

Economic Outlook, February 2011
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I do not often get invited to speak outside of the Fifth Federal Reserve District, which is the Richmond Fed's territory, but when I do, it is a pleasure to visit the district of such a good friend and colleague as President Charles Plosser of the Third Federal Reserve District. As President of the Philly Fed, Charlie has spoken at this event in the past, which implies some measure of continuity today, since I rarely find fault with his perspectives. That said, I should note that my comments today on the economic outlook are indeed my own, and should not be taken to implicate President Plosser or any other of my colleagues on the Federal Open Market Committee (FOMC).¹

Our economy, overall, is growing at a steadily increasing pace and inflation is low and stable, although, as always, visible risks to this outlook for continued recovery remain. The most striking feature of this recovery is that until recently it has been relatively slow compared to past recoveries, particularly those following the two other severe recessions of the past 60 years – the recessions of 1973-75 and 1981-82.

Why has this recovery been subpar? The obvious explanation is that the housing boom that preceded the recession has produced a housing stock that is too large, both in number and size, relative to what households want given current income prospects and credit market conditions. As a consequence, residential investment has failed to make a positive contribution to growth in this recovery. In contrast, residential investment rose at an average of 40 percent in the first year of recovery following the recessions of 1973-75 and 1981-82. Apart from housing, other household outlays have grown relatively slowly in this recovery as well. Consumer expenditures increased at an annual rate just below 2 percent in the first five quarters of this recovery. In contrast, in the two other severe post-war U.S. recessions household spending grew by an average of 6-½ percent in the first year of expansion, thereby adding considerably to GDP growth.

Recently, however, consumer spending has picked up speed. Personal consumption expenditures are estimated to have risen at a 4.4 percent annual rate in the fourth quarter. The concurrent decline in the personal saving rate suggests that many households see brighter income prospects ahead, an assessment that is supported by emerging evidence that labor market conditions are improving. Initial unemployment claims have been on a downward trend since last summer. The unemployment rate has fallen by half a percent over the last two months and by more than a percentage point since the fall of 2009. Manufacturers have added to payrolls over the last three months. And average hourly earnings continue to advance. Granted, last Friday's employment report showed smaller net additions to payrolls than expected. But an array of forward looking indicators of employment trends point to continued labor market improvement. For example, the employment components of several business surveys, such as the ISM's, have shown increasingly positive readings, particularly in the manufacturing sector.

The recent decline in the personal saving rate also suggests that many households have made substantial progress toward repairing their balance sheets. American households stepped up savings during the recession in order to pay down debt and rebuild assets. That prudence, combined with significant gains in equity values since early 2009, has led to substantial improvements in the financial positions of many households. Since the end of the recession, the net worth of households has increased by slightly over \$4 trillion and is up substantially from

its low point in the cycle. Given these stronger fundamentals, it seems quite reasonable to project robust growth in consumer spending this year.

Business investment also should make a significant contribution to growth this year. Investment in equipment and software has grown 22 percent since the end of the recession. Opportunities to streamline business processes and reduce costs through productivity-enhancing investments appear to be widespread. And the pickup in demand growth is providing further encouragement for capital spending plans.

Even investment in new structures is showing some encouraging signs of bottoming out. Spending for private nonresidential structures has risen slightly over the last several months. And, a leading indicator for future spending, the American Institute of Architects' Billing Index, has moved into positive territory for the first time in over two years. Taken as a whole, then, business investment is likely to add significantly to growth this year.

Prospects for export growth also look encouraging. Exports of goods and services have risen 18 percent since the end of the recession, adding 2 percent to GDP growth. While growth in some of our major trading partners has been uneven, expansion has been robust in important emerging economies. Thus demand for American exports is likely to contribute to growth this year as well.

Despite all that the economy has going for it, there are still substantial challenges ahead. Housing activity obviously continues to be depressed; residential investment has fallen nearly 60 percent from its peak at the end of 2005. Given the large inventory of vacant homes in major markets and the ongoing foreclosure wave that continues to generate sales, any advance in residential investment is likely to be slow and uneven. Having said that, residential investment is only 2-¼ percent of GDP, so the damage this sector is capable of inflicting is in some sense limited.

All in all, then, I expect noticeably stronger growth in overall activity this year than last. If I had to write down a forecast today, it would be pretty close to 4 percent. A rate of growth in that neighborhood would result in continued net gains in employment and further reduction in the unemployment rate.

This generally positive assessment is complemented by the benign outlook for inflation. Over the 12 months ending in December, the price index for personal consumption expenditure has risen 1.2 percent. This low inflation rate seems more consistent with our price stability mandate than the figures over 2 percent that were common in the years leading up to this recession. Many forecasters are expecting inflation this year to come in between 1-½ and 2 percent. That is my expectation as well, and would represent a good outcome. Still, recent increases in commodity prices are showing up in consumer price measures and will put upward pressure on overall inflation numbers in the months ahead. Just how much is hard to say. The effect on overall inflation could be transitory, or could persist if firms, encouraged by accelerating demand growth, pass input prices on to their customers. Such pickups in inflation are common at this point in business cycle upturns, and would be consistent with the expected inflation rates implied by prices of inflation-indexed U.S. Treasury debt, which show market participants now expecting inflation to average 2 percent over the next five years, and as much as 3 percent over the following five years.

That's the near-term outlook in a nutshell. Beyond this coming year, the configuration of fiscal policies could have a significant bearing on growth prospects. We have a serious, long-term mismatch between the trajectories of federal spending and taxes. Most of you are no doubt aware of the long-term budget projections published by the nonpartisan Congressional Budget Office. Their most recent projections, under plausible assumptions and current legislation, show deficits falling from around 9 percent of GDP now to around 5 percent of GDP in 2015 and trending steadily upward thereafter. The ratio of debt to GDP rises from the current level of around 60 percent to 150 percent in 2030.

Be clear: there is no uncertainty about whether the long-run federal budget imbalance will be corrected. Continual increases in debt relative to the size of our economy are simply not feasible and *will not happen*. The real question is *how* a sustainable path will be achieved. In advance, by deliberately adopting and following a credible strategy, or *in extremis*, forced by investor retreat and collapsing market confidence to adopt drastic emergency measures? We would be wise to heed the abundant empirical evidence of the superiority of taking action before a fiscal crisis is upon us.

One serious fiscal risk over the long-term concerns the open question of the federal government's role in housing finance. This year, Washington is poised to consider the fate of the government-sponsored enterprises (GSEs), Fannie Mae and Freddie Mac, now operating under government conservatorship. The perception that these two private mortgage intermediaries enjoyed implicit government backing reduced the aversion of their creditors to large downside risks. The resulting incentive misalignment, combined with escalating low-income housing targets, drove the GSEs to accumulate significant exposure to non-prime mortgages, which exacerbated the overbuilding and thus contributed to the magnitude of the resulting decline.

Many proposals would make government guarantees on home mortgages explicit and priced; such proposals differ mainly in the nature of the intermediaries through which such guarantees would be channeled. But perpetuating guarantees for housing-related debt will continue to artificially stimulate the risky leverage that critically fueled the disastrous housing boom we have just experienced. The devastating consequences of the housing bust suggest that government backstops for housing finance are not worth the price of over-built, over-leveraged and at times overheated housing markets, on top of the fiscal burden of large contingent liabilities. I believe we should phase out government guarantees for home mortgage debt. Otherwise, financial stability will be elusive, and fiscal balance will be threatened by repeated boom-bust cycles in housing. Home-ownership may be a laudable social goal, but if that is our objective, we should subsidize housing equity, not housing debt.

I will conclude with a few remarks on monetary policy. During the recession, the Federal Reserve cut short-term interest rates to near zero and expanded the supply of central bank money – that is, currency and bank reserves – from under \$900 billion to over \$2 trillion, which in my view was an appropriate response to a major economic shock. In addition, the FOMC in November decided to further increase the supply of Federal Reserve money by another \$600 billion by the end of the second quarter through purchases of long-term U.S. Treasury securities. The Committee recognized that the provision of further monetary stimulus at this point in the business cycle is not without risks, and therefore committed to regularly review the pace and overall size of the asset-purchase program in light of incoming information and adjust the program as needed. The distinct improvement in the economic outlook since the program was initiated suggests taking that re-evaluation quite seriously. That re-evaluation will be challenging, because inflation is capable of accelerating, even if the level of economic activity has not yet returned to pre-recession trend.

We've come through an extraordinary period in our economic history, which in turn brought about extraordinary policy responses. As the economic expansion continues to strengthen, the challenge becomes determining the time and manner by which policy returns to a more normal mode of behavior. The public's confidence that policy actions derive from a coherent, sustainable long-term plan for policy – both monetary and fiscal – will be an important factor supporting growth in the years to come. I am hoping that we will see steady progress in 2011.

¹ I am grateful to Richmond Fed Economists John Weinberg and Roy Webb for help in preparing this speech.