Good News, Bad News in 2010 Color Outlook for 2011

Over the course of the past year, the U.S. economy exhibited some signs of renewed health—increased spending by consumers and more robust business investment, for example—but also persistent headwinds. The relative weakness of some significant economic fundamentals is likely to restrain growth in 2011.

In September 2010, the National Bureau of Economic Research—the body that determines the start and end dates of recessions—declared that the Great Recession had come to an end in June 2009. At 18 months in duration, it was the longest contraction in real gross domestic product (GDP) since the Great Depression (which was more than twice as long at 43 months). The 2007–09 downturn lasted about eight months longer than the average of the other 11 recessions since World War II, though just barely longer than the relatively severe contractions in 1981–82 and 1973–75, both of which lasted 16 months.

Technically, the U.S. economy has been expanding for nearly a year and a half. During the first three quarters of 2010, GDP expanded at an average pace of 2.6 percent, compared with an average pace of just 0.25 percent in 2009. The economy went from losing an average of about 390,000 private sector jobs every month in 2009 to gaining an average of just over 100,000 per month through October 2010. Business investment spending increased briskly, and even consumer spending picked up. All much welcomed progress.

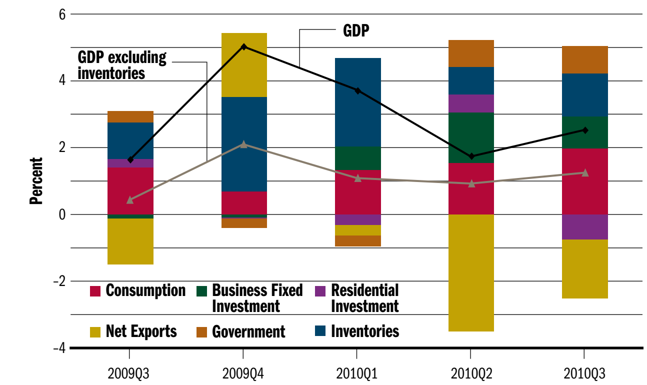
Despite these improvements, economic performance has been somewhat disappointing. The recovery has not been strong enough to meaningfully reduce the unemployment rate. Throughout the year, the unemployment rate has remained well above 9 percent. Income growth (excluding transfer payments made by the government) has been weak—up less than 1 percent for the year on an inflation-adjusted basis. The housing market is struggling in the face of continuing foreclosures despite a variety of tax incentives and historically low mortgage rates, and the commercial real estate sector likewise has not recovered. This theme of improvement in some areas and ongoing weakness in others illustrates the unevenness of the recovery and more uncertainty than normal about future economic prospects.

2010: Off to a fast start, and then...

The economy appeared to enter the year with substantial momentum. After expanding at an annual pace of nearly 6 percent in the fourth quarter of last year, GDP rose at a still-healthy rate of 3.7 percent in the first quarter. Better-than-expected increases in several economic indicators in the spring led many economists to revise up their growth estimates. A quick snap-back in the economy, as has been typical in most other deep recessions in the post–World War II era, seemed a distinct possibility.

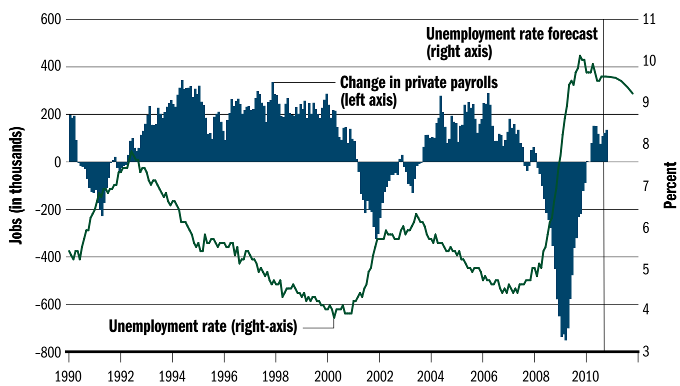
However, such a snap-back was not to be. It is now clear that some of the rebound in growth stemmed from a rebuilding of depleted inventories in the first quarter (see chart 1) and the waning influence of various government spending programs. By summer, the incoming economic data had weakened considerably, and the pace of expansion in the major expenditure categories raised the specter of a step backward into contraction. Indeed, research from Marcelle Chauvet, an economist

Chart 1
Contributions to GDP Growth



Source: U.S. Bureau of Economic Analysis

Chart 2
Labor Market Weakness



Note: The payroll data reflect change on a three-month average.
Source: U.S. Bureau of Labor Statistics, Blue Chip Economic Indicators (Nov. 10, 2010)

at the University of California, Riverside and formerly at the Atlanta Fed, indicated that the probability the United States was in recession had risen to a troubling 28 percent in June, up from just 2 percent in April.

With the benefit of hindsight, both the optimism of the early part of the year and the pessimism that developed in the summer may have been overreactions to the vagaries of short-term data. Bumpy growth for an economy transitioning out of a recession is not unusual. For example, GDP jumped by 3.5 percent in the quarter immediately following the end of the 2001 recession, but it then slowed to just 0.1 percent three quarters later. To date, that pattern of growth proceeding in fits and starts has certainly been representative of this recovery.

Growth and its challenges

Growth in consumer spending has improved during the year, outpacing total GDP growth in the second and third quarters. But it remains constrained by high unemployment, weak income growth, lower housing wealth, and tight credit. The weakness of the labor market has particularly been weighing on households. Chart 2 shows that employment has failed to rebound with the vigor necessary to substantively reduce the unemployment rate, which was 9.8 percent in November compared with 9.7 percent in January.

Wages and salaries, which account for just over half of total personal income, are edging up at their slowest postrecession pace since the data were first collected in 1959. Firms have noted that in some cases they have had difficulty finding workers with the needed skills, scarcity that has in some cases pushed up wages for specific types of workers. But the combination of a large number of unemployed workers looking for jobs and a general hesitancy on the part of firms to hire has restrained wages considerably.

In addition to the dampening effect of weak wage growth, consumption spending has been restrained as households have continued on their path of aggressive deleveraging, or debt reduction. In fact, consumers have made significant headway in repairing their finances. The percentage of disposable income going to service mortgage and consumer debt fell sharply to 12 percent in the second quarter of 2010, which was its lowest level in a decade (see chart 3). Consistent with the movement toward greater frugality, the consumer savings rate has been maintained at levels significantly higher than was seen before the recession. While the efforts to repair household balance sheet positions bode well for the future, they are acting as an impediment to near-term consumption growth.

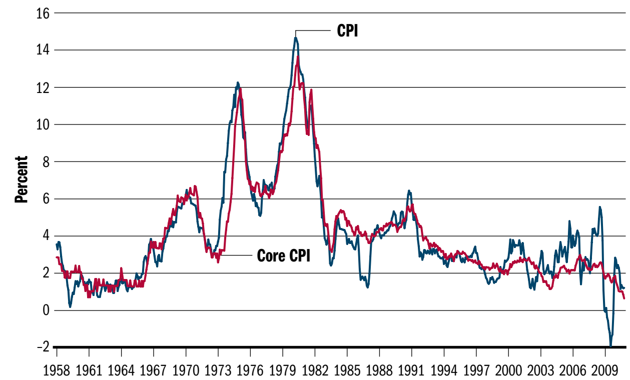
Despite a temporary boost during the spring associated with the homebuyers' tax incentives, activity in the housing market remains depressed. New single-family home sales have remained close to their lowest levels since the government began compiling the monthly statistics in 1963. At just over 4 million, the number of existing homes available for sale would take nearly 11 months to clear at the current sales pace—a much higher pace than the historical average of about seven months for single-family homes. If the number of homes going through the foreclosure process (frequently referred to as the shadow inventory) is factored into the estimate, the months' supply of homes doubles to nearly two years.

Furthermore, many mortgages have principal balances that are greater than the homes' current value. CoreLogic estimated that the share of mortgages with negative equity was about 23 percent in the second quarter of 2010. These data suggest that

Chart 3
Debt Service Ratios and Saving Rates

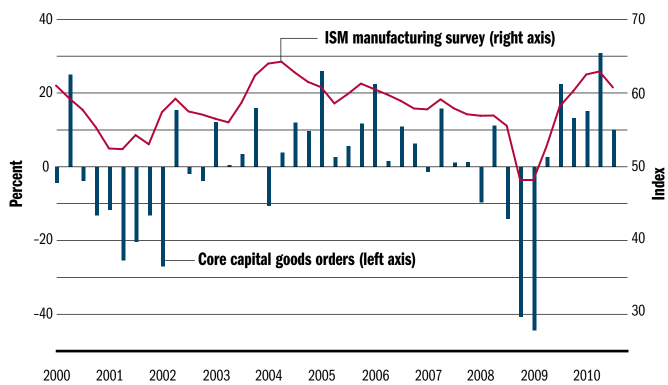
Source: U.S. Bureau of Economic Analysis and Federal Reserve Board

Chart 5
Inflation, 1958–2009



Note: Core CPI excludes food and energy.
Source: U.S. Bureau of Labor Statistics

Chart 4
Manufacturing Activity, 2000–10



Note: Core capital goods orders represent annualized quarter-over-quarter percent change. Manufacturing survey data represent a quarterly average, with greater than 50 representing expansion.
Source: U.S. Census Bureau and Institute of Supply Management

defaults and foreclosures will likely remain elevated for some time. Taken together, the supply and demand imbalances are likely to place additional downward pressure on home prices, further impeding household wealth and restraining construction activity. With housing continuing to work through immense difficulties, this sector is unlikely to contribute much to near-term growth.

One of the brightest spots in 2010 has been the pace of business investment, which is crucial for the economy's long-run productive capacity. Equipment and software (E&S) investment skyrocketed at an average annual rate of over 20 percent during the first three quarters of the year, with some of that rebound stemming from replacement that was postponed during the recession. Although recent indicators, such as capital goods orders and manufacturing surveys, indicate that the rapid pace of E&S investment and industrial activity has slowed some, the pace of business investment remains quite healthy (see chart 4).

The travails in Europe that have played out over the course of the year have somewhat clouded the picture, but many developing economies have been expanding briskly. In general, countries around the world have been, like the United States, on the road to recovery, spurring demand for U.S. exports and contributing to overall domestic growth in 2010.

Inflation falls to historic lows

For consumer prices, 2010 was a historic year. The core consumer price index (CPI)—a widely used gauge of inflation measuring year-over-year price changes, excluding volatile food and energy prices—slid to its lowest level on record (see chart 5). The magnitude of the underlying disinflation, combined with the apparently large amount of unused capacity in the economy, has introduced a more recent concern: the possibility of outright price declines, a scenario known as *deflation*. Atlanta Fed economist Patrick Higgins used data from the Treasury Inflation Protected Securities (TIPS) market to estimate the probability of deflation in the next five years, finding that this probability had jumped from 13 percent in early May to about 30 percent in August 2010. Perhaps not surprisingly, this period of time was also associated with declines in inflation expectations derived from TIPS yields (though measures based on household surveys and surveys of professional forecasters moved little).

Concerns about the potential for further unwanted disinflation have received considerable attention by the Federal Open Market Committee (FOMC), as indicated in its November 3 policy statement: "[M]easures of underlying inflation are somewhat low, relative to levels that the Committee judges to be consistent, over the longer run, with its dual mandate." In choosing to provide additional monetary stimulus in the form of purchasing $600 billion in Treasury securities by the end of the second quarter of 2011, the FOMC was following through on a policy action that had been building since Chairman Bernanke discussed the policy at the Kansas City Fed's annual economic symposium in August. It is notable that, since August, TIPS-based estimates of expected inflation and deflation probabilities have returned to their levels of last spring.

Looking ahead to 2011

The November 2010 Blue Chip consensus forecast calls for GDP to finish 2010 at about 2.4 percent higher than a year earlier and foresees growth averaging 2.9 percent in 2011. The unemployment rate is expected to remain elevated, declining to only 9.1 percent by the fourth quarter of 2011 (see chart 1), and CPI inflation is forecast to rise by an average of 1.7 percent during 2011.

At least part of the evolution in the labor market will depend on how much unemployment stems from structural factors, such as a mismatch of skills between job seekers and employers, and how much is attributable to cyclical factors, such as a decline in spending on goods and services. The divide between the two is crucial because they imply different amounts of economic slack, wage and price pressures, and policy prescriptions—all key variables of the outlook. While the debate among labor market experts is ongoing and opinions vary greatly, Atlanta Fed President Dennis Lockhart recently provided his view on the topic: "In my opinion, the evidence either way is not conclusive. My best assessment is some unemployment is structural in nature and some of it represents weak demand. That so-called natural rate of unemployment is probably now well above the very low level of joblessness we saw prior to the recession, but it is not the current rate of 9.6 percent."

The incoming data as well as reports from the Atlanta Fed's business contacts are broadly consistent with a relatively restrained growth trajectory. There are, in fact, several factors that will plausibly inhibit the pace of the expansion. Weakness in residential and commercial real estate is ongoing. Business and consumer attitudes are still extremely cautious, and slow spending growth by businesses and households is continuing to hold back inflation. Over the near term, additional business spending appears likely to be geared primarily toward activities such as targeted mergers and acquisition and further increases in efficiency rather than toward pure expansion. Slow and uneven sales, opportunities to reduce costs through increased productivity, structural adjustments in labor markets, and uncertainty over government policy—including changes in labor and environmental rules, tax policy, and financial regulations—are restraining job creation. Slow job growth, naturally, implies that unemployment could remain elevated for some time.

Of course, risks lurk on both the upside and downside for the outlook, but there are reasons for optimism. Financial firms and households have made significant headway in repairing their severely compromised balance sheets, and most are in a much better financial position than they were a year-ago. Businesses in particular have substantially more liquidity and significant capacity to deploy capital to new projects. Some of the uncertain-

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ties that have vexed private decision makers, such as the course of near-term tax policy, may finally be abating.

To date, the apparent reluctance of businesses to expand seems to derive from a perception that the risks are not worth the uncertain rewards. But rising confidence among both businesses and households will be critical in driving their spending decisions. Rising confidence is one of the critical factors affecting how quickly the process of economic recovery accelerates. Recent surprises in the economic indicators have been predominantly to the upside, which is a very good sign. If such positive surprises persist, and confidence in the economic environment grows, it could be that current estimates for only slight improvement in 2011 have been too modest. ∎

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