Economic Outlook, December 2013
December 9, 2013

Jeffrey M. Lacker
President
Federal Reserve Bank of Richmond

Charlotte Chamber of Commerce Economic Outlook Conference
Charlotte, North Carolina

It's a pleasure to be with you today to discuss the economic outlook. For several years now, ever since the Great Recession of 2008 and 2009, most forecasts of overall economic activity have followed a common script. They essentially have said that while growth has been modest recently, the economy is likely to pick up speed in the next couple of quarters with the easing of headwinds that have been temporarily restraining growth. My own forecasts have followed this script (at least initially), as have those of a broad range of forecasters. Despite these optimistic forecasts, the reality has been more modest. Real GDP — our broadest measure of overall economic activity — grew by 2.0 percent in 2011, 2.0 percent in 2012, and it looks like GDP growth this year will again be about 2.0 percent. Many forecasters are sticking to their scripts. The latest Blue Chip compilation of economists' projections, for example, calls for 2.8 percent growth in real GDP next year. As you may have guessed, I will share a different view in my remarks today. But before I begin, I should make clear that the views expressed are my own and should not be attributed to any other person in the Federal Reserve System.[1]

A growing number of economists have taken on board the disappointing forecasting record of the last few years and have come to believe that growth is more likely than not to remain low over the next few years. A bit of background helps explain the forecasting disappointments of the last several years: Before the Great Recession, we came to enjoy a period known as the Great Moderation. From 1983 to 2007, real GDP grew at an average annual rate of 3.3 percent. Over that 24-year period, we experienced only two short, shallow recessions that together lasted only five quarters. Real personal income kept pace with GDP, also growing at a 3.3 percent annual rate. And consumer spending advanced even more rapidly than income, growing at a 3.6 percent annual rate. Part of the reason consumer spending was able to grow more rapidly than income over that period was the rise in household wealth. Stock prices, bond prices and housing prices all increased significantly during the Great Moderation.

During the Great Recession, GDP fell by 4.3 percent and payroll employment fell by 8.7 million jobs. The scale and scope of loss of income and wealth experienced by American consumers was far greater than anything seen in the previous 20 years.

Given that experience, both households and lenders were bound to re-evaluate the riskiness associated with indebtedness, reflecting a sense that income and asset returns would be substantially less certain than they had come to believe during the Great Moderation. Under these conditions, it's no surprise that credit is no longer available to consumers on the same terms. And it's no surprise that consumers have been paying off debt and building up savings in order to restore some sense of balance to their household finances.

These developments appear to have led to a persistent cautiousness in household spending behavior. Over the last three years, real consumer spending has increased at an annual rate of 2.0 percent. Given the traumatic events of the past few years, it seems quite likely that consumer caution is not a temporary headwind.

Businesses also appear to be quite reticent to hire and invest. A widely followed index of small business optimism fell sharply during the recession and has only partially recovered since then. Interestingly, when asked about the single most important problem they face, the most frequent answer in the latest survey was "government regulations and red tape." This result accords with reports that we've been hearing from business contacts for several years now. There has been a substantial increase in the pace of regulatory change, and a substantial increase in uncertainty about the exact shape of anticipated new regulations. That uncertainty provides an additional reason for firms to postpone expansion plans. The disorderly implementation of the Affordable Care Act is also likely to be dampening businesses' willingness to expand.

Adding to the uncertainty is the ongoing fiscal drama in Washington. Even with last January's tax increases and with the sequester holding down federal spending, the deficit was about 4 percent of GDP for the 2013 fiscal year. That level is unsustainably high over the long run. Moreover, if you take into account the rising costs of medical entitlements and Social Security, it's clear that current federal budget plans are unsustainable over the long run. So at some point we will see a combination of reduced federal spending growth, higher taxes or both. In the meantime, businesses and households will be unsure about how their tax liabilities will evolve over time, and firms doing business with the federal government will be uncertain about their prospects as well. Although it's hard to quantify, I believe this budget uncertainty is also weighing on business hiring and investment decisions.

So far I've mentioned consumer spending and business investment, which together account for about four-fifths of the economy. Residential investment is one area in which we *have* seen strong growth. Last year, real residential investment increased by more than 15 percent, and so far this year it has increased at a 13 percent annual rate. Despite that, however, housing market indicators, such as housing starts and new home sales, remain well below levels that might be considered normal, so there seems to be room for residential investment to continue to grow. But since this is only 3 percent of GDP, it has only a marginal effect on the overall outlook.

Overall government spending has been weak recently, and, given continuing fiscal pressures, that category is likely to make little, if any, contribution to GDP growth next year. That leaves net exports, which for various reasons are also likely to make little contribution to GDP growth next year. Adding up all these categories of spending yields a forecast for GDP growth next year of just a little above 2 percent — not much different from what we've seen for the last three years.

That's my forecast for next year, but when thinking about growth prospects, I believe it's important to keep an eye on longer-run trends as well. To do that, it's useful to break down real GDP growth into the *sum* of the growth in productivity — that is, output per worker — and the growth in the number of workers. It turns out both of these components have slowed since the Great Moderation.

Starting first with productivity: From 1983 to 2000, productivity grew at a 1.8 percent annual rate. But toward the end of the Great Moderation, productivity growth slowed, and over the last three years, productivity has increased at a very modest 1.0 percent annual rate. Forecasting trends in productivity growth is exceedingly difficult. Having said that, it's hard to see why productivity growth would improve dramatically in the near term; there's no sign of a major surge of technical innovation in the pipeline, significant educational improvement or substantial deregulation — the kind of developments that would lead to a major acceleration in productivity. By the same token, it's hard to believe productivity has hit some sort of plateau. It doesn't take much digging to find examples of continued innovation in today's economy, even if it hasn't generated the rapid aggregate productivity growth we saw during the Great Moderation. The most likely outcome, in my view, is more of the same, and thus my outlook is that productivity growth will be about 1 percent for a considerable period.

Employment growth also has slowed since the Great Moderation. From 1983 to 2000, employment increased at a 1.8 percent annual rate (as estimated in the survey of households). Over the last four years, employment growth has been just 1.0 percent per year — so employment growth has fallen by almost half. An imminent acceleration in employment does not seem likely to me. Population growth is lower now than before. Moreover, the fraction of the working age population that is employed or looking for work — economists call this the labor force participation rate — has been declining due to demographic shifts and other structural factors. Also, I've been struck by the large number of accounts I've heard recently about firms having difficulty finding workers with the appropriate skills, in many cases constraining production. It appears as if the nature of current technological advances may be shifting the mix of requisite workforce skills more rapidly than in the past.

Before I wrap things up, I'd like to make some brief observations on inflation and monetary policy. First, it's important to recognize that inflation has been well-behaved over the last 20 years. Since 1993, inflation has averaged 1.9 percent, which is remarkably close to the Federal Open Market Committee's goal of 2 percent. Second, we've seen some fluctuations in inflation over that time period, but they have all proven to be transitory. For example, inflation averaged 2.8 percent over the three years ending in December 2007. I mention this because many people have noticed that over the last 12 months inflation has only averaged 0.7 percent. My sense is that inflation will move back toward 2 percent over the next year or two, in part because measures of expected inflation remain well contained. This is not a certainty, however, and I believe the FOMC will want to watch this closely.

And that brings us to monetary policy, which has been particularly challenging of late. As you may recall, the Fed reduced its target for the federal funds rate to essentially zero at the end of 2008. Given the state of the economy, that was the appropriate monetary policy response. Since then, the Fed has purchased a significant quantity of assets, which increases the supply of monetary assets to the banking system and in some circumstances can have a stimulative effect. The size of our balance sheet has gone from $2.2 trillion to around $4.0 trillion, and it continues to increase by about $85 billion per month.

When the FOMC meets next week, I expect discussion about the possibility of reducing the pace of asset purchases. The key issue, in my view, is the extent to which the benefits of further monetary stimulus are likely to outweigh the costs. Economic growth trends currently appear to be driven mainly by population growth and productivity growth, in which case monetary stimulus will only have limited and transitory effects. 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. This is why I have not been a supporter of the current asset purchase program.

In conclusion, I'd like to return to the theme with which I began. Yes, 2 percent growth is disappointing relative to our experience during the period of the Great Moderation, and yes, growth may continue at a rate that is slower than in the past. But productivity *is* rising, incomes *are* growing and innovation *is* occurring. Our institutions of higher learning are worldwide leaders in research and education, and they continue to attract exceptional students from abroad. Our markets remain flexible and resilient. The public policy problems we face may be difficult, but they are certainly not insoluble. Consequently, a broad perspective suggests a fundamentally optimistic view about our future.

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