Economic Outlook, July 2010

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Jeffrey M. Lacker
President, Federal Reserve Bank of Richmond

It's a pleasure to discuss the economic outlook tonight. I think the most useful tack to take to get started is to survey the broader economic context, and then set our sights on some of the supporting details. For the last year or so, we have been recovering from a very severe recession, and despite the unique features of the contraction, this recovery resembles many that we've seen in the past; some sectors are expanding, while some sectors are still struggling. Signs of strength are evident in manufacturing, business equipment investment and consumer spending, while weakness persists in the labor market, construction, and state and local government spending. And as was the case in many past recoveries, this one is proceeding at an uneven pace; growth was quite strong in the fourth quarter, but more moderately paced over the last two quarters. Thankfully, inflation has remained low and fairly stable. The most likely scenario is for this pattern to continue – that is, for the recovery to continue at a pace that is generally moderate, but variable over time and across sectors. That's the broad aerial view, and now I'd like to come down to sea level to get a closer look at some of the particulars. I'll be speaking mainly about the national outlook, with occasional comments about the Hampton Roads region. Before I begin, I should mention that these are my own views and are not necessarily shared by my colleagues on the Federal Open Market Committee.[1]

The evidence that overall economic activity has been expanding since the middle of last year is widespread. Real GDP, for example, appears to have grown more than 3 percent over the last four quarters, which is a bit above its long-run trend.[2] Granted, some of the increase was due to one-time factors. Last year's fiscal stimulus measures, for example, have boosted incomes and production over the last year, but those effects are set to diminish over the next few quarters. And due to the way GDP is calculated, it received an additional one-time boost from the completion in mid-2009 of the sharp inventory reduction that is typical of recessions. Demand since then has been met entirely from production, which is what GDP measures, rather than by drawing down inventories.

A look at the major components spending, however, supports the idea that we're on course for sustainable growth. Let's start by taking a look at consumers. Consumer spending accounts for more than two-thirds of total spending in the GDP, and is now clearly on an upswing. During the recession – that is, in 2008 and the first half of 2009 – real consumer spending fell at a 1.2 percent annual rate. But in the last half of 2009, consumer spending *increased* at a 2.4 percent annual rate, and so far this year it has grown at a 2.9 percent rate. That turnaround is likely to be durable, in my view. During a severe recession consumers tighten up on spending, in part due to actual job losses and lower incomes, but also due to their weakening confidence in *future* income growth. Many households prudently defer major purchases when the headlines are alarming and jobs are threatened. But when the bad news begins to crest, a growing number of households begin to become more confident in their job security. That confidence and improving prospects for income growth allow many consumers to begin to satisfy some of their pent-up demand for big-ticket items and discretionary purchases, which boosts overall consumer spending. Although unexpected adverse shocks to household income prospects have the potential, as always, to set this process back, the baseline outlook for consumer spending suggests that reasonably healthy growth will be sustained in the months ahead.

The brighter picture is not limited to consumers. Business investment in equipment and software usually displays large swings in recessions and recoveries, and the latest experience fits that pattern very well. After falling at nearly a 15 percent average annual rate during the recession, this investment category grew slowly in the third quarter last year and then rose at a 15.2 percent annual rate in the next two quarters. Again, prudent firms often defer capital spending in recessions, which creates a pent-up demand that boosts spending early in recoveries. And while sales may have fallen in many industries, technology continues to advance, and as a result there's an array of opportunities to deploy new capital to improve business processes. Major upgrades for IT and communications equipment are underway at many firms. So along with most analysts I expect to see robust increases in spending for business equipment and software this year – and beyond.

The broad growth in business and consumer spending has had a clear impact on the supply side of the economy. In manufacturing we have seen a sizeable swing in activity. Industrial production fell almost 15 percent during the recession. Since June of last year, though, it has risen in 10 of 11 months for a cumulative gain of 9 percent through May. That turnaround is evident in consumer goods, especially autos; business equipment, especially computers and semiconductors; and even the production of construction supplies has begun to increase.

Producers of goods and services also have been aided by the pickup in growth among our major trading partners since the first half of last year. Exports fell sharply in the recession, with the pace of decline hitting a 30 percent annual rate early last year. But since the end of the recession, exports have risen at a healthy 17 percent annual rate. Recent developments in Europe have called into question the extent to which growth there will support demand for our exports. At this point, my sense is that uncertainty regarding fiscal adjustments and banking conditions is likely to be resolved without major effects on U.S. growth, although, to be fair, more adverse outcomes are conceivable. Here in the Hampton Roads area, the fluctuations in export activity are clearly visible at the ports as well as at the trucking and rail connections that serve them. The volume of container units through the Port of Virginia weakened during 2008 and declined even further, by 17 percent, during 2009. Container activity has rebounded in the first half of this year, and has recently returned to pre-recession levels.

Not every sector of the economy has the wind at its back, however. While positive overall growth in economic activity does mark the beginning of a recovery, typically some sectors continue to contract even as others expand. For example, spending on nonresidential construction – a category that includes stores, offices, warehouses and other structures – has fallen almost 30 percent over the last year and a half. Although there are scattered reports of bottoming out in some commercial markets, leading indicators for this sector, including architectural billings and vacancy rates, suggest that nonresidential construction will continue to be very soft for an extended period.

And then there's residential construction, and everyone knows the background here. We had an extreme boom-bust cycle in housing, as the number of new housing starts rose from 1.4 million in 1995 to 2.1 million in 2005 before falling to 554,000 last year. For perspective, last year's number is about half of what it would take to accommodate population growth with an unchanged homeownership rate. During the boom we built more houses – and larger houses – than we ended up wanting. So there are now more than 14 million vacant homes in the country, and population growth and demolitions will only reduce vacancies slowly. It will take some time to plow through the loan modifications, foreclosures and market transactions needed to achieve a more appropriate match between households, homes and mortgages. Looking ahead, one shouldn't count on housing construction to expand much from its current sluggish pace. Indeed, in the Hampton Roads region, annual permitting activity for single-family homes peaked in 2003 before declining by 65 percent through 2009. Regional housing prices peaked in late 2007 and have fallen by 10 percent since then. Although national housing prices peaked earlier in 2007, the subsequent decline was similar in magnitude. Housing activity in the region remains weak and recent trends have been somewhat skewed by the expiration of the homebuyers tax credit.

State and local government spending also has been weak lately, for obvious reasons. This category in the national income accounts has fallen 1.7 percent in real terms since the second quarter of last year, partially offsetting the considerable increase in federal spending since the recession began. With revenue for many state and local governments in the doldrums, budgets are likely to remain quite constrained for some time.

But even after taking on board these sectors where activity is still soft, I believe that consumer spending and business investment are going to continue to be strong enough to keep growth in overall activity on an upward trajectory, though perhaps at a pace that is less robust than has been typical of past recoveries. As a result, I would not be surprised to continue to see somewhat choppy economic reports for a time. For example, spending measures came in better than expected early in the year, but have underperformed of late. This pattern is not at all inconsistent with moderate growth – one can't always be better than expected, after all – so it's wise not to overreact to every crosscurrent in the data flow.

The labor market is another sector where reports were stronger than expected earlier in the year. This was welcome news, since we lost 7.3 million jobs during the recession, and then lost an additional 1.1 million jobs in the last half of 2009, while GDP and manufacturing production were increasing. Many analysts have noted, however, that some of this year's job growth has been attributable to temporary hiring for the Decennial Census, and that *private* payroll growth has been slower over the last two months than the previous two months. This is correct, but it is important to note that as you look through the choppiness, private payrolls have been expanding at a significant pace – over 1.1 percent at an annual rate since December. This is more than what is required to keep up with growth in the working age population, which is part of the reason the unemployment rate has fallen from 10.1 percent, when it peaked last October, to 9.5 percent in June. This is still quite elevated, however, which indicates just how much ground remains to be covered.

The labor market in the Hampton Roads region has been recovering in line with the national labor market, with the addition of 8,200 jobs during the first five months of 2010. This gain provides only a partial recovery of the 33,000 jobs lost since the beginning of the recession. The fact that the unemployment rate for the Hampton Roads region peaked at 8 percent earlier this year suggests that this labor market was not hit quite as hard as the rest of the country, although the current rate of 7.3 percent is more than double the pre-recession rate and remains stubbornly high.

Credit market conditions have been central to the story of the recession and the recovery. Conditions tightened sharply as the recession began, and have improved considerably since the middle of last year as the economic outlook improved. Still, I regularly hear complaints about small businesses being unable to obtain credit. It is certainly true that there are banks and other lenders who have experienced large losses and are now facing a relatively high cost of capital. Those lenders are now reducing their outstanding loans, and firms that have traditionally borrowed from these now-capital-constrained lenders may have difficulty getting new loans, or even retaining existing credit lines. But many banks appear to be ready and able to lend to creditworthy customers – that's what banking is all about. So while borrowers may need to shop around more in this environment, my sense is that the credit market is working well enough to support productive investment and allow a solid recovery to proceed.

The economic picture would not be complete without some comment on inflation. Since the surge of early 2008, inflation has fallen, and over the last 6 months both overall and core inflation have averaged about 1 percent at an annual rate. While I wouldn't like to see these numbers move much lower, our best available measures of inflation expectations have been relatively stable, which suggests that, barring unanticipated shocks, inflation is likely to drift upward in coming quarters.

The stability of inflation expectations implies confidence that the Federal Reserve will act to keep inflation low and stable as the recovery continues and the economy improves. Living up to that confidence will make monetary policy challenging for the foreseeable future. Current policy settings are still at emergency levels, with the federal funds rate near zero and with our balance sheet two-and-a-half times the size it was three years ago. These settings are now providing substantial monetary stimulus to the economy. As a technical matter, whenever we decide to begin normalizing policy it will be straightforward to sell assets, shrink our balance sheet, and raise the level of short-term interest rates. The difficulty, of course, is that no one wants to tighten policy prematurely and needlessly dampen the recovery. So recognizing the right time to begin normalizing our monetary policy settings is going to be hard, and reasonable people can differ about this. For my part, I will be looking for the time at which economic growth is strong enough and well enough established to warrant raising our policy rate.

A broader economic policy challenge we face as a nation is the path of federal deficits that will result from current and planned fiscal policies. In my view, if economists can contribute anything to the policy process, it's our willingness to identify unsustainable trends and remind people that they don't go on forever. And clearly, our current fiscal policy is on an unsustainable path. The Congressional Budget Office estimates that under current legislation, by 2012 the federal debt as a fraction of GDP will have more than doubled in 10 years, with further increases occurring each year unless major changes are made in spending programs and taxes. Granted, the fiscal situation is even worse in some other countries, but I don't think we want to find out how close we can get to a full-blown fiscal crisis before taking corrective actions.

In broad terms we all know what needs to be done – cut spending or raise taxes. If we don't, an adverse sequence of events will be set in motion. Investors will be increasingly reluctant to hold more Treasury securities, yields will consequently rise significantly, the cost of capital will increase for firms producing in the United States, capital formation will suffer, productivity growth will slow, and thus real household incomes will stagnate. In short, the well-being of future generations is at stake. My hope is that policymakers will find a way to move fairly quickly to make the adjustments needed to put the budget on a sustainable path. The sooner we make the necessary adjustments, the longer the period over which we can spread out the adjustment cost, and the more likely we are to avoid a fiscal crisis of the type Greece is now experiencing.

Despite these serious policy challenges, however, I remain fundamentally optimistic about the capacity of the American economy to generate sustained improvements in standards of living. Our country has repeatedly demonstrated an unsurpassed ability to generate technological and organizational innovations and deploy them to deliver improved products and services for consumers and businesses. While we have struggled from time to time with economic policy, and no doubt will continue to struggle in the years ahead, that should not distract us from our signal achievements, nor should it dim our hope for the future.

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[1] I am grateful to Roy Webb for assistance in preparing this speech.
[2] Second quarter 2010 GDP has yet to be released.