Economic Outlook, May 2012
May 2, 2012

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Economics Club of Hampton Roads Economic Conference
Sheraton Waterside Hotel
Norfolk, Va.

It's a pleasure to discuss the economic outlook with you today. My plan is to discuss prospects for economic growth and inflation over the next few years, and then share some thoughts about the outlook for monetary policy over that time horizon.[1] As always, the views expressed are my own and may not reflect those of my colleagues within the Federal Reserve System.

To set the stage for a look ahead, let's start by taking a look at how far we've come since the dramatic contraction in economic activity that we suffered in 2008 and the first half of 2009. Since the second quarter of 2009, real income has increased 4.8 percent, consumer spending has risen 6.1 percent and real gross domestic product (GDP), our best measure of overall economic activity, has risen 6.8 percent. Moreover, we have added over 3.5 million net new jobs since total employment bottomed out early in 2010. The record shows that we've made considerable progress in recovering from the Great Recession, as it's been called.

And yet, for many observers, this performance has been sorely disappointing, and the reasons are understandable. Looking back to two other U.S. recessions that were nearly as deep — 1974-75 and 1981-82 — real GDP expanded at rates more like 5 or 6 percent per year coming out of those recessions.[2] Similarly, the current unemployment rate of 8.2 percent is viewed as relatively elevated, whereas numbers like 5 or 6 percent are viewed as more normal. Clearly, a substantial number of Americans are seeking suitable employment, but have not been able to do so. For many of them, the moderate pace of this expansion has meant significant economic hardship.

Some critics see this moderate pace of expansion as prima facie evidence that the Federal Reserve should provide more economic stimulus in order to boost growth. I disagree, as I will attempt to explain. While frustration with current economic conditions is understandable, our economy's performance is nonetheless comprehensible, given what has befallen us over the last few years. Moreover, the reasons for more moderate growth suggest that further monetary stimulus is not likely to be of much help. So, before talking about the outlook, I'd like to take a closer look at the most likely reasons for our muted growth rate.

The most obvious factor holding back this recovery is the lingering depression in new home construction. In past recessions, homebuilding fell sharply but invariably snapped back rapidly at the outset of the recovery, with growth rates of 30 percent or more not uncommon. Homebuilding fell sharply in this recession — 73 percent from the peak — but has barely increased since. That leaves housing starts running at a rate about half of what we saw in the 1990s, before the latest housing boom and bust cycle.

Several forces are holding the housing market down. First — and foremost — is that we built many more homes during the boom than it turned out were needed to accommodate population growth and rising incomes. As a result, in many parts of the country, there are more homes than households want to own. Second, it's now clear that mortgage underwriting standards were too lax during the height of the housing boom. While this is often attributed to fraud and lax supervision, one has to include the pervasive effects of the distorted incentives and moral hazard associated with financial entities viewed as too big to fail, both here and abroad.[3] Such institutions were prone to undervaluing the risks associated with mortgage lending. Their demand for mortgage-backed securities played a significant role in weakening lending standards, which in turn played a significant role in driving the demand for housing. The end result was many areas with large numbers of vacant houses.

In the wake of widespread losses on mortgage lending, underwriting standards have become significantly more conservative since the height of the housing boom, and this is another factor restraining housing demand. We should expect tighter credit terms in most markets in a downturn because any given loan will look riskier in a weak economy. Moreover, the housing bust taught us that some innovative mortgage lending products were unprofitable without rapid home price appreciation, and importantly, that the risk of a broad, sustained fall in housing prices was much larger than had been believed. Borrowers and lenders alike now have a much greater appreciation for the economic risks associated with highly leveraged home ownership. In that light, a highly cautious attitude toward home ownership and mortgage debt makes abundant sense.

For all these reasons, a lengthy adjustment process in housing seems inevitable. Population growth will gradually absorb some of the vacant properties, and income growth will lead some households to move up to larger homes and others to return to owning a second home. Housing properties in less desirable locations or needing extensive repairs may never be occupied. Apart from the imbalance of aggregate demand and supply of housing, the housing boom and bust also has resulted in a substantial number of households for whom the home they occupy is a poor match in terms of affordability. While many of these cases of mismatch are being resolved voluntarily as people sell homes and move into smaller quarters or rental units, many are being resolved through the painful and time-consuming mortgage foreclosure process.

Over time, we'll see a better match between households and the housing they want to own or rent, and in an increasing number of local markets, we will see the overhang of vacant homes diminish to the point that significant construction increases are warranted. It's hard to predict just when these tipping points will be reached, and we will need to build houses at a rate in line with the growth in the number of households, but my sense is that we are several years away.

That said, we *are* seeing some bright spots. In many areas, rental vacancy rates have fallen, rents have increased, and as a result, the construction of multifamily rental units is rising, consistent with a broad shift away from owner-occupancy. In fact, virtually all of the recovery in housing starts has been multifamily units. It's worth noting that home improvement spending is also on the rise, consistent with a dampened desire to trade up to larger homes. But even with these positive factors, residential investment is now only 2-¼ percent of GDP — compared to over 6 percent of GDP at the peak. So housing still is likely to contribute far less to overall economic growth than in past recoveries.

Many of the factors holding back growth in this expansion can be traced to fallout from the housing bust. The huge decline in housing prices from 2006 to 2009 erased a large portion of the home equity that households had accumulated during the boom. And in late 2008 and early 2009, households lost another large chunk of wealth to a rapidly falling stock market. This deterioration in their net worth gave consumers ample reason to rein in spending, pay down debt and rebuild balance sheets, both in the recession and in the recovery that followed.

Consumer spending *has* been much more sluggish in this recovery than in the typical recovery, rising at only a 2.1 percent annual rate since the end of the recession. Part of the explanation was the reduction in net worth, as I said, but more important has been the deterioration in labor market conditions. We lost over 8 million jobs, on net, during the recession and its immediate aftermath. Since bottoming out in early 2010, we've added 3.5 million jobs, which is less than halfway back to the level of employment we had attained in 2007. Moreover, hourly earnings have decelerated from 4 percent before the recession to 2 percent now. Thus, the weak labor market has held down wage and salary income, which has hindered consumer spending growth.

One impediment to more rapid employment growth is the extent of the mismatch between the skills of unemployed workers and the skills sought by firms seeking to hire. Recessions and recoveries always involve shifting resources from declining industries to expanding industries in response to emerging technologies and new patterns of demand; expansions are often not the mirror image of the preceding contraction. While many workers who lose jobs in a downturn will find jobs in newly expanding firms as the economy recovers, the search process that connects unemployed workers to new jobs can be lengthy and can require significant training. The costs and delays associated with reallocating workers to expanding industries can elevate unemployment and impede the rate of job growth. The extent of this type of skills mismatch is difficult to measure with any precision, but my reading, based on both statistical research and informal contacts with businesses in our District, is that mismatch is a significant factor in the labor market weakness we are seeing today.

Fortunately, we have seen some improvement in labor markets. Job growth has fluctuated from quarter to quarter, but overall appears to have accelerated as the expansion has gone on. In the first 18 months after employment bottomed out, we added 125,000 jobs per month; in the last seven months that increased to 190,000 jobs per month. The improved pace of job growth may be giving consumers more confidence in their future labor market prospects, leading them to loosen their purse strings. We are actually seeing evidence of that. Household spending rose at more than a 3-½ percent annual rate in the first three months of this year. Moreover, spending has been strong in the new car and truck market, where unit sales increased 8 percent in the fourth quarter last year and another 7.6 in the first quarter this year.

So far, I've discussed two impediments to growth that appear to have been important lately — the overbuilt housing market and labor market mismatch. Another impediment to growth cited by many observers is the array of changes in tax and regulatory policies, both actual and anticipated, that makes it difficult for businesses to evaluate the profitability of potential investment or hiring commitments. We continue to hear widespread and persistent anecdotal reports from our contacts in the Fifth Federal Reserve District that new regulations and uncertainty about imminent regulations are discouraging firms from hiring or undertaking new investment projects. While these effects are impossible to quantify, it seems plausible to me that they could be noticeably lowering measured growth rates.

In addition, the dire federal budget outlook also poses significant uncertainties for many consumers and businesses. As you are all no doubt aware, the path for federal debt under current law is simply not feasible. One way or another, significant adjustments will occur. Marginal tax rates may increase, the tax base may expand, benefits or entitlement programs may be cut, or other government programs may be reduced or eliminated. These changes could be far reaching and could affect a large part, if not all, of the population. Uncertainty about just where the adjustments will take place — just where the ax will fall, so to speak — is likely to be discouraging hiring and spending. For example, we hear that anticipated defense cuts are already affecting employment and investment in the Washington area, as well as the business outlook here in the defense-heavy region around Norfolk. Uncertainty about what specific fiscal actions will be taken in coming years may well be impeding growth throughout the economy.

These impediments to growth are important, but they are not the whole story. I don't want to paint too gloomy a picture. One category of economic activity *has* been living up to our usual expectations of robust growth following a recession. Business investment in equipment and software — our broadest measure of private sector capital formation apart from structures — rose 14.6 percent in 2010 and another 10.4 percent over the course of 2011. Even with overall sales growing less rapidly than in the typical recovery, firms continue to identify profitable opportunities to deploy capital goods to produce new products and services, reduce costs and improve business processes. This suggests that we are continuing to reap benefits from the underlying forces of innovation and creativity that have supported economic growth in this country throughout our history.

The trade sector has been another contributor to growth in this expansion. Exports, after adjusting for inflation, increased over 11 percent in 2010 and over 6-½ percent in 2011, and prospects there remain bright. A large fraction of the world's population resides in countries that have relatively low household income but are growing rapidly. In these emerging economies, firms are deploying capital rapidly to equip growing labor forces, thereby creating a strong demand for technology-intensive American investment goods. And as these more productive workers move into the middle class, they will want to purchase a range of consumer goods from the U.S., from sodas, to movies, to video games. So I expect export growth to continue to add to overall economic activity over the near term.

Considering all these factors, I come back to the improvement we have seen in the labor market recently. Most forecasts expect job gains to continue this year. That seems reasonable to me and would generate noticeable improvements in consumer incomes and spending that would nudge GDP growth higher as well. Next year, we are likely to see further improvement, and I see that process as gradually lifting growth.

This mildly optimistic forecast comes with several caveats, of course. The impediments to growth that I mentioned are still exerting a drag on activity that will keep growth from being as robust as we would like. In addition, this forecast allows for the mild recession that Europe is going through, but many European countries have not yet adopted credible policies to achieve long-run fiscal balance. Until they do, further turbulence and a deeper recession there cannot be ruled out, and that could dampen growth here as well. Finally, my forecast incorporates just a minor risk of any large discontinuous fiscal adjustments by our own government.

No central banker's outlook would be complete without a forecast for inflation. Last year, we were reminded that inflation can rise even in the face of elevated unemployment. In 2010, the inflation rate was 1.3 percent, but it then more than doubled to 2.7 percent last year, even though the unemployment rate averaged about 9 percent. Despite that run-up, I believe that the inflation outlook is reasonably good right now. The most recent reading on inflation is 2.1 percent, on a year-over-year basis. While gasoline prices pushed up the overall inflation rate last year and early this year, gasoline prices have fallen in recent weeks, and futures markets are pricing in further declines this year.

More important, in my view, is that the public's expectations of future inflation have remained well anchored within the range they have been in for several years. Much of that stability can be attributed, I believe, to the Federal Reserve's consistent pursuit of monetary policy that keeps inflation low and stable. Over the past 19 years, inflation has fluctuated around an average of 2 percent. In January of this year, the Federal Open Market Committee (FOMC) took a step forward by announcing that its specific goal for inflation is 2 percent growth in the price index for personal consumption expenditures. Adopting this goal should eliminate any lingering doubt about the FOMC's commitment to price stability and should enhance accountability, since it will be obvious how actual inflation compares to the target. While inflation can fluctuate from quarter to quarter, over time inflation is the result of monetary policy.

Speaking of monetary policy, some of you may have noticed that in all three FOMC meetings this year I have cast a dissenting vote on the Committee's monetary policy decision. In each case, I objected to a phrase contained in the press release following the meeting. As background, before last August, the FOMC's press release following our meeting stated that "the Committee … currently anticipates that economic conditions … are likely to warrant exceptionally low levels for the federal funds rate for an extended period." This has come to be known as our "forward guidance language." At our meeting last August, we changed "for an extended period" to "at least through mid-2013," a more specific calendar-based way of providing forward guidance. Then in January, the FOMC voted to change that date to "late 2014."

It's important to recognize that our forward guidance language is a forecast of how monetary policy will turn out, not an unconditional promise. Future monetary policy decisions will depend on future economic data — and the future economic outlook. As new data arrive, the outlook for future economic conditions will change, and the outlook for the future of monetary policy should change as well.

I dissented in January because I did not believe that economic conditions are likely to warrant low interest rates all the way through 2014. (I was not a voting member last year.) My projection is that if we want to keep inflation at 2 percent, we will likely need to raise rates in 2013. Incoming data could change my assessment in either direction; weaker data could lead me to push out my projection, and stronger data could lead me to advance my projection. I have continued to dissent against that specific language because my projection continues to differ significantly from the Committee statement.

It may sound strange to talk of raising rates when much of the chatter in financial markets is about the possibility of *easier* policy. In my view, it would be quite hard to justify additional monetary stimulus, absent a dramatic deterioration in economic conditions, which I do not view as likely. The impediments to growth that I have discussed today are all quite real. That is, they are factors for which monetary policy is not the remedy. Monetary policy will not occupy vacant homes or give unemployed workers the skills to fill vacant jobs or reduce regulatory and fiscal uncertainty. Policy is already quite accommodative. Additional easing is unlikely to have much positive effect on growth prospects, but could well generate a sustained surge in inflation that would be costly to reverse.

So my outlook is for 2 percent inflation, consistent with the FOMC's officially articulated goal, and I am pleased that we have come through this challenging period with price stability intact. I recognize, however, that sustaining that achievement may require some difficult decisions in the months and years ahead.

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[1] I am grateful to Roy Webb and Laura Fortunato for assistance in preparing these remarks.

[2] Real GDP grew at an average annual rate of 4.7 percent and 6.3 percent in the eight quarters following the recessions of 1974-75 and 1981-82, respectively.

[3] Jeffrey M. Lacker, "What Lessons Can We Learn From the Boom and Turmoil?" Speech at the CATO Institute 26th Annual Monetary Conference, Washington, DC, November 19, 2011; Jeffrey M. Lacker, "A Program for Financial Stability." The Inaugural George and Susan Beischer Address, The Banking Institute, UNC School of Law, Charlotte, NC, March 29, 2012.