Economic Outlook, May 2013

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It's a pleasure to address the Richmond Chapter of the Risk Management Association once again. We've typically held this event on a cold, blustery January day. Shifting the date to early May puts us in the midst of a truly wonderful springtime in Richmond this year. Our landscape is graced now with an abundance of dogwoods and azaleas in full bloom, which makes it hard not to feel a bit more optimistic about the world. I'll be discussing economic conditions, however, and they call economics the dismal science for a reason; so my description of the outlook may contrast with the cheery thoughts inspired by our magnificent spring. Nevertheless, I will argue that our situation is not as dismal as many would have you think, and the economic landscape does have its attractive elements. Before I begin, 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'll start with some good news about the economic situation; inflation remains well contained. Over the last four quarters, our most reliable measure of prices, the price index for personal consumption expenditure, has risen 1.2 percent. That's on the low side of our recent experience. Inflation has been fluctuating around 2 percent, and just a year and a half ago, inflation was 2.8 percent. There is widespread confidence that the Federal Reserve will keep inflation low and stable, consistent with our announced inflation goal of 2 percent.[2] Indeed, most forecasters expect inflation to run at or a little below 2 percent over the next few years, and household surveys and financial market measures also indicate that inflation is expected to remain near its longer-term average. One local example of this confidence was the announcement by The College of William and Mary that tuition charges would remain fixed over a student's entire four-year term, which suggests some assurance that inflation will be held in check. My own view is that inflation is likely to begin to edge back toward the Federal Open Market Committee's (FOMC) target of 2 percent by next year.

In contrast to inflation, which over time is determined by central bank actions, real economic growth and labor market conditions are affected by a wide variety of factors outside a central bank's control. And it's real economic conditions that many view as disappointing lately.

To get a handle on that disappointment, think back to the beginning of the new millennium and recall the pervasive optimism of the time. Much of that optimism was based on past experience. For example, over the previous half-century we had enjoyed remarkable economic performance — real gross domestic product (GDP) grew at a 3.5 percent annual rate between 1950 and 2000. Since 2000, though, growth has fallen short of that long-run average. We had a very severe recession in 2008 and 2009, our worst since the 1930s, and growth has averaged 2.1 percent since then, well below the longer-run average. Looking ahead, the key question regarding the economic outlook is whether growth will remain relatively low, or will instead return to rates we saw in the last half of the 20th century.

This is an active area of economic research, and would make a suitable topic for a university seminar, or perhaps a massive open online course. So I won't attempt to be comprehensive, but I do want to take a closer look at a few of the features of the post-recession economic expansion that distinguish it from our pre-2000 growth experience.

First, let's break down GDP growth into two components. One is the growth in employment and the other is growth in labor productivity, measured as GDP per worker. Labor productivity increased at an average of 1.8 percent per year from 1950 to 2000. In this expansion, labor productivity increased rapidly in the last half of 2009, as is typical when coming out of a deep recession. But since then the trend in productivity has been only about 1 percent at an annual rate, which has contributed to the slowness of the expansion. Slower productivity growth therefore is responsible for a significant portion of the growth shortfall in this expansion, relative to the late 20th century. Productivity growth is the consequence of many disparate factors, including research and development, business capital expenditures, labor force skills and public sector infrastructure investment. Note that monetary policy is not on this list.

Setting aside labor productivity growth, the rest of real GDP growth is attributable to the growth in labor inputs. Employment grew at a 1.7 percent annual rate from 1950 to 2000. Employment fell dramatically during the recession and its immediate aftermath, but has expanded at only a 1.1 percent annual rate since the end of 2009. So a significant portion of the growth shortfall is attributable to slower growth in employment.

Movements in employment have been mirrored by movements in unemployment. During the recession the unemployment rate — the fraction of the labor force that is out of work — rose from 5.0 percent in December 2007 to 10.0 percent in October 2009. During this expansion, the unemployment rate has fallen to a level of 7.6 percent as of March of this year, a pace of seven-tenths of a percentage point per year. This is faster than the pace at which unemployment fell in last two business-cycle expansions. Thus, this expansion resembles other recent expansions in the pace at which we've been able to reduce the pool of unemployed workers.

The unusual feature of this expansion, relative to our 20th century experience, is the evolution of the size of the labor force. The fraction of the working age population that is either working or actively looking for work — economists call this the labor force participation rate — rose steadily from 1950 to 2000, as women entered the work force in ever larger numbers, and improving health allowed people to work later in life. Since 2000, labor force participation has fallen significantly, from a peak of over 67 percent to a rate of 63.3 percent as of March. Much of that decline has occurred since the Great Recession. Thus understanding people's decisions about whether to participate in the labor force is essential to understanding the economic outlook.

One obvious explanation for the decline in labor force participation is that workers are discouraged by adverse labor market conditions. Weak GDP leads to a weak demand for labor, and poor job prospects can keep some people from even looking for work. This effect was pronounced during the Great Recession, given the magnitude of the increase in unemployment. But a good deal of time has passed since the recession, and the unemployment rate has come down significantly. Moreover, labor force participation was affected by demographics and other structural factors even before the recession, and these trends have continued and perhaps intensified since then.

One development that stands out is the sharp fall in the labor force participation of young people. In December 2007, the participation rate for people aged 16 to 24 was 59.2 percent. It fell during the recession, and since then has fallen further; it now stands at 54.5 percent. One might hope this simply reflects more young people pursuing higher education, or possibly students devoting more time to their studies, and there is some evidence to support that hypothesis. This may reflect difficulty finding desirable entry-level jobs, a by-product of weak economic growth. But it also may reflect a response to the widening wage premium associated with higher levels of education, a broader structural factor that is unlikely to be reversed rapidly.

At the older end of the labor market, a basic demographic fact is that over the last decade the baby boom generation has begun entering an age range in which labor force participation typically falls. Thus an increasing fraction of the labor force is in these low-participation-rate demographic groups. As the baby boomers continue to age, this will continue to pull down overall labor force participation rates over time.[3]

Turning to the middle of the age distribution, economists who study labor markets often label workers aged 25 to 54 as the "prime working age" population. This group is characterized by high-participation rates, generally good health, and relatively high productivity, and they play a key role in economic growth. In recent years, the baby boomers have been aging out of the prime working age population, and smaller cohorts have been entering. Back in the 1980s this group was growing by about 2-¼ percent annually, but by the late 1990s growth had fallen below one percent per year. The absolute size of the prime working age population has shrunk each year since 2008.

In addition to that demographic challenge, participation rates for the prime working-age population also have fallen, declining from 84 percent in 2000 to 81.4 percent in 2012. While weak economic activity could account for some of this decline, other secular trends may be at play.

To summarize then, the slow growth in real GDP in this expansion is related both to lower productivity growth and to the decline in labor force participation. Some of the shortfall could reflect the lingering effects of the Great Recession on labor force participation. But longer-run structural trends, such as our aging population and the changing schooling decisions of young people, also seem to be playing an important role. If so, we need to adjust to the implication that GDP growth will continue to fluctuate around a 2 percent trend for the foreseeable future.

With that long-term perspective in mind, we can turn our attention to the latest data and what we might expect over the next year or two. In recent quarters we've seen a seesaw pattern, with growth looking fairly strong for a few months, but then looking fairly weak for a few months. For example, real GDP grew at a 0.4 percent annual rate in the fourth quarter, but is estimated to have grown at a 2.5 percent annual rate in the first quarter.

One exception to the choppiness is that housing activity is finally on a solid growth path. New housing starts have more than doubled since the low point in April 2009, and have risen by an especially rapid 47 percent over the last 12 months. Home prices are also on an upswing, rising almost 10 percent in the last 12 months. Now I should caution that residential investment is only 2.6 percent of GDP, so that housing by itself is only making a modest contribution to overall GDP growth. But the improvement in housing activity does seem to have bolstered households' confidence in the market value of their most valuable asset.

And that leads to the outlook for consumer spending, which accounts for 70 percent of GDP. Over the last four quarters, real consumer spending has risen by 2.0 percent, in line with real GDP. But real disposable personal income has only risen by 0.9 percent over those same four quarters, which raises an obvious concern over the viability of the spending growth. The slow growth in spending in part reflects sluggish compensation growth; for example, average hourly earnings have only risen 1.8 percent over the last 12 months, barely ahead of inflation. Another factor that lowered take-home pay is the increase in federal taxes that took effect in January. More broadly, the breadth and depth of the income and wealth shocks that hit American households during the Great Recession are undoubtedly adding to their cautious attitudes. Such memories are unlikely to fade rapidly, so it's hard to be very bullish on the outlook for consumer spending.

Business capital spending is likely to make a sizeable contribution to growth over the next few years. Not surprisingly, investment fell sharply during the recession, but technological advances have continued to provide ample motive for new investment, even in the absence of rapid GDP growth. Companies appear to be finding ways to improve effectiveness by deploying new technologies. Business fixed investment rose 5.5 percent last year and most forecasters expect solid growth this year and next.

Despite these bright spots in residential and business investment, there are some important challenges that are holding back growth and deserve mention. First, the federal fiscal outlook is a mess. Last year the federal deficit exceeded $1 trillion, and was 6.9 percent of GDP. Projections by the Congressional Budget Office show the deficit declining for several years but then increasing, without bound, as a fraction of GDP. That large deficit puts the stock of federal debt on a steep upward trajectory. In other words, the current course is unsustainable, and some combination of higher taxes and less spending growth is inevitable. It's not clear, though, when and by how much any particular tax will increase. It's also not clear when and by how much any particular spending program will be cut back. This pervasive uncertainty has undoubtedly affected business and household decisions, and it appears unlikely that we'll soon see a grand bargain that will put the federal budget on a sustainable, long-term path.

Another challenge for the U.S. economy is Europe. The Euro area is in recession, as are other countries; one result is a weak demand for U.S. exports. Several European countries have fiscal imbalances that appear to be unsustainable. Moreover, several European countries have unit labor costs well above the German level, making many of their industries uncompetitive and shrinking. While there have been dramatic crises in Greece and Cyprus, the fiscal and competitive challenges are clearly more widespread. At this time it's hard to see how the struggling countries can return rapidly to a persistent growth path with a sustainable fiscal policy. And it's difficult to project much growth for Europe as a whole until these problems in the Euro area are healed.

Yet another challenge comes from the need for firms to adapt to the large volume of new regulation that has been added in recent years. This is not the place to argue the ultimate merits of any particular legislation, but simply to note that even if net social benefits of new regulations are significantly positive, businesses may still face large compliance costs that in turn affect hiring and investment decisions. Moreover, many key decisions regarding implementation of far-reaching regulations have yet to be made, and this uncertainty is another factor affecting firms and households. Banks, for example, are worried about new regulations on mortgage lending that have not yet been finalized. A wide range of businesses are worried about how to respond to new healthcare requirements, many of which have not yet been written.

Let's take a step back and survey the landscape. Prospects for housing and business investment are strong, but uncertainty about fiscal and regulatory policy in the U.S. and economic activity in Europe are an offsetting drag on growth. Consumers are cautious, understandably so given what they've been through, and are unlikely to drive a spending surge. Adding it all up, the economy's current trend rate of GDP growth appears to be around 2 percent. We are likely to see brief swings above and below that rate from time to time, but I don't see a compelling case for a sustained departure any time soon. That's a change for me; like most other forecasters I've been looking for GDP to significantly accelerate a year or two down the road. But I would add that when I think about the challenges our economy is facing, 2 percent growth actually looks like a fairly good outcome. It represents significant forward momentum and sustained real income gains. It also demonstrates the resilience of an economy that has weathered a huge shock in the most recent recession and is back on a solid growth track, despite an array of obstacles.

I'll end with a few thoughts on monetary policy. Federal Reserve policy is exceptionally accommodative right now, with short-term interest rates near zero and our balance sheet at about four times the size it was before financial turmoil began in 2007. A highly expansive policy was an appropriate response to a severe recession, I believe. Growth has resumed, however, and it appears as if it's limited, in large part, by structural factors that monetary policy is not capable of offsetting. In this situation, the benefit-cost trade-off associated with further monetary stimulus does not look promising. The Fed seems to be unable to improve real growth, despite striving mightily over the last few years, and further increases in the size of our balance sheet raise the risks associated with the "exit process" when it's time to withdraw stimulus. This is why I do not support the current asset purchase program.

Keeping inflation low and stable *is* within the capability of a modern central bank. On that score, the recent behavior of inflation has been heartening. Measures of inflation expectations remain within ranges consistent with price stability, and the low current readings on some inflation indices are likely to be transitory. Well-contained inflation, the most fundamental contribution a central bank can make to economic growth, seems likely to continue.

Thank you for your attention, and I would be happy to take any questions.

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[1] I am grateful for assistance from Roy Webb and Andreas Hornstein in preparing these remarks.

[2] Board of Governors of the Federal Reserve System, "Longer-Run Goals and Policy Strategy," News and Events, Monetary Policy Press Release, January 29, 2013.

[3] This has been offset somewhat by the increase in participation rates for people aged 65 and older.