The Economic Outlook in 2014

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Key points

- Atlanta Fed President and CEO Dennis Lockhart, in a January 13 speech at the Rotary Club of Atlanta, reviews current economic conditions, the economic outlook for the year ahead, and the Fed's winding down of quantitative easing (QE).
- Lockhart says we are entering this year on a more solid economic footing than we did last year. His view is that real GDP will expand between 2.5 and 3 percent in 2014.
- Lockhart: Although the country has made a lot of economic progress, there's a fair distance yet to go before we should be satisfied. Both the employment picture and the inflation state of affairs have worrisome aspects. About 4 million more people than before the recession are unemployed today, and continued disinflation could pose risks to economic performance.
- Lockhart believes that the overall accommodative posture of monetary policy is appropriate. The FOMC has stated that it intends to keep the short-term policy rate unchanged "well past" the achievement of a 6 ½ percent unemployment rate.
- Lockhart does not expect the change in leadership at the Federal Reserve to bring a change of basic policy direction. But if all goes as expected, there is a policy transition underway from a QE world to a post-QE world.
- Lockhart concludes that economy seems poised to transition to better conditions.

Introduction

History is likely to characterize the recovery from the Great Recession as slow and frustrating. The last four-and-a-half years have been frustrating, especially to those of us who give predictions about the economic path ahead. In previous years, many of us have forecast accelerating growth only to be disappointed by developments in the year that followed.

I was not the most optimistic among my colleagues, but the outlook I offered in some of my earlier speeches here at the Atlanta Rotary didn't completely pan out. In recent years, there has been a tendency in my business to predict that the next year will be better. The repeat of "false dawns" has taught me to be cautious.

I did a little better a year ago. In preparation for today, I took a look at that speech and can claim that my forecast for 2013 mostly played out. I predicted gross domestic product (GDP) growth of between 2 and 2 ½ percent for the year. This pace of growth would be in line with the slow growth trend since the recession ended and the recovery began in 2009. Although I did not explicitly lay it out in last year's speech, I expected rather weak growth in the first half of 2013 followed by stronger growth in the second half.

The most recent estimate of full-year growth for 2013 is 2.5 percent, according to the consensus of private forecasters—and indeed, growth accelerated in the second half. The final number for third-quarter growth was 4.1 percent, and unofficial estimates for the fourth quarter, with the most recent export numbers, exceed 3 percent.

Compared to previous Januaries, we are entering this year on a more solid economic footing. A year ago, I stressed the drag of uncertainties hanging over economic activity. Fiscal policy uncertainty was most prominent. Although it wasn't always pretty, Congress got past the fiscal cliff and the fiscal drama of October. I think the weight of uncertainty holding back the economy has diminished.

So here we are again—here I am again—at an appropriate juncture to take stock of progress achieved, the state of the economy, and the challenges and risks in the year ahead. And once again, I will offer an outlook for the coming year, this time with growing confidence. That's what I intend to talk about today. I hope to provide you some context for your own business decisions in 2014. I must emphasize I am speaking only for myself, not the Federal Reserve. My colleagues on the Federal Open Market Committee (FOMC) and in the Federal Reserve System may not see things the same way.

Progress

By most measures, the economy has made significant progress since the recession ended. Financial markets have stabilized, and the banking sector overall is in a much healthier state.

Housing has made a partial comeback. Housing starts are up significantly from recession lows. House prices are rising, and foreclosures are down.

The rebound in home values has helped households repair their balance sheets and given consumers more confidence. This trend, combined with the playing out of a long deleveraging process, has put the household sector in a healthier state.

The corporate community—to generalize—is in solid financial shape, with debt down and lots of cash available for investment. Business conditions are improving broadly. Manufacturing, for example, is making a comeback. Factory output, which had been growing slowly, accelerated late in 2013. Capacity utilization in manufacturing is now at its highest level since March 2008. Motor vehicle assemblies, which are an important and growing segment of our regional manufacturing base, have reached levels approaching the prerecession peak.

Manufacturing is benefiting from lower energy costs. Total U.S. oil and natural gas production stands at historic highs. We can thank technological advances for that. The strength of the U.S. energy sector, coupled with rising international demand for American products, has generated export growth. The long-term prospects for domestic energy supplies and cost reinforce my sense that the economy's fundamentals are improving.

Outlook and risks

Now let's look ahead. I expect the stronger pace of economic growth in the second half of 2013 to continue in 2014. My current view is that real GDP will expand between 2.5 and 3 percent this year, and I would not be surprised if we achieve results at the upper end of this range.

Given this outlook for growth, it's reasonable to expect further progress on the employment front. The trend in jobs growth improved throughout most of 2013, notwithstanding the surprisingly soft initial reading for December. The unemployment rate declined to 6.7 percent in December, about a year sooner than forecasters were expecting when the year began. Despite this improvement, about 4 million more people than before the recession are unemployed today. In a moment, I'll provide much more detail, but here's the point regarding employment. While we've made substantial progress, we are far from a satisfactory situation. Hold that thought!

To round out my outlook for 2014, let me say a word on inflation. Rising inflation is not currently a problem. If anything, inflation is too low—well below the FOMC's longer-term objective of 2 percent. I see inflation rates moving gradually toward that objective as economic growth gains momentum. Again, I want to come back to the subject of inflation, so please also hold that thought—too low, not too high.

Forecasting is not a very certain exercise. It breeds humility. Things can go wrong. I mentioned at the beginning that disappointment followed earlier forecasts. Things have gone wrong in past years that slowed the recovery. To name two, there have been global financial problems, particularly coming from Europe. More recently, fiscal policy uncertainty and some amount of fiscal drag have disrupted the pace of improvement. A replay of these factors is not in my baseline outlook.

In fact, if I gauge the risks around the outlook I've laid out here, I conclude that the risks (the downside risks, to be more precise) have lessened. The restraining effects of federal fiscal measures should diminish this year. That's one of the key reasons my growth outlook is more optimistic.

Employment

So now let me make my main point. While the country has made a lot of progress economically, and the economy appears to have some bounce in its step as we enter 2014, there's a fair distance yet to go before we should be satisfied. Both the employment picture and the inflation state of affairs have worrisome aspects.

Let's first take a deeper look at employment. As I mentioned earlier, the unemployment rate—the share of the labor force not working—has come down significantly since the recession began. It doubled from 5 percent at the end of 2007 to almost 10 percent at the end of 2009, when employment trends began to improve. As of last Friday's report, the unemployment rate now stands at 6.7 percent. Sixty-five percent of the increase in the unemployment rate caused by the recession has been reversed.

I don't often resort to slides in my speeches, but I want to back up my central point as vividly as possible. One way to look at the nation's employment conditions is utilization of the country's labor resources. I'll use a familiar image (a football field) as a backdrop to make the argument that the unemployment rate is far from the whole story. Progress in the employment sphere has been uneven.

Using the prerecession peak as the goal line, in terms of the unemployment rate, we've gotten the ball 65 yards down the field.

But the unemployment rate is influenced by labor force participation, and there has been a sizable decline in the share of the population in the labor force since 2009. This explains how you could get a big drop in the unemployment rate with anemic job gains, as occurred in December.

Some of the decline in labor force participation since 2009 is due to the baby boomers retiring, but even among prime-age workers—those aged 25 to 54—the participation rate is down significantly. This suggests that other factors, such as low prospects of finding a job, are playing a role.

To examine this possibility, we can look at the sum of *marginally attached workers*. These are people who say they are willing to work and have looked for work recently but are not currently looking. During the recession, their numbers swelled. Using our football analogy, we've gained (or regained) only 12 yards of the ground lost (the increase in the marginally attached) from 2007 to 2009. It's accurate to say the country has a large number of people in the so-called "shadow labor force."

Some economists have suggested that, because of the challenge of interpreting the decline in labor force participation, it might be more illuminating to look at the share of the population that is working. When we look at the *employment-to-population ratio* for the prime-age group (aged 25 to 54), the picture is similarly discouraging. Since the end of 2009, employment gains for the core of the workforce have advanced down the field only 27 yards toward the prerecession peak.

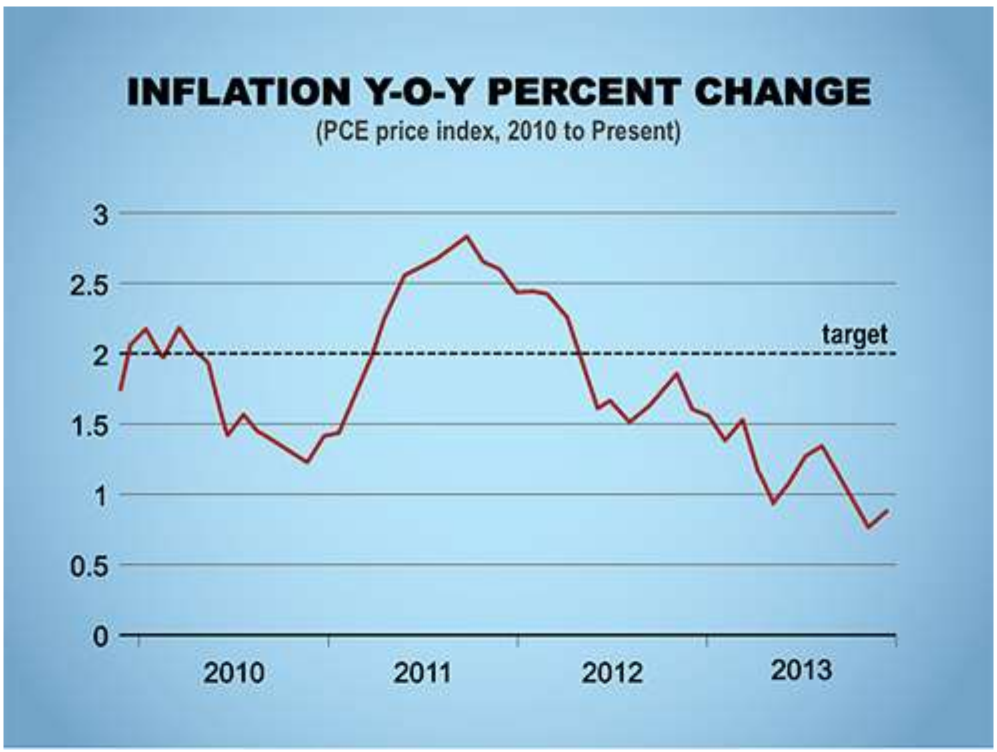
Also, there is the issue of underemployment. Many Americans are working fewer hours than they would prefer because their employers are offering them only part-time work. The share of workers who are involuntarily working part time doubled during the recession and has moved only about 30 percent lower since the employment recovery began. In football terms, we've advanced the ball only 31 yards on this measure of labor utilization.

To sum up, these comparisons of employment data suggest that the labor market is not as healthy as the improved unemployment rate might indicate. The unemployment rate drop may overstate progress achieved.

It's worth noting that wage and salary income growth remains weak. I hear very little from business contacts about upward wage pressures except in a few specialized job categories. Wage pressures usually accompany growing demand and rising inflation but, although demand appears to be growing, inflation is very soft.

Inflation

The Federal Reserve has chosen an inflation target of 2 percent over the longer term.



Such a target is far enough away from the deflation danger zone and yet low enough to be ignored by businesses and households in their longer-term decision making.

Over the past 12 months, inflation has averaged only 0.9 percent. Indeed, the broad patterns in the price data suggest we have been on a disinflationary trend for about two years, as shown in this slide.

Continued disinflation could pose risks to economic performance. This slide shows the trend of one key measure of inflation (the personal consumption expenditures inflation index) over the last four years. At the Fed, we follow a number of inflation indices, and they show basically the same picture.

The inflation situation shown here seems disconnected from the recent growth momentum and the outlook that it will continue.

As I mentioned earlier, I think inflation will stabilize and begin to move back in the direction of the FOMC's 2 percent objective as the economy gathers momentum. So I'm interpreting the soft inflation numbers as a risk signal. Through the lens of prices, the economy could be weaker than we currently believe.

I talk with a lot of business people across the Southeast. Very few claim to have much pricing power. At the same time, inflation expectations—measured by surveys and inflation-adjusted financial instruments—have remained stable. There are no signs of disinflationary expectations being priced in. This gives me some confidence that inflation will firm.

Policy

Let me conclude with a brief discussion of the Federal Reserve's monetary policy. The overall posture of policy is very accommodative, as we central bankers say, and appropriately so, in my opinion.

In earlier communications, the FOMC set a threshold of 6 ½ percent unemployment as a condition for consideration of raising rates. In our most recent statement after the December meeting, the Committee communicated its intent to keep the short-term policy rate unchanged "well past" the achievement of a 6 ½ percent unemployment rate. I think this, too, is appropriate. As my football field representation showed, on what you might call a qualitative basis, we have a substantial employment gap. And, as of now, the inflation data indicate disinflation, which is also worrisome.

As I'm sure you know, the FOMC decided at its December meeting to begin reducing the amount of monthly asset purchases by $10 billion a month—that is, from $85 billion a month to $75 billion. This was the well-publicized "tapering" decision to phase out quantitative easing, or QE. This decision acknowledges progress made—especially in the employment realm—and improving confidence in the outlook.

If the positive outlook I've outlined plays out, I would support similar tapering steps over the course of this year. Of course, the Committee will assess how things are going, economically speaking, at each meeting, and decide on the next step.

At the end of one year and the beginning of another, it's tempting to attribute more and deeper historic significance to the turning of the calendar page than often turns out to be real. That said, 2014 does look to me to be a year of transition.

There will be a transition of leadership of your central bank—that is certain. Janet Yellen will become chair on February 1. I do not expect the leadership change to bring a change of basic policy direction, however.

If all goes as expected, there is a policy transition under way from a QE world, so to speak, to a post-QE world. As I said, that decision was made in December.

And the economy itself seems poised to transition to better conditions. I hope I can return in a year and report I had it right.