The Storm Clouds Begin To Depart

By Kevin L. Kliesen

Indications are that the U.S. economy is beginning to climb out of the worst recession since World War II. As the recovery begins to take hold, many economists, policymakers and financial market participants have begun to focus on the long-run implications of the exceptional actions taken to jump-start economic activity over the past year or so. These concerns center on the potentially damaging effects of large projected budget deficits over the next several years and on the possibility of higher inflation and inflation expectations, both of which could cause long-term interest rates to rise sharply.

A Deep Recession

According to the National Bureau of Economic Research, the U.S. economy has been in recession since December 2007. As is normal during a recession, labor markets contract, firms cut production and inventories accumulate. But this recession has been much longer and deeper than normal. From the third quarter of 2008 to the first quarter of 2009, the U.S. economy contracted at an annual rate of 6 percent, the largest two-quarter decline in more than 50 years. Private industry has cut more than 6 million jobs since December 2007, causing the nation's unemployment rate to rise to 9.4 percent as of May 2009. In the manufacturing sector, capacity utilization rates have dropped to levels not seen since the 1930s—a response to the sharp drop in domestic and foreign demand for U.S.-produced goods. Not surprisingly, firms have drastically reduced their capital outlays.

Often, deep and protracted recessions—such as those of 1973-75 and 1981-82—are the byproduct of a fundamental restructuring of the economy. In this regard, two current developments stand out. First, the Detroit automotive industry, which was throttled by last year's surge in gasoline and diesel prices, is consolidating. In all likelihood, the industry will re-emerge with dozens fewer vehicle assembly and parts plants, hundreds fewer dealers and tens of thousands fewer employees.

Massive changes are also likely to hit the housing, banking and mortgage finance industry. In the first quarter of 2009, both single-family housing starts and new-home sales fell to their lowest level on record—two short years removed from a record-setting boom in construction and house prices. In response, large numbers of home builders and mortgage lenders have gone out of business, as have many large commercial banks and thrifts that were active participants in the boom. Other large banks have received considerable financial aid from the government to prevent their failure. Adding to the uncertainty, financial regulatory reform legislation may produce further enduring changes.

Some Good News and Some Worries

Stock prices, which tend to rise toward the tail end of recessions, have posted significant gains since early March. Rising stock prices increase household net worth and decrease the cost of capital for firms, thereby helping to boost spending by households and firms. Still, most measures of U.S. house prices continue to decline from year-earlier levels. Rising levels of mortgage defaults and home foreclosures have exacerbated the downward pressure on house prices.

Recessions tend to produce lower inflation rates, as firms cut prices, slack in the economy builds, and oil and other commodity prices decline. Thus far in 2009, these pressures have kept inflation well below last year's rates. Accordingly, the consensus of professional forecasters is that inflation will be a nonevent in 2009 and 2010 and that long-term inflation expectations will remain low and stable.

Many reputable economists have warned that these forecasts should be viewed cautiously, given the Fed's highly expansionary policies. In a signal that global demand conditions could be improving by more than expected, oil and commodity prices have risen noticeably since mid-February, while yields on 10-year U.S. Treasury securities have risen considerably. It is too early to tell whether this is an inflation scare in the bond market or whether long-term interest rates are merely readjusting upward to a level that is consistent with a growing economy.

In response to the deep downturn and disruption in financial markets, monetary and fiscal policy remains highly expansionary. These actions will eventually produce faster growth in aggregate demand and prices. Hence, if the recovery turns out to be more robust than expected, inflation and inflation expectations may begin to increase. In that case, Fed policymakers will need to shift gears. However, the unusual nature of this recession makes it much harder to predict the tenor of the recovery. While there was abundant evidence of some stabilization in the economy and in financial markets this spring, the risk of an extended period of slow growth should not be automatically dismissed. Such an outcome would not necessarily diminish the risk of higher inflation. Ω

Kevin L. Kliesen is an economist at the Federal Reserve Bank of St. Louis. Douglas C. Smith provided research assistance. For more on Kliesen's work, see http://research.stlouisfed.org/econ/kliesen/index.html.