The U.S. economy showed some vitality entering 2011, and economists predicted modest growth. But by summer, a series of events—natural disasters, price shocks, and the debt ceiling stalemate, among others—threatened to derail the economy once again. Will 2012 finally see an acceleration of growth?

2011's Reluctant Recovery: Breaking through in 2012?

At the beginning of 2011, most economic forecasters predicted U.S. gross domestic product (GDP) growth for the year would be 3 to 4 percent. After all, the economy had grown at an average 3 percent quarterly annualized rate in the second halves of 2009 and 2010, partially supported by government stimulus and pent-up household demand, and the recovery seemed to be taking hold. But more than two years after the end of the deepest recession since the Great Depression, the U.S. economy continued to undergo significant adjustments and face shocks that have battered the rebound in economic growth.

Shocks to the system

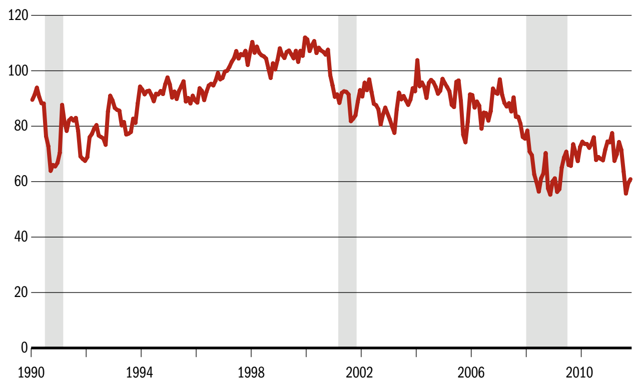
Unfortunately, a series of events in the spring and summer contributed to increased pessimism and much weaker than expected economic growth, which was below 1 percent in the first half of the year. These events included oil and commodity price shocks, the March 11 natural disaster and tragedy in Japan, the debt ceiling standoff in the United States and the resulting downgrade of the U.S. credit rating by Standard & Poor's, Hurricane Irene's destruction on the U.S. East Coast, and growing concern over the European debt crisis.

Improving conditions in the second half of the year were a welcome development. Gains in GDP were finally seen in the third quarter, mainly because of the resolution of some of the factors weighing on the economy in the first half of the year, along with increased investment and consumer spending. However, despite those developments, most forecasters remain skeptical that economic activity will improve dramatically in 2012, as a number of more persistent factors continue to restrain the pace of recovery. For instance, participants at the November 2011 Federal Open Market Committee (FOMC) meeting expect GDP growth in 2012 in the 2.5 to 3 percent range and the unemployment rate to decline only to 8.5 to 8.7 percent by the end of 2012.

Consumer confidence plummets

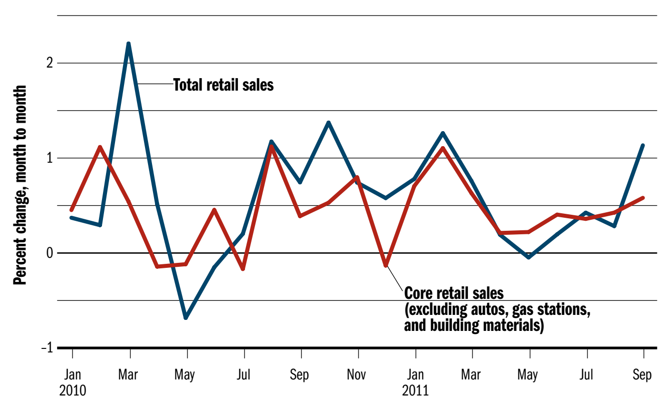
Consumers' behavior is a key aspect of the recovery, as it both reacts to and affects the strength of the economy. Many families continue to face high debt burdens and a constrained ability to borrow. They also own homes whose values continue to be depressed. At the same time, unemployment is high, and

Chart 1
University of Michigan Consumer Sentiment Index



Note: Data are through October 2011 and are indexed so that first-quarter 1966=100. The gray bars indicate recessions.
Source: Thomson Reuters/University of Michigan

Chart 2
U.S. Retail Sales



Note: Data are through September 2011.
Source: U.S. Census Bureau

businesses remain hesitant to expand payrolls. All these factors are reflected in the University of Michigan Consumer Sentiment Index, which fell dramatically during the third quarter (see chart 1).

In this environment, low consumer confidence is likely to continue to depress household spending. In spite of the boost seen in September retail sales activity, total core retail sales, which exclude autos, building materials, and purchases at gas stations, accelerated only slightly (see chart 2). Though consumer confidence improved modestly in October, households remain uncertain about the future, which will likely continue to restrain consumer spending through 2012.

Housing headaches persist

Another factor contributing to consumer uncertainty is the ongoing weakness in the residential real estate market. Depressed property values have eroded household balance sheets. According to the Economist Intelligence Unit, which conducts business and economic research, roughly one-quarter of homeowners with mortgages were underwater in October 2011. Following declines in the first quarter, housing prices began to rise modestly last spring. However, the S&P Case-Shiller home price index remains more than 30 percent below its mid-2006 peak (see chart 3). According to the Mortgage Bankers Association, home values are unlikely to appreciate very rapidly in the near term, with more than 3.4 million mortgage loans either more than 90 days delinquent or in foreclosure at the end of the second quarter of 2011. Foreclosed properties will only add to the already high supply of homes for sale.

Stabilizing the housing market will likely take place only gradually, leaving households to repair their balance sheets through other channels, including continued spending restraint. One bright spot in the housing sector has been the resurgence in the rental market, which has spurred construction of multifamily rental units. Apartment markets have become relatively tight, pushing rents higher and attracting demand for new residential investment.

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Jobs slow to return

Perhaps the factor most weighing on consumer confidence and spending at the end of 2011 is the ongoing weakness in the labor market. One of the most striking and painful aspects of the economic recovery has been its joblessness. Though the recession officially ended more than two years ago, labor markets still have a long way to go to recover lost ground. They were particularly hard hit during the downturn. At the peak of employment in January 2008, there were nearly 138 million employees on nonfarm payrolls in the United States. The gradual pace of improvement over the past couple of years has left the economy with a high rate of joblessness and almost 7 million fewer jobs than when the recession began (see chart 4).

Long-term unemployment is a particular concern because the longer workers are without jobs, the more difficulty they face in developing skills to keep up with changing workforce demands. About 45 percent of unemployed workers have been out of work for more than six months, compared with about 20 percent of unemployed workers out of work for that length of time in the five years preceding the recession. In addition to low underlying demand for workers, the labor market appears to feature a number of rigidities, inefficiencies, and behavioral impediments that may make returning quickly to prerecession levels of employment even more difficult. For instance, contraction of the manufacturing and construction sectors resulted in a large number of unemployed workers with skill sets that may not be easily transferrable to other types of jobs.

Other potential factors that are making the reduction of unemployment a challenge include employers requiring a wider spectrum of performance competencies than in the past,

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changes in government regulations, and some job applicants being unable to pass credit background checks.

After adding an average of 250,000 jobs per month in February to April, employment growth slowed considerably during the summer, as government workforces shrank and private-sector hiring slowed. In the six months that ended October 2011, the economy added an average of only about 90,000 jobs per month. That level is well below the threshold of around 150,000 to 200,000 monthly, according to Atlanta Fed calculations, necessary to make substantial progress in bringing down the unemployment rate. With the economic growth outlook relatively subdued, and the government sector likely to contract further in response to budget pressures, most economic forecasters expect that job creation will remain relatively modest through next year and unemployment will decline only gradually.

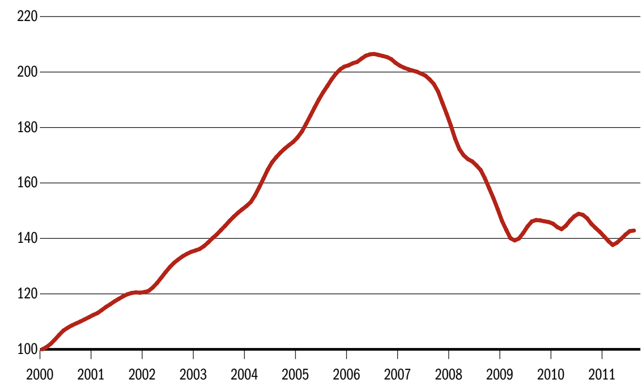
Inflation moderates

A high unemployment rate is consistent with considerable excess capacity in the economy, and is generally thought to constrain wage growth and have a moderating influence on inflation. However, the amount of slack is probably a bit less than it otherwise would have been because of the various rigidities, inefficiencies, and behavioral impediments that economists think may be influencing labor markets.

A number of transitory influences helped fuel higher inflation in 2011. The biggest were an upswing in commodity prices as well as a jump in auto prices because the Japanese disaster induced supply-chain bottlenecks. In fact, the personal consumption expenditure (PCE) price index rose at a pace

Chart 3

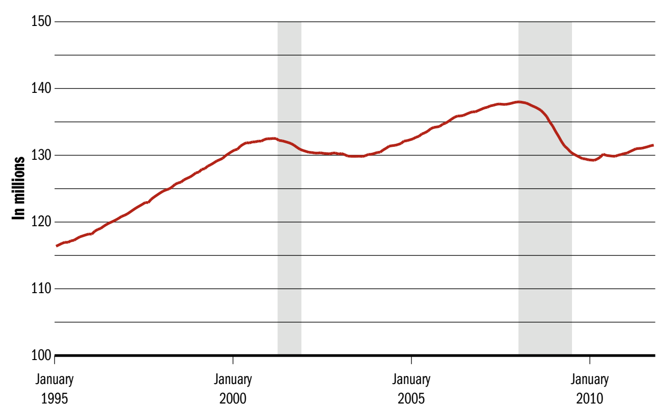
S&P/Case-Shiller Home Price Index



Note: Data are through August 2011, are indexed so that January 2000=100, and are for 20 metropolitan areas.
Source: Standard & Poor's

Chart 4

Total U.S. Nonfarm Employment



Note: Data are through August 2011 and are seasonally adjusted. The gray bars indicate recession.
Source: U.S. Bureau of Labor Statistics

exceeding the FOMC's long-term inflation objective of 2 percent or less for most of the year. However, inflation began to moderate later in the year as those transitory influences waned. Prices for oil and some other commodities moderated and a resurgence in auto production eased pressure on the prices for cars and light trucks. Additionally, surveys of households and economic forecasters, and measures of investors' inflation expectations derived from Treasury markets, suggest longer-term inflation expectations have remained reasonably stable. The stability of longer-term inflation expectations, combined with resource slack in the labor markets, is likely to continue to restrain inflation

The Financial Outlook in 2012

In 2011 the United States faced a number of challenges that prevented ideal financial market functioning and threatened broader financial stability. These issues may continue to shadow the country in the coming year.

Political gridlock, credit downgrade, and European crisis disrupt markets

In August, after contentious debate, Congress raised the debt ceiling to avoid defaulting on U.S. debt obligations. Not long after, Standard & Poor's downgraded the U.S. credit rating for the first time in history. Meanwhile, Europe's ongoing sovereign debt crisis added to the turmoil and continues to pose risks. The European situation threatens U.S. financial institutions through their direct and indirect exposures to European debt. Given the modest nature of the U.S. recovery, the risks coming from Europe, and underlying vulnerabilities in the U.S. financial system, uncertainty and volatility will likely continue near term.

Nervous investors eye Europe

Financial spillovers from the European crisis figure prominently in the most severe negative scenarios for U.S. financial markets. If financial pressures on European sovereigns continue to escalate, global credit markets could freeze up. European financial institutions with large exposures to troubled economies would come under intense scrutiny, leading to negative effects in the United States. The likelihood of such a financial shock is causing market participants to be risk-averse. And as investors hedge against various negative scenarios—by seeking safety in U.S. Treasuries and gold and by selling riskier assets such as stocks and corporate bonds—U.S. financial markets are suffering from much higher volatility. A comprehensive policy response in Europe would help U.S. financial market functioning.

The financial system may be better prepared for another shock

Despite these challenges, the U.S. financial system should be in a better position to withstand a financial shock than in the past. Banks have made progress in deleveraging from the high debt levels they had before the crisis, and their levels of capital are now higher. However, the deep interconnections embedded within the financial system remain a concern. These concerns include counterparty risk in certain wholesale funding markets, the clearing of derivatives contracts in the wake of a large default, and the potential for acute liquidity pressures on institutions outside the traditional banking system, such as money market mutual funds. ∎

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

pressures going forward. Participants at the November 2011 FOMC meeting expect inflation as measured by the PCE price index to be in the 1.4 to 2 percent range in 2012.

Looking ahead to 2012

Though modest improvement is likely, it appears that growth will continue to be restrained through 2012. Inflation is likely to return to the 2 percent range, consistent with the FOMC's objective. However, as with any forecast, the economic outlook comes with a number of risks. Most economists' assessments of the risk to the growth and employment outlook are weighted to the downside. Volatility in financial markets, slow jobs growth, and weak consumer confidence make the economy vulnerable to any number of adverse shocks coming from Europe or elsewhere (see the sidebar on the financial outlook in 2012).

Regarding inflation, several factors contribute to a sanguine outlook. The potential for resource slack in the economy placing further downward pressure on inflation expectations is roughly balanced by the risk of upward pressures from commodity prices or other influences supporting inflation expectations.

Atlanta Fed economists anticipate that the process of financial deleveraging within most sectors of the domestic economy will continue to play out, and this paying down of debt is likely to restrain the pace of expansion in 2012 and beyond. In addition, a weaker European economy and shifts in the growth and composition of emerging economies is likely to restrain demand for U.S. exports in the coming year. Relatively high unemployment and a slow pace of employment growth along with little improvement in housing markets are likely to weigh on the confidence of households, and these factors will hold back consumer spending and the expansion plans of business. Confidence will return only as the expansion proceeds and the various economic headwinds dissipate. ∎

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