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/) 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

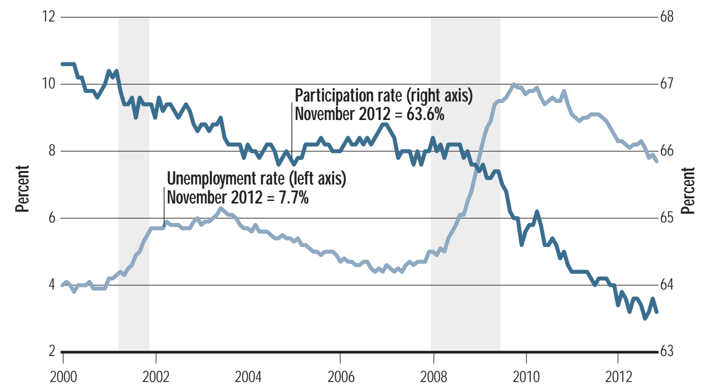
was actually 7.9 percent, seemingly rendering the FOMC's past forecast overly pessimistic.

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.

Chart 1
Unemployment and Labor Force Participation Rates



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

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

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. ▮

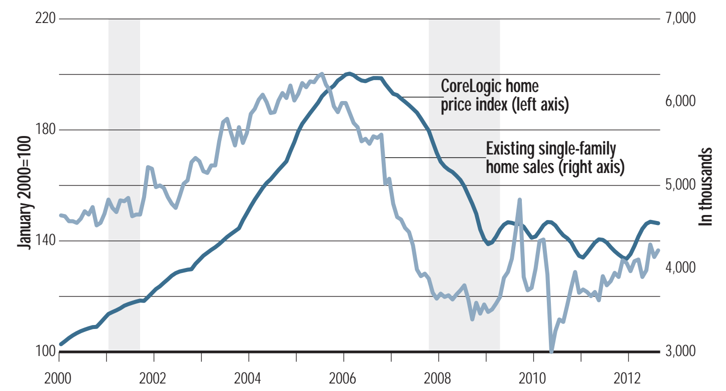
2013. Consider business investment, for example. Spending on equipment and software (E&S) rose sharply in the early part of the recovery after a steep decline during the recession. Since its low point in the second quarter of 2009, inflation-adjusted E&S spending has been up 30 percent. In fact, the 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.

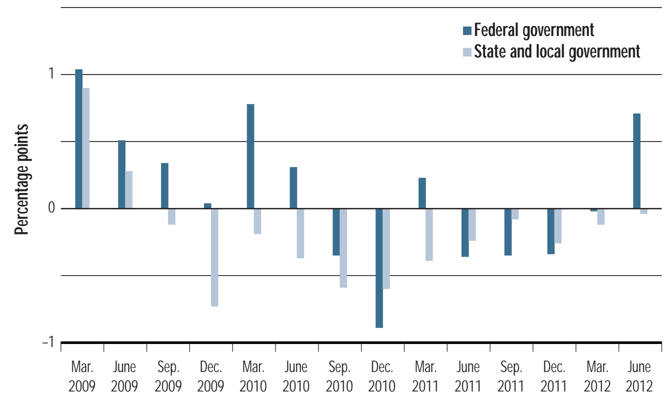
Government expenditures also underperform

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 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

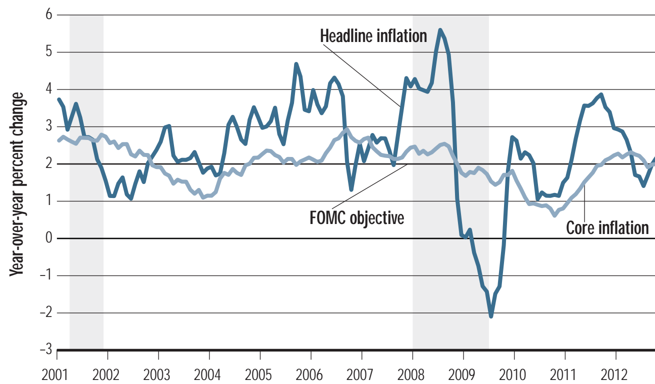
Chart 3

Government Expenditures: Contribution to Real GDP Growth



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

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. ▮

This article was written by Andrew Flowers, a senior economic research analyst in the Atlanta Fed's research department.

A promising start to 2012 eventually yielded to the slower activity that dogged the region in much of 2011. With some signs pointing to a faster pace of economic activity, will 2013 lead the way to a broad-based recovery?

The regional economy's recovery path largely mirrored broader, national trends in 2012. Stronger economic activity early in the year gave way to a slower track by the summer months. By autumn, it became clear that any real momentum in the southeastern economy had been lost. While the region's economic activity continued to expand, the pace had clearly slowed. By the end of October, economic data and reports from the Atlanta Fed's business and community contacts throughout the region indicated that businesses and workers had resigned themselves to an environment where growth is likely to remain modest.

Will that sense of resignation continue in 2013? Several factors point to an improving economy, but uncertainty may prevent a more robust level of activity.

A fall stall

Recent economic data and information gathered from the business community in the third quarter showed that the expansion of economic activity was positive but had slowed in the fall. The halting nature of activity continued through late October. Most of the business leaders the Atlanta Fed talked with expect little change in the near term, and they cite weak demand and uncertainty as reasons for the slow pace of expansion. Firms remain uncertain about the durability of the recovery (expected demand) and future health care, tax, and regulatory costs.

While weak demand was the most frequently cited reason for soft growth expectations, the theme of "bigger is not better" persisted. Many contacts stated that business expansion is simply not worth the risk in the current environment, and the focus was cost control and maintenance of profit margins. A number of companies contacted by the Atlanta Fed said they were running at capacity for a slow-growth environment and experiencing growth in sales but were opting not to take on the risk of investing for expansion. Others reported that they were postponing planned investments until 2013. The health care

industry is an exception to this trend, as it continues to prepare for the implementation of the Affordable Care Act.

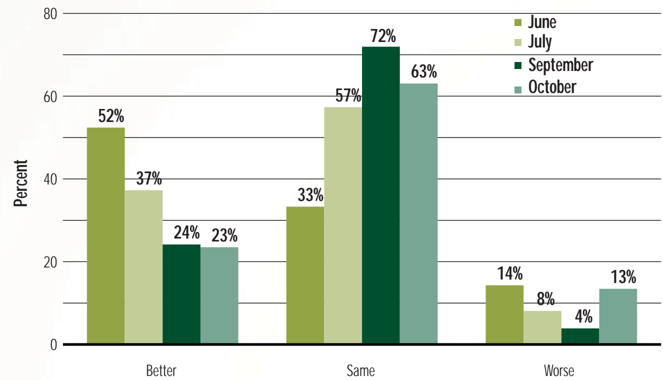
Expectations partly sunny, turned cloudy during the year

Before every meeting of the Federal Open Market Committee (FOMC), the boards of directors of the Atlanta Fed and its five branches (44 directors in total) respond to a poll regarding the outlook for their businesses. Our directors' expectations didn't change much in October compared with September. Although the majority of directors said that they expect growth in their business to be unchanged from current levels, the percent who expected slower growth increased. A quarter of them see improvement. These responses reflect a softening of sentiment in the second half of the year (see chart 1). In June, more than half of the Atlanta Fed's directors anticipated some degree of improvement in the short term.

Farther out, Atlanta Fed directors expect growth to accelerate. The driving force behind this anticipated improvement is fairly straightforward; most believe current uncertainties will fade and demand will pick up. That said, one in three directors do not see much improvement from current levels of activity.

Chart 1

Atlanta Fed Directors' Business Sentiment



Note: Percentages indicate Atlanta Fed directors' responses to the question "Do you expect the growth in your business over the next three months to be better, about the same, or worse than it was over the previous three months?"
Source: Atlanta Fed poll

Southeast Banking Conditions Moderate in 2012

Banking conditions in the Southeast improved somewhat during 2012 as the economy slowly began turning around. Nationwide, 2012 saw slightly more than half the bank failures that 2011 experienced. The Southeast continued to have more than its share of banks fail, with more than two of five U.S. failures in 2012 occurring in southeastern states. Since 2008, Georgia has been home to more failed banks than any other state in the nation, and nearly one in five failures in 2012 occurred in Georgia. De novo bank expansion was nonexistent again in 2012.

Lending remained tight in 2012

Loan qualification remained a problem for many potential borrowers whose credit scores were marred by missed payments and loan defaults, often as a result of job loss. Fixed-rate mortgages were at or near all-time lows, and although property values stabilized in some areas, other areas continued to struggle. Regulatory compliance hindered many community bankers' ability to originate loans, and the time and scrutiny required to qualify for a loan led many consumers to simply walk away before completing the process.

Business lending makes halting progress

Small business loan demand increased slightly, but many businesses remained hesitant to borrow, citing uncertainty in the economy as a drawback. Banks had money to lend, but qualified borrowers were scarce. Some banks reportedly loosened credit standards to attract new loans. For high-quality loans, competition remained fierce. Banks experienced some residential loan growth, most often as a result of refinanced loans instead of entirely new demand. Some southeastern bankers reported an increase in demand for construction loans and slightly increased lending levels from last year.

While banks are no longer tightening credit, many are keeping underwriting standards high, and competition for high-quality loans is intense. The outlook for the banking industry remains cautious, as regulators anticipate the number of problem banks and failures will remain elevated and credit will remain fairly tight as banks continue to shore up their balance sheets. ∎

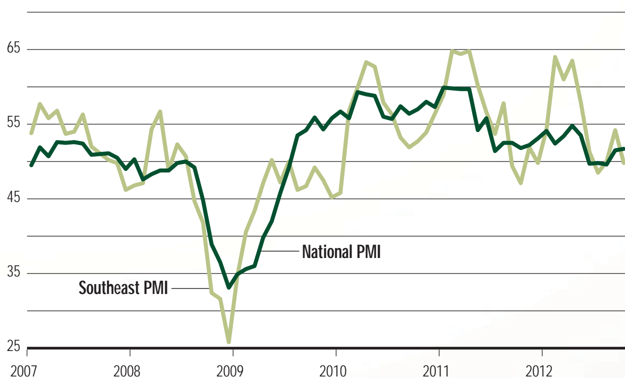
By Pam Frisbee, an analyst in the Atlanta Fed's research department

As the timid economic expansion continued, the one bright spot to emerge was the housing sector. Of course, housing is coming off historically low levels of activity, but improving sales and an increase in building activity are welcome developments (more on this sector later).

Mixed signals emanated from the manufacturing sector as the year progressed. After posting healthy gains early in the year, activity softened over the summer before rebounding in September. However, production levels and new orders decelerated again in October, according to the Southeast Purchasing Managers Index (PMI) produced by Kennesaw State University (see chart 2). The overall Southeast PMI was just below the level of 50, and the national PMI was a few points above 50. A reading above 50 represents expansion in the manufacturing sector.

Auto production was a positive factor for the region in 2012. Automobile fabrication and production of parts and other related auto supplies should remain a bright spot. Energy-related activity, from manufacturing and refining to exploration and extraction, also continues to do well and is experiencing significant capital investment from extraction through refinement.

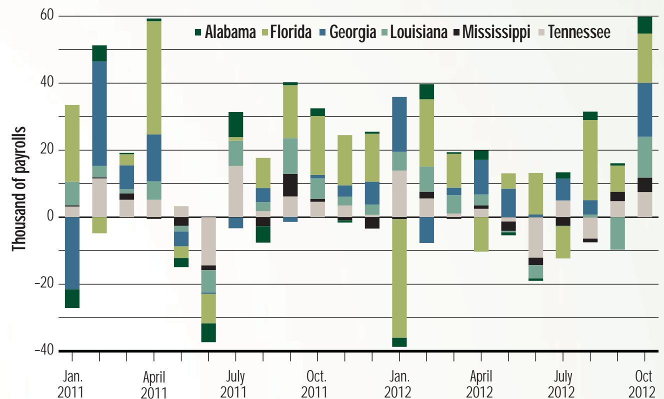
Chart 2
Purchasing Managers Index



Note: A reading above 50 represents an expansion in the manufacturing sector, and a reading below 50 indicates a contraction.
Source: Institute for Supply Management, Kennesaw State University Econometric Center

Retail is another sector that sent mixed signals. Although reports on current and expected activity remain rather subdued, retail trade shows have been well-attended and are reporting improved orders for goods. That said, transportation and retail contacts expect the holiday season to be similar to last year's and will continue to limit inventory build-ups. Tourism reported solid activity in the early fall, but those in the sector are concerned that higher fuel costs and weaker global growth, especially in Europe, will weaken bookings from international visitors.

Chart 3
Southeastern Payroll Employment



Note: Data are from January 2011 through October 2012 and compare month-over-month net changes in total employment.
Source: U.S. Bureau of Labor Statistics

Are the labor market's dark clouds receding?

Good, and frankly somewhat surprising, news came from regional labor markets. The U.S. Bureau of Labor Statistics reported on November 20 that southeastern states added nearly 60,000 jobs in October—the strongest monthly increase since October 2010—and the region's unemployment rate fell to 8.3 percent, the lowest reading since December 2008. Perhaps more importantly, October's positive numbers represent a marked improvement over the soft labor market readings of the spring and summer months.

October's gains were broad-based in geographic terms, as all states of the region added jobs (see chart 3). The largest increase was in Georgia, with 16,100 new jobs. Florida was next, at 14,700 jobs, followed by Louisiana with 12,200. Louisiana's increase was the largest in percentage change terms (up 0.6 percent). The Bayou State also had the largest regional decline in the unemployment rate, down 0.4 percentage point (see chart 4).

Regional employment gains were shared across industries as well, with all sectors adding jobs in October. Trade and transportation employment rose by 13,500 for the region, while private education and health care increased another 12,600 (this sector continued to add jobs throughout the recession). Construction, by far the hardest hit during the recession, added 2,300 jobs in the region.

ECONSOUTH NOW PODCAST

Chris Cunningham of the Atlanta Fed's research department discusses the national and regional economy. On frbatlanta.org, select "Podcasts."

This news is certainly good and welcome, but economic observers should keep the champagne on ice for a number of reasons. First, one month's data do not make a trend. Along those lines, a

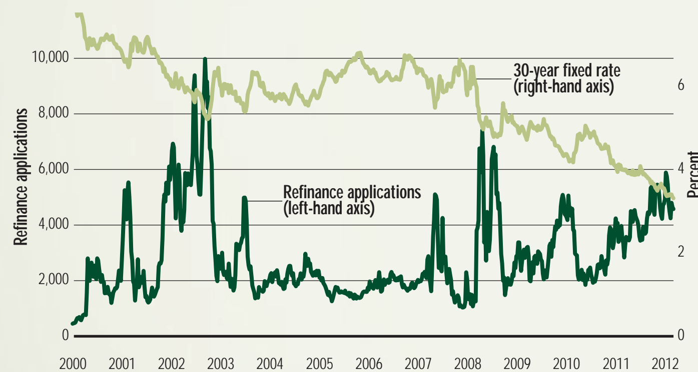
look at the three-month moving average of regional job growth shows that the Southeast has experienced similar increases in job growth in the years since the recession officially ended. The jump in 2010 was boosted by temporary census-related hiring, but in the first few months of 2011 and again in late 2011 into early 2012, encouraging increases in employment occurred, only to be followed by periods of disappointing results. Simply said, although increases in employment and declines in the headline unemployment rate are good news, these increases need to be sustainable, and no one is yet making that call.

Second, Atlanta Fed President Dennis Lockhart noted in his November 1 speech in Chattanooga, Tennessee, that he is look-

Mortgage Rates Decline, Boosting Applications in 2012

The Mortgage Bankers Association's weekly applications survey (WAS) reported this fall that the volume of mortgage loan applications—approximately 83 percent of which are applications for refinancing—has exceeded prerecession levels. This volume is thanks, in part, to historically low and still declining rates.

Mortgage Rates and Applications for Refinancing



Note: Data are through November 22, 2012, indexed so March 1990 = 100, and seasonally adjusted.
Source: Mortgage Bankers Association and Freddie Mac's Primary Mortgage Market Survey

Southeastern Mortgage Rates		
	Average Mortgage Rates (Percent)	
	15-Year Fixed	30-Year Fixed
National average	2.72	3.41
Atlanta-Sandy Springs-Marietta, GA	2.83	3.49
Birmingham-Hoover, AL	2.92	3.53
Jacksonville, FL	2.85	3.51
Miami-Fort Lauderdale-Pompano Beach, FL	2.91	3.59
Nashville-Davidson-Murfreesboro-Franklin, TN	2.83	3.49
New Orleans-Metairie-Kenner, LA	3.15	3.92
Tampa-St. Petersburg-Clearwater, FL	2.90	3.53

Note: Data are current through October 30, 2012.
Source: Freddie Mac's Primary Mortgage Market Survey

According to Freddie Mac's Primary Mortgage Market Survey (PMMS), average rates for 30- and 15-year fixed rate mortgages have fallen approximately 0.69 basis points (bps) and 0.66 bps over the last year, respectively (see the chart). As of October 25, they hover around 3.4 percent for a 30-year and 2.7 percent for a 15-year fixed-rate mortgage. To put these rates into perspective, the series' average 30-year fixed-rate mortgage rate (since the PMMS began in April 1971) was approximately 8.69 percent, and the 15-year rate (since 1991, when the 15-year series began) was approximately 6.13 percent.

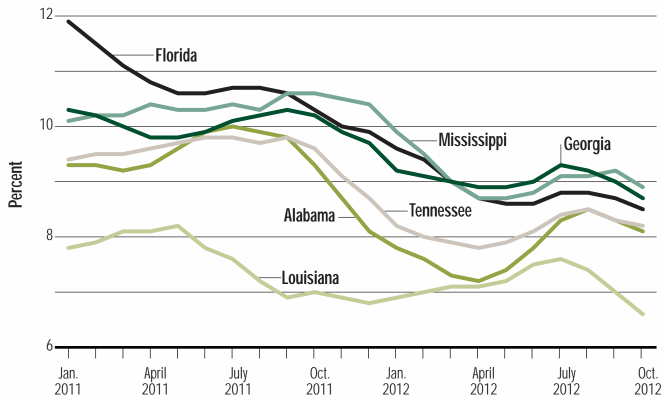
Refis rise as rates fall

As rates continue their decline, the level of mortgage loan applications trends upward. Data from the WAS show that the volume of mortgage loan applications for refinancing has increased 34 percent over the year ending October 18, 2012. How has the region fared in this low-rate environment? Data show that average rates in southeastern metro areas are slightly above but very near the national average (see the table).

How long will low rates last and will they decline further? The Federal Reserve's open-ended purchase of $40 billion of mortgage debt each month should continue to put downward pressure on rates, offsetting some of the increases that might have resulted from increased demand for financing. Given that, in the words of Federal Reserve Chairman Ben Bernanke, the Federal Open Market Committee is seeking "ongoing, sustained improvement in the labor market" before it ends these purchases, only time and economic conditions will tell how long these low mortgage rates will last. ∎

By Nicholas Parker, an analyst in the Atlanta Fed's research department

Chart 4
Unemployment Rates for Southeastern States



Note: Data are from January 2011 through October 2012.
Source: U.S. Bureau of Labor Statistics

ing for "substantial improvement" in the labor market that one month's worth of data do not alone accomplish. In his words:

> The starting point certainly should be the headline unemployment rate and the payroll jobs number. The interpretation of movements in these two statistics would be enriched and reinforced by a review of additional data elements.
>
> Here are examples of what I would look for:
>
> First, I would look for lower unemployment rates that are driven by increased flows of job seekers into employment. I would not interpret discouraged workers dropping out of the labor force as a sign of improvement, even if the unemployment rate falls as a consequence.
>
> Conversely, I'd like to see growing public confidence in the labor market as measured by increased movement of people from out-of-the-labor-force status into the labor force—that is, growing labor force participation. I would interpret a reduction in the number of marginally attached workers as a sign of improvement, even if the unemployment rate goes temporarily higher.
>
> Third, I'd look for employment gains that are associated with reductions in underemployment. I would interpret a pickup in job growth less positively if it is associated with increases in part-time jobs for people who seek full-time work.
>
> Finally, I'd like to see signs that improvements in all these indicators are gaining momentum and are sustainable. A framework for assessing labor market conditions needs to include forward indicators of labor market health, such as falling claims for unemployment insurance.

So, in addition to the need for sustainable trends in job growth and ongoing declines in unemployment rates, quite a few other indicators need parsing.

The Atlanta Fed's network of business contacts throughout the Southeast saw no shift in sentiment that would portend a recovery in labor markets. Firms remain cautious regarding hiring, especially in light of the short-term fiscal challenges facing the country. (For more on this subject, see President Lockhart's November 16 speech on our website.)

October's employment reports were a pleasant surprise, to be sure, and perhaps a sustainable, positive trend is building in the labor market. Several more months of positive reports and more progress on a number of labor market indicators—not just the headline grabbers like the unemployment rate—are needed before we would consider saying that "substantial improvement" in labor markets was under way.

Despite the recent increase in employment, reports of skills mismatches persist. Several manufacturers reported challenges finding entry-level workers for the line, despite offering what they see as highly competitive starting salaries. Several firms reported some increase in wages, driven by the need to attract already-employed workers away from their current jobs. However, many companies across several sectors have not significantly raised entry-level salaries to attract employees. Some companies have engaged in an advanced screening process to help identify qualified workers and minimize turnover. Mortgage lenders said they were reluctant to train new workers to meet the large but transitory wave of refinances, limiting home lending activity, according to several banking industry contacts.

A broader view: Why has the recovery turned chilly?

Fundamentally, the regional economy relies a great deal on in-migration and the associated economic development and job creation it brings. Last year's economic outlook issue of ***EconSouth*** said, "The driving force behind the region's economic growth over the years has been robust population growth, which ignited development and spurred job creation. The slowdown in population growth to the levels experienced by the rest of the country explains a big part of the regional economic contraction, and lagging in-migration appeared to continue in 2011."

Chart 5

Southeastern Residential Housing Starts

Note: Data indicate new, privately owned housing units.
Source: U.S. Census Bureau, Atlanta Fed calculations

Early estimates suggest that in-migration and population growth have improved, but have not returned to the heady levels seen before the 2007–09 recession. The breakdown of the region's economic engine during the recession was, of course, tied directly to the real estate bust that helped make both the national and southeastern downturns so deep. Several housing indicators showed sustained improvement in 2012, indicating that the regional housing sector has continued to heal.

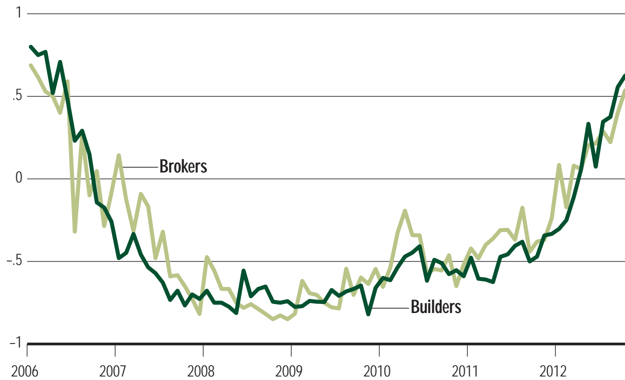
Housing becomes a potential ray of sunlight

Regional housing starts, sales, and prices stabilized in many areas throughout 2012. Florida led the way. After suffering some of the nation's largest declines, data show that a rebound in this state is clearly under way. However, Florida is in many ways unique. Significant investor activity has boosted the housing sector in the Sunshine State, as have the number of international sales in the Florida market. Many of these transactions have been in cash, so the tight underwriting standards that persist in the mortgage markets have not posed as high a barrier to recovery that other areas of the region face. That said, trends outside Florida are also turning positive in terms of both sales and new residential construction.

Both the sale prices of nondistressed homes and the cost of owning versus renting a home stabilized in many areas in 2012. However, the large number of distressed properties will likely work against any broad home-price appreciation. Home price indices, which have recently exhibited year-over-year increases, may continue to experience sluggish, uneven growth despite high levels of affordability and stability in housing starts and sales.

The new-home market has made significant progress toward recovery (see chart 5). Housing starts have begun to trend

Chart 6
Southeastern Home Prices



Note: Data represent an index of southeastern housing prices and are through October 2012.
Source: Atlanta Fed business contact poll

upward, though they remain near historically low levels. Many builders who survived the recession have positioned themselves within desirable submarkets (for example, those in better-performing school districts, close to employment centers, or with limited competition from distressed properties).

The majority of regional builders polled by the Atlanta Fed reported that home construction during the third quarter of 2012 exceeded the year-ago level. Most said construction is up slightly compared with a year earlier. Year to date, single-family permits in the Southeast were up 18 percent, driven by activity in Florida (up 24 percent) and Georgia (up 23 percent). The outlook among the region's homebuilders for construction activity over the next several months remains positive. Most anticipate construction activity will be flat to slightly up compared with a year earlier.

Rising demand for new homes and limited supply have enabled many builders to increase prices or reduce incentives. Vacant developed lot inventory is shrinking in the most desirable submarkets, and home prices in many areas have not risen to levels that make it profitable for builders to build on lots located in less desirable locations or to develop new lots. Therefore, home inventories may continue to drop and remain low for some time. In some markets, residential developers warn of a looming crisis in the availability of lots. The location of many existing vacant developed lots make them functionally obsolete while more desirable areas may restart new lot development. Still, the market share for new homes remains constrained because of appraisal issues, difficulty in financing new construction and development, and competition from the existing home market.

Most Atlanta Fed contacts in the real estate sector continued to report modest home price gains through the third quarter (see chart 6). Importantly, modest increases in overall home prices mask important differences in markets and submarkets.

While some markets in the region continue to have a large number of vacant homes, boosted by the ongoing inflow of foreclosed properties, other markets have a low level of inventory, multiple offers on houses for sale, and reduced time on market. Typically, markets with a higher share of distressed property sales tend to experience greater downward pressure on prices while markets with fewer distressed properties are more likely to experience price stabilization.

Seriously delinquent mortgages remain elevated, and thus an ongoing flow of foreclosed properties may continue to hold down home price appreciation. A rebound in home prices is

Southeastern Agriculture Weathers Challenges in 2012

The drought that gripped much of the country was the big news in U.S. and Southeast agriculture for 2012. Many farmers in drought-stricken midwestern areas saw their corn and soybean crops severely affected, but southeastern farmers with more favorable soil conditions were able to increase crop production and enjoy the higher 2012 prices these crops demanded.

An overall rise in feed prices put pressure on livestock producers, with many deciding to liquidate herds. However, some cattle producers are now increasing herd size in anticipation of higher prices. Poultry producers saw somewhat better prices in 2012; their margins were also squeezed because of high feed costs.

The Florida citrus crop was quite robust, and export demand held up well. Cotton prices in 2012 remained relatively weak compared with 2011 prices, as lower demand and greater international stocks constrained price increases.

Labor costs are stable, with the soft economy placing no significant upward wage pressure. However, labor availability—particularly immigrant labor—affected some southeastern farmers. Alabama and Georgia recently passed stringent immigration laws, and many workers in those states left for Florida, a more hospitable environment for guest workers. Some agricultiural producers are reportedly switching to less labor-intensive crops because of labor availability issues. ∎

By Teri Gafford, director of the Regional Economic Information Network at the Birmingham Branch of the Atlanta Fed

important, given that many homeowners who would like to sell cannot because their current mortgage exceeds the sales price. Until home prices improve, negative equity will likely create a logjam, preventing those who may be "move-up" home buyers from reentering the market.

Heading into 2013: Cost control and conservative hiring and investment

Controlling costs remains a central theme for businesses in the Southeast. Higher energy and crop-related input prices, along with the ongoing challenge of rising health care costs, represent a large part of this challenge. That said, the Atlanta Fed's feedback from firms throughout the region is that the pressure from input prices overall has eased over the last several months. While energy and agricultural goods prices are important because they have an impact on most firms, widespread input cost pressures are not presently a factor.

Although firms in the region are facing cost pressures from energy-related prices, the decline in natural gas prices has helped utilities and manufacturers manage these challenges. Transportation firms face a more difficult situation because of the high cost of gasoline, but in many cases these costs have been passed along to customers.

Higher crop prices pose a serious challenge for many companies in the region, especially for food service firms and restaurants. They are also having an impact on companies that use agricultural goods as inputs in production processes. Still Atlanta Fed survey respondents, as noted earlier, did not detect any widespread concerns regarding input costs.

No firm in the region is free from the challenges posed by higher health care costs. Many are passing these increases along to employees as higher deductibles or reduced benefits. Some firms have adopted a strategy of shifting more of their workforce to part-time status to reduce the number of employees eligible for company-provided health care coverage. However, most firms continue to wait for the full requirements of the Affordable Care Act to be spelled out before making formal changes to their health care plans.

The Atlanta Fed's results from the most recent business inflation expectations survey illustrate this broader view nicely. The survey includes responses from roughly 300 businesses across a broad range of industries in the Atlanta Fed's region. Firms reported that their unit costs were up just 1.4 percent on average compared with this time last year. That number falls below their October 2011 year-ahead expectation of 1.9 percent. Looking forward, on average, businesses expect unit costs to rise 1.8 percent over the next 12 months. That number is up slightly from 1.7 percent in September but still somewhat below recent year-ahead inflation forecasts of private economists.

According to the businesses surveyed, firms continue to operate in an environment of below-normal sales levels and profit margins. Firms continue to anticipate little or moderate upward pressure coming from input costs over the next 12 months. Respondents also anticipate that margin adjustments and sales levels are likely to have a small upward influence on the prices they charge in the coming year. Clearly, firms' ability to fully pass along higher input prices is constrained by competitive forces in the marketplace and generally subdued demand in most areas of the economy.

Positive but slow job gains

The overriding theme from the Atlanta Fed's business inflation expectations survey and from recent discussions with business contacts is that firms remain very conservative and are hiring full-time staff only to meet current needs. Some acceleration in hiring earlier in the year—based on the need to staff up to necessary levels—was observed, but it tapered off in the spring. The October increase in employment is a positive development, but several more months of strong gains are needed to determine if a sustained rebound in hiring is under way.

Hiring seems to focus on accommodating growth from new customers, which mainly reflects market share gains, rather than increased sales to existing clients. This evidence is consistent with limited growth in demand.

Weak sales expectations and a lack of clarity about the near-term outlook were cited most often when businesses were asked why their hiring intentions remained subdued. When firms see clear evidence of increasing sales, they will still add positions. However, when improvement is marginal or volatile or uncertain, firms choose to keep workforce levels unchanged. These uncertainties focus on the durability of the recovery (expected demand) and future health care, tax, and regulatory costs.

On the other hand, energy exploration and extraction firms are increasing or planning to increase their workforces. Auto manufacturers and suppliers are running at capacity, and increased demand will result in additional hours or staff. Some auto-related manufacturing contacts are hiring and are looking at changing their scheduling practices to allow more upside production flexibility. Another area where some hiring momentum appears to be building is the housing sector, where some builders and building products manufacturers report beefing up staff to meet increases in broader demand.

Many companies report that they are shifting existing employees' responsibilities from less productive divisions to more productive areas as they struggle to adapt to current conditions. In addition, the underlying, ongoing theme of technology replacing labor in certain occupations—most notably, those that can be described as performing routine tasks—continues. Overall, businesses have become more selective in their hiring over the past few years. These practices are tied to firms' conservative approach to adding to their workforces.

And the ongoing theme of the difficulty in finding qualified workers for some specialized positions was reinforced in our most recent conversations with regional business leaders. Trucking and energy firms were the most vocal about this problem, but across the board firms were searching for hard-to-find qualified IT-related workers, engineers, and finance and accounting experts. Some firms are increasing wages to attract and retain workers, but that practice is not widespread.

Our bottom line is that demand—or the lack thereof—appears to be the driving force behind hiring decisions. Uncertainty is having an impact on hiring decisions at the margin. The ongoing drive for efficiency through the application of technology and automation is also playing a role in limiting overall increases in workforces.

Investment postponed until sunnier days

Atlanta Fed staff polled their business contacts in July with regard to capital spending plans. Fifty-five percent of the respondents noted that they planned to increase spending on capital equipment over the next six to 12 months, relative to what they spent over the last six to 12 months. About one in three said they planned to leave capital expenditures unchanged, and only 14 percent said they anticipated decreasing spending.

Of the businesses that planned to increase spending in the near term, high expected growth of sales and the need to replace IT equipment were the two most common factors driving their plans.

Among the businesses that said they do not plan to increase spending in the near term, firms noted increased or high economic or financial uncertainty followed by low expected growth of sales as the two major factors behind not increasing capital spending.

In our conversations with businesses since the survey was completed, we have detected that many firms have postponed capital expenditures. They cited worries over the impact of the fiscal cliff as a main reason for such postponements, but delays also appear to be tied to disappointing sales results.

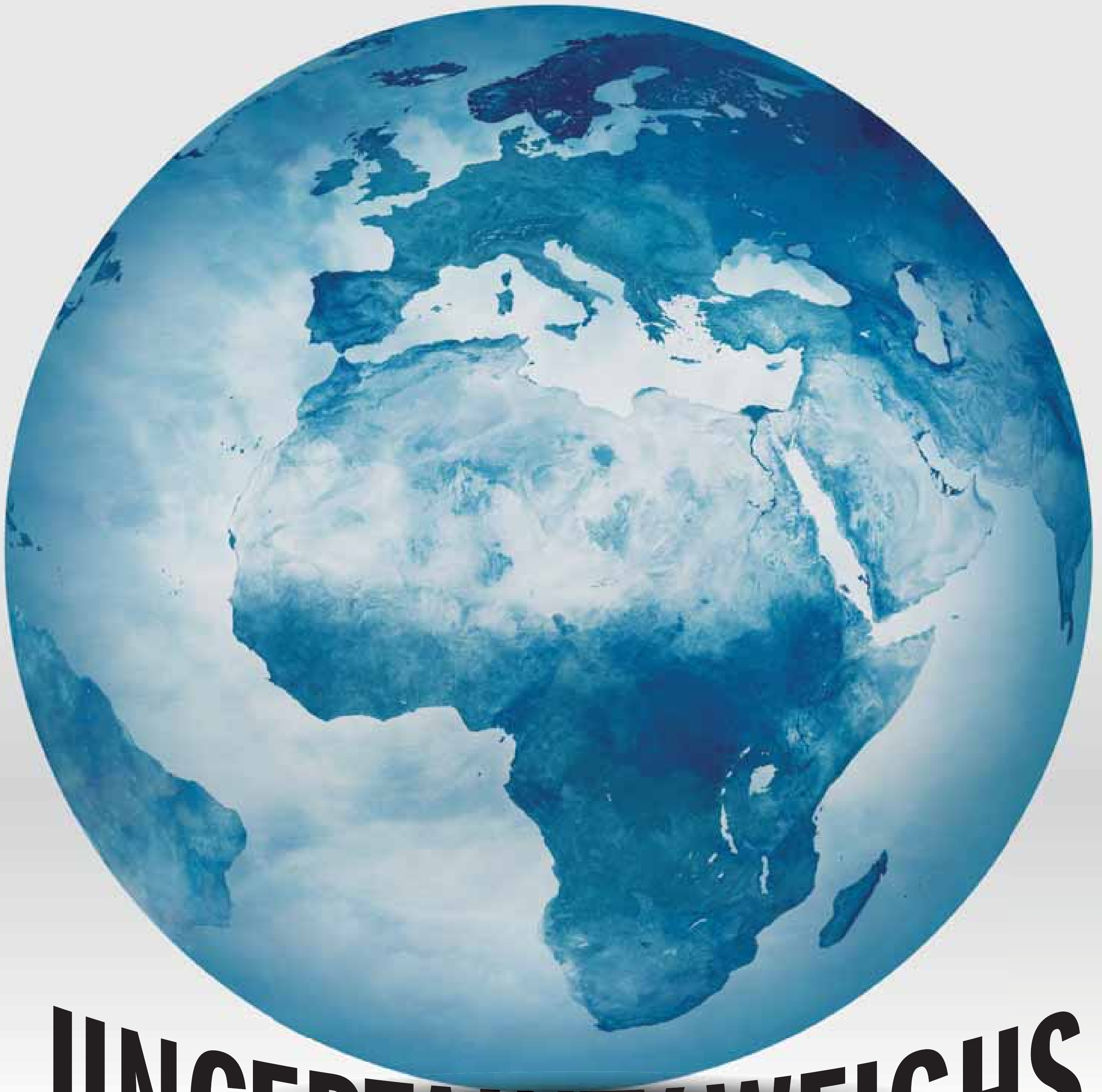
The July survey did not tackle the question of inventories. However, in discussions with business leaders throughout the region, most say they are content with their current levels. Very few were building inventories in anticipation of future demand, and excess inventories do not appear to be a widespread issue. Regardless, tight inventory management is one of the cost-reducing strategies adopted by many firms over the last few years, and it's not clear that this will change if demand begins to increase.

Looking at the clouded horizon

In his November 1 speech in Chattanooga, Atlanta Fed President Dennis Lockhart commented on his economic outlook for the nation. He said, "I think the most plausible forecast is continued modest growth with gradual employment gains. Around this more-of-the-same forecast are downside risks of economic shocks as well as chances of somewhat better economic performance if certain risk elements are eliminated or attenuated."

Focusing on the latter part of his comment, the national, and for that matter the regional, outlook will clearly be helped if the short-term uncertainty surrounding U.S. fiscal policy is removed. Economic activity in the region will likely closely track national developments. Housing should lend some support, to be sure, as should auto manufacturing and energy production. But while desirable, a broader recovery—one that generates more robust employment gains and lower levels of unemployment as well as accelerated levels of investment—remains elusive. ▮

This article was written by Michael Chriszt, a vice president in the Atlanta Fed's research department. Jessica Dill, Pam Frisbee, Whitney Mancuso, Shalini Patel, and Ellyn Terry, analysts in the Atlanta Fed's research department, also contributed.



UNCERTAINTY WEIGHS ON GLOBAL GROWTH

Global economic expansion weakened in 2012. Europe's ongoing debt crisis and recession hampered growth and heightened uncertainty in the rest of the world. Even the emerging economies of China, India, and Brazil, which had been growing robustly for some time, weakened. Economic conditions may not improve quickly as we enter 2013, and the downside risks facing numerous countries are likely to remain elevated.

Over the course of 2012 through the third quarter, global economic growth decelerated, and economic forecasters continually revised down the outlook for most major economies. In addition, downside risks to the world's economic expansion appeared to intensify around midyear. Growth in global manufacturing flagged. World trade barely grew. All-around uncertainties shook confidence. Most forecasters were expecting only a slight acceleration in global growth in the final months of the year and in 2013—if uncertainties dissipate and as the latest round of global monetary policy easing boosts economic activity.

Overall, low growth and high risks characterized the world economy in 2012, and economic conditions in most parts of the world are not likely to improve rapidly as we head into 2013.

Despite austerity measures, European debt problems persist

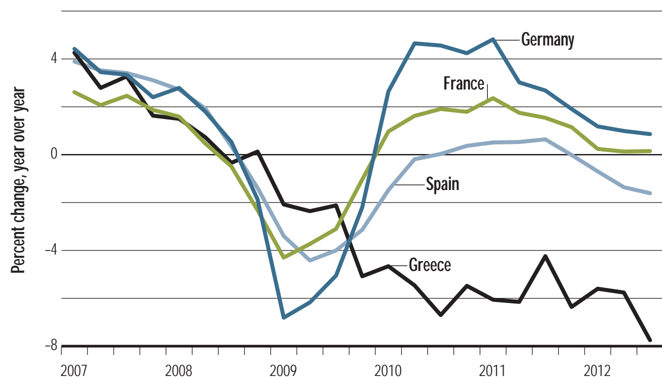
The financial crisis brought on by high levels of government debt has battered Europe since 2009 and proved a formidable impediment to global growth. Greece has been in the eye of the storm, with Ireland, Portugal, Spain, and Italy also suffering from the devastating loss of investor confidence. The crisis abated somewhat in the beginning of 2012, in part as a result of the European Central Bank's (ECB) provision of relatively cheap three-year funding to European banks that allowed them to refinance maturing debt. But a few months later, market sentiment deteriorated again amid rising concerns about Greece's potential abandonment of the euro, Spain's ability to address its fiscal and banking sector problems, and continued worsening of the euro zone's economic prospects.

As the crisis intensified, European leaders agreed at their June summit to develop a road map toward strengthening the European Union's fiscal, financial, and economic integration. On the financial side, as a step toward forming an area banking union, the European Union's finance ministers decided in December to establish a single supervisory mechanism for the region's banks under the ECB.

However, the June summit failed to prevent the financial crisis from deepening. Market sentiment became progressively worse until late July, when ECB President Mario Draghi said, "Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough." In early September, the ECB followed through by announcing that it would buy short-term bonds of euro zone governments without limit, but the purchases would be subject to strict conditions. The central bank would buy the bonds only of those countries that have applied for help from the region's rescue funds—the European Financial Stability Facility and its successor, the European Stability Mechanism—and accepted the funds' policy conditionality, essentially submitting to outside control of the countries' fiscal matters. The announcement caused financial markets to rally in relief, but it will likely be months before the outlook substantially improves for the broader economy.

The euro zone's economy, weakened by the loss of confidence and severe austerity measures, has not grown since the third quarter of 2011. Although Germany and France—the region's largest economies—have managed to avoid recession thus far, the economies of fiscally weak countries in southern Europe have been contracting for a number of quarters, in some cases at

Chart 1
Gross Domestic Product, Europe



Note: Data indicate 2005 chained euros.
Source: Haver Analytics

alarming rates (see chart 1). The unemployment rate for the region as a whole reached a record high of 11.7 percent in October, with rates of joblessness varying from less than 6 percent in Germany to more than 25 percent in crisis-stricken Greece and Spain.

Emerging economies weaken

Through trade and financial interconnections, the euro zone's crisis has impeded economic growth and heightened uncertainty all over the world.

Advanced economies as a group have grown at a lackluster pace since mid-2011. Actual growth has varied across different parts of the world—from moderate expansions in Canada and Australia to pronounced weakness in the United Kingdom and double-dip recessions in southern Europe. Japan's economy grew strongly in the beginning of the year as the country rebuilt after the devastating 2011 natural disasters, but economic output fell in the third quarter as both domestic demand and exports weakened.

A recession in the euro zone and tepid growth in the rest of the developed world have put the brakes on growth in export-oriented emerging market economies, including commodity-exporting countries. Although domestic demand has by now become an increasingly important source of growth in emerging markets, exports continue to be a key driver of economic activity. Most developing countries still cannot grow at their trend rates if growth stays weak for a long time in advanced economies. Recently, domestic demand itself has lost momentum in key developing countries, in part as a result of earlier policy tightening as well as increased global risk aversion that dampened capital flows to emerging markets.

For emerging Asia, the outlook markedly deteriorated, mainly because of the deceleration in China. The world's second-largest economy was hit by a double whammy of weakening European demand for its exports and earlier domestic tightening measures intended to cool the red-hot real estate sector. China's economic expansion has been decelerating for more than two years. In response to slowing growth, the country's authorities recently introduced a package of fiscal and monetary stimulus measures. While it may take time for these measures to affect the economy significantly, the latest available data show that at the end of the third quarter, growth momentum in China had picked up somewhat.

Economic conditions have also notably deteriorated for India. The country continues to suffer from a poor business environment and a lack of much-needed structural reforms. The country has dealt with two years of political gridlock, which has resulted in a failure to implement major reforms. India also continues to struggle with high public deficits and debt, as well as elevated inflation. Putting more downward pressure on economic growth in 2012 were unfavorable weather conditions that negatively affected agricultural production.

Latin America has also experienced slowing growth. The region's weak economic numbers mainly reflect a sharp slowdown in Brazil. As Brazil's economy began to slow in 2011, the country's central bank started aggressively easing monetary policy. The easing, combined with some fiscal measures, has had

CONTINUES ON PAGE 22

For emerging Asia, the outlook markedly deteriorated, mainly because of the deceleration in China.

SMOOTHER SAILING *IN CHALLENGING TIMES*

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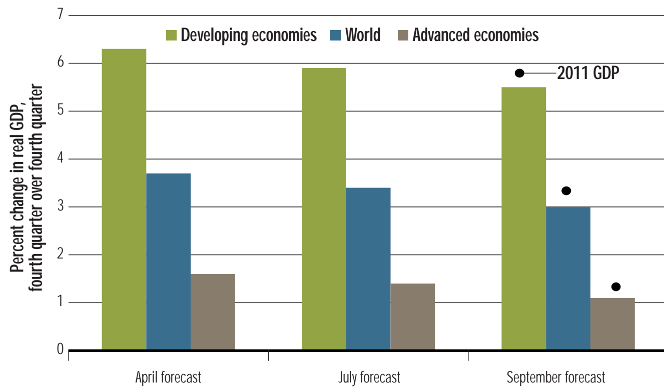
Chart 2
Changes in GDP Forecast for 2012



Note: The black dots in the September forecast are to facilitate comparison of GDP between actual growth in 2011 and expected growth in 2012.
Source: International Monetary Fund, *World Economic Outlook*, September 2012

some positive effect—monthly data indicate that in the third quarter of 2012, industrial production grew for the first time in more than a year.

Globally, slowing growth has led to a number of policy actions, mainly in the monetary policy realm since, in general, goverments and their citizens largely lack the appetite for additional fiscal stimulus. In addition, many of these countries are already coping with high levels of public debt. In advanced economies, the Federal Reserve and the ECB let loose a new wave of monetary easing. Many emerging markets' central banks have been easing their policies as well, but few are in a position to undertake aggressive monetary easing because of domestic capacity constraints and inflation that is at or often above official targets.

Global outlook remains uncertain

At the moment, the world economy is in a precarious state. In September, the International Monetary Fund (IMF) revised down its 2012–13 growth forecast for the global economy for the second time since April, citing the persistent intensity of the European crisis and policy uncertainties that have hurt confidence around the world (see chart 2). Similarly, the Blue Chip consensus forecast has recently showed broad-based and, for a number of countries, continued markdowns for growth this year and in 2013.

The IMF expects only modest acceleration in economic activity from 3.3 percent this year to 3.6 percent in 2013. In the euro zone, diminishing austerity measures and easing financial conditions are hoped to spur some positive growth. Most forecasters project continued lackluster growth in advanced economies, but relatively solid growth in emerging markets. In these markets, economic expansion is likely to accelerate, helped by relatively strong fundamentals in many countries. Still, the developing world's growth rates are not likely to return to precrisis levels in the near term.

The outlook for the global economy is highly uncertain and subject to a number of serious downside risks. The inability of European policymakers to contain the region's crisis is at the top of most forecasters' list of risks. Another risk is the so-called fiscal cliff in the United States. A sharp slowdown in China's economy and a jump in oil prices are also on forecasters' radars. All the risks and uncertainties are weighing on businesses' and consumers' decisions to invest, hire, and spend and are not allowing the global economy to gather strong growth momentum heading into 2013. ∎

This article was written by Galina Alexeenko, director, Regional Economic Information Network at the Atlanta Fed, Nashville Branch.

CONTINUED FROM PAGE 1

Underemployed workers in this category—also called "part-time for economic reasons"—grew during the recession.

Another factor shaping labor markets is the rate of participation, which has been falling since the early 2000s. This trend is largely the result of demographics—namely, the aging population. Of course, some of the decline in participation rates also reflects recent economic conditions. Consider, for instance, the millions of "marginally attached" workers—people who indicate that they are ready and willing to work but are not actively searching. Many of these individuals will likely return to the labor market as conditions improve.

In my view, efforts to evaluate employment conditions must consider the complexity and dynamism of the U.S. labor market.

Additional aspects include the variations in employment conditions across regional labor markets, as well as the way in which new jobs are created. Research indicates that new and early-state businesses are responsible for a significant share of jobs created in this country. At the same time, young firms often do not survive past five years. Indeed, job creation in our country is in a state of continuous churn as jobs disappear due to business failure and are replaced by jobs in newer, growing industries.

Determining what improvement looks like

Hopefully, these factors provide some insight into the complexities that shape the U.S. employment market. This brings us to the challenge my FOMC colleagues and I face as we consider the labor market's progress toward "substantial improvement." My framework for defining this important milestone is, admittedly, a work in progress. Although the monthly unemployment rate and payroll figures are a good starting point, I will look to additional data elements to reinforce and enrich movements in these two statistics.

Examples of what I would look for include a lowering of the unemployment rate that is driven by a steady stream of job-seekers into employment. Discouraged workers leaving the labor force would also lower the unemployment rate, but I would not necessarily interpret that as a sign of improvement. I'd also look for growing public confidence in labor markets, as indicated by greater labor force participation. I would like to see employment gains that are associated with reductions in underemployment. And finally, I'd look for signs that these improvements are gaining momentum, are sustainable, and are complemented by forward-looking indicators such as falling initial claims for unemployment insurance.

Adding context to the term "substantial improvement" is important, I believe, because future monetary policy actions by the FOMC hinge on improving labor market prospects. The latest monetary policy actions announced by the FOMC, in addition to earlier measures, demonstrate its commitment to the Fed's dual mandate of price stability and maximum sustainable employment. We will not waver on that commitment. ∎

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