Research Seminar in Quantitative Economics
University of Michigan Ann Arbor, MI 48109
734-764-2567

George A. Fulton, Director
Saul H. Hymans, Director Emeritus

www.rsqe.econ.lsa.umich.edu

For Release: 11/17/2011

The U.S. Economic Outlook for 2012–2013
Executive Summary: November 2011

Still Fragile

The economy has been battered this year by a series of shocks: a spike in oil prices this spring, the Japanese earthquake, and flare-ups in the European debt crisis that have kept financial markets roiling. The GDP growth rate slowed to a crawl during the first half of the year, averaging less than one percent. Payroll job gains, which had briefly topped 200,000/month in February–April, dwindled to less than 100,000 in May and June. Consumer sentiment dropped, and talk of a double dip in the economy surfaced.

Economic news has improved a bit this fall, lessening the chances of a double dip. Output growth rebounded in the third quarter to register a 2.5 percent pace. Job gains have picked up a notch, averaging 117,000 since midyear. Consumer sentiment has reclaimed part of the ground lost since May. The economy remains vulnerable, however, as the main problems that have plagued this recovery persist.

A Marathon, Not a Sprint

Output growth has averaged just 2.5 percent during the recovery, half a percentage point behind the recoveries following the recessions of the 1990s and early 2000s and a far cry from the 5+ percent growth following recessions in the '70s and '80s.

Homebuilding, which normally surges ahead in a recovery, has gone nowhere. Consumers, saddled with "under water" mortgages, high unemployment, and an overhang of debt, haven't provided their usual boost to the economy. Local governments, faced with sharp declines in revenue, have scaled back to an unprecedented degree.

Fiscal Policy, Lose-Lose?

To date, Congress has been unable to solve the fiscal policy puzzle: how to move toward a sustainable long-run budget position when the economy is currently fragile and could probably benefit from additional fiscal support. It is not at all clear that the "Super Committee" that was charged with finding a long-run budget solution will be successful, and there has already been some discussion of backpedaling away from the sequestration that is supposed to be triggered if the "Super Committee" fails.

In the current political environment, it also seems unlikely that Congress will pass any new stimulus measures. We have assumed the payroll tax holiday and investment tax incentives will be held over for another year, but neither of those extensions is a sure thing. We may well end up with a fiscal policy that doesn't address either our short- or long-term problems.

Monetary Policy, Changes at the Margin

At its three most recent policy meetings, the Federal Reserve decided to (1) clarify its intent to maintain interest rates near zero for the medium term, (2) shift its balance sheet toward longer-term Treasuries to hold down long-term rates, and (3) stand pat. We expect any further accommodation to again operate at the margin. With the unemployment rate remaining unacceptably high over our forecast horizon and with a lack of inflationary pressures, we do not anticipate any hike in the federal funds rate before sometime in 2014.

The 3-month T-bill rate stays below 25 basis points over the forecast horizon. The 10-year T-note rate rises gradually from 2.2 percent in 2011q4 to 2.9 percent by the end of 2013. The 30-year conventional mortgage rate hovers near 4 percent through 2012 and then edges up to 4.5 percent by the close of 2013.

The 2012–2013 Outlook

Over the next two years, we expect moderate economic growth that generates only enough jobs to slowly reduce the unemployment rate. All evidence is that fiscal policy will be contractionary, while monetary policy effects are likely to be limited, and foreclosure is still a threat for far too many homeowners for the housing market to show rapid improvement.

over....

Quarterly, the GDP growth rate stays in the range of 2–3 percent, and averages out to 2.5 percent during both 2012 and 2013.

Consumer spending is steady but remains muted by subdued job gains and the assumed end of the payroll tax holiday in 2013. Growth in business capital spending, a mainstay of the recovery thus far, moderates a bit as investment incentives are scaled back.

After scraping along near the bottom in 2010–11, housing activity gradually comes up off the floor. Housing starts rise from about 600 thousand units in 2011 to 728 thousand and 950 thousand for 2012 and 2013, respectively. Although a sizeable improvement from 2011, the projected 2013 level would be lower than the starts recorded in each year from 1955 through 2007.

Light vehicle sales, expected to total 12.7 million units this year, improve by about 800 thousand units per year in 2012 and '13. At 14.3 million units, sales in 2013 would be nearly 4 million units higher than the recession low in 2009 but still well short of the 16–17+ million sold annually from 1999 to 2007.

Employment and Inflation

With slightly stronger growth over the next two years, job creation picks up as well. Measured from 4th quarter to 4th quarter, payroll employment rises by 1.9 million jobs during 2012 and 2.0 million during 2013, after a gain of 1.5 million this year. The cumulative job growth from 2010q1 through the end of 2013 implied by our forecast would still fall short of the jobs lost during the recession by 2.4 million.

With such modest employment gains, unemployment remains high. The jobless rate edges down from its current reading of 9 percent to 8.5 percent by the close of 2013. After averaging 9 percent this year, the unemployment rate slips to 8.9 percent for calendar 2012 and 8.6 percent a year later. In the post-war era prior to 2009, the calendar-year unemployment rate exceeded 8 percent in only three years. Our forecast implies at least five consecutive years of above 8 percent unemployment.

Consumer price inflation shot up earlier this year as food price increases accelerated and the price of oil spiked. The subsequent decline in oil and other commodity prices has produced some easing of consumer inflation in recent months. Core CPI inflation settles in the 1.6–1.7 percent range, up from the uncomfortably low one percent rate posted in 2010. The all-items CPI registers a 3.2 percent inflation rate for calendar 2011, but headline inflation retreats to 2.2 percent in 2012 and 1.9 percent the following year as oil and food prices moderate.

	Actual	**RSQE Forecast**		
	2010	2011	2012	2013
GDP (billions of current $)	14526.5	15109.3	15757.0	16440.5
Real GDP (billions of chained 2005 $)	13088.0	13322.2	13644.6	13984.2
% change: year-over-year	3.0	1.8	2.4	2.5
% change: 4th-qtr-to-4th-qtr	3.1	1.7	2.5	2.5
Nonfarm payroll employment (millions)	129.8	131.1	132.8	134.7
Civilian unemployment rate (%)	9.6	9.0	8.9	8.6
Capacity utilization, total industry (%)	74.5	77.1	78.0	78.7
Inflation (private nonfarm GDP deflator, % change)	1.1	2.0	2.0	2.2
Inflation (CPI-U, % change)	1.6	3.2	2.2	1.9
Inflation (core CPI, % change)	1.0	1.6	1.7	1.6
Light vehicle sales (millions)	11.6	12.7	13.5	14.3
Private housing starts (thousands)	585	599	728	950
3-month Treasury bill rate (%)	0.1	0.1	0.1	0.2
10-year Treasury note rate (%)	3.2	2.8	2.5	2.8
Conventional mortgage rate (%)	4.7	4.5	4.1	4.3
Real disposable income (billions of chained 2005 $)	10061.7	10184.6	10338.9	10496.1
% change	1.8	1.2	1.5	1.5
Corporate profits after tax (billions of current $)	1408.4	1488.7	1466.9	1745.7
Value of U.S. $ (FRB broad index), % appreciation	–3.6	–5.1	–0.5	–2.3
Current account balance (NIPA basis, billions of current $)	–479.2	–474.5	–482.3	–516.5
Federal surplus (FY, NIPA basis, billions of current $)	–1269.2	–1226.2	–1088.0	–883.1