



# Cloudy with a Chance of Growth

## Lackluster. Anemic. Sluggish. Whichever adjective you might choose, most observers agree that the U.S. economy has grown more slowly during this recovery than in past recoveries. What are economic forecasters telling us to expect next year?

Economic forecasting is a mercurial and difficult process. Still, it is clear to most economic forecasters that the current recovery has been disappointing and the economy has consistently underperformed. Take, for example, the economic forecasts of the Federal Reserve. The Federal Open Market Committee (FOMC), the Fed's main policy-setting body, releases quarterly with its minutes a Summary of Economic Projections (SEP) for economic growth, inflation, and unemployment, among other variables. In November 2011, the rough average of FOMC-member submissions for real GDP growth in 2012 was 2.7 percent (from fourth quarter to fourth quarter). But growth this year is likely to be about a full percentage point lower than that projection, at or slightly below 2 percent. Similarly, the FOMC had projected 2011 growth to be 3.3 percent, but it was 2 percent. And expectations for growth in 2010 were 3 percent while actual growth was 2.4 percent. The most recent FOMC forecast for 2013, made in December 2012, averages about 2.65 percent.

Many other forecasters have also seen actual growth rates fall below their projections over the last few years, and their forecasts for 2013 are relatively weak. As of December 2012, the Blue Chip Consensus Outlook—the average projections from a panel of more than 50 professional economic forecasters in both the public and private sectors—expects 2013 real GDP to grow at 2.2 percent (fourth quarter to fourth quarter), which is a slightly more pessimistic outlook than the FOMC's.

The Congressional Budget Office (CBO), in a recently released report (*What Accounts for the Slow Growth of the Economy after the Recession?*), estimated that growth since the official end of the recession has been less than half the rate

of past post-World War II recoveries. As analysts look ahead to 2013, they expect gradual improvement, but major economic challenges remain, including trying to improve the economy's underlying potential (see the sidebar on page 4). The most consequential effect of the slow recovery is that unemployment has remained painfully high.

### **Labor market improves, but remains in the doldrums**

The U.S. Bureau of Labor Statistics survey of establishments found that the average monthly increase in payroll employment (as reported by businesses, not households) for January through November 2012 was about 150,000. This rate is well below the 200,000 to 250,000 net new jobs per month that many economists estimate must be added not only to keep pace with population growth but also to make progress in lowering the unemployment rate.

The Jobs Calculator is a tool on the Atlanta Fed website ([frbatlanta.org/chcs/calculator/](http://frbatlanta.org/chcs/calculator/)) that allows users to specify a target unemployment rate and the number of months for the target rate to be achieved. When these numbers are entered, the calculator returns the average monthly payroll employment change that would be required, using assumptions about the labor force participation rate and other variables. For example, as of November 2012, the national unemployment rate stood at 7.7 percent. For the unemployment rate to decline to 6 percent within two years, the average monthly payroll increase would have to be about 210,000 jobs. In the fourth quarter of 2011, the FOMC had projected that the unemployment rate would average between 8.5 and 8.7 percent in the fourth quarter of 2012, but it

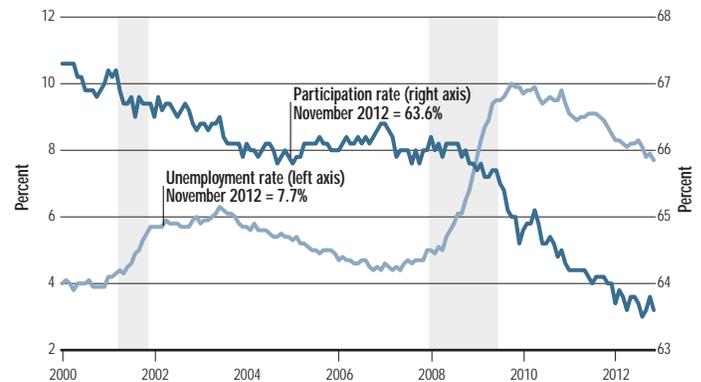
## Cyclical versus Structural Growth Issues

The Congressional Budget Office's (CBO) recent report (*What Accounts for the Slow Growth of the Economy after the Recession?*) estimated that two-thirds of the difference between this recovery and the average of past recoveries is attributed to slow growth in potential gross domestic product (GDP). As the CBO defines it, potential GDP is "an estimate of the amount of real GDP that corresponds to a high rate of use of labor and capital resources." (Economists debate how to estimate and use potential GDP, but this sidebar does not focus on the CBO's methodology.)

According to the CBO, the slow growth in potential GDP over the last three years is mostly a long-term trend—such as the nation's changing demographics—and so is unrelated to the current recession. In fact, the growth of potential GDP has been trending downward for the last 50 years. The aging and retirement of the baby boomer generation has slowed the growth of the potential labor force, as has the leveling off of the growth in female labor force participation. The slowing in productivity growth and a lower amount of investment in the nation's capital stock are the other primary factors behind lower potential GDP.

Most of the economic issues related to potential GDP are structural in nature. That is, they are related to the underlying dynamics of the economy rather than to cyclical factors attributed to the ebb and flow of the business cycle. And a wide range of economic policies affect the structural economy: tax, international trade, and labor market policies, as well as demographic trends, retirement, health care, and other issues. So, if lower potential GDP is two-thirds responsible for the weakness of the current recovery, according to the CBO, the other third is attributable to the slowing of real GDP as a ratio of potential GDP—the cyclical component. While the Federal Reserve analyzes structural economic phenomena during the process of setting monetary policy, its primary focus is often on cyclical factors. But lurking in the background are larger economic policy problems that will need to be addressed. ■

Chart 1  
Unemployment and Labor Force Participation Rates



Note: Data are seasonally adjusted. Gray bars indicate recessions.  
Source: U.S. Bureau of Labor Statistics

was actually 7.9 percent, seemingly rendering the FOMC's past forecast overly pessimistic.

Part of the improvement in the headline unemployment rate, despite only modest employment growth, is the result of a suppressed labor force participation rate. This rate, currently down nearly two percentage points from when the recession ended in June 2009, is at its lowest level in nearly 30 years (see chart 1). Demographic trends—in particular, the aging of the baby boomer generation—explain some of this decline, but the CBO attributes a significant part of it to the recent recession. So even though the unemployment rate declined more than expected, the underlying labor market fundamentals remain weak. For 2013, the Blue Chip panel projects a modest decline of the unemployment rate, to only 7.6 percent.

Another consequence of slow employment growth is that long-term joblessness has been remarkably high. The fraction of the unemployed who have been out of work for 27 weeks or longer is 39.8 percent as of November 2012. (Until November, however, the number had been above 40 percent since the end of 2009.) The rate has improved just slightly from its peak of over 45 percent in 2010, but these postrecession levels are higher than at any time since 1947.

As economists project some improvement in the unemployment rate in 2013, structural labor market challenges are likely to remain daunting. If labor force participation recovers, the United States will need substantially faster growth to bring down the unemployment rate.

### Business investment and exports weaken

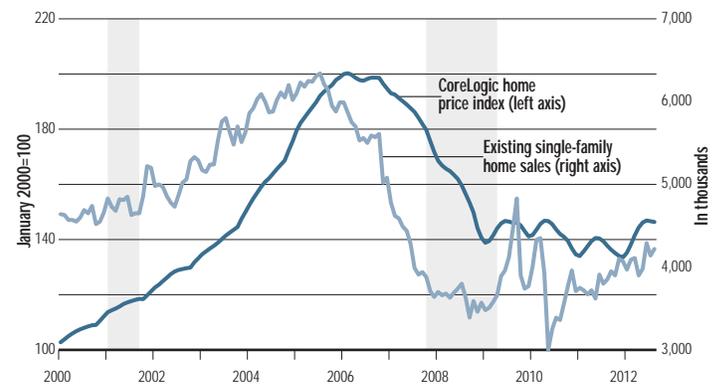
Two components of growth that have performed relatively well during the recovery are business investment and exports. However, some factors indicate that these sectors may be weaker in

2013. Consider business investment, for example. Spending on equipment and software (E&S) rose sharply in the early part of the recovery after a steep decline during the recession. Since its low point in the second quarter of 2009, inflation-adjusted E&S spending has been up 30 percent. In fact, the CBO estimated that business investment had been relatively *stronger* in this recovery than in other postwar recoveries. But in 2012, E&S spending leveled off from its double-digit 2011 growth. This investment slowdown is mostly a response to a weakening sales outlook. Other drags include slowing global growth and uncertainty about the fiscal cliff. For 2013, the Blue Chip panel projects 5.2 percent (year-over-year) growth in nonresidential fixed investment, which, in addition to E&S investment, includes businesses' nonresidential structures investment. This projection is almost three percentage points below the growth the panel expected for 2012.

One of the reasons total business investment has slowed in recent quarters is the weakened outlook for exports resulting from the slowing global economy. The U.S. recovery has certainly been disappointing, but European growth has been anemic on net—and a number of European countries are back in recession. At the same time, a number of the emerging economies that powered through the Great Recession—notably, China—are now slowing.

The International Monetary Fund's (IMF) World Economic Outlook estimated that world output growth (year over year)

Chart 2  
Housing: Sales and Prices



Note: Data are monthly and are through October 2012.  
Source: CoreLogic; National Association of Realtors

would slow from 5.1 percent in 2010 to below 4 percent in 2011 and 2012. It projected only 3.6 percent growth for 2013. China, which averaged double-digit output growth over much of the past few decades, slowed to 7.8 percent in 2012, and the IMF forecasts 8.2 percent growth for 2013. Euro zone economies contracted 0.4 percent in 2012, according to the IMF, and are expected to grow negligibly in 2013.

Against this backdrop, U.S. net exports held up well through 2012. Indeed, net exports were most often a positive contributor to real GDP growth in 2011 and early 2012 and were relatively stronger, along with business investment, than in past recoveries. However, for only the second time since the recovery began, real exports fell below 2 percent growth in the third quarter of 2012. In addition, the trade-weighted U.S. dollar exchange rate strengthened about 5 percent in 2012 through the third quarter. If the weakening of global growth prospects and the relative strengthening of the dollar continue, net exports could exert a greater drag on growth than expected. Like business investment, exports powered the early parts of the recovery but have a weaker outlook for 2013.

### Housing market revives

On a brighter note, the housing market, which led the economy into recession and showed no growth for much of the recovery, began to show signs of life in 2012. Because of the overbuilding of homes during the housing boom, residential investment, which usually leads a recovery, was a cyclical drag on growth, according to the CBO. But in 2012, construction, home sales, and house prices all trended up. Sales of newly built single-family homes were 17 percent higher in October 2012 than they were a year before. And existing single-family home sales rose nearly 10 percent.



This growth is of course relative to a very depressed level, but the trend is encouraging.

As of October 2012, the “months of unsold inventory” for new and existing homes—as measured by the Census Bureau and the National Association of Realtors, respectively—hit its lowest levels since 2005. Reflecting this tightness in the market, the widely watched CoreLogic home price index rose 4.6 percent between the third quarters of 2011 and 2012. Like the larger residential market, business investment in nonresidential structures (mostly commercial and industrial buildings) was declining when the recovery began, and bottomed out in the first quarter of 2011. It has since risen 20 percent. Given the dearth of new construction during the recession and the initial recovery, most private-sector forecasters expect housing to be a bright spot for the U.S. economy in 2013 (see chart 2 on page 5).

### Consumer spending declines

Consumer spending, the largest component of growth, has an uncertain outlook for 2013. During the recession (from the third quarter of 2007 to the second quarter of 2009), household wealth fell by \$15 trillion, or 22 percent. Since then, household wealth has risen 24 percent, but it is still about \$2.5 trillion short of its previous peak. Tied to the change in household wealth is a reduction in household liabilities, or debt. During this recovery, consumers have spent less, saved more, and paid down (or discharged) debt, all while confronting a sluggish labor market and high rates of joblessness.

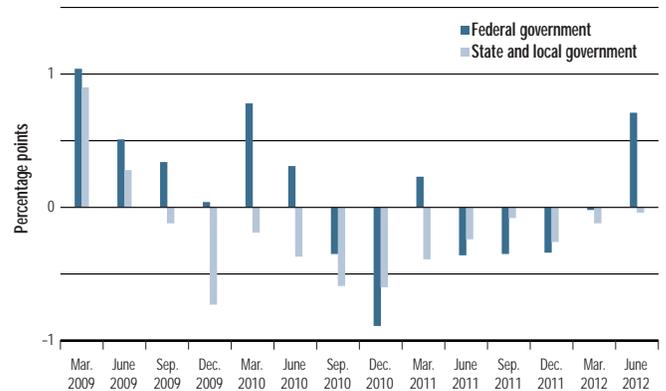
This process of “deleveraging,” in which we see a mass movement by households to lower their ratio of debt to income, is a painful process. Initially, these suppressed spending habits lowered aggregate demand. Since the recession ended in June 2009, quarterly real personal consumption expenditures (PCE) growth has averaged 2.1 percent, compared with a 2.9 percent average over the three years of recovery following the 2001 recession. In the near term, analysts expect deleveraging to continue but at a slower rate, and consumption growth to expand only modestly. According to the Blue Chip panel, real PCE should grow 2 percent in 2013 (fourth quarter over fourth quarter) and 2.3 percent in 2014 and 2015.

### Government expenditures also underperform

Declining government spending has been the largest single cause of the weak recovery, according to the CBO (see chart 3). Although automatic stabilizers—such as greater safety net expenditures, along with the stimulus bills—probably alleviated the recession in 2009, the subsequent recovery has been slowed by massive retrenchment by state and local (S&L) governments. The relatively weaker levels of state and local government purchases have lowered cyclical growth by a full percentage point over the course of the recovery, according to the CBO. Reductions in S&L government employees, the majority of them

Chart 3

Government Expenditures: Contribution to Real GDP Growth



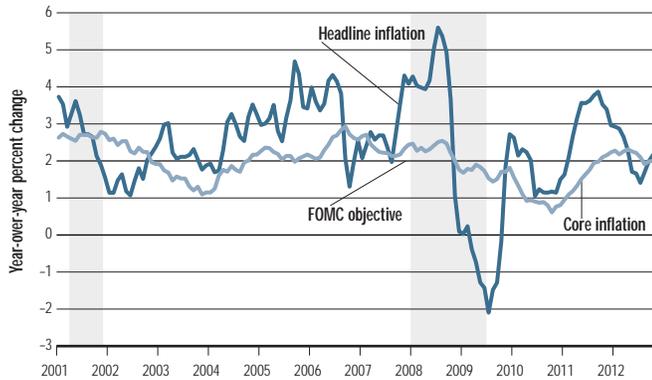
Note: Data are quarterly and are through third-quarter 2012.  
Source: U.S. Bureau of Economic Analysis

teachers, and lower government purchases and construction have combined to be the largest drag on the recovery. In addition, federal expenditures—defense purchases, in particular—declined later in the recovery, reducing growth by an additional three-fourths of a percentage point.

It is important to note that this conclusion by the CBO—the notion that lower government purchases mean less support for



Chart 4  
Consumer Price Index



Note: Data are through October 2012.  
Source: U.S. Bureau of Labor Statistics

the economic recovery—is controversial among some economists. If the economy is operating at potential (which means, basically, full employment), economists generally think that additional government purchases just crowd out private-sector activity. However, when the economy is operating below potential, this is not the case (see the sidebar on page 4). Thus, during the weak recovery, the CBO estimates that relatively lower government spending, across all levels, lowered cyclical growth

**As analysts look ahead to 2013, they expect gradual improvement, but major economic challenges remain.**

more than did weak residential investment and slower consumer spending combined. And with the fiscal cliff negotiations being arguably the most important unknown variable for the outlook in 2013, this issue is not going away.

**Inflation outlook and future threats to the economy**

Despite unprecedented interventions by the Federal Reserve, inflation has remained remarkably subdued. Year-over-year changes in the consumer price index (CPI) declined from 3 percent at the start of 2012 to 2 percent, or possibly just below. Energy prices and global commodities are generally large drivers of the fluctuations in the headline CPI index. Because they are more volatile than other components, they are not as representative of underlying inflation inertia. When we look just at core inflation measures—that is, everything but food and energy—prices have

been much more stable, fluctuating between 2 and 2.3 percent in 2012 (see chart 4).

Arguably more important than these inflation measures are inflation expectations. Current market-based measures show medium-term inflation expectations of around 2.75 percent per year. Forecasters projecting headline CPI in 2013 and beyond generally put inflation below 2.5 percent.

As mentioned at the start of this article, economic forecasting is a mercurial exercise. Not only are the underlying components difficult to forecast, but unexpected shocks to the economy can wreck earlier projections. Throughout this recovery, a series of negative economic shocks—including the rapid rise in commodity prices last year, euro zone troubles, and brinksmanship over raising the U.S. government’s debt ceiling—have negatively affected sentiment and growth. And looking ahead, the ongoing economic and political fragility in the euro zone continues to be a concern. Conflict in the Middle East could spike energy prices. But the most immediate threat to the U.S. economy is the fiscal cliff.

What is the fiscal cliff? In short, it is about \$600 billion in legislatively mandated tax increases and spending cuts scheduled to begin in January. The CBO, the Federal Reserve Board, and most other policymaking bodies project that full implementation of these tax increases and spending cuts would push the U.S. economy off the cliff into another recession. The CBO, for instance, projects that U.S. real GDP would decline by 3 percent in the first half of 2013 in a scenario of no congressional action.

In addition to the direct negative shock to output that is likely to occur if the U.S. economy goes off the cliff in 2013, this potential event has indirectly restrained investment activity in 2012 because of heightened uncertainty over tax rates and the near-term economic outlook. In the current political environment, it is impossible to project the course of negotiations to come.

In conclusion, it is fair to say that most analysts project that the U.S. economy will continue growing in 2013, though not spectacularly—barring a shock such as the fiscal cliff. Growth will be modest; progress against unemployment will be gradual; and inflation will remain in check. ■

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