Economic Outlook, October 2010

The Carolina Inn, Chapel Hill, North Carolina
October 13, 2010

Jeffrey M. Lacker
President, Federal Reserve Bank of Richmond

It is a pleasure to be with you tonight. I have been visiting the area for the past few days and I am impressed with the knowledge and innovation that this region has to offer and the possibilities for future growth. However, I am here with you tonight to discuss the nation's economic outlook, which, as you probably know, is disappointing. As I will outline, this recovery has been more sluggish than many expected, although it is worth bearing in mind that the economy *is* growing. As usual, but worth emphasizing nonetheless, the views I express are my own and do not necessarily reflect the thinking of my colleagues on the Federal Open Market Committee.[1]

I will begin with some background. In 2008 and the first half of 2009 we experienced our worst recession since the Great Depression, as measured by the traditional gauges of depth, duration and breadth. To mention one, the unemployment rate more than doubled, rising from 4.4 percent in early 2007 to 10.1 percent last fall. The Business Cycle Dating Committee of the National Bureau of Economic Research, the people that officially decide these things, recently declared that June 2009 marks the end of the recession. In the four quarters following the end of the recession, real GDP rose by 3 percent, which is pretty sluggish in comparison to other similar periods.

When this recovery began, it was not obvious that growth would be this sluggish. After all, monetary and fiscal policies were highly stimulative, according to measures such as the level of the federal funds rate or the increase in the federal budget deficit. Moreover, past recoveries have tended to be stronger following deep contractions than after shallow ones.

So why has growth been so sluggish in this recovery? This is a difficult question to answer. For clues, I am going to compare the first four quarters of the current recovery, to the first four quarters of the recoveries from two other very deep postwar U.S. recessions – namely, the 1974-75 recession, which ended in the first quarter of 1975, and the 1981-82 recession, which ended in the third quarter of 1982.

One reason for the sluggishness of this recovery is apparent in the residential real estate market. Housing was significantly overbuilt during the boom that lasted for about 10 years, beginning in the mid-1990s. As a result there are a large number of vacant houses that are reasonably good substitutes for new construction. A recent estimate puts the number of vacant homes at 14 million nationwide. This overhang of unoccupied homes has put a damper on construction in many markets and has kept new housing starts down around a half a million units at an annual rate. This is far below the one million or more new homes that would be required each year to keep pace with the rate at which the population of new households is growing. Even though home prices appear to have stabilized, construction is likely to remain depressed until growth in population and real incomes brings the demand for the housing back in line with supply. This is likely to take a good deal of time – population growth is only about one percent per year, for example. In the meantime, the decentralized process underway of separating households from homes and/or mortgages for whom they are poorly matched will be lengthy and arduous.

As a result, residential investment has failed to make a positive contribution to growth in overall economic activity over the past year. This contrasts with the two other severe recessions of the past 60

years, in which residential investment increased an average of 40 percent in the first four quarters of the recovery, contributing an average of 1.3 percentage points to overall GDP growth. Putting it another way, if we had had a "normal" contribution from residential investment, real GDP would have grown at least 4.3 percent in the first year of recovery, significantly more than the 3.0 percent we actually saw. Given the legacy of overbuilding, I do not expect housing to contribute significantly to growth over the next couple of years.

Investment in nonresidential structures, such as stores, office buildings and warehouses also has been an area of weakness. Over the last four quarters, investment in this category has fallen 15 percent, and has *subtracted* a half percentage point from top line growth. That's just slightly worse than average, and it is not unusual for nonresidential investment to lag behind the rebound in overall economic activity.

What *has* been unusual is the behavior of household spending. In a typical recovery, consumers see a brighter future ahead and are willing to ramp up spending ahead of anticipated gains in employment and incomes. That hasn't happened this time. Instead, household spending has grown just 1-⅔ percent, and has added a modest 1.2 percentage points to real GDP growth over the last four quarters. In contrast, after each of the two other severe recessions, household spending grew at an average of 6-½ percent in the first year of expansion, and has added more than 4 percentage points to growth. A major portion of the gap between growth in this recovery and growth in the recoveries following previous severe recessions is thus attributable, at least in an arithmetic sense, to weaker than usual household spending.

There *are* a couple of brighter spots in the outlook, however. Real business investment in equipment and software grew 15.8 percent over the last year, and there are good reasons to expect that growth to continue. 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 funds appear to be readily available for creditworthy firms. And profitably has rebounded for many firms, which has been reflected in rising stock prices. All these factors are likely to continue to encourage new business investment going forward.

Investment hasn't been the only bright spot. Exports of goods and services have grown 14 percent over the last four quarters, adding over 1-½ percent to growth. This is far better than in the two previous recoveries following severe recessions, in which exports were flat or declining and thus contributed little to growth. While economic growth in some of our major trading partners has slowed somewhat since earlier this year, the robust expansion of many emerging economies will continue to support export demand.

What emerges, then, from comparing the three recoveries from the most severe recessions in the postwar era is a mixed picture. Exports and equipment and software investment are bright spots, but home building has been flat and government spending growth has been subpar, while consumer spending has been expanding at a relatively restrained pace.

The behavior of consumer spending is critical to the recovery, since it comprises two-thirds of final demand. Households appear to be working hard to adjust their balance sheets by repaying debt and building up assets. The saving rate has risen from around 2 percent in the years just before the recession, to a level now around 6 percent. But the saving rate has been hovering around 6 percent ever since the recovery began, which implies that household spending has been growing in line with disposable income over that period.

This points to labor market conditions as the predominant factor restraining consumer spending in this recovery. Here, two features of this recovery have been widely cited as keeping labor markets from healing as rapidly as they usually do following a severe downturn. One is the idea of labor market "mismatch," that is, the skills required by firms that have openings are different, to a greater degree than usual, from the skills of workers who are looking for jobs. The mismatch hypothesis is difficult to verify directly, but it is consistent with the observation that aggregate job vacancy rates appear to have risen despite the stubbornly high unemployment rate. It is also consistent with the apparent fact that technological change has been shifting labor market demand toward higher-skilled workers over time.

A second hypothesis is that extended unemployment benefits are discouraging workers from accepting employment offers. Indeed, some economists estimate that the unemployment rate would be as much as 1-½ percent lower were it not for extended unemployment benefits. This is a sizable difference and, if accurate, would cast labor markets in a distinctly different light.

Many commentators have attributed the sluggishness of the recovery to a third factor – namely, pervasive uncertainty regarding an array of government policies. Quantitative economic statistics alone are of little use in assessing a hypothesis like this, since it has to do with the expectations and motivations of firms and consumers. But one part of my job is that I (and my FOMC colleagues) get to talk to a wide range people and gather firsthand accounts that go beyond the usual statistics. (Indeed, that's one of the main purposes of this trip to the Triangle region.) Over the course of this year we've heard many forceful and impassioned views about the economy. There appears to be a broad feeling of apprehension that goes beyond the normal grumbling about Washington or partisan political opponents. In some cases, that sentiment is attributable to specific regulatory actions. In West Virginia, for example, the federal government's wholesale withdrawal of previously issued coal mining permits has led many businesses to suspend investment plans, and there are no doubt numerous other regulatory actions around the country that have reduced production and employment. Part of the negative sentiment likely reflects the explosion of federal debt and uncertainty about how a sustainable fiscal policy will be achieved. More broadly, people may be having difficulty absorbing and adjusting to three separate 2000-page pieces of federal legislation that have been passed in the last two years. Add to that the continuing uncertainty about tax rates for 2011 (now less than three months away), business planners may be finding it more difficult than usual to project economic conditions or the financial implications of prospective hiring and investment commitments. While it is hard to estimate the magnitude of the effects of these fears, or to disentangle them from general expectations of weak demand growth, they are too broad and deep for me to dismiss as implausible the notion that they have significantly dampened consumer and business spending of late.

So, where does the economy go from here? The consensus among professional forecasters is that growth will be about 2 percent at an annual rate over the second half of this year, and will slowly gain enough speed thereafter that unemployment begins to decline next year. That strikes me as a reasonably likely scenario, and in fact, if forced to choose right now, my forecast would lie quite close to that path.

This outlook is not without some risks, of course. Growth could stagnate if, for example, the policy uncertainty I discussed earlier intensifies. On the other hand, it is not inconceivable that uncertainty could dissipate and unleash a surge in investment and hiring that boosts consumer spending and growth. But I believe the most likely outcome is for growth to continue at the modest rate we have been seeing, and gradually accelerating next year.

This gradual improvement for the country as a whole should help North Carolina rebuild its own economy and employment base. Relatively speaking, North Carolina's job losses were more severe during the downturn than the rest of the nation, mainly due to the concentration in manufacturing, construction, and financial services industries. Here in the Research Triangle region, unemployment surpassed the highs reached in each of the three prior recessions, and (at roughly 7-½ percent) remains

elevated. Because of the stabilizing presence of state government and educational institutions, as well as a diverse and innovative private sector, job loss in the Raleigh-Durham area has not matched the national decline, much less the state's. Moreover, employment gains in this area, while still weak, are proceeding at nearly twice the national rate. So the Research Triangle region has weathered this recession better than most areas of the country, and appears well positioned to take advantage of whatever support the modest U.S. recovery can provide.

I've barely touched on monetary policy, and I'm happy to correct that omission now. First things first: inflation is now on target, as far as I'm concerned. Over the last 12 months the price index for personal consumption expenditure has risen 1.5 percent, which is exactly what I've been recommending for the last six years. We also track a core price index that omits volatile food and energy prices, and it is sending the same message, having risen by 1.4 percent over the last 12 months. I believe that the Fed's best contribution to our nation's economic prosperity over time would be to keep inflation stable near the current 1.5 percent rate. But inflation has been lower this year, with overall inflation increasing at only a 0.7 percent annual rate, which is too low for me. I would point out that these inflation numbers often run hot or cold for several months at a time, which is why economists focus on the 12-month number I cited a moment ago. I am not yet convinced that inflation is likely to remain undesirably low. Moreover, the public's expectation of future inflation is not at such a low level; indeed, the latest survey from the University of Michigan puts the public's short-run inflation expectation at 2.2 percent. So I do not see a material risk of deflation – that is, an outright decline in the price level.

It is worth noting that we have experienced extended periods of low inflation before without drifting into a deflationary spiral. From January 1959 through December 1965, for example, the price index for personal consumption expenditures averaged 1.4 percent. It never rose above 1.9 percent, and though it fell to as low as 0.5 percent at one point, it never entered negative territory. In fact, not only did this episode of around 1-½ percent inflation not lead to deflation, it was actually followed by a gradual upward drift that led into the Great Inflation of the 1970s, and inflation ultimately exceeding 10 percent.

The disastrous unraveling of price stability after 1965 provides an important cautionary tale, I believe. It is now widely recognized that tilting monetary policy toward expanding employment gave policy a distinctly inflationary bias.[2] With inflation reasonably close to any plausible definition of price stability, and all expectations measures pointing in the right direction, making unemployment a policy imperative poses clear risks to the credibility of our long run inflation goals.

In closing, I want to note that despite the widespread expectation that near-term economic growth is likely to be weak by historical standards, I remain persuaded that the fundamental economic prospects for our country look bright. If we can navigate the policy turbulence ahead in a way that restores credible fiscal balance and preserves the resilience and flexibility of our system, we will find and implement plenty of ways to improve standards of living for generations to come.

---

[1] I am grateful to Roy Webb for assistance in preparing these remarks.

[2] Robert L. Hetzel, "The Monetary Policy of the Federal Reserve: A History." Cambridge University Press, Cambridge, 2008.