The Economic Outlook

Loretta J. Mester*
Executive Vice President and Director of Research

7th Annual Temple University Fox School of Business Leadership and Professional Development Seminar

February 23, 2012

*The views expressed here are those of the author and do not necessarily reflect those of the Federal Reserve Bank of Philadelphia or of the Federal Reserve System.
According to Dante, those who seek to forecast the future are condemned to the fourth ditch of the eighth circle of hell!
In accordance with the punishment described by Dante...

- Review 2011 economic performance
- Discuss the forecast for 2012 and 2013
- Discuss new steps toward more transparent communication about monetary policy
We expected the recovery to take hold in earnest in 2011, with a gradual improvement in labor markets and low inflation. Our labor market forecast was about right, but our growth forecast was too optimistic and prices accelerated more than expected.

<table>
<thead>
<tr>
<th>FOMC Central Tendency in January 2011</th>
<th>Actual for 2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP Growth (4Q/4Q)</td>
<td>3.4% to 3.9%</td>
</tr>
<tr>
<td>Unemployment Rate (4th quarter average)</td>
<td>8.8% to 9.0%</td>
</tr>
<tr>
<td>Total PCE Inflation (4Q/4Q)</td>
<td>1.3% to 1.7%</td>
</tr>
<tr>
<td>Core PCE Inflation (4Q/4Q)</td>
<td>1.0% to 1.3%</td>
</tr>
</tbody>
</table>
Many of the risks we cited at the beginning of 2011 came to pass. The economy was hit by a number of shocks that dampened growth and put upward pressure on prices in 2011.

- Severe weather at the start of the year
- Earthquake and tsunami in Japan => worries about nuclear meltdown and supply disruptions
- Arab spring => surge in oil prices
  - Gasoline prices rose more than $1 per gallon from late 2010 to peak in spring 2011
- European sovereign debt and potential banking crisis => high volatility and financial market strains
- U.S. debt ceiling debacle, potential government shutdown, and S&P credit downgrade
Transitory factors held growth down in the first half of 2011. Growth picked up in the second half.

Quarterly data: Last point plotted is 2011Q4
At the end of 2010, activity was increasing at a modest pace in many states, but was still flat or contracting in several Philadelphia Fed Current Economic Activity Indexes, annualized growth over the three months ending in November 2010.
By the end of 2011, activity had strengthened in most states.

Philadelphia Fed Current Economic Activity Indexes, annualized growth over the three months ending in November 2011.
Business investment in equipment and software was one of the economy’s strengths, supported by strong corporate profits.
The natural disasters in Japan disrupted supply chains. Manufacturing activity was hurt but has since recovered.

**Business Outlook Survey: General Activity Index**

Future General Activity Index

Index represents percentage of respondents reporting an increase minus percentage reporting a decrease.

Monthly data: Last point plotted is February 2012
Consumer sentiment plunged this summer but has rebounded

Sentiment index, 66Q1 = 100
Confidence index, 1985 = 100

Consumer Sentiment Index, University of Michigan
Consumer Confidence Index, Conference Board

Monthly data: Last point plotted is January 2012 for Confidence and February 2012 for Sentiment
Despite low consumer confidence and high oil prices, consumer spending held up in 2011

Real personal consumption
4Q/4Q growth, SAAR*

Percent

<table>
<thead>
<tr>
<th>Year</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011</td>
<td>4.4</td>
</tr>
<tr>
<td>2010</td>
<td>2.8</td>
</tr>
<tr>
<td>2009</td>
<td>1.9</td>
</tr>
<tr>
<td>2008</td>
<td>3.4</td>
</tr>
<tr>
<td>2007</td>
<td>4.0</td>
</tr>
<tr>
<td>2006</td>
<td>2.8</td>
</tr>
<tr>
<td>2005</td>
<td>3.2</td>
</tr>
<tr>
<td>2004</td>
<td>1.7</td>
</tr>
<tr>
<td>2003</td>
<td>-2.5</td>
</tr>
<tr>
<td>2002</td>
<td>-0.2</td>
</tr>
<tr>
<td>2001</td>
<td>3.0</td>
</tr>
<tr>
<td>2000</td>
<td>1.6</td>
</tr>
</tbody>
</table>
Labor market conditions improved in 2011. Job gains averaged 152 thousand per month last year and in January, payrolls rose by 243 thousand jobs.
Employment growth in our three states picked up to 1% last year, a bit less than the nation’s 1¼% rate. The pattern was uneven, with gains in PA and NJ, and losses in DE. All three states lost government jobs last year, as did the nation.

Year-over-year payroll job growth, as of November 2011

Pennsylvania has made more progress than the nation, New Jersey, and Delaware in terms of recovering lost jobs.

Incorporates January 2012 for the nation and December 2011 for PA, NJ, and DE.
The national unemployment rate moved down nearly a percentage point in 2011

Monthly data: Last point plotted is January 2012 for U.S. and December 2011 for the states
Household debt-to-disposable income has fallen and creditworthiness is improving. Households will likely continue to deleverage.

Quarterly data: Last point plotted is 2011 Q3
After rising in 2009 and 2010, household net worth fell over the first three quarters of 2011. Both real estate and stock market wealth declined.

Source: FRB Flow of Funds, annual data for 1990-2010; 2011Q3 is year-to-date, annualized
Housing markets finally stabilized in 2011.
We had our first increase in residential investment in six years.

Real residential investment
4Q/4Q growth, SAAR*

FEDERAL RESERVE BANK
OF PHILADELPHIA
House prices continued to fall last year, even excluding distressed sales. Respondents to our Survey of Professional Forecasters expect little change in house prices over the next two years.

Quarterly data: Last point plotted is 2011 Q3; 2012Q1 SPF
The surge in oil prices put upward pressure on inflation. Inflation remains above the long-run goal of 2 percent, but has begun to moderate.
The sovereign debt problems in Europe continue to be a risk to the forecast. But European countries are moving forward with initiatives to address the fiscal crisis.
Financial markets were extremely volatile last year as investors focused on the fiscal situation in Europe. Stock prices started this year on a strong note.
The FOMC was an active group in 2011

- **March**: Announced Chairman to hold press conferences four times a year. These began in April.
- **June**: Published exit strategy principles.
- **June**: Finished second large-scale asset purchase program – QE2.
- **August**: Changed forward guidance: zero rates likely *at least through mid-2013*.
- **September**: Began maturity extension program – Operation Twist.
- **September**: Began reinvesting maturing MBS into MBS instead of Treasuries.
- **November**: Announced coordinated central bank action to address pressures in global financial markets – lower price on dollar swap lines, bilateral currency swap lines, extension until February 2013.
- **December**: Announced it will publish interest rate assumptions starting in January 2012, and will clarify the long-run goals of monetary policy and its decision-making framework.
Monetary policy remained very accommodative in 2011. The fed funds has been at essentially zero for three years and other interest rates remain very low.

Weekly data: Last point plotted is February 7, 2012
The Fed’s balance sheet remains very large. The Fed holds nearly $1 trillion in housing agency mortgage-backed securities and agency debt.
What does the future hold?
Fed and private sector forecasters expect growth to accelerate, unemployment to gradually decline, and inflation to move toward its long-run goal.

<table>
<thead>
<tr>
<th></th>
<th>Central tendency of Fed Governors and Presidents January 2012 Forecasts</th>
<th>Survey of Professional Forecasters 2012 Q1 Survey</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2012</td>
<td>2013</td>
</tr>
<tr>
<td>Real GDP Growth*</td>
<td>2.2 to 2.7%</td>
<td>2.8 to 3.2%</td>
</tr>
<tr>
<td>Unemployment Rate in Q4</td>
<td>8.2 to 8.5%</td>
<td>7.4 to 8.1%</td>
</tr>
<tr>
<td>PCE Inflation (Q4/Q4 growth)</td>
<td>1.4 to 1.8%</td>
<td>1.4 to 2.0%</td>
</tr>
</tbody>
</table>

*Q4/Q4 growth for Fed forecasts and 2012 SPF; annual growth for 2013 SPF
Our latest *Survey of Professional Forecasters* forecasts sustained economic recovery with growth at or slightly above trend.

Hatched bars are median forecasts from the 2012Q1 *Survey of Professional Forecasters*. 
Our latest *Survey of Professional Forecasters* indicates the unemployment rate will continue to decline over the year but will remain high.

Dotted line is median forecast from the 2012Q1 *Survey of Professional Forecasters*.
As oil and commodity prices stabilize, inflation moderates. Our SPF forecasts total PCE inflation will be 2% over the next two years, consistent with the Fed’s long-run goal.

Hatched bars represent median forecasts from the 2012Q1 Survey of Professional Forecasters.
The forecast includes the effects of fiscal and monetary policy

- 2% payroll tax cut and emergency unemployment insurance benefits are extended through 2012
  - Adds about 1/2% pt to real GDP growth in 2012 and subtracts about 1/2% pt from growth in 2013 as these programs expire.

- Automatic sequester cuts are avoided in 2013 with a package of spending cuts and tax increases.

- “The Committee ... currently anticipates that economic conditions – including low rates of resource utilization and a subdued outlook for inflation over the medium run – are likely to warrant exceptionally low levels for the federal funds rate at least through late 2014.” (January 25, 2012 FOMC Statement)
As always, there are risks to the baseline forecast

- The major risk to the forecast is the European debt crisis
  - If Europe implodes, all bets are off
- Other risks to growth:
  - Uncertainty may exert a stronger dampening effect than expected
  - Foreclosures may continue to be a larger drag on housing than expected
  - Federal government budget deficits are not sustainable, posing a risk to the outlook over the medium and longer run
  - Internal dynamics of the economy + effect of accommodative fiscal and monetary policy may be stronger than we think
- The risks to inflation are balanced in the near term but are on the upside in the medium term
  - The success of the Fed’s exit strategy from the period of extraordinary monetary accommodation is the key to anchoring inflation expectations
  - Will concerns about large looming fiscal deficits increase inflation expectations?
  - Oil prices, as usual, are a wild card
The baseline forecast

• The economic recovery continues in 2012 and 2013, with growth at or slightly above trend – around 2-3/4% to 3%.
  – Supported by strong profits, businesses continue to invest in equipment and software at a healthy pace and hiring strengthens
  – Improvement in labor market conditions and households’ balance sheets will support consumer spending
  – Residential investment will not contribute much, but won’t be a major drag either
• Labor markets improve. Payroll growth strengthens and the unemployment rate falls gradually to around 8% at the end of 2012 and 7% at the end of 2013.
• Inflation moderates back to 2%, consistent with the Fed’s long-run goal.
Clear communication about monetary policy has several benefits

• Increases the effectiveness of monetary policy
  – Reduces uncertainty about the path of monetary policy =>
  – Firms and households can make more informed investment, production, spending, and labor market decisions
  – Reduced uncertainty can lead to lower financial volatility and risk premia

• Increases the accountability of the Fed to meet its statutory mandate
  – Increases credibility of the Fed, which increases monetary policy effectiveness
The FOMC strives to improve its communications about monetary policy and in January took two steps toward increased transparency

• The FOMC released a statement of principles about its longer-run monetary policy goals and strategy
  – The FOMC is committed to its statutory mandate to promote maximum employment, stable prices, and moderate long-term interest rates.
  – Set a longer-run inflation goal is 2 percent, measured by the annual change in the PCE price index.
  – Did not set a maximum employment goal.
  – FOMC takes a balanced approach in promoting the goals

• The FOMC began releasing information on the policy assumptions underlying their economic projections.
  – These assumptions represent each individual participant’s view of “appropriate policy.”
  – “Appropriate policy” is the path of policy that is most likely to foster monetary policy’s long-run goals of price stability and maximum employment.
The FOMC is releasing participants’ assumptions about the appropriate policy paths underlying their economic projections.

Only six participants anticipate that the appropriate liftoff from the zero bound will be before 2014.

**Appropriate Timing of Policy Firming:**
Liftoff from the Zero Bound

<table>
<thead>
<tr>
<th>Year</th>
<th>Participants</th>
</tr>
</thead>
<tbody>
<tr>
<td>2012</td>
<td>3</td>
</tr>
<tr>
<td>2013</td>
<td>3</td>
</tr>
<tr>
<td>2014</td>
<td>5</td>
</tr>
<tr>
<td>2015</td>
<td>4</td>
</tr>
<tr>
<td>2016</td>
<td>2</td>
</tr>
</tbody>
</table>

Source: FOMC Minutes and Press Conference
The six participants projecting liftoff before 2014 anticipate that the fed funds rate target will need to rise to 1.5 to 2.75% at the end of 2014. Eleven other FOMC participants project that the appropriate fed funds rate will be 1% or less in 2014.

Source: FOMC Minutes and Press Conference