Twelfth Federal Reserve District

FedViews

Economic Research Department
Federal Reserve Bank of San Francisco
101 Market Street
San Francisco, CA 94105

Also available upon release at
www.frbsf.org/publications/economics/fedviews/index.php

February 14, 2013

Bart Hobijn, senior research advisor at the Federal Reserve Bank of San Francisco, states his views on the current economy and the outlook.

- The initial estimate of gross domestic product (GDP) growth in the fourth quarter of 2012 was a slightly negative –0.1% at an annualized rate. The quarter's weak GDP was due to various one-time factors including a sharp decline in inventory investment and a historic drop in defense spending. We don't believe these factors will continue to put negative pressure on economic growth or stifle the pace of the recovery. Importantly, private-sector final demand for goods and services was strong in the fourth quarter. Consequently, we forecast that GDP growth in 2013 will probably be about a percentage point stronger than in 2012, that is, 2.7% versus 1.5%.

- We see two risks that economic activity could be weaker than our forecast. The first stems from greater fiscal austerity. With the March 1 sequestration deadline looming, substantial additional cuts in federal spending have become more likely. The second risk reflects the continued economic weakness in Europe and the possibility of a resurgence of strains in the global financial sector. If either of these risks materializes, a sizable drag on U.S. economic growth would result.

- In the absence of such events, we anticipate that the unemployment rate will continue to decline at about the same pace it has fallen over the past two-and-a-half years, reaching 7% by the end of 2014. Continued labor market slack and a moderate pace of recovery are likely to keep inflationary pressures subdued. We expect inflation to come in below the Federal Reserve's 2% target over the next two years.

- In the short run, the subdued pressures on prices are showing up in a broad set of inflation measures. Importantly, these measures are very much in line with our main inflation gauge, the personal consumption expenditures (PCE) price index. Moreover, we do not see any significant changes in longer-term inflation expectations, whether in financial markets, private-sector forecasts, or surveys of households. Thus, inflation expectations remain well-anchored.

- Over the past year, house prices have risen about 7.5%. Private residential investment, which is the main component through which housing affects GDP, has increased 11.9%. These are signs of a robust turnaround in the housing market. An important question is how such a housing recovery will affect overall economic activity and job creation.

- As far as housing is concerned, new home sales are the main direct contributor to GDP growth. Apart from some transaction fees, existing home sales do not generate new assets or income and are not counted as economic output. Hence, housing directly affects GDP mostly through investments in the construction and renovation of homes and apartments. As noted, such private residential investment has grown over the past year. Nevertheless, the nation is still spending only half as much on such investment as it did at the beginning of 2006.

- Private residential investment currently makes up 2.6% of GDP. This small share means that residential investment is not expected to contribute much to overall GDP growth over the next couple of years. For example, if residential investment grew at a rapid 15% in 2013, it would still contribute only 0.4 percentage point to GDP growth. Though not negligible, such a contribution could not on its own support a robust recovery.

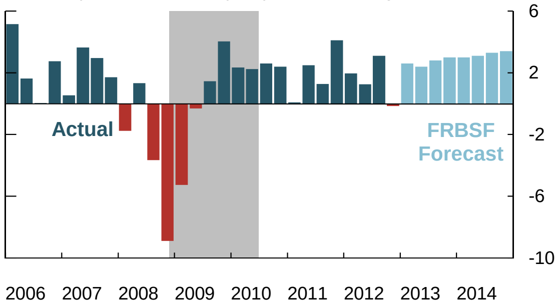
- A similar view comes from examining the jobs contribution of increased homebuilding. A 15% rise in residential investment would create about 550,000 jobs, of which 360,000 would be in construction. To put this in perspective, there are currently two million fewer payroll jobs in construction than at the beginning of 2006.

- However, housing can "punch above its weight" in economic growth in at least two ways. First, recent house price increases have brought many homeowners to the cusp of having a 20% equity stake in their properties. Twenty percent is generally the threshold at which they can borrow against their homes. Thus, continued house price appreciation would give a substantial fraction of households access to credit unavailable to them over the past few years. Second, increases in house prices lead to greater household net wealth and can thereby boost household demand more generally.

Dip in growth a temporary setback

GDP Growth: Actual and FRBSF Forecast

Quarterly obs, seasonally adj; annualized growth

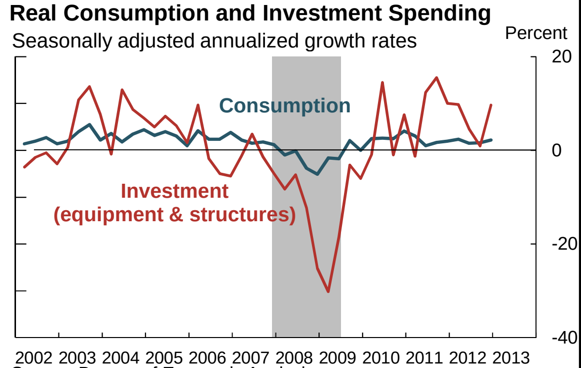


Source: Bureau of Economic Analysis and FRBSF

Steady growth in private-sector spending

Real Consumption and Investment Spending

Seasonally adjusted annualized growth rates

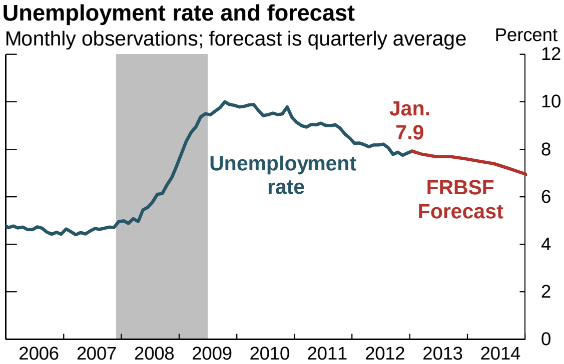


Source: Bureau of Economic Analysis

Unemployment rate continues slow decline

Unemployment rate and forecast

Monthly observations; forecast is quarterly average

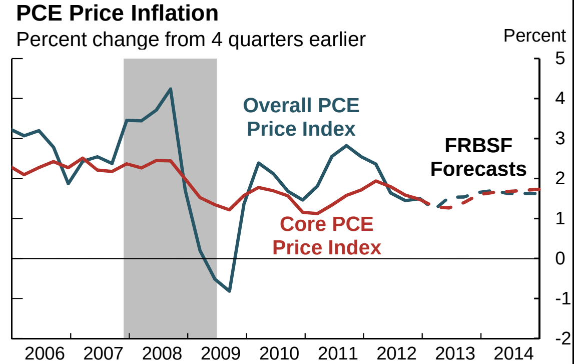


Source: Bureau of Labor Statistics and FRBSF staff

Inflation remains subdued

PCE Price Inflation

Percent change from 4 quarters earlier

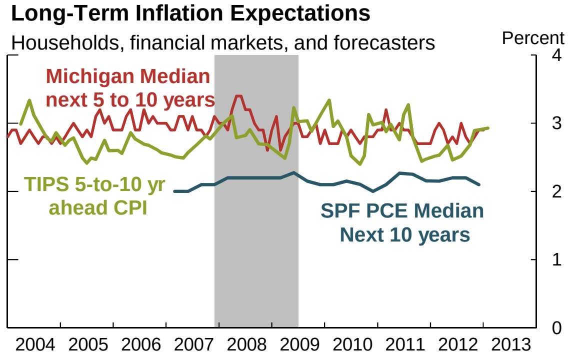


Source: Bureau of Economic Analysis and FRBSF staff

Long-run inflation expectations not adrift

Long-Term Inflation Expectations

Households, financial markets, and forecasters

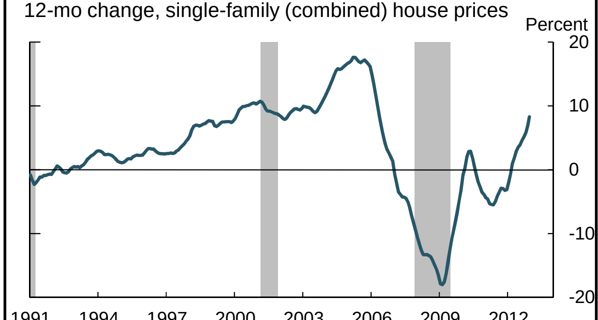


Source: Michigan Survey, SPF, FRBSF calculations

House prices are rebounding

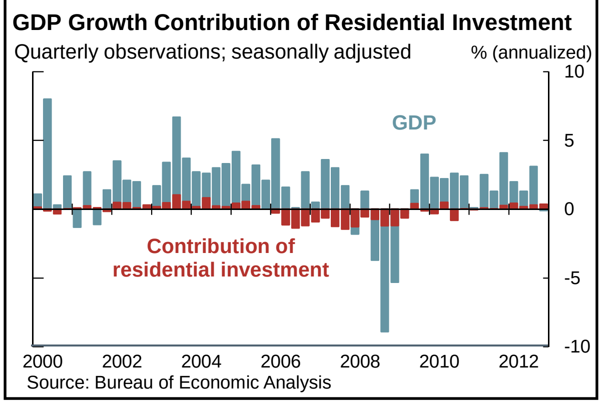
Change in House Prices

12-mo change, single-family (combined) house prices



Source: CoreLogic

Direct effects of housing remain small



... also in terms of job creation