Economic Outlook, January 2012

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It's a pleasure to be here today. I greatly appreciate you inviting me back again. I believe I have appeared before you six times before, and that has provided me with plenty of opportunity over the years to wear out my welcome. So again, I'm grateful to be asked back yet again. My usual topic at these January luncheons is the economic outlook for the new year. And, as usual, my remarks reflect my own independent views and do not necessarily coincide with those of my colleagues on the Federal Open Market Committee (FOMC).[1]

Before I talk about the upcoming year, it will be useful to set the stage by taking a look back at last year's RMA luncheon. A year ago, I was thinking that real gross domestic product (GDP) would grow by about 3 percent in 2011. Right now, it looks like we will get about 1.7 percent GDP growth for the year, which is a fairly large miss. Although I can take consolation in the fact that many private forecasters also projected real growth of 3 percent or more, this sizeable error illustrates the inconvenient truth that even the best economic forecast is the midpoint of a rather wide range of plausible outcomes.

Several unanticipated developments contributed to these forecast misses. Commodity prices had already begun rising this time last year, but energy and food price increases continued in the first half of 2011 and significantly outpaced the predictions embodied in futures market prices as of last January. This price surge took a sizeable bite out of real household incomes and overall consumer spending slowed accordingly. Moreover, the earthquake and tsunami in Japan disrupted global supply chains in a number of industries; in the U.S., the effects were most noticeable in the auto market. As a result of these disturbances, real GDP grew at a paltry 0.8 percent annual rate in the first half of 2011.

One would expect such transitory factors to have only limited implications for future growth. Indeed, auto production and sales recovered in the second half of 2011 and commodity prices fell, reversing much of the earlier dampening effect on household real incomes.

The more significant development over the course of the past year, in my view, is the growing sense that there are *relatively persistent* impediments holding back economic expansion in the U.S. While the pace of growth has rebounded since the first half of 2011, it appears that real GDP growth averaged around 2-½ percent at an annual rate over the second half. Moreover, growth has averaged only 2-½ percent since the recession bottomed out in the second quarter of 2009.

To put this in perspective, consider that over the last century and a half real GDP has tracked remarkably close to a trend line representing growth at close to 3 percent. Apart from the Great Depression and World War II, deviations from trend have been relatively transitory, and recessions were followed by expansions at significantly greater than 3 percent. In fact, it was commonplace to see growth rates of 5 or 6 percent coming out of a sharp recession. In this recession, real GDP contracted by over 5 percent, and we have not closed the gap to that trend line. Instead of catching up, we appear to be tracking a new lower trend line.

What is hampering our recovery? The still-overbuilt housing market tops the list. Residential construction almost invariably expands rapidly at the beginning of a recovery, with growth rates of 30 percent or more not uncommon. This time, home building has basically been flat. The number of single-family housing starts in 2011 will be basically the same as in 2009.

Several understandable forces are holding the housing market back. First, in many areas of the country, there are still more homes than households want to own. Looking back on the housing boom with the benefit of hindsight, it's clear that mortgage underwriting standards were too lax. This was largely the result, I believe, of the distorted incentives and moral hazard associated with financial entities viewed as too big to fail. As a result, many regions are simply oversupplied with housing.

Mortgage underwriting standards have become significantly more conservative since the housing bust, and that is a second factor restraining housing demand. Some of the tightening in credit standards reflects new regulatory constraints, particularly those governing Fannie Mae and Freddie Mac, who are now wards of the state and being managed to protect taxpayers against further losses. But some of the tightening in credit standards also reflects the natural ebb and flow of credit terms over the business cycle. Credit terms tighten in a downturn because any given borrower is riskier then, all else constant. Moreover, the housing boom and bust taught us significant lessons about the risks associated with innovative mortgage lending practices and the odds of a broad, sustained decline in home prices. Certainly, this is not the first credit market that has experienced a cycle of overshooting and retrenchment; such dynamics are natural and to be expected in markets in which significant learning is taking place over time. 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 mortgage debt makes abundant sense.

Given sizeable oversupply and tighter credit standards, the housing market appears to be in for a lengthy adjustment process. Substantial real income gains will be required before demand catches up to the current housing stock. Moreover, there is a "mismatch" problem to solve, in that some households have homes and mortgages for which they are not well matched. Transitioning people into homes they want and can afford given their current income is a time-consuming process. Unfortunately, for some households, the transition process involves delinquency and foreclosure. In such cases, the adjustment has been slowed by the inability of the servicing industry to handle effectively the mountain of unanticipated foreclosure cases, as well as by judicial congestion and regulatory intervention.

Much progress has been made in the process of adjusting to the new environment, but substantial adjustment lies ahead. Fortunately, home prices appear to have stabilized in 2011, at least for non-distressed properties. Part of the adjustment process in the housing market involves a broad movement away from owner-occupied homes and toward rental housing. Indeed, vacancy rates for rental properties have declined of late, and rental rates are firming as a result. And what gains we've seen in residential construction have been in the multi-unit rental segment. This appears to be a relatively persistent development, representing a natural response to the aftermath of the housing boom. I expect single-family home building to remain soft for some time, however.

The fall in housing prices from 2006 to 2009 erased a substantial portion of the home equity that households had accumulated in the housing boom. Another facet of the adjustment process has been the propensity of consumers to pay down debt and build up savings to restore their balance sheets to a more desirable relationship with their current and prospective income. As a consequence, consumer spending has been expanding at a more moderate pace than in past recoveries.

Consumer spending has also been dampened by labor market conditions, which have improved at a disappointingly slow pace since bottoming out in early 2010. Over that period, employment growth has averaged 120,000 jobs per month; at that rate, it would take over four years to recover the jobs lost in the recession and its immediate aftermath. Last month's payroll employment gain of 200,000 was a heartening sign of a potential firming trend.

Evidence suggests that one impediment to more rapid employment gains is the magnitude of the mismatch between the skills of the unemployed and the skills most in demand by firms with expanding output. Recessions and recoveries always involve shifting resources from some economic sectors to others in response to new technologies and new patterns of demand. Many of the workers that leave declining industries in the downturn eventually find work in newly expanding industries in the recovery. That search process can take some time and might require some additional training, since the skills of those released from contracting sectors, such as construction, may not line up with the skills required in expanding sectors, such as health care. The frictions associated with this process of sectoral and occupational reallocation appear to be empirically significant. One recent estimate indicates that labor market mismatch might account for between 0.8 and 1.4 percentage points of the increase in unemployment in this recession.[2]

Another impediment to growth cited by a wide range of observers is the array of changes in tax and regulatory policy, both actual and anticipated. We continue to hear widespread and persistent anecdotal reports from our Fifth Federal Reserve District contacts about how uncertainty about regulatory policy changes is discouraging firms from making new hiring or investment commitments. It seems plausible to me that such effects could be having a noticeable impact on measured growth rates.

Apart from regulatory changes, the dire federal budget outlook also imposes significant uncertainties on consumers and businesses. The path for federal debt under current law is simply not feasible. One way or another, significant adjustments will occur, either through higher marginal tax rates, cuts in programs' benefits or reductions in government payrolls and supplier contracts. Evidence suggests that uncertainty about the nature of those adjustments is impeding some firms' willingness to commit to new hiring or investments.

I have been talking about the impediments that have been weighing on growth in the U.S., but 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 business capital formation apart from structures — grew at a solid 7.6 percent annual rate in the first three quarters of 2011. Even with overall economic activity growing less rapidly than in the typical recovery, firms continue to identify profitable opportunities to deploy technology to reduce costs or improve business processes. This suggests that the underlying forces of innovation and creativity — forces that are evident in over 150 years of economic growth — are still at work.

Another contribution to growth has come from the trade sector. Exports have increased 23 percent since the end of the recession, and prospects there remain bright. A large fraction of the world's population resides in countries that have relatively low household incomes but are growing rapidly. In these emerging economies, firms are deploying capital to equip a growing labor force, creating a strong demand for American investment goods. And as these more productive workers move into the middle class they will want to purchase a range of goods from U.S. firms, from sodas, to movies, to video games. So I expect export growth to continue to add to overall economic activity this year.

On balance, until now, the impediments to recovery — including the housing stock overhang, consumer deleveraging, skills deficits and uncertainty regarding regulatory and tax policy — have had the upper hand. They represent difficult economic challenges that are not likely to cure themselves quickly over time. My takeaway from 2011 is the lesson that the impediments to more rapid U.S. growth are likely to be deeper and more persistent than we thought a year ago. As a consequence, I am expecting only a modest improvement for 2012, with GDP expanding at a pace between 2 and 2-½ percent. This is a forecast of growth at a moderate pace — not as rapid as past expansions, but positive growth nonetheless.

I see three main risks to this outlook. First, while my projection builds in a substantial slowdown in European economies in the first half of this year, the risk exists that a more pronounced recession in Europe could significantly dampen U.S. growth. Second, I believe there is a chance that U.S. consumers could regain confidence at a more rapid pace and propel a stronger pickup in overall growth. And third, while business investment spending is expected to moderate this year, we could miss that forecast.

A key part of any forecast is inflation. In 2011, we were reminded that inflation can rise despite elevated unemployment. In 2010, the inflation rate was 1.4 percent.[3] In the first 11 months of 2011, inflation has averaged 2.5 percent at an annual rate. Obviously the run-up in energy and food prices earlier this year played a big role in this increase. But the pickup in inflation last year was broad based. Core inflation — which strips out food and energy prices — was 0.9 percent in 2010, but averaged 1.7 percent in 2011 through November. This higher inflation rate in 2011, despite unemployment averaging 9 percent, undercuts the hoary notion that "slack" in the labor market can be counted on to keep inflation contained. This lesson is of course not new; we learned this all too well during the 1970s.

Despite last year's run-up, I believe the inflation outlook is reasonably good right now. Recent price trends have been quite favorable, and indeed, headline inflation has been quite low in recent months. The most likely outcome this year, in my view, is for overall inflation to average close to 2 percent. A rate noticeably below 2 percent *is* possible, particularly if global growth should soften enough to further ease pressures on commodity prices. But I still view the risks to inflation as tilted to the upside. A comparison of 2011 with the experience of 2004 through 2007, for example, suggests that an upswing in inflation at this stage of the business cycle is typically long-lasting.

No review of the economic outlook would be complete without some comment on policy outlook. Disappointingly slow growth often prompts calls for more central bank stimulus. But monetary policy is given credit for entirely too much influence on real economic activity. Monetary policy is about inflation — that is, the value of money. The effects of changes in monetary policy on real output and employment are largely the transitory byproducts of frictions that delay the timely adjustment of prices to changes in monetary conditions. Over time, these effects dissipate, and growth is governed almost entirely by the evolution of a society's technology, skills, resources and trading opportunities. The macroeconomic experience of 2011 provides vivid illustration; despite large-scale efforts to provide more monetary stimulus, growth disappointed and inflation moved upward.

So to summarize, I expect growth to continue in the year ahead, though at a moderate pace, and I expect inflation to remain in the neighborhood of 2 percent. I wish you all a happy New Year, and I hope that this year brings with it more modest expectations for monetary policy.

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[1] I am grateful to Roy Webb and John Weinberg for their assistance in preparing this speech.
[2] Ayşegül Şahin, Joseph Song, Giorgio Topa and Giovanni L. Violante, "Measuring Mismatch in the U.S. Labor Market," Federal Reserve Bank of New York, working paper, July 2011.
[3] This refers to the price index for personal consumption expenditures through December 2010.