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The Economic Outlook: On the Cusp of Something Great?

St. Louis Council of Construction Consumers
St. Louis, MO

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Federal Reserve Bank of St. Louis
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Disclaimer

The views I will express today are my own and do not necessarily reflect the positions of the Federal Reserve Bank of St. Louis or the Federal Reserve System.

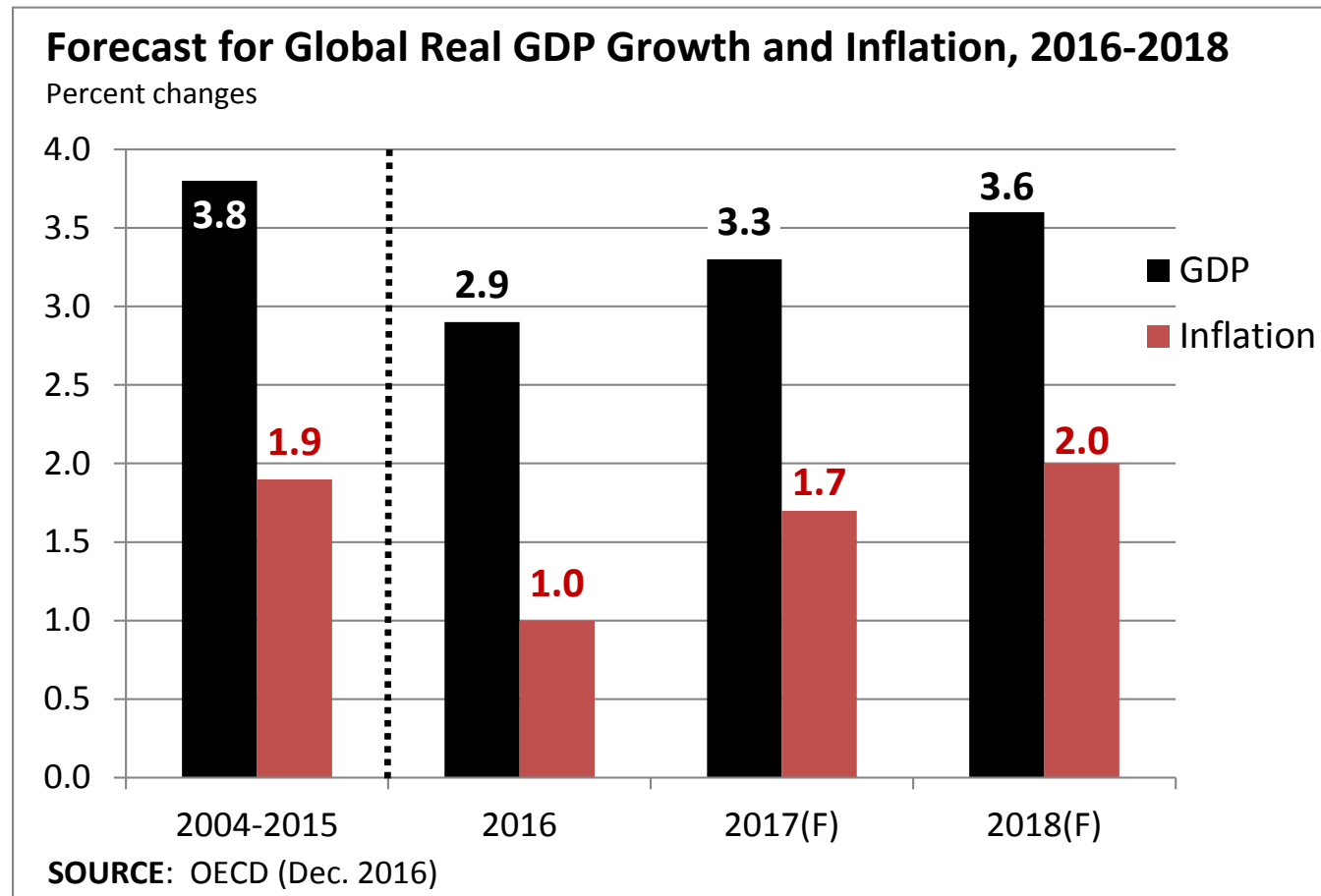
Outline of Today's Talk

- Lead off with a discussion of the global economy.
- Then turn to the U.S. economy and Federal Reserve policy, with a short detour on infrastructure economics.
- Finally, end with a discussion of the state and local economy, with an emphasis on the construction sector.

Current Global Economic Developments.

- According to the December FOMC Minutes, global growth rebounded in Q3.
- Faster growth in Canada and Mexico a key driver.
- FOMC participants noted potential “downside risks” stemming from an appreciation of the U.S. dollar and “financial vulnerabilities in some foreign economies.”
- According to the IMF, China, India, Japan, and Spain are among the countries to watch in 2017.

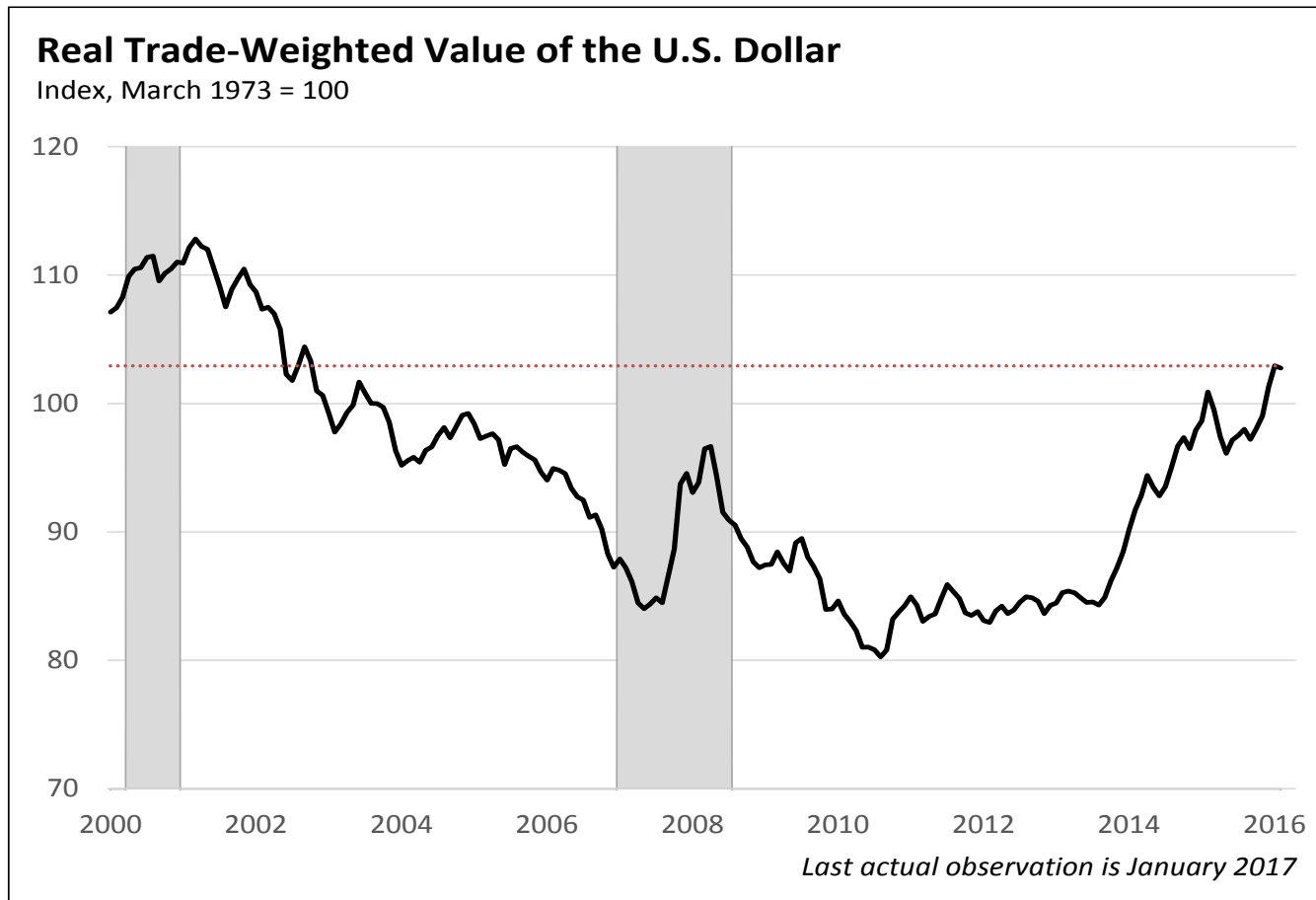
The Global Economic Outlook: Modestly Stronger Growth and Inflation.



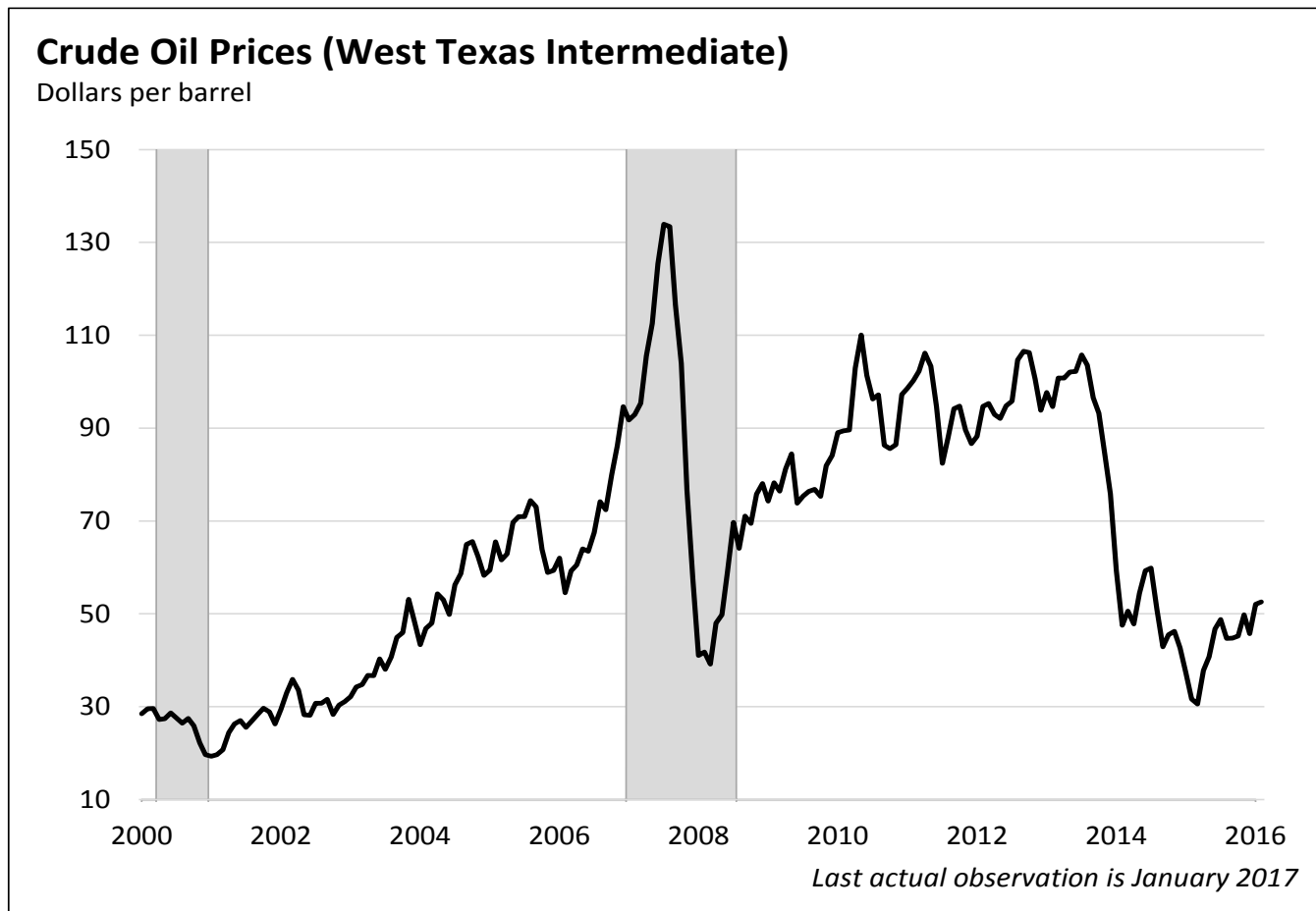
U.S. Linkages with the Global Economy.

- The U.S. economy is less susceptible to global economic developments than most other countries.
 - Exports: 13% of GDP; Imports: 16% of GDP.
 - For Germany: 90% (exports + imports)
- Still, global trends influence national and local economic conditions through a variety of channels.
 - For example, oil prices and the value of the dollar are traded in global markets and can have far-reaching effects on the U.S. economy. Global saving flows can affect U.S. interest rates.

In December the real value of the U.S. dollar hit its highest level since Oct. 2003.



Oil prices have rebounded, but they are still well below record levels in 2008.



What are the Economic Effects of a Stronger Dollar and Rising Oil Prices?

- A stronger dollar lowers the price of imported goods and services. This helps consumers and manufacturers who import materials.
- But a stronger dollar increases the prices of U.S. goods and services to foreign purchasers. This tends to have a dampening effect on exports.
- Rising oil prices increase costs faced by consumers and energy-intensive firms, but . . .
- Higher oil prices helps the U.S. energy sector.

The U.S. Economy: A Long-term View.

- We're into the 8th year of expansion . . . The average post-WWII expansion lasts about 5 years.
- This expansion has been the weakest since the 1930s—growth has averaged about 2.25% per year, well below the historical average of 3% per year.
- There are many reasons for this: Deleveraging, tighter access to credit, reregulation, higher taxes.

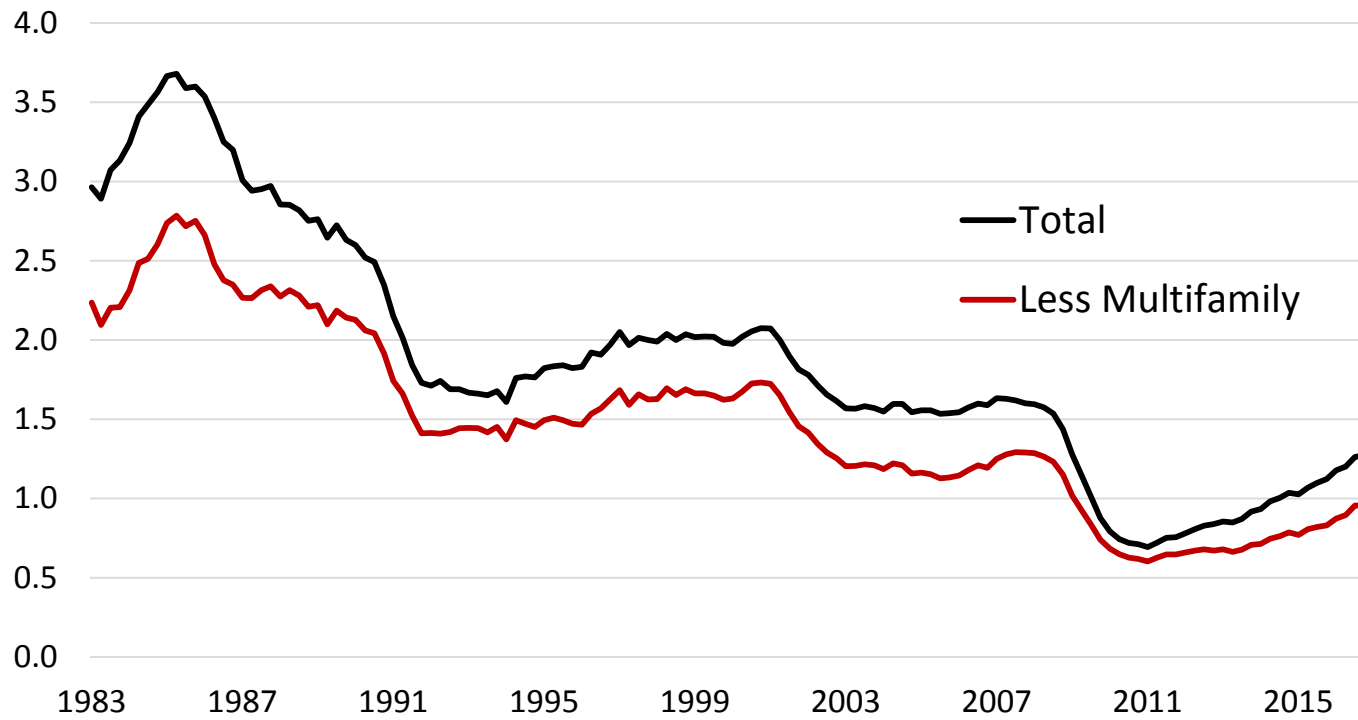
Areas of Strength and Weakness.

- Consumer spending—especially on big ticket items like autos—has been a strength of the economy.
- Residential construction activity downshifted a bit in 2016, but commercial and industrial construction activity remained solid.
- Capital spending by business has weakened over the past two years; some blame this on uncertainty.
- State and local government finances have improved, helping to spur increased spending.

U.S. commercial construction trends.

Private Fixed Investment in Commercial Structures, 1983-2016

Percent of real GDP



NOTE: Private fixed investment in commercial, health care, and residential multifamily.

SOURCE: Bureau of Economic Analysis

Nonresidential segments: 2014-16 change, 2017 forecast

	<u>2015 vs.</u> <u>2014</u>	<u>2016 vs.</u> <u>2015</u>	<u>2017</u> <u>forecast</u>
<u>Nonresidential total (public+private)</u>	<u>7 %</u>	<u>4%</u>	<u>2-</u> <u>6%</u>
Power (incl. oil & gas field structures, pipelines)	-16	3	5-10
Highway and street	6	2	2-5
Educational	5	6	3-7
Manufacturing	33	-4	<0
Commercial (retail, warehouse, farm)	6	11	0-5
Office	18	25	8-13
Transportation	8	-6	0-5
Health care	5	2	0-5
Lodging	30	25	~0

Source: U.S. Census Bureau construction spending report; Ken Simonson, Associated General Contractors of America, 2017.

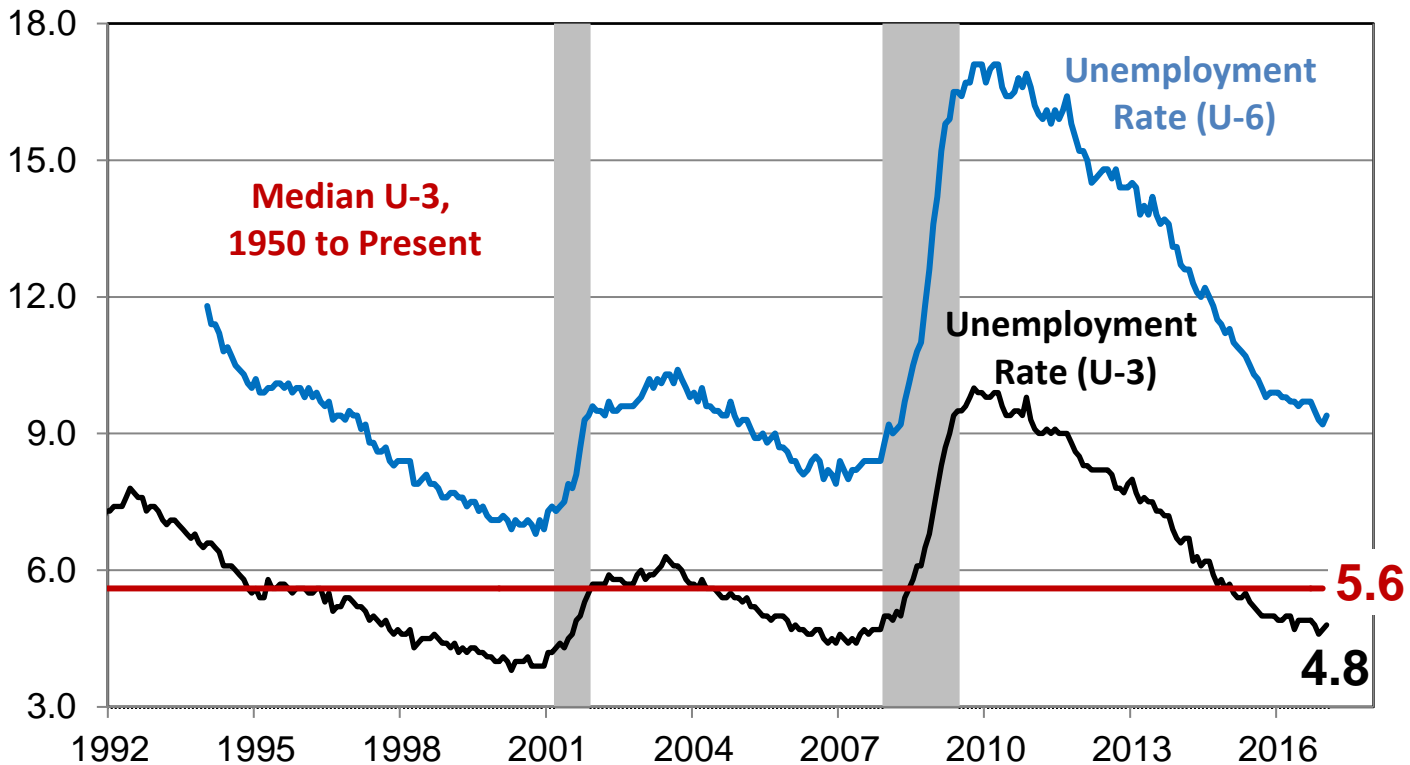
Solid Labor Markets.

- Despite the anemic growth of real GDP growth, job growth has been robust.
 - In 2016, monthly job gains averaged about 187,000 per month. This is well above its sustainable rate.
 - Industries that have seen the strongest job growth have been professional business services and construction.
 - Mining employment was strong for several years.
- The unemployment rate is 4.8%—that's basically full employment, but some impairment remains.

A mostly healthy labor market.

The U-3 (Official) and U-6 Unemployment Rates

Percent



Source: Bureau of Labor Statistics.

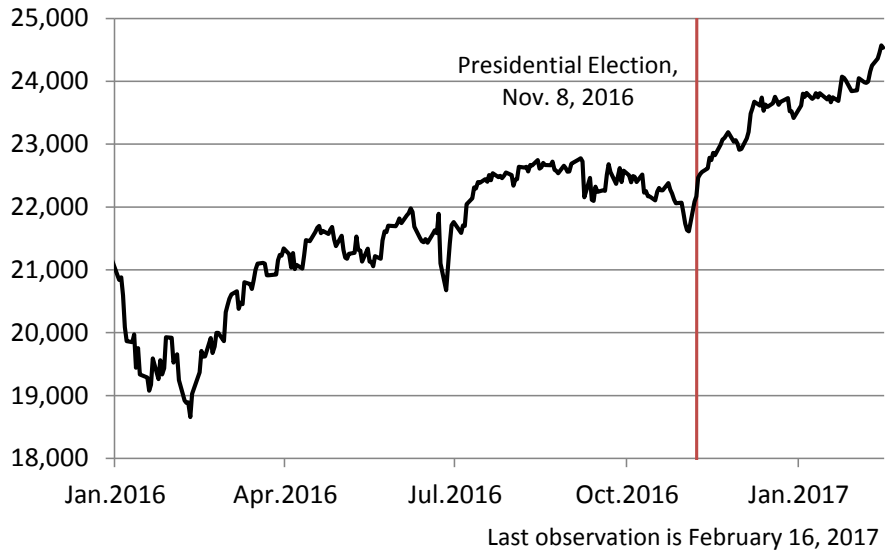
Data through January 2017.

Is the tide turning?

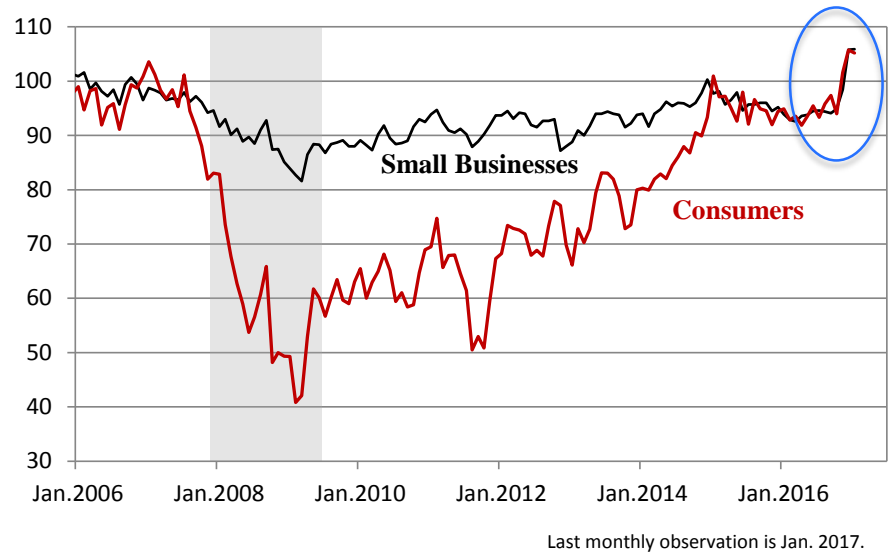
- Some polls suggest large percentages of people believe the economy is still in a recession.
- Likewise, business remain reluctant to commit to long-lived investments.
- But sentiment appears to be improving according to several indicators.

Stock prices and confidence surges.

Wilshire Total Stock Market Index



Confidence Measures: Consumers and Small Businesses
Index



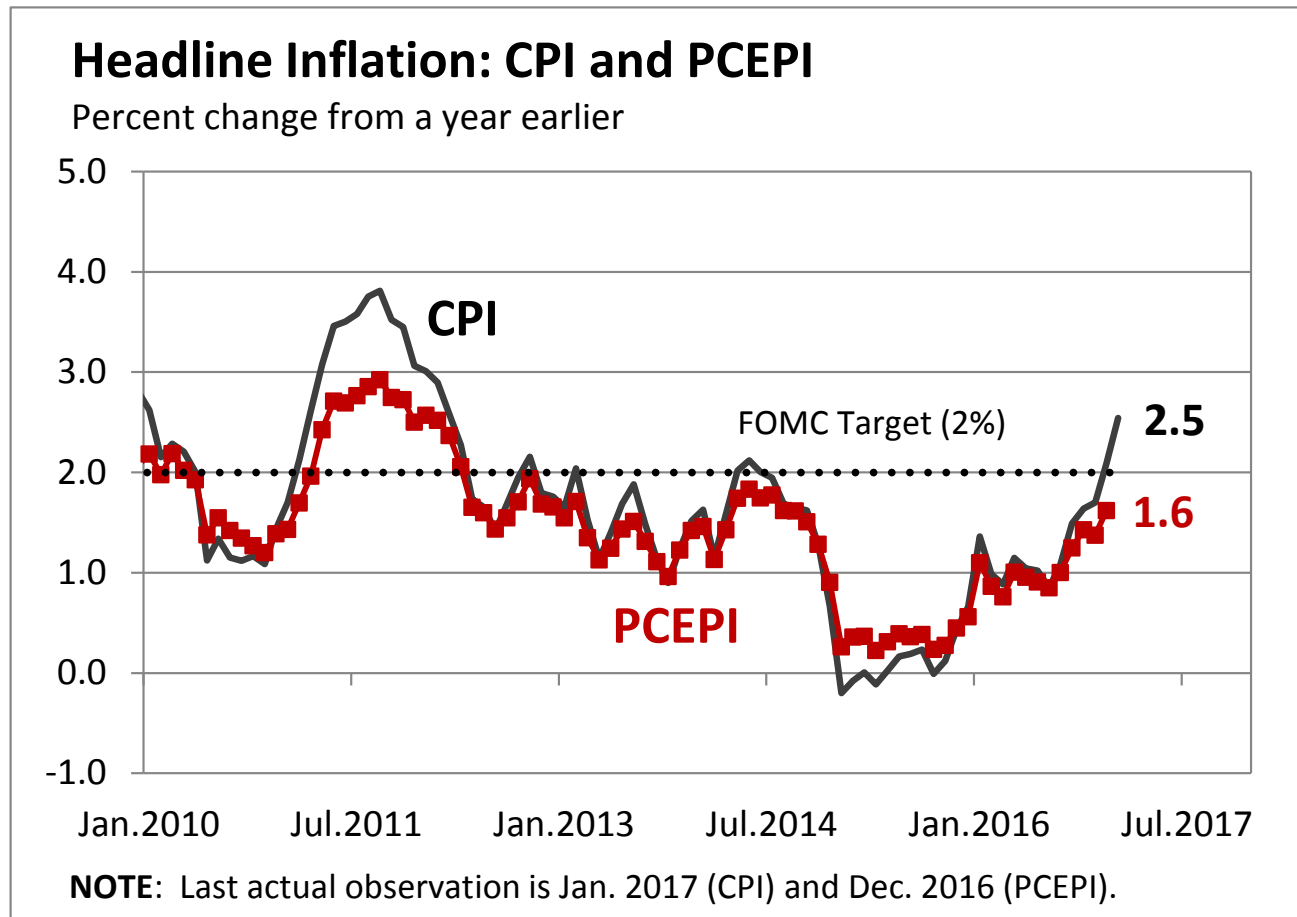
Why the improving optimism?

- Several factors are at work.
- The prospect of tax reform, such as lower rates and a broadening of the base; full expensing of business investment, etc. fuel expectations of faster growth and higher corporate profits.
- These positive effects are partially offset by the expectation of trade and labor restrictions, and the possibility of higher budget deficits and inflation.

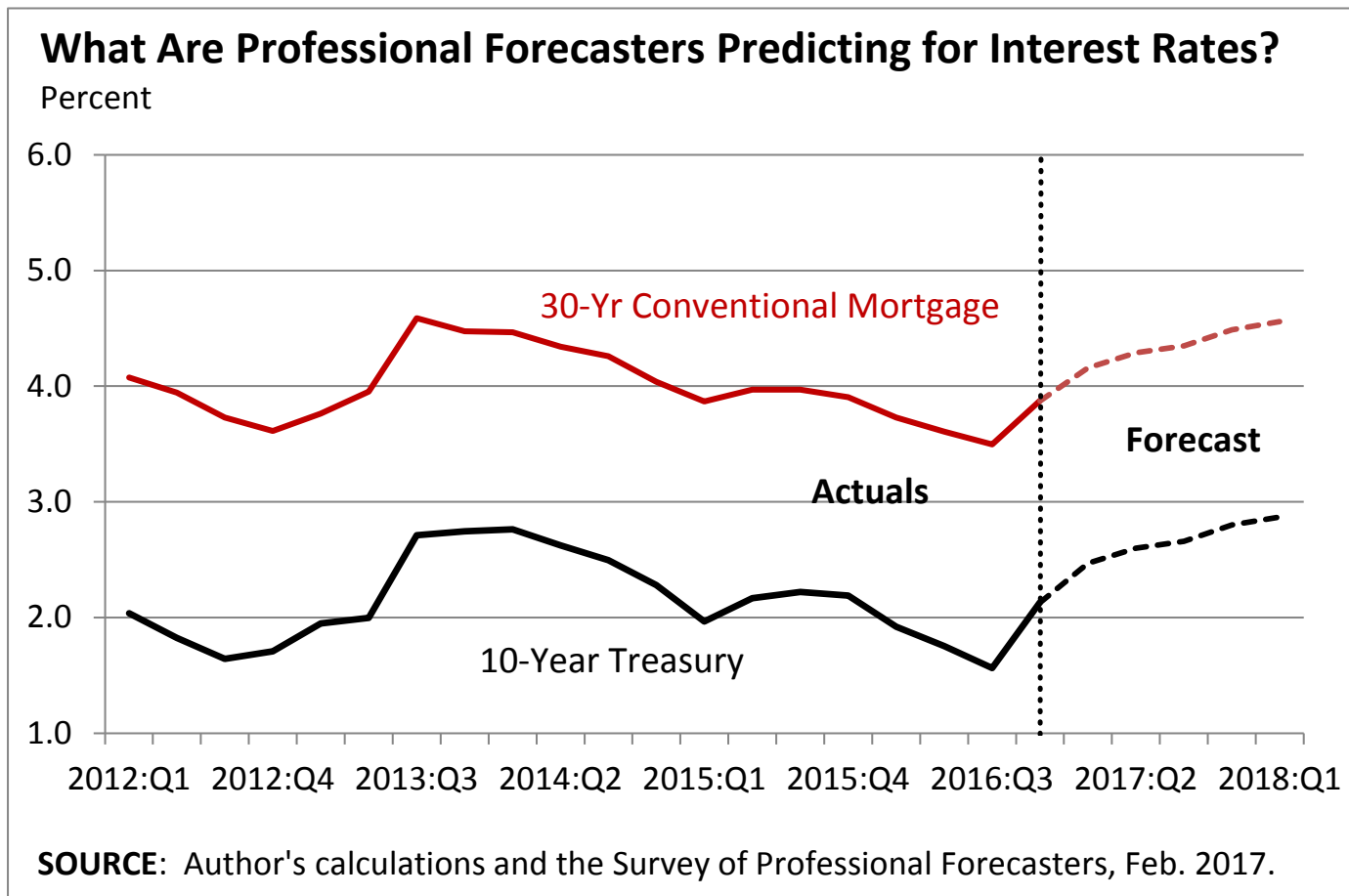
The U.S. Inflation Outlook.

- Inflation has also been very low—below the Fed's 2% inflation target for the past four years.
 - Low inflation and weak economic growth mean low interest rates.
 - If inflation or growth picks up, then rates will rise.
- As noted earlier, the next Administration wants to pursue policies that could boost growth.
- One worry is that goosing the economy when it's at full employment could spark higher inflation.

Inflation is increasing—and it's not just the effects of higher oil prices.



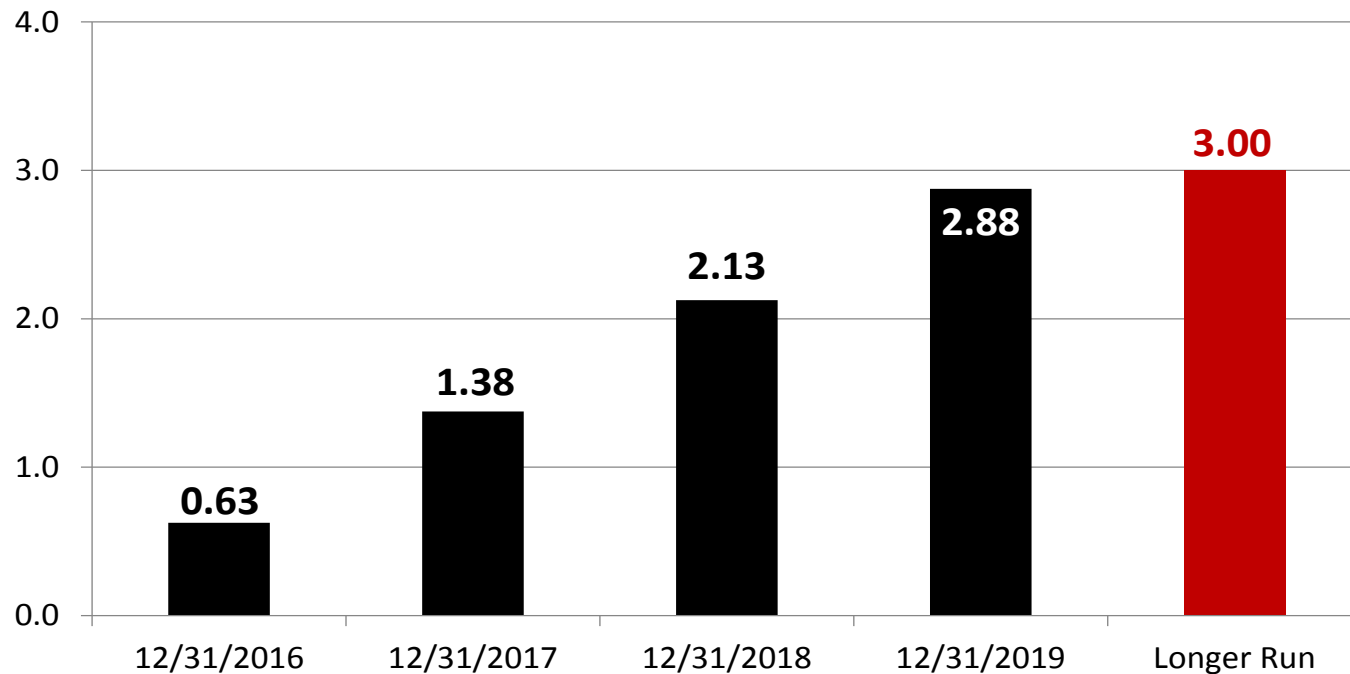
Forecasters project a modest increase in interest rates over the next year.



The FOMC's interest rate target could increase by 0.75% over the next year.

Projections of the FOMC's Federal Funds Target at the End of the Indicated Year According to the Median FOMC Participant

Percent



SOURCE: Federal Reserve Summary of Economic Projections, December 14, 2016.

Kliesen's Fearless Forecast.

- Projected averages, 2016 to 2019:
 - Real GDP growth: 2.25% to 2.75%
 - Unemployment rate: 4% to 4.5%
 - Headline inflation: 2% (some upside risk)
- Punchline: Policy changes, if realized and designed appropriately, could boost economic growth by 0.5% to 0.75%. But inflation will need to stay low.

Risks to the Economic Outlook.

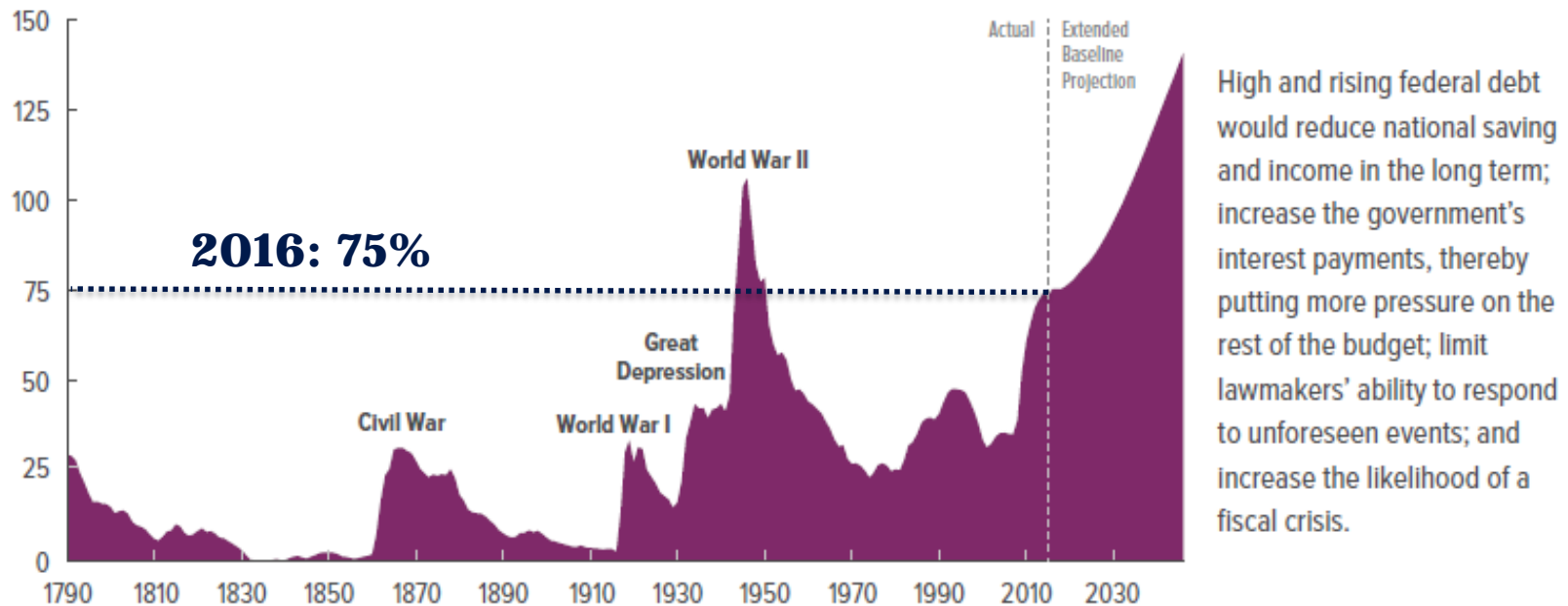
- Recession risks . . . Recessions don't die of old age, but neither are they predictable.
- Big unexpected events: A surge in energy prices or a collapse in asset prices.
- Oil prices likely to rise only so far due to the U.S. shale oil producer.
- Geopolitical risks: China, North Korea, Russia, Middle East, etc. Pick your poison.

Rising debt: This trend is not our friend!

Figure 1-1.

Federal Debt Held by the Public

Percentage of Gross Domestic Product



High and rising federal debt would reduce national saving and income in the long term; increase the government's interest payments, thereby putting more pressure on the rest of the budget; limit lawmakers' ability to respond to unforeseen events; and increase the likelihood of a fiscal crisis.

Source: Congressional Budget Office. For details about the sources of data used for past debt held by the public, see Congressional Budget Office, *Historical Data on Federal Debt Held by the Public* (July 2010), www.cbo.gov/publication/21728.

The extended baseline generally reflects current law, following CBO's 10-year baseline budget projections through 2026 and then extending most of the concepts underlying those baseline projections for the rest of the long-term projection period.

Is 4% Real GDP Growth possible?

- Difficult, but not impossible.
- With an aging population, the boost will need to come from factors that generate faster productivity growth.
- Economists look to several factors in this regard:
 - Ideas (new technologies spawned by R&D)
 - Institutions (rule of law; universities; government)
 - Population (fertility rates, immigration, longevity)
 - Human capital (knowledge, education)

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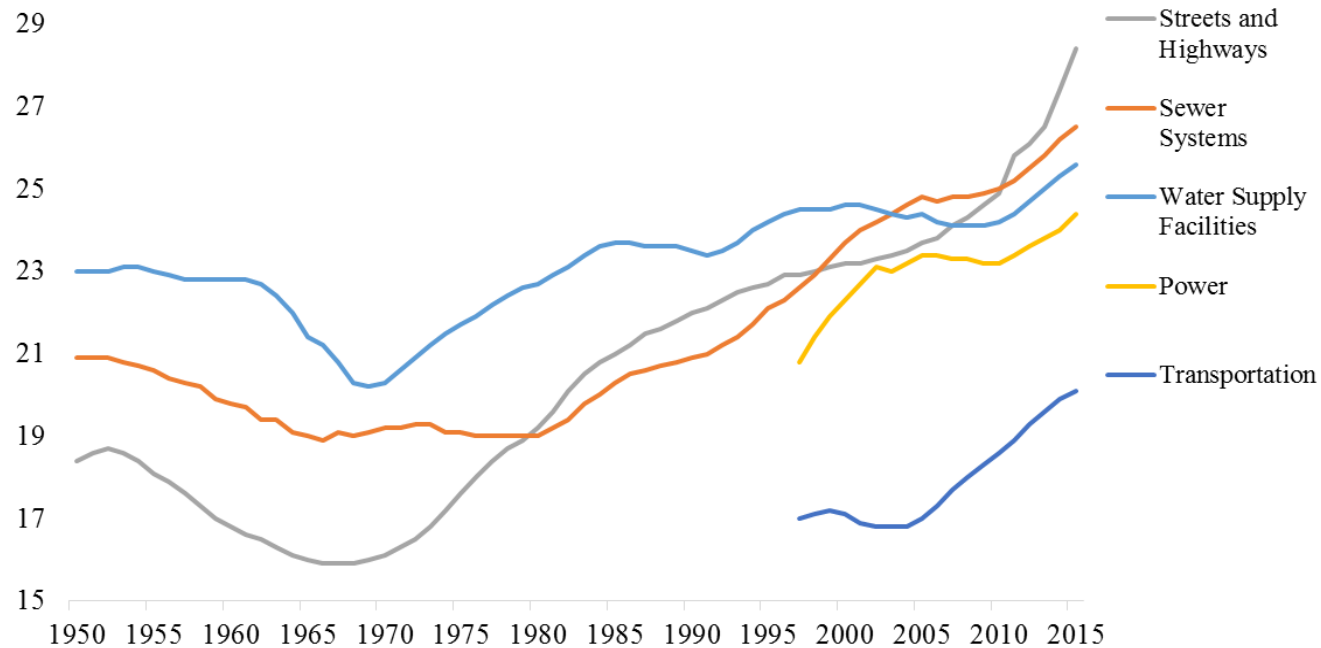
The Infrastructure Debate

- Some believe that now is the time to “go big or go home” because of low borrowing costs.
- Others believe that the benefits of a large infrastructure program are oversold.
- Still others point to the limitations posed by regulations, land acquisition costs, etc.
- Many economists argue that the highest returns come from investing in existing infrastructure.

Average age of structures is at all-time highs. Better quality (technology)?

Average Age of Public Structures

Age, Years

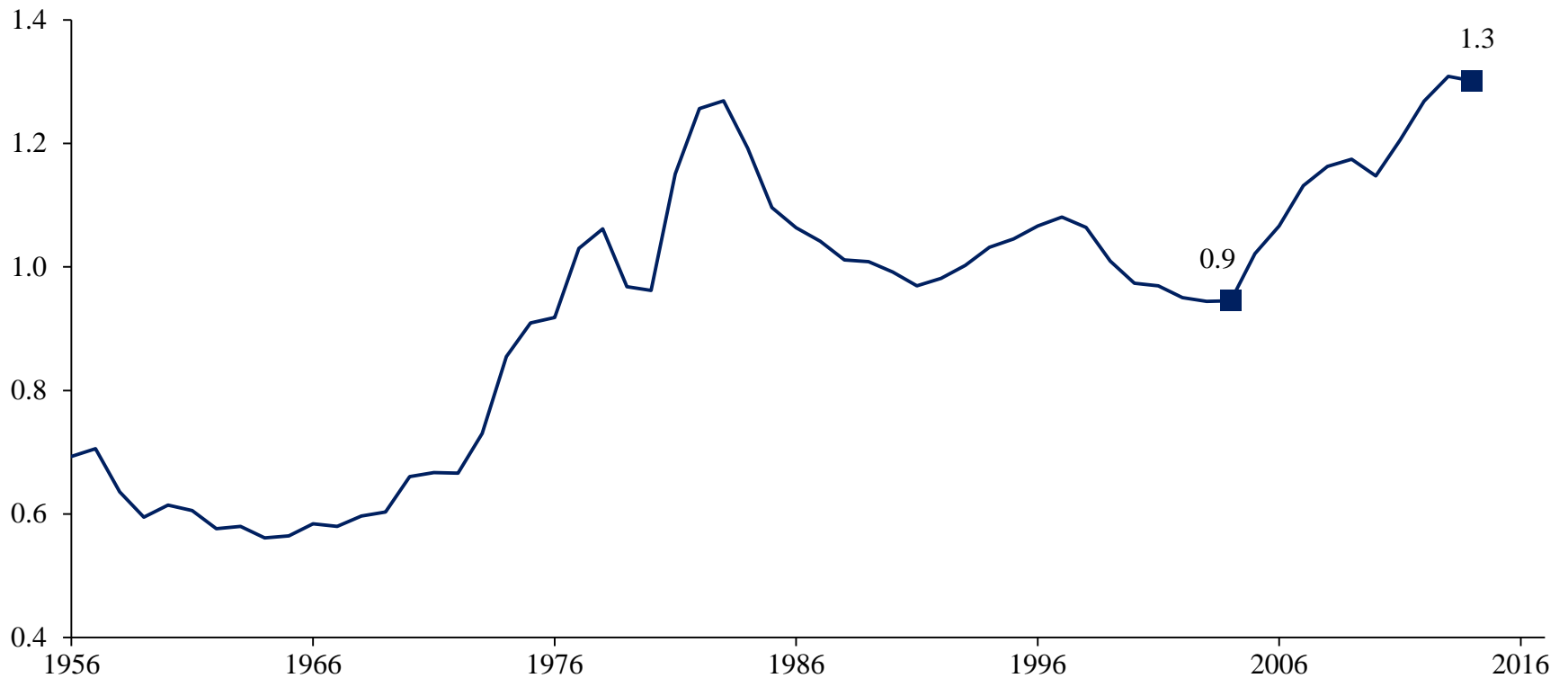


Source: BEA/Haver

Note: Water supply facilities and sewer systems exclude Federal structures - which account for at most 6 percent of the value of their combined capital stock - because disaggregated Federal data are unavailable. Data for power and transportation fixed assets begin in 1997 because disaggregated data are unavailable prior.

More spending on maintenance.

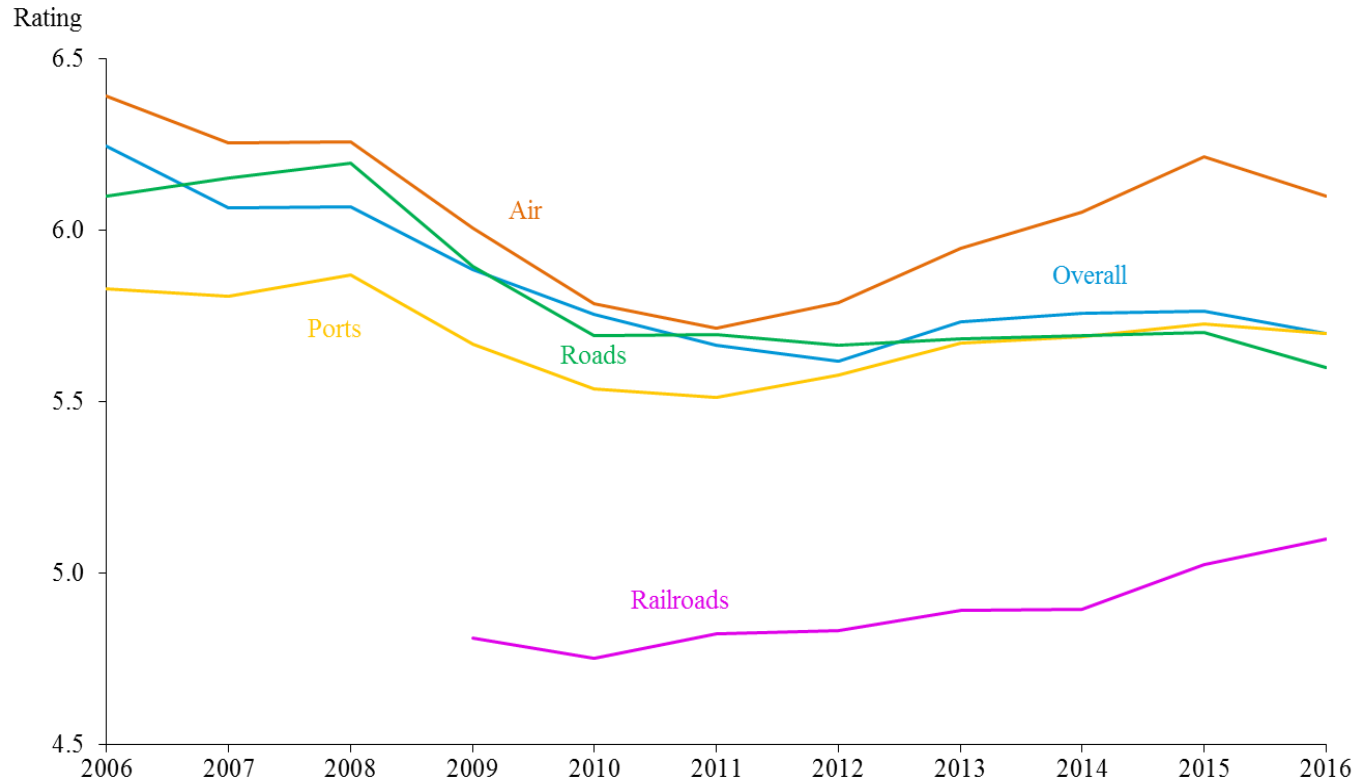
Ratio of Public Spending on Operation and Maintenance to Public Spending on New Capital



Source: Congressional Budget Office (2015); CEA calculations.

Infrastructure qauality has improved in some areas, lagged in others.

Quality of U.S. Infrastructure, 2006–2016



Note: Scale of 1-7, with a higher score indicating better infrastructure quality. Rating for railroads is first available in 2009.

Source: World Economic Forum, Global Competitiveness Report Survey.

Case Study: 2009 Recovery Act.

- Federal infrastructure spending may crowd out state and local infrastructure spending.
- My colleague, Bill Dupor, found:
 - As states spent Recovery Act highway grants, many simultaneously cut their own contributions.
 - States substituted highway grants into other spending that had little economic benefits, limiting the Act's effectiveness.

TURNING TO THE ST. LOUIS ECONOMY

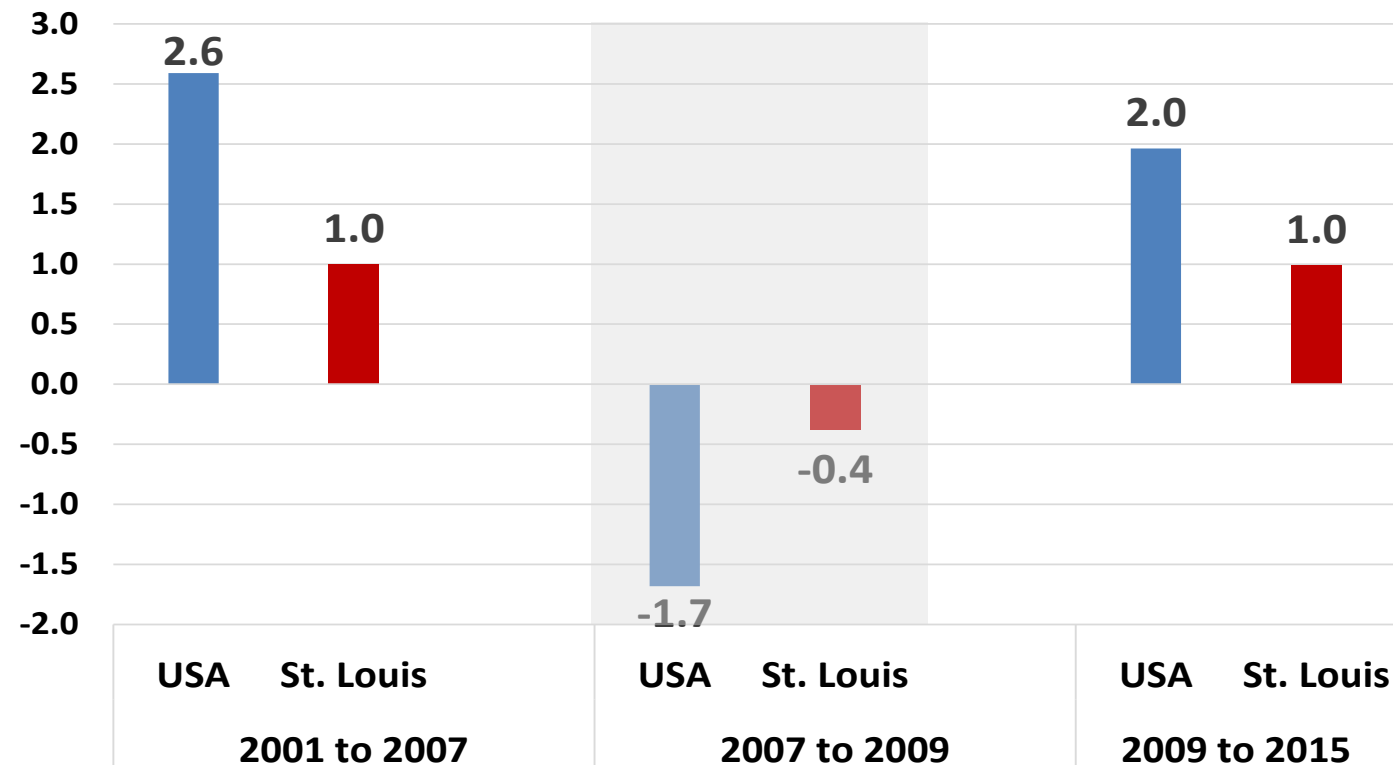
Turning to the St. Louis Economy

- In this talk, “St. Louis” refers to the Metropolitan Statistical Area (MSA), a 14-county area of Illinois and Missouri surrounding the city of St. Louis.
- The St. Louis MSA’s labor force is currently about 1.5 million; population is about 2.8 million.
- In 2015, household median income in the St. Louis MSA was about \$56,500; it was \$55,800 for the United States.

The St. Louis-area economy has grown at a slower pace than the U.S. economy since 2001.

Growth of the St. Louis Economy vs. the U.S. Economy: 2001 to 2014

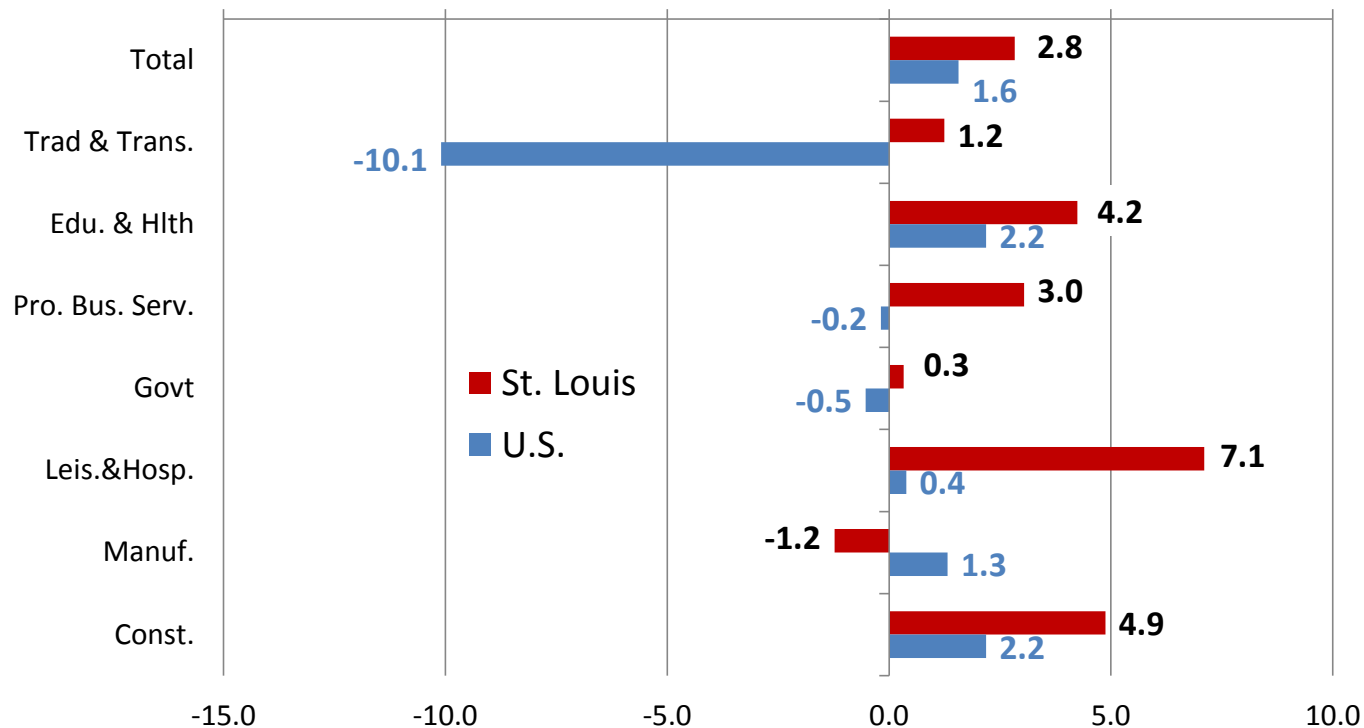
Percent changes at annual rates



Over the past year, St. Louis' job growth has exceeded the nation's by quite a bit.

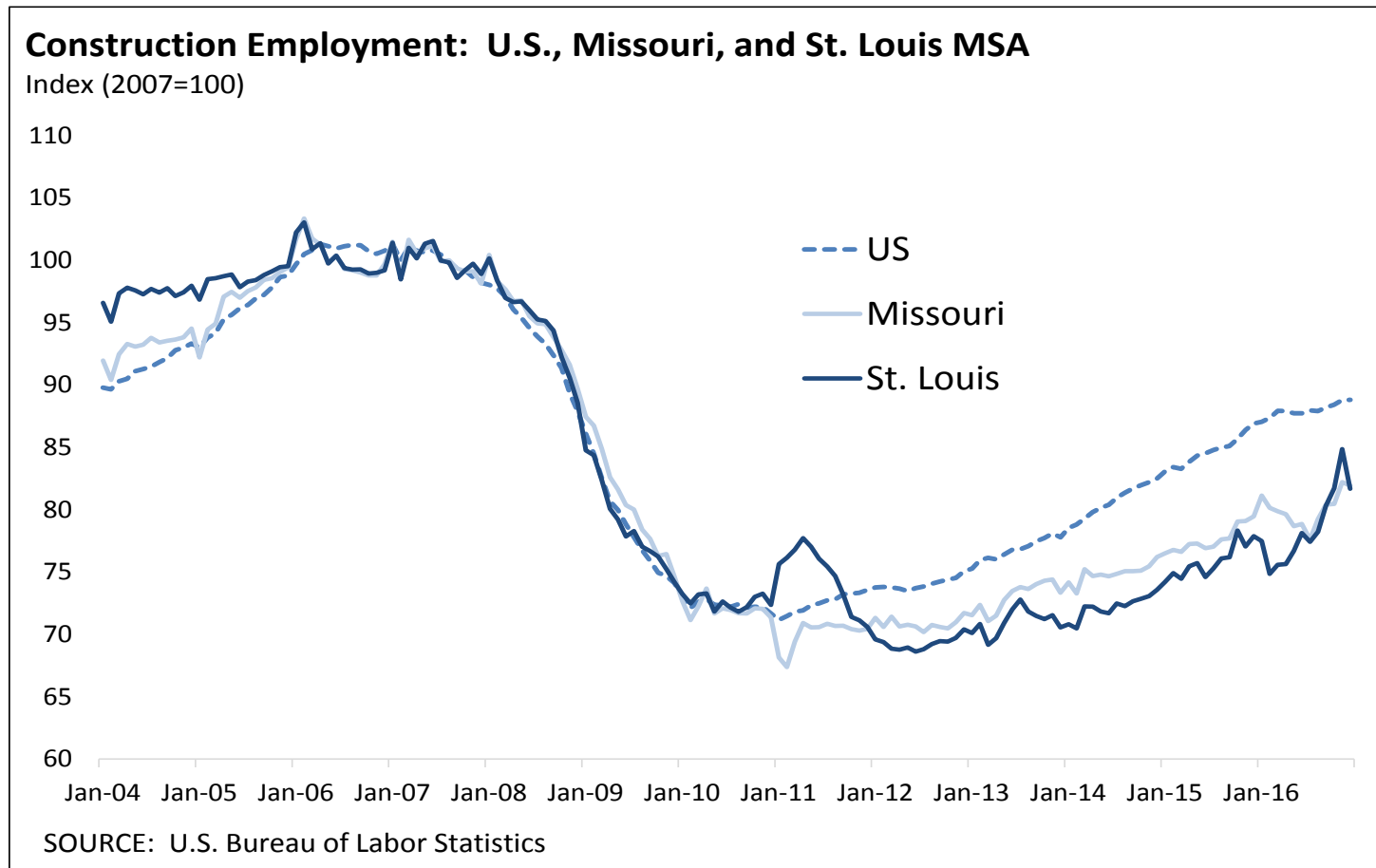
U.S. and St. Louis MSA Payroll Employment by Industry Over the Past Year

Percent change, through December 2016



SOURCE: U.S. Department of Labor and Haver Analytics

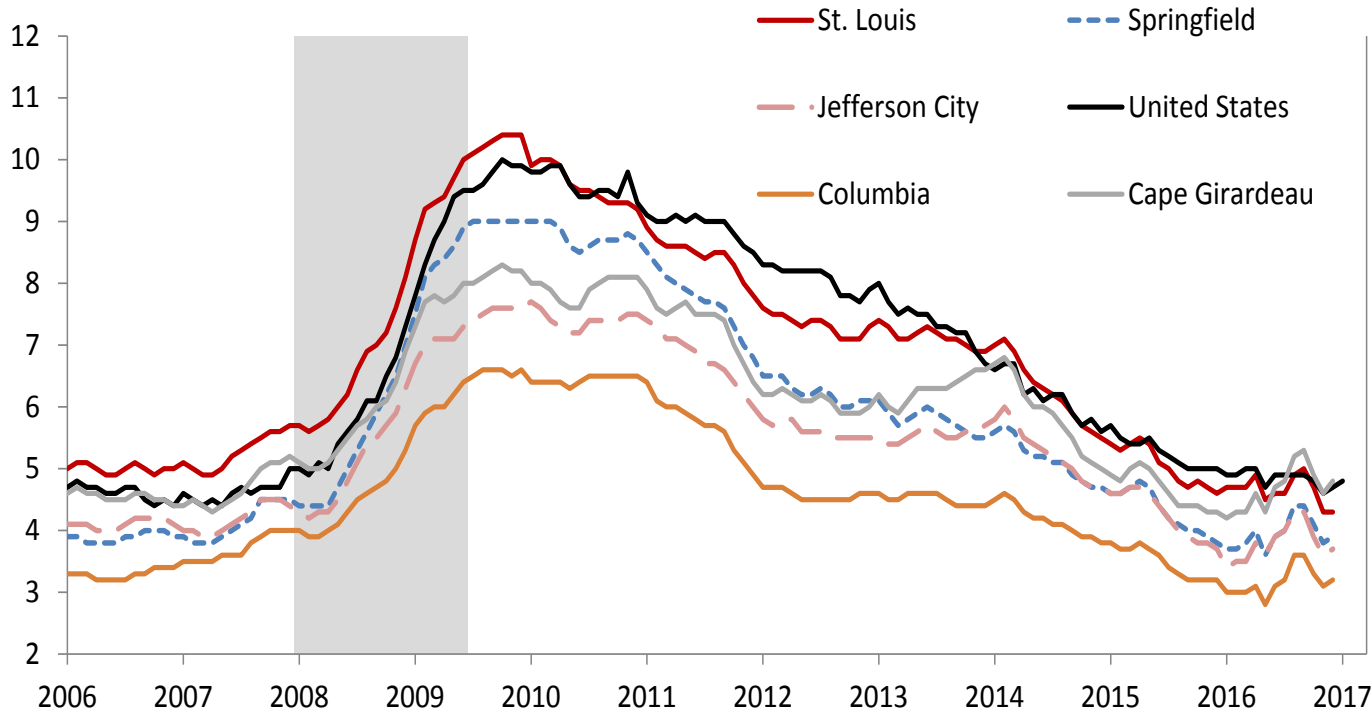
Construction employment remains well below its pre-recession peak.



In Missouri, the St. Louis unemployment rate is above other MSAs. College towns have low rates!

St. Louis Zone MSA Unemployment Rates

Seasonally Adjusted Percent



Source: Bureau of Labor Statistics/ Haver Analytics.

Data through December 2016.

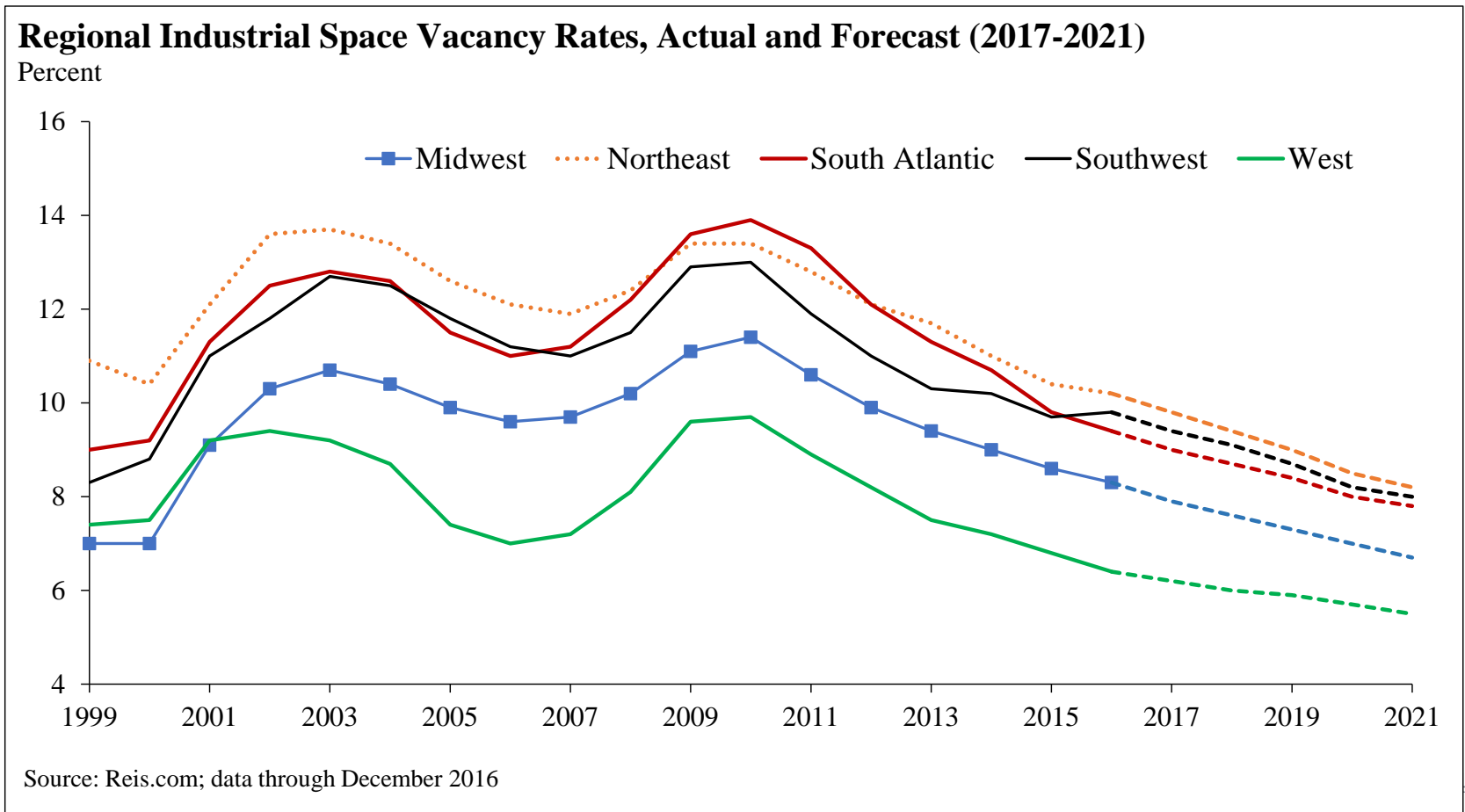
December 2016
unemployment
rates:

Columbia: 3.2%
Jeff. City: 3.7%
Springfield: 3.9%
St. Louis: 4.3%
U.S.: 4.7%

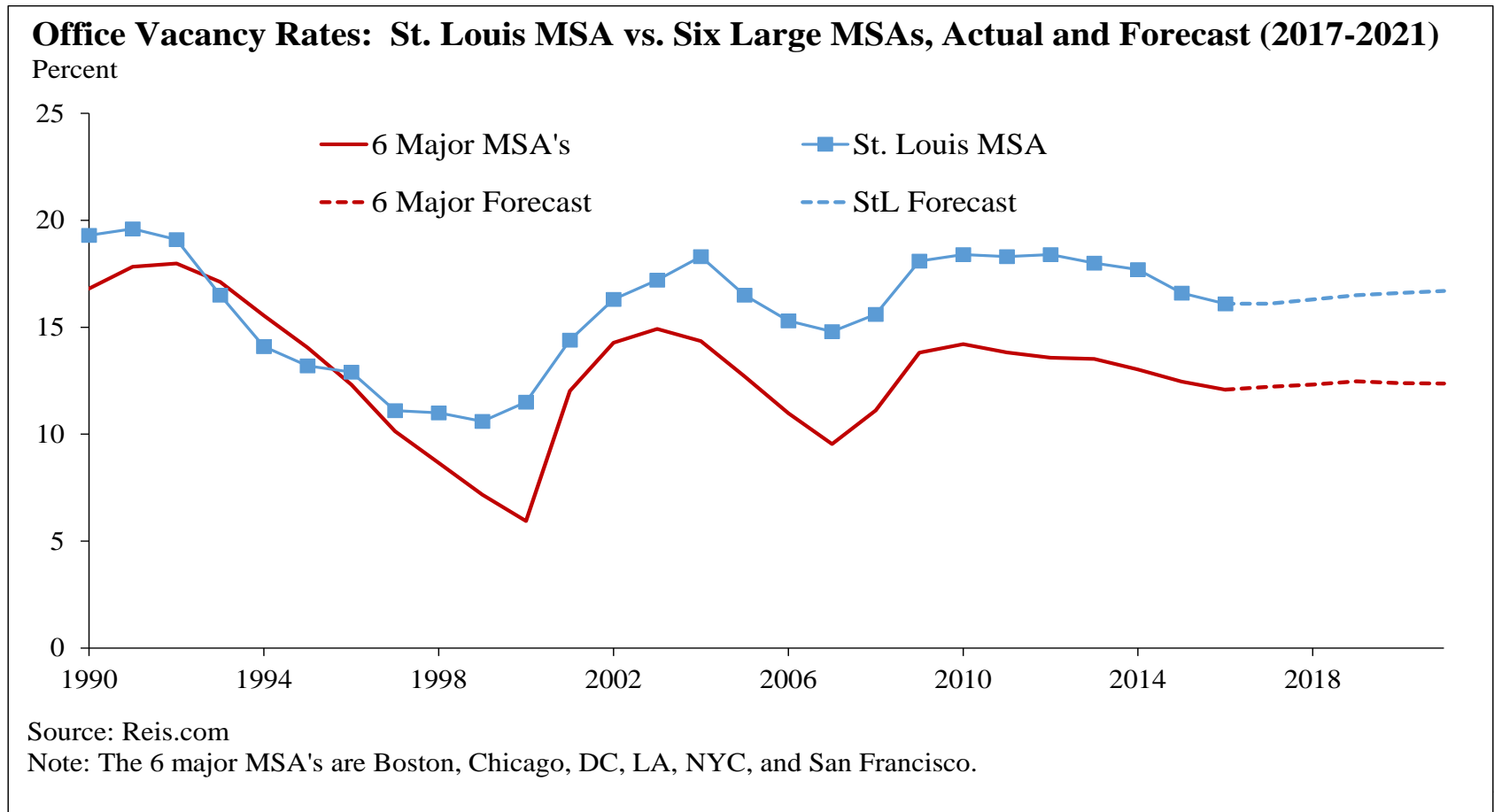
Anecdotes from St. Louis contacts.

- As reported in the Burgundy and Beige Books.
- Construction activity is strengthening.
 - “increases in build-to-suit and spec projects.”
 - Industrial space under construction in 2016 nearly double 2015’s level.
- A “booming” entrepreneurial sector could portend stronger future growth.
 - New business creation tends to support the increased demand for services and thus more office space.

Industrial space vacancy rates are falling and are the lowest in the Midwest and in the West.



Office vacancy rates are higher in the St. Louis MSA than in the nation's largest MSAs.



The Outlook for St. Louis: Near and Far

- St. Louis economy has been growing slower than the nation's economy for quite some time. A key reason has been weak labor force growth.
- Housing and commercial construction have been a source of strength for the U.S. economy, but this is a relatively small part of the St. Louis economy.
- A “booming” entrepreneurial sector could portend stronger future growth.

QUESTIONS?

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