

Economic Outlook, June 2013

June 28, 2013

**Jeffrey M. Lacker
President
Federal Reserve Bank of Richmond**

**Judicial Conference of the Fourth Circuit
White Sulphur Springs, W.Va.**

It's a pleasure to join you in this pleasant setting to discuss the economic outlook. 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

Let's begin with some good news about the economic situation; inflation remains well contained. Over the last 12 months, our most reliable measure of prices, the price index for personal consumption expenditure, has risen by only 1 percent. That's on the low side of our recent experience. Inflation has been fluctuating around 2 percent for two decades now, and just 21 months ago, inflation was 2.9 percent. There appears to be widespread confidence that the Federal Reserve will keep inflation low and stable, consistent with our announced inflation goal of 2 percent. Indeed, most forecasters view the current readings on inflation to be a temporary phenomenon and expect inflation to run at or a little below 2 percent over the next few years. Household surveys and financial market measures also indicate that inflation is expected to remain near its longer-term average. My own view is that the transitory factors depressing inflation are likely to ebb, and we'll see inflation edge back toward the Federal Open Market Committee's 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 that are outside a central bank's control. And it's real economic conditions that many now view as disappointing.

To get a handle on that disappointment, think back to the beginning of the new millennium and recall the pervasive optimism of that time. Much of that optimism was based on experience. Over the previous half-century, we had enjoyed remarkable economic performance — real gross domestic product grew at a 3.5 percent annual rate between 1950 and 2000. Since 2000, though, growth has fallen short of that long-term average. We had a very severe recession in 2008 and 2009, our worst since the 1930s, and growth has only averaged 2 percent since the end of 2009, well below the longer-run average. Looking ahead, the key question regarding the economic outlook is whether growth will remain relatively low. Many forecasters expect growth to pick up

to over 3 percent next year. I have become increasingly persuaded, however, that low growth rates are likely to persist for several years.

To see the logic behind this expectation, it is helpful to break 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 rate 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, productivity has been only 0.9 percent at an annual rate, and thus slower productivity growth 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 affecting the deployment of innovations, including research and development, business capital expenditure, regulatory and tax policies, labor force skills and public infrastructure investment. Note that monetary policy is not on this list.

After accounting for productivity growth, the rest of the reduction in GDP growth has been due to slower employment growth. Employment grew at a 1.7 percent annual rate from 1950 to 2000. Employment fell dramatically in the recession and its immediate aftermath, but has expanded at only a 1.1 percent annual rate since the end of 2009. It should not be surprising to see relatively slow growth in employment now, though, since the number of people of normal working age is itself growing slowly. For example, the civilian population aged 16–64 is only growing at a 0.4 percent annual rate. The part of the population growing most rapidly is above age 65, as aging baby boomers are hitting traditional retirement benchmarks in increasing numbers.

In addition to slowing population growth, labor force participation is also falling, even taking age into account. The most dramatic fall has been among young people, aged 16 to 24, whose labor force participation rate fell from over 59 percent in December 2007 to less than 55 percent now. But participation has declined for other age groups as well — the participation rate of so-called prime-age workers, aged 25 to 54, has fallen from 83.1 percent in December 2007 to 81.3 percent currently. Part of the decline in participation rates could be due to a sluggish overall economic environment. Another part may be due to structural factors such as an expansive safety net. For example, the number of potential workers receiving disability payments has risen almost 2 percent over the last year. And among young people, falling labor force participation seems related to higher school attendance, which could be motivated by the secular upward trend in the wage gap between educated and less-educated workers. Note that except for the effect of the economy on labor force participation, these factors behind slowing employment growth are also independent of monetary policy.

To summarize then, the slow growth in real GDP in this expansion is related to both lower productivity growth and lower employment growth. While economists understand the principles underlying productivity growth, it's quite difficult to parse the causes of medium-term swings in productivity growth, particularly as they are happening. At this juncture, low productivity growth has persisted long enough that I think the best guess is that it will remain low for an extended period. Some of the shortfall in employment could be due to the lingering effects of the Great

Recession on labor force participation, but at this point, four years since the recession ended, I doubt this effect is very large. I think longer-run structural trends, such as an aging population and higher school attendance among young people, are important drivers of the falling participation rate. And other persistent structural impediments, which I will discuss in a moment, seem to be depressing growth as well. Thus, the combination of relatively low productivity and employment growth leads me to conclude that real GDP growth will fluctuate around a 2 percent trend for the foreseeable future.

This view, based on medium- to long-run structural factors, contrasts with the views of some leading economic forecasters that I mentioned earlier. They believe that after a brief period of sluggish growth, real GDP will accelerate significantly. They see growth as being temporarily restrained by “headwinds” that limit spending and will dissipate relatively soon. A few years ago I subscribed to that view as well, and I would routinely predict that growth was about to accelerate after a quarter or two. Year after year though, our forecasts of acceleration were proven wrong, and growth remained near 2 percent. Eventually I started feeling an affinity for Charlie Brown, trying time after time to kick the football that Lucy kindly offers to hold for him, only to yank it away. I began to re-examine my basic premise that growth would soon accelerate behind my forecast, and I came to appreciate the structural factors that appear to be persistently limiting growth.

Although growth has averaged 2 percent since the end of 2009, our experience lately has been somewhat choppy, with significant fluctuations above and below 2 percent from quarter to quarter. One exception to this choppiness has been housing activity, which is finally on a solid growth path. New housing starts have more than doubled since the low point in 2009 and have risen by 29 percent over the last 12 months. Home prices are also on an upswing, rising almost 12 percent on average over the last 12 months. Now I should caution that home building is still far below the levels we saw before the recession, and even below the typical levels of the 1990s. Moreover, residential investment is less than 3 percent of GDP, so housing by itself is not going to have a large effect on total GDP growth. But having said that, the improvement in housing activity has bolstered the confidence of many households in the market value of their most important asset.

Rising confidence would be a good thing for consumer spending, which accounts for over 70 percent of GDP. Over the last 12 months, real consumer spending has risen by 1.8 percent, in line with GDP growth and the growth in real personal income. But the increase in federal taxes that took effect in January took a sizable bite out of take-home pay, and real *after-tax* personal income has risen only 1.1 percent since last year this time. Despite these headwinds, consumer spending has held up pretty well so far this year. The more persistent restraint on consumer spending in this expansion has been the aftereffects of the income and wealth shocks that hit American households during the Great Recession. Memories of these losses have undoubtedly made individuals more cautious about spending commitments. And while consumers have made great progress restoring some semblance of order to their balance sheets, much remains to be done. For example, close to 20 percent of all residential mortgages are still underwater. So even

though consumers have been fairly resilient in recent months, these fundamentals make it hard for me to be bullish about a pickup in consumer spending growth.

Business capital spending, on the other hand, is likely to make a solid contribution to growth over the next few years. While investment fell sharply during the recession, new technologies continued to be developed and improved. There are ample motives to implement these better technologies, even in the absence of rapid growth. Business fixed investment rose 5-½ percent last year, and most forecasters expect solid growth to continue. I would agree.

Thus the private sector seems to be in reasonably good shape, and if I could stop here, my growth forecast would be greater than 2 percent. But for completeness, I need to mention other important factors. First, the federal fiscal outlook is a mess. Last year, the federal deficit exceeded \$1 trillion and was almost 7 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 is not clear, however, what adjustments will be made to specific taxes and spending programs. This pervasive uncertainty has undoubtedly affected household and business 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 comes from the need for businesses 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 I would simply 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, or fully litigated, I might add. The magnitude of the uncertainty facing firms and households is bound to be elevated relative to the past. For example, we hear often from our contacts that they are worried about how to respond to new health care requirements, many of which remain to be written. The fiscal sector is clearly a net impediment to growth right now.

Forecasting is nothing if not a humbling endeavor, but rather than say “caveat emptor,” I will supply you with a list of reasons I could be wrong. Medium-term productivity forecasting is notoriously imprecise, as the 1990s demonstrated. Productivity growth could conceivably come in stronger over the next few years, and that could pass through to real wage gains that propel consumer spending at a faster rate. Also on the positive side, growth for our major trading partners could improve more rapidly than expected, which would boost export demand and incomes. Thus I cannot dismiss the possibility that growth will be somewhat better than I expect.

But there are also downside risks to the forecast. It is not clear that countries in the Euro area have solved their fiscal and competitive challenges, and thus there is a chance that stagnant conditions there prove more persistent, and growth languishes this year and next. Moreover, several emerging market economies are facing significant challenges right now, and should their

adjustments prove more formidable than expected, their growth could suffer. Closer to home, implementation of provisions of the Affordable Care Act later this year could prove highly consequential for hiring incentives, despite whatever benefits it might bring, and thus could conceivably slow down job growth around year-end. So one shouldn't take my outlook for moderate growth for granted, either.

I should add one important qualification to my portrayal of the economic outlook. At a longer horizon — that is, the next couple of decades — I am fundamentally quite optimistic about prospects for the U.S. economy. The resilience inherent in our institutional framework, the strength of our great research institutions and the intrinsic capabilities of our workforce all auger well for our capacity to develop and apply the innovations that drive gains in our standards of living over time.

At this point in discussing the outlook, you may have noticed that one topic is missing, and so I'll conclude with some thoughts on monetary policy. Federal Reserve policy is exceptionally accommodative right now, with short-term interest rates near zero and our balance sheet about four times the size it was before the financial turmoil began in 2007. Moreover, the balance sheet continues to expand, consistent with Fed Chairman Ben Bernanke's announcement last week that the Federal Open Market Committee anticipates reducing the pace of asset purchases later this year and ending purchases around mid-year 2014, provided incoming data are broadly consistent with the Committee's forecast. This means that over the course of the next 12 months, the Committee will be reducing only the pace at which it is *adding* accommodation. In other words, the Federal Reserve is not only leaving the punch bowl in place, we're continuing to spike the punch, though at a decreasing rate over the next year.

A highly stimulative policy was the appropriate response to a severe recession of 2008 and 2009, in my view. 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 for further monetary stimulus does not look promising. I seriously doubt additional monetary stimulus can provide much impetus to real growth right now. But further stimulus does increase the size of our balance sheet and correspondingly increases the risks associated with the "exit process" when it becomes time to withdraw stimulus. That is why I have not supported the current asset purchase program.

I did, however, think it wise of Chairman Bernanke to clarify the Committee's expectations regarding how the pace of asset purchases is likely to evolve. Bond and stock markets fell sharply in response, but that should not be too surprising. The Chairman's statement forced financial market participants to re-evaluate the likely total amount of securities the Fed would buy under this open-ended purchase plan — in other words, how much liquor would ultimately be poured into the punch bowl. Market participants also had to reconsider their estimate of when the Federal Reserve would begin to remove the punch bowl by raising interest rates. These reassessments appear to have warranted price changes across an array of financial assets. As market participants gain additional insight from the words of Federal Reserve officials or by policy actions in coming quarters, further asset price volatility seems likely.

This type of volatility is a normal part of the process of incorporating new information into financial asset prices and should not interfere with the moderate-growth scenario that I have presented today. And I would emphasize that keeping inflation low and stable is within the capability of any 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 inflation readings are likely to be transitory. Inflation is likely to remain well contained, and that is the single most important contribution a central bank can make to economic growth.

¹ I would like to thank Roy Webb for assistance in preparing these remarks.