The Economic Outlook

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*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
“But the long run is a misleading guide to current affairs. In the long run we are all dead.

Economists set themselves too easy, too useless a task if in tempestuous seasons they can only tell us that when the storm is long past the ocean is flat again.”

John Maynard Keynes
A Tract on Monetary Reform (1923), Ch. 3

• Review 2012 economic performance
• Present our forecast for 2013 and 2014
• Discuss monetary policy tools
We expected the recovery to continue and on firmer footing in 2012, with a pickup in growth, a gradual improvement in labor markets, and low inflation.

FOMC labor market and inflation forecasts were about right. FOMC forecast of moderate growth was too optimistic.

<table>
<thead>
<tr>
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<th>Actual 2011</th>
<th>FOMC Central Tendency in January 2012</th>
<th>Actual 2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP Growth</td>
<td>2.0%</td>
<td>2.2% to 2.7%</td>
<td>1.5%</td>
</tr>
<tr>
<td>(Q4/Q4 growth)</td>
<td></td>
<td></td>
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<tr>
<td>Unemployment Rate</td>
<td>8.7%</td>
<td>8.2% to 8.5%</td>
<td>7.8%</td>
</tr>
<tr>
<td>(Q4 average)</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Total PCE Inflation</td>
<td>2.5%</td>
<td>1.4% to 1.8%</td>
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Many of the risks to the forecast we cited at the beginning of 2012 tried to erupt. They were largely contained but caused concern and created uncertainty.

- The European sovereign debt, banking, and fiscal situation raised concerns at the start and mid-year, but then stabilized as some progress was made to improve fiscal arrangements and banking systems – but there is still a considerable way to go.

- We did not have a major natural disaster like the Japanese earthquake and tsunami in 2011 – but Hurricane Sandy affected the local economy.

- Oil prices were fairly stable – we did not see the surge we saw in 2011 around the Arab spring, but tensions in the Middle East caused some jitters.

- The U.S. fiscal policy situation was a major issue, and similar to the debt ceiling debacle in 2011, dampened the appetite for spending.
Although the pattern of growth varied quarter to quarter, overall growth was moderate last year. Hurricane Sandy did not change the national outlook, but likely resulted in a small reduction in growth in 2012Q4, which will be made up in 2013.

Real GDP Growth, SAAR

Quarterly data: Last point plotted is 2012Q4
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.
Economic activity continued to expand in most states in 2012

Philadelphia Fed Current Economic Activity Indexes, annualized growth over the three months ending in November 2012
It weakened toward the end of the year – but that was due to temporary factors.

Philadelphia Fed Current Economic Activity Indexes, annualized growth over the three months ending in December 2012.
After performing quite well in 2011, business investment slowed significantly last year. Many of our business contacts report that uncertainty rather than lack of profits is holding back spending and hiring.

2012Q4 for Corporate Profits is an estimate
Manufacturing activity slowed last year, even before Hurricane Sandy hit. Our BOS current activity index weakened further in February, but respondents remain optimistic about the future.

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 2013
Consumer sentiment and confidence stayed positive but low. The drop in December may have reflected concerns about the fiscal cliff.

Monthly data: Last point plotted is January 2013 for confidence and February 2013 for sentiment.
Consumer spending held up in 2012

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

Percent

-3 -2 -1 0 1 2 3 4 5 6

00 01 02 03 04 05 06 07 08 09 10 11 12

4.4 2.8 1.9 3.4 4.0 2.8 3.2 1.7 2.9 -0.3 -2.5 1.9 1.9

Percent

FEDERAL RESERVE BANK OF PHILADELPHIA
The recession destroyed wealth. Consumers have been saving more to shore up their balance sheets, so consumer spending has been growing a bit slower than its long-run average.

Billions of chain-weighted 2005 dollars

Real personal consumption expenditures

Average growth (SAAR)
Jan 1987 – Dec 2012 = 2.7%
Jun 2009 – Dec 2012 = 2.1%

Monthly data: Last point plotted is December 2012
Labor market conditions continued to improve in 2012. Job gains averaged 181 per month in 2012, about the same as in 2011.

Last month plotted is January 2013
Average monthly gains for each year are indicated by the grey lines
Total employment growth in the nation is weaker than in the 1991 recovery and earlier ones.

Cumulative % change in nonfarm payrolls since recession trough

U.S. payroll employment

Avg of 8 recoveries, 1949-1982

1991

2009

2001

Last point plotted for 2009 recovery is January 2013
Employment in our three states grew at a slower pace than in the nation, which is typical. Both the region and nation continued to lose government jobs.

Year-over-year payroll job growth, as of December 2012

Job growth
ann. yr-over-yr as of Dec 2012
US: 1.4%
3-state: 0.9%
PA: 0.7%
NJ: 1.2%
DE: 0.4%

3-state employment as share of nation: 8%
PA employment as share of 3-state: 57%
NJ employment as share of 3-state: 39%
DE employment as share of 3-state: 4%

The U.S. is over the halfway point on recovering lost jobs. Pennsylvania is outperforming the nation and the rest of the region.

<table>
<thead>
<tr>
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<th>% of jobs lost from employment peak to employment trough and % of lost jobs regained since employment trough</th>
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<tbody>
<tr>
<td>US</td>
<td>6.3% = 8.7 million jobs</td>
</tr>
<tr>
<td>PA</td>
<td>4.4% = 255 thousand jobs</td>
</tr>
<tr>
<td>NJ</td>
<td>6.3% = 260 thousand jobs</td>
</tr>
<tr>
<td>DE</td>
<td>7.8% = 34 thousand jobs</td>
</tr>
</tbody>
</table>

Incorporates January 2013 data for US (includes benchmark revisions) and December 2012 data for states.
Progress is being made: 
Compare this year’s chart with last year’s. 

% of jobs lost from employment peak to employment trough and 
% of lost jobs regained since employment trough

Percent

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<th>PA</th>
<th>NJ</th>
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<tbody>
<tr>
<td>Revision</td>
<td>6.3%</td>
<td>4.4%</td>
<td>6.3%</td>
<td>7.8%</td>
</tr>
<tr>
<td>% of jobs lost from peak to trough</td>
<td>63.0%</td>
<td>71.1%</td>
<td>32.7%</td>
<td>32.6%</td>
</tr>
<tr>
<td>% of jobs regained since trough</td>
<td>36.1%</td>
<td>51.1%</td>
<td>19.6%</td>
<td>10.0%</td>
</tr>
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</table>

Note, % of jobs lost peak to trough for 2012 and 2013 can differ because of data revisions.
The U.S. unemployment rate continued to gradually decline last year. It is down 0.4 percentage point from a year ago. The region saw an increase in the unemployment rate, especially in NJ.

Source: Bureau of Labor Statistics
Monthly data: Last point plotted is January 2013 for US and December 2012 for states
Households continue to make progress on shoring up their balance sheets.

Household debt has been declining since 2009.

Yr-over-yr growth in household debt

Quarterly data: Last point plotted is 2012 Q3
Household debt-to-disposable income continued to fall and creditworthiness is improving. The drag from deleveraging will wane over time.

Debt-to-Disposable Income

1.25% trend = growth over prior expansion 1991-2000

Quarterly data: Last point plotted is 2012 Q3
Since the steep decline in 2008, household net worth has been rising.

Source: FRB Flow of Funds, annual data for 1995-2011; quarterly data for 2012
Housing markets strengthened in 2012, but housing as a share of GDP remains near its post-WWII low

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

- 00: -1.6
- 01: 1.5
- 02: 7.4
- 03: 11.5
- 04: 4.0
- 05: 5.3
- 06: -15.7
- 07: -20.7
- 08: -24.4
- 09: -13.3
- 10: -5.7
- 11: 3.9
- 12: 14.4

Percent

0 5 10 15

00 01 02 03 04 05 06 07 08 09 10 11 12

*SAAR: Seasonally Adjusted Annual Rate
Housing as a share of the economy is near its post-WWII low

Dotted lines represent average shares from 1955Q1 – 2012Q4
Housing starts are expected to pickup to keep up with demand stemming from household formation and deterioration of the existing housing stock.

Monthly data: Last point plotted is December.
Household formation is 12-month moving avg in change in no. of households, break adjusted.
Estimated demolitions = 288 thousand per year = average difference betw. housing starts and household formation 1992-2000.
House prices at the national level began rising in mid-2012.

Quarterly data: Last point plotted is 2012Q3 for Case-Shiller and FHFA and 2012Q4 for CoreLogic; 2013Q1 Survey of Professional Forecasters (SPF)
Inflation fell in 2012 to slightly under the FOMC’s longer-run goal of 2 percent.
European sovereign debt and banking problems continued to be a risk to the global outlook in 2012 and Europe is in recession. But European countries have taken some positive steps and sovereign debt spreads have been moving down since mid-2012.
Financial markets continued to be volatile in 2012. Prices fell sharply in mid-year on concerns of the European sovereign debt crisis and the outlook for weaker global growth, and in the fall on fiscal cliff worries. But, on net, stock prices were up between 10 to 20 percent in 2012 depending on the index.
The FOMC had another active year in 2012

- **January:** Announced an inflation target of 2% and explained why it is inappropriate to set an employment target.
- **January:** Began publishing FOMC participants’ appropriate fed funds rate paths in the *Summary of Economic Projections*.
- **June:** Extended the Maturity Extension Program – Operation Twist – to year-end.
- **September:** Began a flow-based purchase program of agency mortgage-backed securities ($40 billion per month) – QE3.
- **September:** Changed forward guidance on the fed funds rate: zero rates likely *at least through mid-2015*.
- **December:** Announced a flow-based purchase program of longer-term Treasuries ($45 billion per month).
- **December:** Changed forward guidance on the fed funds rate from calendar date to economic conditions: zero rates likely *as long as $U > 6.5\%$, outlook for inflation between one and two years ahead $\leq 2.5\%$, and longer term inflation expectations remain well anchored*. 
Monetary policy accommodation increased in 2012.

The Fed has kept the fed funds rate at essentially zero for 4 years and has pushed out expectations for when the first rate hike is likely to occur.

30-year mortgage rates are around 3.5% and 10-year Treasury yields are around 2%.

Weekly data: Last point plotted is February 15, 2013
The Fed is expanding its balance sheet.

It is buying agency mortgage-backed securities at a pace of $40 billion per month and longer-term Treasury securities at a pace of $45 billion per month.
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 of 2 percent.

<table>
<thead>
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<th>Central tendency of Fed Governors and Presidents December 2012 Forecasts</th>
<th>Survey of Professional Forecasters 2013 Q1 Survey</th>
</tr>
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<tbody>
<tr>
<td><strong>2013</strong></td>
<td><strong>2014</strong></td>
<td><strong>2013</strong></td>
</tr>
<tr>
<td>Real GDP Growth*</td>
<td>2.3 to 3.0%</td>
<td>3.0 to 3.5%</td>
</tr>
<tr>
<td>Unemployment Rate in Q4</td>
<td>7.4 to 7.7%</td>
<td>6.8 to 7.3%</td>
</tr>
<tr>
<td>PCE Inflation (Q4/Q4 growth)</td>
<td>1.3 to 2.0%</td>
<td>1.5 to 2.0%</td>
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* Q4/Q4 growth for Fed forecasts and 2013 SPF; annual growth for 2013 SPF
Our latest *Survey of Professional Forecasters* projects sustained economic recovery with growth gradually accelerating.

**Real GDP**
4Q/4Q growth, SAAR

Hatched bars are median forecasts from the 2013Q1 Philadelphia Fed *Survey of Professional Forecasters*.
Currently, payrolls are about 2¼ percent below their peak. It is projected to take almost two more years of job growth to return to that level.

Monthly data: Last historical data point plotted is January 2013. Dotted line is median forecast from the 2013Q1 Philadelphia Fed Survey of Professional Forecasters.
Respondents to our 2013Q1 Survey of Professional Forecasters expect rising payroll employment will lead to a gradual decline in the unemployment rate this year.

Quarterly data: Last historical data point plotted is 2012 Q4
Dotted line is median forecasts from the 2013Q1 Philadelphia Fed Survey of Professional Forecasters

2013Q1 SPF Forecast
U = 7.5% by 2013Q4
Over the next two years, inflation remains moderate and near the FOMC’s goal of 2 percent.
As always, there are risks to the baseline forecast

- Fiscal policy remains a risk:
- Progress has been made on the European sovereign debt and banking problems, but the problems are far from solved
- Labor market dynamics have been difficult to forecast during this recovery
- Internal dynamics of the economy + effect of accommodative monetary policy and resolution of some uncertainty could be stronger than we think
- The risks to inflation are balanced in the near term but are on the upside in the medium term
  - Accommodative monetary policy
  - Concerns about large looming fiscal deficits could increase inflation expectations
  - Oil prices, as usual, are a wild card
How the U.S. decides to return to sustainable fiscal policy will matter for the economy

Important dates:
- March 2 – automatic sequestration cuts
- March 27 – possible federal government shutdown
- Late spring/early summer – debt ceiling becomes binding again

Percentage points
Government Debt as % of GDP

Actual

CBO Projections

Extended Alternative Fiscal Scenario = “Current Policy”

Baseline after the fiscal cliff deal

Extended Baseline Fiscal Scenario = “Current Law” before the fiscal cliff deal

Source: CBO: The 2012 Long Term Budget Outlook, June 2012 for extended scenarios and CBO: The Budget and Economic Outlook: Fiscal Years 2013 to 2023 for baseline after fiscal cliff deal
Majority of FOMC participants believe it will not be appropriate to raise the funds rate until 2015.
The baseline forecast

• The economic recovery continues in 2013 and 2014, with growth 2.5 to 3%, which is at or slightly above trend.
  – As some of the uncertainty on fiscal policy both here and abroad is resolved, business investment in equipment and software picks up, and firms gradually increase their hiring
  – Improvement in labor market conditions and households’ balance sheets will support consumer spending. Continued emergency UI benefits help offset the effects of the expiration of the payroll tax holiday on the macroeconomy.
  – Residential investment continues to improve, adding to growth
  – Labor markets improve. Payroll growth strengthens and the unemployment rate falls gradually to around 7.5% at the end of 2013.
• Monetary policy remains accommodative.
• Inflation moderates back toward 2%, consistent with price stability.
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