EMBARGOED UNTIL PRESIDENT LACKER BEGINS SPEAKING – TARGET TIME 12: 45 P.M. EST

Economic Outlook, January 2011
January 14, 2011

Jeffrey M. Lacker
President
Federal Reserve Bank of Richmond

Risk Management Association, Richmond Chapter
OMNI Hotel
Richmond, Va.

I am sure you are all familiar with the macroeconomic background to our current situation, even if you did not attend last year's luncheon. The 18-month long recession that ended in June 2009 was the most severe contraction since the Great Depression. In the five quarters that followed, real GDP grew at only a 2.9 percent annual rate, which is barely above trend and is quite modest when compared to other cyclical recoveries. Particularly frustrating was the soft patch that the economy entered last summer when GDP growth fell below 2 percent. But I believe we have emerged from that soft patch and have begun a phase of the recovery in which growth can be sustained at an above-trend rate. That should help us make more rapid progress on our pressing economic challenges.

Let's take a closer look at our relatively sluggish economic performance in this recovery. But before we do, let me note that the views I express here are my own and do not necessarily reflect those of my colleagues on the Federal Open Market Committee (FOMC.)[1] An obvious explanation is the sharp drop in housing construction. The preceding housing boom caused significant overbuilding in most regions, which resulted in a large number of vacant houses that were good substitutes for new construction. This overhang has dampened housing activity in many local markets and has kept new housing starts at about half the rate that would be needed to grow the housing stock at the same rate as population. Consequently, residential investment has failed to make a positive contribution to growth in this recovery. In contrast, consider the two most severe recessions of the past 60 years before the most recent episode – the recessions of 1973-75 and 1981-82. Residential investment rose at an average of 40 percent in the first year of recovery following those recessions.

What has been particularly striking this time is the behavior of household spending. In a typical recovery, consumers gradually begin to see a brighter future ahead and add to spending ahead of anticipated gains in employment and income. That did not happen in the first five quarters of this recovery, in which consumer spending increased at an annual rate just below 2 percent. This is in contrast to the two other severe recessions when household spending grew by an average of 6-½ percent in the first year of expansion, thereby adding considerably to GDP growth. Thus a major part of the relative weakness of the early part of this recovery has been due to the cautious pace of household spending.

And there were ample reasons for caution. First, the labor market remained weak in the early stage of the recovery. The unemployment rate hit 10.1 percent in October, 2009, and only declined marginally through most of last year. Second, during the recession consumer wealth was battered by a sharp drop in stock prices and a substantial fall in home prices. As a result, households devoted more of their income to repairing their balance sheets by reducing outstanding credit and rebuilding savings; spending growth had to take a back seat.

While housing construction and consumer spending underperformed in this recovery, I should note that equipment and software investment and exports have been stronger than in comparable past recoveries. Investment in nonresidential structures has been weak, but no weaker than was typical in past recoveries.

Against that backdrop of a disappointingly sluggish recovery, many of our readings for the last quarter of 2010 point to a distinctly sunnier outlook. Most importantly, consumer spending is starting to show some real signs of life. Retail sales rose at a blistering 12 percent annual rate over the five months ending in December. We also know that auto and light truck sales posted a solid 2.3 percent seasonally-adjusted advance in December from the previous month, and that capped off a fourth quarter that was the strongest in over two years.

The fundamentals supporting household demand also are improving. Labor markets have been gradually firming. The national unemployment rate ended last year down 0.7 percentage point from its peak. Payroll employment has been growing, with 128,000 jobs per month added in the fourth quarter. In another sign of improving demand for labor, the average work week increased by a half hour last year. And while the growth in average hourly earnings was only 1.8 percent last year, inflation was even less, at 1.0 percent, so real earnings were on an upward trajectory.

The firmer labor market has given a modest boost to growth in real household income. At the same time, increased saving has allowed many households to pay down debt and build assets. Household debt has fallen for the last 2-½ years, and stock prices have risen significantly during the recovery, which 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 about 12 percent from its low point in the cycle. Given these stronger fundamentals, it's not a stretch 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 20 percent since the end of the recession. Technological innovations continue to provide organizations with new opportunities for streamlining business processes and reducing costs through productivity-enhancing investments. Moreover, the cost of capital is extremely low for a large segment of corporate America, and credit conditions have eased some, with business lending by banks beginning to rise in fourth quarter. Even investment in new structures is showing some encouraging signs of bottoming out. Spending for private nonresidential structures has risen slightly over the last four 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. All in all, then, business investment is likely to add significantly to growth this year.

I am also encouraged by the prospects for export growth. Exports of goods and services have risen 16 percent since the end of the recession, adding 1-¾ 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 be quite firm this year as well.

The economy has a lot going for it, although there are still considerable difficulties 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. For the record, though, residential investment is only 2-¼ percent of GDP, so further

developments in this sector will not have a large effect on overall growth. Also, we have seen small increases in residential construction spending in each of the last three months, so I would be not be surprised if the worst was behind us in the housing market.

All in all, then, I expect stronger growth in overall activity this year than last. Most private forecasters have been busy bumping up their forecasts in recent weeks, and forecasts of 4 percent growth are beginning to surface. If I had to write down a forecast today, it would be pretty close to that – somewhere between 3.5 and 4 percent. A rate of growth in that range would result in continued net gains in employment and a more sizable reduction in the unemployment rate than we've seen so far.

Let me digress for a moment to comment on prospects for the Commonwealth of Virginia. Hiring here picked up more rapidly than for the nation last year. Year-over-year employment growth in Virginia was more than double the national figure – 1.3 percent versus 0.6 percent. Moreover, the overall impact of the recession has been less severe in Virginia, where the unemployment rate is about three percentage points lower than the national rate. In contrast, the Richmond area has not yet added jobs relative to a year ago, but appears poised to gain some ground after two-and a-half years of contraction. Not surprisingly, the Richmond metropolitan area's unemployment rate, at 7.4 percent, is higher than the state average, but we expect this will edge downward as job growth in the region gains momentum.

This generally positive assessment, both for the region and the nation as a whole, is complemented by the benign outlook for inflation. Over the 12 months ending in November the price index for personal consumption expenditure, our preferred price measure at the Richmond Fed, has only risen 1.0 percent. That's a relatively low inflation rate, especially compared with figures over 2 percent that were common in the years leading up to this recession. The downward trend in inflation during the recession had many commentators warning of the possibility of outright deflation. At this point, I think the risk of deflation is negligible. That's 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 3 percent over the five years after that. The recent increases in energy prices will show up in consumer price measures for the next few months, pushing overall inflation numbers up somewhat. Forecasters are expecting inflation this year to come in between 1 and a half and 2 percent, and that is my expectation as well.

That's the near-term outlook in a nutshell. Beyond this coming year, a lot depends on the configuration of fiscal and regulatory policies. On the fiscal front, we have a serious, long-term mismatch between the trajectories of spending and taxes. Many businesses contemplating new capital spending face significant uncertainty about how future cash flows will be taxed. And any business selling to the government has to recognize the possibility of new spending limits. Be clear: there is no uncertainty about whether the long-run federal budget imbalance will be corrected. Projections of steadily diverging revenue and spending, such as the estimates published by the Congressional Budget Office, are simply not feasible and *will not happen*. The real question is *how* a sustainable path will be achieved: in advance, by deliberately adopting a credible strategy, or *in extremis,* forced by 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 crisis is upon us.

On the regulatory side, thousands of pages of new legislation have been recently enacted and many new implementing regulations are in the process of being drafted and adopted. Anticipated shifts in regulatory policy appear to have produced a degree of apprehension that has dampened private sector willingness to

hire and invest. As implementation proceeds, the shape of the new regulatory regimes will come into view and the dampening effect of regulatory uncertainty may dissipate.

For federal financial policy, however, major unfinished business remains; we have yet to resolve the government's role in housing finance. The appalling consequences of the housing boom should thoroughly discredit a system centered around private mortgage intermediaries with implicit government guarantees. Making those guarantees explicit and priced is a key component of many popular proposals, but that would just recreate many of the incentives of the old regime and continue to burden taxpayers with huge contingent liabilities. Financial stability and fiscal balance are likely to be illusive if we do not wind down government subsidies and guarantees for housing debt. Home-ownership may be a laudable social goal, but if so, we should subsidize housing equity, not housing leverage.

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 its balance sheet from around $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 Fed's balance sheet by another $600 billion by the end of the second quarter through purchases of long-term U.S. Treasury securities. While this was motivated mainly by the disappointing pace of employment growth, the provision of further monetary stimulus at this point in the business cycle is not without risks. I was among those who viewed the benefits as outweighed by the risks, including the risk that a larger balance sheet might complicate the withdrawal of monetary stimulus, when the time comes to do so. The Committee recognized the risks and the need to be able to adjust policy as the outlook evolves, and therefore committed to "regularly review the pace of its securities purchases and the overall size of the asset-purchase program in light of incoming information and … adjust the program as needed." While the outlook may not have improved enough yet to warrant adjusting our purchase plans in the near-term, I anticipate earnest re-evaluation as economic developments unfold in the months ahead. That re-evaluation will be challenging, because the level of economic activity, relative to pre-recession trends, may distract from the need to raise real interest rates as the rate of growth improves.

We've come through an extraordinary period in our economic history, which in turn brought about extraordinary policy responses. As the signs of stronger economic performance emerge, 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 are consistent with a coherent, sustainable long-term plan for policy – both monetary and fiscal – will be an important factor supporting growth in the years to come. As this year begins, I am hopeful that we will see progress in 2011.

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