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The Outlook for the Economy

Remarks by

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at

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Good afternoon. I am pleased to be with you, and it is good to be back in Providence. As many of you know, I attended Brown University, and the city I see today is very different from the one I remember from my time here in the 1960s. Many of those differences reflect dramatic and, at times, wrenching economic changes in Rhode Island over those years, especially since the financial crisis and the Great Recession. As ever, Providence has faced these challenges, and I am impressed by the revival and renewal evident downtown, encouraged by attractions like Waterfire, which bring visitors and commerce here and build civic pride.

Today I would like to speak with you about the outlook for the U.S. economy. I should note at the outset that my remarks today reflect my own views and not necessarily those of others in the Federal Reserve System.

The Recession and the Recovery So Far

As you all know, the economy is still recovering from the Great Recession, the worst downturn since the terrible episode of the 1930s that inspired its name. The recession began more than seven years ago, the result of the collapse in the housing market and the financial crisis that it sparked. Rhode Islanders are well aware of the great toll taken by the recession. The unemployment rate hit 10 percent nationally, and it reached 11.3 percent here in Rhode Island. Nationally, payrolls shrank by some 8-1/2 million, about 6 percent, and the 41,000 jobs lost in Rhode Island represented close to 8 percent of the state's employment. U.S. economic output fell more than 4 percent nationally, the most since the Great Depression, and many of the hardest-hit industries,

including housing construction and manufacturing, are important to the Rhode Island economy.[1]

The Federal Reserve took action to help stabilize the financial system during the crisis, and we have supported the economic recovery with monetary policy actions designed to hold down longer-term interest rates. With this help, the economy has made significant strides. The pace of job gains has gradually strengthened, and payrolls expanded by more than 3 million in 2014 alone. The unemployment rate has come down steadily to 5.4 percent in April. One sign of a stronger labor market is that the number of job openings has risen impressively, and another is that more workers are quitting their jobs, signaling greater confidence in their ability to find a new job.

Rhode Island is sharing in this recovery, but I am well aware that economic conditions remain difficult here. Rhode Island's unemployment rate improved very slowly during the recovery, and, for a time, it was the highest of any state. The jobless rate has come down a lot over the past year or so, but at 6.3 percent in March, unemployment here remains above the national average, and payroll employment has yet to regain its pre-recession peak.

In recent months, some economic data have suggested that the pace of improvement in the economy may have slowed, a topic I will address in a moment. And even with the significant gains of the past couple years, it is only now, six years after the recession ended, that the labor market is approaching its full strength.

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[1] For a discussion of recent economic developments in Rhode Island, see Mary A. Burke (2014), "Rhode Island in the Great Recession: Factors Contributing to Its Sharp Downturn and Slow Recovery," Federal Reserve Bank of Boston, Current Policy Perspectives 14-9 (Boston: FRB Boston, December), www.bostonfed.org/economic/current-policy-perspectives/2014/cpp1409.htm.

I say "approaching," because in my judgment we are not there yet. The unemployment rate has come down close to levels that many economists believe is sustainable in the long run without generating inflation. But the unemployment rate today probably does not fully capture the extent of slack in the labor market. To be classified as unemployed, people must report that they are actively seeking work, and many people without jobs say they are not doing so--that is, they are classified as being out of the labor force. Most people out of the labor force are there voluntarily, including retirees, teenagers, young adults in school, and people staying home to care for children. But I also believe that a significant number are not seeking work because they still perceive a lack of good job opportunities.

In addition to those too discouraged to seek work, an unusually large number of people report that they are working part time because they cannot find full-time jobs, and I suspect that much of this also represents labor market slack that could be absorbed in a stronger economy. Finally, the generally disappointing pace of wage growth also suggests that the labor market has not fully healed. Higher wages raise costs for employers, of course, but they also boost the spending and confidence of customers and would signal a strengthening of the recovery that will ultimately be good for business. In the aggregate, the main measures of hourly compensation rose at a rate of only around 2 percent through most of the recovery. And in Rhode Island, average hourly earnings have not risen at all in the past year. Nationally, there are at least some encouraging signs of a pickup so far this year.[2] The fact that some large companies, such as Wal-Mart

[2] According to the Bureau of Labor Statistics' (BLS) employment cost index--which measures both wages and the cost of employer-provided benefits--hourly compensation in private industry rose 2-3/4 percent over the year ended in March after having averaged gains of about 2 percent per year during most of the recovery. However, some other prominent aggregate wage measures have remained softer. For example,

and Target, have announced wage increases for their employees also might be a sign that larger wage gains are on the horizon.

This improvement in the labor market has brought the economy closer to one of the two goals of monetary policy assigned to the Fed by the Congress--maximum employment. Less progress has been made toward the other goal, price stability. Consumer price inflation remains below the Fed's stated objective of 2 percent. The notion that inflation can be too low may sound odd, but over time low inflation means that wages as well as prices will rise by less, and very low inflation can impair the functioning of the economy--for example, by making it more difficult for households and firms to pay off their debts. Overall consumer price inflation has been especially low--close to zero--over the past year, as the big fall in oil prices since last summer lowered prices for gasoline, heating oil, and other energy products. But inflation excluding food and energy, which is often a better indicator of where overall inflation will be in the future, has also been low, below the Fed's 2 percent objective both now and for almost all of the economic recovery. Inflation has been held down by the continued economic weakness during the slow recovery and, more recently, by lower prices of imported goods as well as the fall in oil prices. With oil prices no longer declining, and with the public's expectations of future inflation apparently stable, my colleagues on the Federal Open Market Committee (FOMC) and I believe that consumer price inflation will move up to 2 percent as the economy strengthens further and as other temporary factors weighing on inflation recede.

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the BLS's average hourly earnings for all employees on nonfarm payrolls have increased 2-1/4 percent over the 12 months through April.

A number of economic headwinds have slowed the recovery, and to some extent they continue to influence the outlook. These headwinds include, first, the fact that the housing crash left many households with less wealth and higher debt, weighing on consumer spending. Many homeowners lost their homes, and many more ended up "underwater," owing more on their mortgages than their homes were worth. Economists have noted that areas of the country that saw a larger boom and bust in housing have subsequently fared worse economically than other areas of the country.[3] Rhode Island is one such place. While the housing bust was not as large here as in Florida, Nevada, and parts of California, it was larger than average, and the largest in New England. This factor likely has contributed to the fact that the overall recovery here in Rhode Island has lagged.[4]

In some respects, this headwind has diminished. Home prices have moved up appreciably in many areas of the country, alleviating the burden for many homeowners, though the improvement in some areas, including Rhode Island, has lagged. Nationally, the share of mortgages that are underwater fell by about one-half between 2011 and 2014.[5] And credit availability for mortgages has improved as well, although mortgages are still very hard to obtain for would-be homeowners without pristine credit records. So I would score this headwind as still a concern, but one that is likely to continue to fade.

A second headwind, also quite important here in Rhode Island, has come from changes in fiscal policy to reduce budget deficits. At the federal level, the fiscal stimulus

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[3] See Atif Mian and Amir Sufi (2014), *House of Debt: How They (and You) Caused the Great Recession, and How We Can Prevent It from Happening Again* (Chicago: University of Chicago Press).
[4] See Burke, "Rhode Island in the Great Recession," in note 1.
[5] The share varies by source of data. According to Zillow's October 2014 *Real Estate Market Overview,* the share of mortgages in negative equity positions declined from about 30 percent in 2011 to 17 percent in 2014. According to CoreLogic's 4th quarter 2014 *Equity Report,* the share declined from about 25 percent to 11 percent over that period.

of 2008 and 2009 supported economic output, but the effects of that stimulus faded; by 2011, federal fiscal policy actions became a drag on output growth when the recovery was still weak. Meanwhile, states and municipalities, faced with serious budget problems due to the recession and required by law to balance their budgets, were forced to cut spending and raise taxes. The recovery has by now boosted tax revenue in most states, though Rhode Island, I know, is among those areas still facing considerable budget strain. Overall, fiscal policy actions at both the federal and the state and local levels look like they are no longer a significant drag on economic growth. So this headwind, I hope, is mostly behind us.

A third headwind has been the restraining influences on the United States from the global economy. I won't say as much about this factor today, but I will make just a few observations. Initially the euro-area crisis was the biggest headwind coming from the rest of the world. Supported by monetary stimulus, reduced fiscal drag, and significant institutional reforms, the recovery in the euro area now appears to be on a firmer footing. However, growth in many other parts of the global economy, including China and some other emerging market economies, has slowed. Weak growth abroad, together with its accompanying implications for exchange rates, has dented U.S. exports and weighed on our economy. This headwind too should abate as growth in the global economy firms, supported by monetary policies that generally remain highly accommodative.

Factors Affecting the Outlook

With the waning of the headwinds that I have discussed, the U.S. economy seems well positioned for continued growth. Households are seeing the benefits of the

improving jobs situation, and consumer confidence has been solid. In addition, the drop in oil prices amounts to a sizable boost in household purchasing power. The annual savings in gasoline costs has been estimated at about $700 per household, on average, and savings on heating costs--especially here in the Northeast, where it was so cold this winter--are also large.[6] Given these energy savings on top of the job gains, real disposable income has risen almost 4 percent nationally over the past four quarters. Households and businesses also are benefiting from favorable financial conditions. Borrowing costs are low, supported by the Fed's accommodative monetary policies. And credit availability to both households and small businesses has improved.

In recent months, as I noted earlier, there has been some softness in the economic data. Recent indicators of both household spending and business investment have slowed, and industrial output has declined. The Commerce Department's initial estimate was that real gross domestic product was nearly flat in the first quarter of 2015. If confirmed by further estimates, my guess is that this apparent slowdown was largely the result of a variety of transitory factors that occurred at the same time, including the unusually cold and snowy winter and the labor disputes at ports on the West Coast, both of which likely disrupted some economic activity. And some of this apparent weakness may just be statistical noise. I therefore expect the economic data to strengthen.

All of that said, the headwinds facing our economy have not fully abated, and, as such, I expect that continued growth in employment and output will be moderate over the remainder of the year and beyond.

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[6] The gasoline figure is from the U.S. Energy Information Administration (2015), *Short-Term Energy Outlook* (Washington: EIA, May), available at www.eia.gov/forecasts/steo.

Despite the recovery I noted in home prices and a greater number of home sales, residential construction activity remains quite low. I mentioned the ongoing issues with mortgage credit, but more generally, many years of a weak job market and slow wage gains seem to have induced many people to double-up on housing, and many young adults continue to live with their parents. Population growth is creating a need for more housing, whether to rent or to own, and I do expect that continuing job and wage gains will encourage more people to form new households. Nevertheless, activity in the housing sector is likely to improve only gradually.

The pace of business investment has also been only modest during this recovery, and some of the reasons might persist a while longer. Businesses seem not to have had sufficient confidence in the strength and durability of the recovery to undertake substantial capital expenditures. Moreover, some analysts have suggested that uncertainty, not only about the strength of the recovery but also about economic policy, could be a significant factor. And the fact that many businesses seem to be holding large amounts of cash may suggest that risk aversion is playing a role.

Weak investment in the energy sector is also likely to persist. This represents the negative side to the fall in oil prices, one being felt by the oil-producing regions of the country. New domestic oil drilling has plunged over the past few months, and we have also seen a slowdown in activity in sectors that supply oil production companies, including steel and certain types of machinery. I would add, however, that, on balance, the plusses for energy consumers from the fall in oil prices almost surely outweigh the minuses. Remember that we are still a net importer of oil.

Putting it all together, the economic projections of most members of the FOMC call for growth in real gross domestic product of roughly 2-1/2 percent per year over the next couple of years, a little faster than the pace of the recovery thus far, with the unemployment rate continuing to move down to near 5 percent by the end of this year. And for inflation, as I noted earlier, my colleagues and I expect inflation to move up toward our objective of 2 percent as the economy strengthens further and as transitory influences wane.

Of course, the outlook for the economy, as always, is highly uncertain. I am describing the outlook that I see as most likely, but based on many years of making economic projections, I can assure you that any specific projection I write down will turn out to be wrong, perhaps markedly so. For many reasons, output and job growth over the next few years could prove to be stronger, and inflation higher, than I expect; correspondingly, employment could grow more slowly, and inflation could remain undesirably low.

Implications for Monetary Policy

Given this economic outlook and the attendant uncertainty, how is monetary policy likely to evolve over the next few years? Because of the substantial lags in the effects of monetary policy on the economy, we must make policy in a forward-looking manner. Delaying action to tighten monetary policy until employment and inflation are already back to our objectives would risk overheating the economy.

For this reason, if the economy continues to improve as I expect, I think it will be appropriate at some point this year to take the initial step to raise the federal funds rate target and begin the process of normalizing monetary policy. To support taking this step,

however, I will need to see continued improvement in labor market conditions, and I will need to be reasonably confident that inflation will move back to 2 percent over the medium term.

After we begin raising the federal funds rate, I anticipate that the pace of normalization is likely to be gradual. The various headwinds that are still restraining the economy, as I said, will likely take some time to fully abate, and the pace of that improvement is highly uncertain. If conditions develop as my colleagues and I expect, then the FOMC's objectives of maximum employment and price stability would best be achieved by proceeding cautiously, which I expect would mean that it will be several years before the federal funds rate would be back to its normal, longer-run level.

Having said that, I should stress that the actual course of policy will be determined by incoming data and what that reveals about the economy. We have no intention of embarking on a preset course of increases in the federal funds rate after the initial increase. Rather, we will adjust monetary policy in response to developments in economic activity and inflation as they occur. If conditions improve more rapidly than expected, it may be appropriate to raise interest rates more quickly; conversely, the pace of normalization may be slower if conditions turn out to be less favorable.

Longer-Run Growth

Before I conclude, let me put this discussion into a longer-term context. The Federal Reserve's objectives of maximum employment and price stability do not, by themselves, ensure a strong pace of economic growth or an improvement in living standards. The most important factor determining living standards is productivity

growth, defined as increases in how much can be produced in an hour of work. Over time, sustained increases in productivity are necessary to support rising incomes.

Here the recent data have been disappointing. The growth rate of output per hour worked in the business sector has averaged about 1-1/4 percent per year since the recession began in late 2007. This rate is down from gains averaging 2-3/4 percent over the preceding decade. I have mentioned the tepid pace of wage gains in recent years, and while I do take this as evidence of slack in the labor market, it also may be a reflection of relatively weak productivity growth.

Productivity depends on many factors, including our workforce's knowledge and skills and the quantity and quality of the capital, technology, and infrastructure that they have to work with. Economists debate how optimistic to be about our nation's productivity prospects. Some argue that the decade starting in the mid-1990s was exceptional, with unusually large advances in information technologies, and that the more recent period provides a better guide to the future. Others are more optimistic, suggesting that recent technological innovation remains as impressive as ever, and that history shows it may take some years to fully reap the economic benefits of such innovations.[7] I do not know who is right, but I do believe that, as a nation, we should be pursuing policies to

[7] For a relatively pessimistic view of productivity growth because "the low-hanging fruit is picked," see Robert J. Gordon (2012), "Is U.S. Economic Growth Over? Faltering Innovation Confronts the Six Headwinds," NBER Working Paper Series 18315 (Cambridge, Mass.: National Bureau of Economic Research, August); and Tyler Cowen (2011), *The Great Stagnation: How America Ate All the Low-Hanging Fruit of Modern History, Got Sick, and Will (Eventually) Feel Better* (New York: Dutton). For a more optimistic perspective, see Joel Mokyr (2014), "Secular Stagnation? Not in Your Life," in Coen Teulings and Richard Baldwin, eds., *Secular Stagnation: Facts, Causes and Cures* (London: CEPR Press), pp. 83-89; and Erik Brynjolfsson and Andrew McAfee (2014), *The Second Machine Age: Work, Progress, and Prosperity in a Time of Brilliant Technologies* (New York: W.W. Norton & Company). The greatest return to adopting information technology appears five to seven years after investment, according to Erik Brynjolfsson and Lorin M. Hitt (2003), "Computing Productivity: Firm-Level Evidence," *Review of Economics and Statistics,* vol. 85 (November), pp. 793-808.

support longer-run growth in productivity. Policies to strengthen education, to encourage entrepreneurship and innovation, and to promote capital investment, both public and private, can all be of great benefit.

It also is possible that a portion of the relatively weak productivity growth we have seen recently may be the result of the recession itself.[8] Firms slashed their capital expenditures during the recession, and as I noted earlier, the increases in investment during the recovery have been modest. In particular, investment in research and development has been relatively weak. Moreover, a lack of financing may have impaired the ability of people to start new businesses and implement new ideas and technologies. As the economy strengthens further, many of these processes could work in reverse, boosting our productivity prospects. To the extent this is so, Federal Reserve actions to strengthen the recovery may not only help bring our economy back to its productive potential, but it may also support the growth of productivity and living standards over the longer run.

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[8] See Dave Reifschneider, William Wascher, and David Wilcox (2015), "Aggregate Supply in the United States: Recent Developments and Implications for the Conduct of Monetary Policy," *IMF Economic Review,* advance online publication, March 17, http://dx.doi.org/10.1057/imfer.2015.1. (A previous version of this paper is also available on the Board of Governors website at www.federalreserve.gov/pubs/feds/2013/201377/201377abs.html.)