowering of the metabolic rate of the economy. Growth has been subdued, but it's been good enough to bring unemployment down by half.

When I joined the Fed in March 2007, the official unemployment rate was 4 1/2 percent. The inflation rate was running about 2 1/2 percent. And, as mentioned earlier, the Fed's policy interest rate was set at 5 1/4 percent.

Today, the unemployment rate is 4.7 percent, almost identical to the rate 10 years ago. The equivalent inflation rate is currently running at 1.6 percent. So conditions are close to the same. Yet the target range of the Fed's policy rate is set at 1/2 to 3/4 percent. How can this stark difference in policy be explained?

One answer lies in the weight of secular trends on the economy. While the economy has enjoyed cyclical recovery, some underlying fundamentals have been restraining the pace of growth. Most prominent among them are productivity, business investment, and labor force trends.

Outlook

Now to the outlook. The economy going into 2017 appears solid, but growing at a moderate pace. To put a number on this, it's around 2 percent per annum, as mentioned earlier. The last half of 2016 will likely register a bit stronger growth, but the year overall will clock growth of near 2 percent, consistent with earlier years.

My outlook anticipates more of the same over the next three years. I expect inflation—which is still below the Fed's 2 percent longer-run target—to move higher, converging on target in 2017 or 2018. I expect employment to reach or even exceed most estimates of full employment.

Many in the business and financial community are anticipating improved growth prospects with the change of administration in Washington. Again speaking only for myself, I have not factored fiscal stimulus and regulatory change into my growth forecast. Without details, I consider it too early to estimate the effect of these policy changes.

How is our economy positioned for the future? This is the key question. The economy today is well positioned for moderate growth and steadily improving conditions. It's less certain that the economy is positioned for a breakout to markedly higher growth on a sustained basis. To accomplish such a breakout—as many anticipate and certainly we all hope for—requires offsetting demographic drags and accelerating productivity growth, in my opinion. To boost productivity growth, we need a number of things on the supply side of the economy to come together, among them more business investment.

The job of cyclical recovery is largely done. The Federal Reserve is quite close to achieving its mandated policy objectives of full employment and stable prices. The job of mitigating secular trends and implementing structural adjustments lies ahead. This set of challenges will define the next phase.

This juncture feels transitional to me. During the Great Recession and the recovery phase, the Fed and monetary policy took the lead. Now I think it's time for the Fed and monetary policy to shift to more of a support role.

The Fed's monetary policy mostly affects demand conditions. Inducing supply-side and structural change is more the domain of Congress, the administration, and the private sector.

With the cyclical job largely complete, it’s personally tempting to claim that we’re at the end of an era—or at least a phase—and that this transition coincides with my leaving the scene. That’s going a bit too far. As I said, correlation does not equal causation.