Economic Outlook, January 2013

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Thank you for that kind introduction. It's a pleasure to join you at the turn of the year. This traditionally is a time to reflect on the year just past and take a look at what the new year might hold in store for us. I think I can guess what many of you are concerned about regarding the year ahead, so I should warn you that I will have nothing to say about the prospects of the Ravens or the Redskins. Instead, my focus today will be on the economic outlook, and while for some that might be less interesting than pigskin prognostication, it might be a good thing to take our minds off sports for a time. Before I begin, however, I should emphasize that the views expressed are my own and should not be attributed to anyone else in the Federal Reserve System.[1]

I will begin with the outlook for inflation, since maintaining price stability over time is really the Fed's primary mission as the nation's central bank. Over the last 20 years, the Fed has had a commendable record on inflation, averaging 2 percent inflation per year. There have been year-to-year fluctuations, to be sure. But these temporary swings have evened out over time, and inflation has tended to return to around 2 percent. In fact, inflation has averaged quite close to that figure since the end of the Great Recession in June 2009. Overall inflation has subsided of late, led by the recent easing in energy prices; headline inflation was just 1.4 percent, year over year, in November. But the same measure of inflation was 2.6 percent in November 2011, which is a good illustration of the short-term swings we've been seeing. With futures markets forecasting flat or declining energy prices, most economists expect headline inflation to average a little less than 2 percent this year. I agree with that outlook.

The record of low and fairly stable inflation over the last two decades is a substantial improvement over previous decades.[2] The Federal Open Market Committee, or FOMC (the group that determines monetary policy), issued an important statement in January 2012 on its "Longer-Run Goals and Policy Strategy."[3] In that document, the Committee stated that inflation at the rate of 2 percent, as measured by the annual change in the price index for personal consumption expenditures, is most consistent over the longer run with the Federal Reserve's statutory mandate. This formally committed the FOMC to what Fed watchers had long believed was the FOMC's unofficial target of 2 percent inflation.

A formal commitment to a numerical inflation objective is important for transparency and accountability, but it's also important for keeping expectations regarding future inflation well anchored. Because doubts about whether the Fed will keep inflation low and stable can themselves give rise to inflation pressures, history has shown that restoring our credibility can be an arduous and costly process. Fortunately, current measures of inflation expectations suggest that consumers, business firms and investors anticipate continued stability in inflation in coming years. These measures include survey-based indexes and measures of inflation expectations derived from the relative yields of indexed and unindexed U.S. Treasury securities. Each of these measures has its own peculiarities, but they're all providing readings consistent with the low and stable inflation rates of the last two decades.

In contrast to inflation, real economic growth and labor market conditions are affected by a wide range of factors outside a central bank's control. In fact, the effects of monetary stimulus on real output and employment are less than is widely thought; they consist largely of the transitory byproducts of frictions that delay the timely adjustment of prices by businesses. Attempts to overstimulate real economic activity via monetary policy can instead run the risk of raising inflation. Indeed, for reasons I will discuss later on, I see material upside risks to inflation in 2014 and beyond, given the current trajectory for monetary policy, though my baseline outlook is for inflation to move toward the Fed's long-run goal of 2 percent in coming years.

Turning to the outlook for real economic growth, since the Great Recession officially bottomed out at the end of the second quarter of 2009, economic activity has expanded at only a modest pace. Real gross domestic product, for example, has risen at an average annual rate of 2.2 percent since the end of the recession. This pace is widely viewed as disappointing, since it falls short of the average gross domestic product growth of 3-1/2 percent the U.S economy achieved over the course of the 20th century. Virtually this entire shortfall represents a difference in the average growth in employment — that is, the growth in output per worker is not terribly different between the two periods. Typically, one would expect growth to exceed the long-run average at some point during an expansion to make up for the negative growth recorded during recessions.

Several factors appear to be impeding a more rapid expansion in the U.S. economy. First, the housing boom created a substantial oversupply of new homes, and while significant progress is evident, we have not completely worked through that oversupply. Thus home construction and home prices were essentially flat for the first two years of the recovery. Last year, however, housing activity picked up and was a source of modest strength for the economy. Prices in many markets bottomed out and began to rise, and new construction activity has been steadily improving. Having said that, my sense is that there is a substantial overhang of homes that are a poor match for what consumers want and can afford right now. Thus, we should not expect, nor should we desire, a return to the booming housing market conditions that we saw prior to the last recession.

A second, and related, factor behind the slow recovery was the significant shift in economic activity away from industries related to residential construction. The rapid loss of jobs in these industries, layered on top of ongoing longer-run sectoral shifts, resulted in large inflows into the ranks of the unemployed and an adverse shift in the composition of the pool of unemployed. This often occurs in recessions, when the need for capital investment and retraining to facilitate the shift of workers to new sectors slows down the decline in unemployment. The magnitude of the residential construction job loss in this recession was unprecedented, however, so this effect is likely to be significantly larger now.

Third, the recession appears to have made many consumers more cautious and less willing to spend, relative to their income and wealth. The magnitude of the decline in jobs and aggregate income in this recession was far larger than anything American households have seen in the prior 25 years. And it was accompanied by an unusually large decline in home equity and household net worth. Moreover, given lenders' loss experience following the last recession, terms and qualification standards for secured and unsecured consumer credit have become more stringent. Thus households understandably have become more apprehensive about their future income prospects and more interested in paying down financial obligations and building up savings. So while consumer spending has grown during this recovery, the tempered pace of that growth has limited the overall pace of the expansion, relative to historical experience.

Finally, our Fifth District business contacts have long been emphasizing that uncertainty has caused them to delay hiring and investment commitments. These reports became more frequent this past spring and more focused on the uncertainties related to the year-end "fiscal cliff." The array of conceivable fiscal policy remedies would affect a wide range of economic decisions, and in response, many businesses have expressed a preference for sitting on the sidelines. But apart from ambiguity about how Congress and the administration will navigate past the fiscal cliff and the debt ceiling, significant uncertainty remains about the longer-run tax and spending paths, the broad regulatory realignments that are currently in train, and the uncertain prospects for European economies.

In short, a range of factors appear to be restraining our current pace of economic expansion. While that pace is below the long-run average for the U.S. over the last century, it's not hard to identify potential explanations for that shortfall. In fact, if you look back at how other advanced economies have typically behaved following recessions associated with significant housing slumps, you will find that the current U.S. expansion is actually not out of the ordinary.[4] This economic expansion, while disappointing, may be the best we should expect given the large decline in the housing market.

The data we've seen over the course of 2012 have been consistent with this picture of an economy expanding at a moderate pace. Last year this time, growth appeared to be strengthening, and measures of output and employment were picking up pace. In the late spring and early summer, however, growth appeared to slow as business investment and exports flattened. The reluctance of businesses to invest persisted into the fourth quarter, but some of the slowdown in job growth at midyear was later revised away. Early readings on consumer spending for the fourth quarter have been encouraging, though survey measures of consumer sentiment have fallen sharply, perhaps in response to the post-election media focus on the fiscal cliff negotiations. And the modest strengthening in residential construction has continued into the last half of 2012.

As for the outlook for the U.S. economy, my best guess is that growth will continue into next year at an annual rate of around 2 percent, as many of the recent impediments to faster growth continue to restrain activity. Beyond 2013, the rate of growth could rise if the effects of these restraining factors ease, which seems plausible. Meaningful progress on federal budget issues, particularly the long-run imbalance that must be addressed, would alleviate some of the policy uncertainty that appears to have dampened growth in 2012. The risks emanating from Europe could diminish this year as it emerges from a recession and makes progress toward new institutional arrangements. Improved European growth prospects for 2014, which most economists are forecasting, would be a positive for U.S. exports.

And I think U.S. households could well be more confident and better disposed to spending a year from now. Improvements in the effectiveness of labor markets at matching workers and job openings would lead to gains in household income. Modest additional growth in home prices, along the lines of what we saw in 2012, would add to net household wealth and aid the deleveraging process. All of these developments would tend to reduce consumer apprehension about downside risks and thereby bolster spending.

This outlook is not without risks, of course. Significant energy price increases or an unexpected downturn in some major trading partners could temporarily reduce overall U.S. growth. Failure to resolve a significant measure of the uncertainty hanging over federal tax and spending policy this year would indefinitely prolong the reluctance of businesses to commit to investment and hiring in the U.S. Moreover, even with a resolution of fiscal uncertainty, significant uncertainty regarding regulatory policies could continue to dampen growth. On the other hand, a stronger-than-expected resurgence in confidence is not inconceivable; rapid and convincing progress toward fiscal sustainability, for example, might release a rush of pent-up spending, perhaps leading to the above-trend growth that has so far eluded us.

Even though growth has been below our long-run trend rate since the recession, and may remain below trend for some time, I believe that the fundamental prospects for longer-term U.S. growth remain quite strong. The flexibility and resilience of our markets, along with a relatively well-educated population, make this an advantageous place to implement innovations. One sector where this longer-term strength of our economy is evident is manufacturing, where growth during the current expansion has actually been fairly strong compared to the decade leading up to the recession. The backstory in manufacturing, of course, is the global outsourcing of low-skilled operations that has occurred over the last several decades. But we've seen countervailing growth in cases where locating domestically has significant advantages. For some suppliers, for example, proximity to downstream operations is critical, as in the automobile industry. For others, proximity to key research and design personnel is important, as with advanced manufacturing that uses more sophisticated capital equipment. In addition, the emergence of inexpensive new energy resources in the U.S. — in the shale bed regions — could support cost-effective domestic production in industries that are relatively energy-intensive or reliant on petrochemical feedstocks.

Our major challenge over the longer haul is finding effective ways to deepen the knowledge and skills of our people. Expanding our human capital is fundamental to improving our standards of living because implementing new technologies has generally required a more skilled workforce. In this arena, an array of strategies could yield beneficial returns over the long run, from ensuring the continued vitality of institutions of higher education and research to investing in high-quality early childhood education. Particular attention is warranted, I believe, to career and technical training, which can provide flexible, market-responsive skill development for both new entrants to the labor force and those workers transiting from declining to expanding sectors.[5]

What role does monetary policy play in this outlook? Our primary responsibility at the Federal Reserve is to keep inflation low and stable; this allows businesses and consumers to make economic decisions without needing to worry about the purchasing power of money. My economic outlook presumes that the FOMC will not allow monetary instability to disrupt economic growth, as arguably took place in the 1970s. But beyond avoiding the economic damage associated with high and variable inflation, I believe it is unlikely that the Federal Reserve can push real growth rates materially higher than they otherwise would be, on a sustained basis.

Nonetheless, at its December meeting, the FOMC adopted measures to attempt to bolster economic growth. Notably, the Committee decided to continue the monthly purchases of $40 billion in agency mortgage-backed securities and $45 billion in long-term U.S. Treasury securities. It also underscored its attention to real economic activity and employment by stating its forward guidance for interest rate policy in terms of a 6.5 percent threshold for the unemployment rate.

I dissented from these Committee actions and have expressed my concerns at length elsewhere.[6] Briefly, as I've touched on today, I think that further monetary stimulus is unlikely to materially increase the pace of economic expansion, and that these actions will test the limits of our credibility. At some point, we will need to withdraw stimulus by raising interest rates and reducing the size of our balance sheet, and the larger our balance sheet, the more vulnerable we will be to seemingly minor miscalibrations in policy. Accordingly, I see an increased risk, given the course the Committee has set, that inflation pressures emerge and are not thwarted in a timely way. I intend to remain alert for signs that our monetary policy stance needs adjustment.

In closing, I should reiterate that despite the unique nature of the monetary and fiscal policy challenges facing us, U.S. economic fundamentals are strong and auger well for growth possibilities in the years just ahead. To me, this suggests that the rewards are high for getting economic policy right. And as an economist, I have to believe that people, including policy officials, respond to incentives.

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[1] I am grateful to Roy Webb, John Weinberg and Andy Bauer for assistance in preparing these remarks.

[2] For an account, see Marvin Goodfriend, "Monetary Policy Comes of Age: A Twentieth Century Odyssey." Federal Reserve Bank of Richmond Economic Quarterly, Winter 1997, vol. 83, no. 1, pp. 1-22.

[3] Board of Governors of the Federal Reserve System, "Longer-Run Goals and Policy Strategy." News and Events, Monetary Policy Press Release, January 25, 2012.

[4] Board of Governors of the Federal Reserve System, "Are Recoveries from Banking and Financial Crises Really So Different?" International Finance Discussion Papers, no. 1037, November 2011.

[5] Jeffrey M. Lacker, "Technology, Unemployment and Workforce Development in a Rapidly Changing World." Speech to business and community leaders, Greensboro, N.C., May 7, 2012; and, Jesse Romero, "Where Have All the Workers Gone?" Federal Reserve Bank of Richmond Region Focus, Second/Third Quarter 2012, pp. 12-16.

[6] Jeffrey M. Lacker, "Richmond Fed President Lacker Comments on FOMC Dissent." Press Room, Press Releases, December 14, 2012.