

The Economic Outlook and Long-Term Growth

New Jersey Economic Leadership Forum

New Jersey Bankers Association

Somerset, NJ

January 11, 2013

Charles I. Plosser

President and CEO
Federal Reserve Bank of Philadelphia



FEDERAL RESERVE BANK
OF PHILADELPHIA

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Introduction

Good morning and thank you for inviting me to address the New Jersey Economic Leadership Forum. Last year, my colleague Bill Dudley, president of the New York Fed, addressed your group. As you may know, the northern part of New Jersey lies within the New York Fed's District, and the southern part lies within the Philadelphia Fed's District. I am sometimes asked why it was set up this way, with District boundaries that don't always follow state boundaries. The answer is I don't know. But if the political nature of decision-making in 1914 was anything like it is today, I am not sure any of us would find the rationales offered at the time particularly enlightening.

Nevertheless, President Dudley and I each lead one of 12 Federal Reserve Banks across our nation. Together with the Board of Governors in Washington, this decentralized structure of the Federal Reserve System helps ensure that monetary policy decisions are based on the full breadth of economic conditions across our diverse country.

The goals of monetary policy are set by Congress in the Federal Reserve Act, which states that the Fed should conduct monetary policy to "promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates." I have long believed that the most effective way monetary policy can contribute to maximum

employment and moderate long-term interest rates is by ensuring price stability over the longer term. Price stability is also critical in promoting financial stability.

The Fed seeks to promote these objectives by influencing the cost and availability of credit through its decisions about interest rates and the supply of money. These decisions are the primary responsibility of the FOMC – the Federal Open Market Committee – the group within the Fed charged with setting monetary policy.

By design, policy is set by 12 voting members on the FOMC — the seven members of the Board of Governors in Washington always have a vote, as does the president of the New York Fed. The remaining four votes come from among the other 11 Reserve Bank presidents, who serve one-year terms on a rotating basis.

Whether or not we vote, all Reserve Bank presidents contribute to the discussion. Though we may, at times, disagree on how to promote the best outcome, we share the same goals and objectives prescribed by the Federal Reserve Act. This process ensures that the Committee considers a wide range of independent assessments of the economy and of the policy options available to pursue.

Before I continue, I must note today that my views are my own and not necessarily those of the Federal Reserve Board or my colleagues on the FOMC.

Economic Outlook

Let me begin with an overview of the economy as we enter 2013. We are now in the fourth year of an economic expansion that officially began in mid-2009. Yet economic growth has come in fits and starts, taking two steps forward, only to then stall or take one step back. The general path has continued to be forward, but we've made far slower progress than anyone would like. A year ago, many economists were forecasting that economic growth would be closer to 3 percent for 2012. Instead, when the year-end data are released later this month, we are likely to see that growth in 2012 was near 2 percent.

I anticipate that the pace of growth will pick up somewhat, to about 3 percent in 2013 and 2014 – a pace that is slightly above trend. In December’s projections by FOMC participants, the central tendency showed real GDP growth of 2.3 to 3 percent in 2013 and 3 to 3.5 percent in 2014. So my outlook places me at the high end of the central tendency for 2013 and at the low end for 2014.

This level of growth should allow for continued improvements in labor market conditions, including a gradual decline in the unemployment rate, similar to the improvements we have seen over the past two years.

In the fourth quarter of 2010, the unemployment rate averaged 9.5 percent. By the fourth quarter of 2011, the average rate had fallen to 8.7 percent. We now know that the unemployment rate for the fourth quarter of 2012 came in at 7.8 percent. Thus, over the last two years, we have seen unemployment fall by 1.7 percentage points. I believe we will see the rate continue this downward trend at a similar pace, falling to near 7 percent by the end of 2013.

Part of the challenge with this recovery has been the modest number of net jobs added to the economy. In 2012, employment growth averaged 153,000 jobs per month, on par with the average monthly gain in 2011. We are simply not adding jobs at a pace that will rapidly reduce the unemployment rate.

The economy lost 8.8 million jobs from the peak of employment in January 2008 to the employment trough in February 2010. We have regained just over half of these jobs. Progress has been particularly challenging here in New Jersey. As of the latest employment numbers from November, New Jersey had regained under a quarter of the 260,000 jobs lost in the recession. The state’s unemployment rate stood at 9.6 percent, compared to 7.8 percent in Pennsylvania and 6.7 percent in Delaware, and the rate is higher than its level at the start of last year.

Many people are understandably frustrated by the modest pace of the recovery, especially when it is compared with the recovery from the 1981-82 recession, which was

also a severe downturn. In 1982, the unemployment rate peaked at 10.8 percent – notably above the 10 percent peak of this recession. Yet by the end of 1985, three years after the peak, the rate had fallen 3.8 percentage points, to 7 percent. In contrast, today, about three years after the unemployment rate peaked in October 2009, the rate has fallen only about 2.2 percentage points. But recessions are not all alike, and to understand the dynamics of recovery, including why this one has been relatively sluggish, we must understand the size and nature of the shocks that sent the economy into recession in the first place.

We entered this recession over-invested in the housing and financial sectors. The adjustment in the housing market as a result of this boom and bust has been painful for the housing sector and the financial markets. Those sectors have shrunk as a share of the economy, and labor and capital must be reallocated to other uses. Indeed, it would not be particularly wise to seek to return those sectors to their pre-crisis highs, which we learned the hard way were not sustainable. Moreover, the labor force needs to be at least partially retooled to match the skills employers demand. Even within sectors such as manufacturing, the skills of workers now being hired are different from those who were let go. Employers are seeking generally higher skilled workers who are more technology savvy, and thus better able to deliver the increases in efficiency that firms have sought to achieve. This adjustment takes time. It is painful to be sure, but it will lead to a healthier economy in the long run.

The housing collapse also significantly reduced consumer spending, which accounts for about 70 percent of the nation's GDP. The sharp decline in housing values destroyed a lot of the equity that families had built up in their homes. Thus, a huge chunk of their savings vanished. Many households had been counting on that equity to help send their children to college or to help fund their retirement. With that wealth gone, it is only natural, and rational, for consumers to want to rebuild savings. Consequently, private savings rates have risen substantially and consumption by households has been restrained.

I believe these adjustments are unlikely to be significantly accelerated through traditional government policies that seek to stimulate aggregate demand. This is especially true in the case of ever more aggressive monetary policy accommodation.

The conventional view is that by lowering interest rates, monetary policy lowers the price of consuming today relative to consuming in the future, thereby encouraging households to reduce savings and bring consumption forward. However, as I've noted, in the current circumstances, consumers have strong incentives to save. They are trying to restore the health of their balance sheets so they will be able to retire or put their children through college. They are behaving wisely and in a perfectly rational and prudent way in the face of the reduction in wealth. In fact, low interest rates and large budget deficits can frustrate those efforts to save. For example, low interest rates encourage households to save even more because the return on their savings is very small. And large budget deficits suggest that they are likely to face higher taxes in the future, which also encourages more saving. Thus, efforts to drive real rates more negative or promises to keep rates low for a long time may have frustrated households' efforts to rebuild their balance sheets without stimulating aggregate demand or consumption. In my view, until household balance sheets are restored to a level that consumers and households find comfortable, consumption will remain sluggish. This is likely to take some time, and attempts to increase economic "stimulus" may not help speed up the process and may actually prolong it.

Manufacturing activity has also shown sluggish growth. The Philadelphia Fed's monthly Business Outlook Survey of regional manufacturers has been a useful barometer of national trends in manufacturing over many years. The survey's general activity index posted negative numbers over the summer, recovered briefly in September and October, and then posted declines in November in the wake of Hurricane Sandy. In December, the index returned to positive territory. The good news is that the survey's future activity index suggests that firms expect growth to continue over the first six months of 2013. Yet that growth may be restrained compared to other recoveries.

Even though the balance sheets of most corporations are in pretty good shape, we continue to hear of weak demand and a great deal of uncertainty. Domestic demand has slowed as U.S. consumers save more, as I have just described. Yet, global demand has also slowed, due in large part to the economic turmoil in Europe, which is hovering near recession. This slowdown has restrained world trade. U.S. exports have slackened and, with it, so has our manufacturing sector.

Uncertainty is the other factor restraining hiring and investment by businesses. The fiscal issues in Europe remain unresolved. While leaders in Europe have, at least so far, avoided the financial implosion that some have feared, they are far from resolving the underlying fiscal issues they confront.

Of course, uncertainty is not limited to Europe. Many U.S. firms have taken a wait-and-see attitude with respect to hiring and investing as businesses and consumers wait to see how our own fiscal problems will be resolved. How much will tax rates rise? How much will government spending be cut? U.S. fiscal policy is clearly on an unsustainable path that must be corrected. Yet, there remains significant uncertainty about the choices that will be made. And that uncertainty has been a drag on near-term growth. Although recent efforts by Congress have reduced some of the near-term uncertainty over personal tax rates, the long-term fiscal issues have not been fully addressed. However, we will have to wait and see if the somewhat greater clarity on near-term tax rates reduces some of the drag on business spending going forward.

Here, too, in my view, monetary policy accommodation that lowers interest rates is unlikely to stimulate firms to hire and invest until a significant amount of the uncertainty has been resolved. Firms have the resources to invest and hire, but they are uncertain as to how to put those resources to their highest valued use.

So to sum up, there are good reasons to expect that the recovery will continue but at a moderate pace over the next couple of years.

Turning to inflation, it has been running near our longer-term goal of 2 percent. Although the drought in the Midwest and higher gasoline prices during the summer pushed inflation up slightly, these effects are waning. Thus, I do not see a risk of higher inflation, or deflation, in the near term. Indeed, over the medium to longer term, I expect inflation to be near our 2 percent target. But this expectation is based on my assessment that the appropriate monetary policy is likely to tighten more quickly than the Committee anticipated in its latest statement. Thus, I do see some risks to inflation in the medium to longer run, given the current stance and anticipated path of monetary policy.

Long-Term Growth Prospects

The shocks we have experienced are large and likely to impact the economy for some time. During this period, the economy's level of output has been significantly reduced, and it is unlikely we will ever fully recoup those losses. This is a painful and disruptive consequence of the imbalances and shocks that have hit the economy. But what are the longer-term consequences of the Great Recession? Has the economy's longer-term trend rate of growth been permanently impaired? This is much harder to determine, and the answer will depend, in part, on the economic policy choices we make.

A simple way to assess the long-term trend rate of growth is to think of it as the sum of labor productivity growth, which is typically measured as the growth of real output per worker or real output per hours worked, and labor force growth. If an economy is averaging 1.5 percent labor productivity growth and labor force growth of 1 percent, you can anticipate that its trend growth will be about 2.5 percent per year. Over the long term, labor force growth is mostly a demographic phenomenon, although economic policy can affect it as well. Japan is an interesting example, as its labor force is declining at a pace of about 1 percent per year. This is due in part to an aging population, low birth rates, and fairly stringent immigration policies. Thus, if Japan were experiencing 1.5 percent productivity growth, its long-term trend growth rate would only be 0.5 percent per year.

Over the long run, productivity growth is the primary determinant of rising living standards, or per capita income. Over the shorter run, variation in labor force participation rates and the share of income going to labor vs. capital are also factors. But over the longer run, these latter factors tend to be more stable, leaving productivity growth as the main determinant of per capita income growth. Without productivity growth, economies would stagnate and living standards would fall as the population increased. Thus, productivity growth is the essential ingredient for continued improvements in economic prosperity.

Most economists view productivity growth as being determined over the long run by education and the quality of the labor force, innovation, and enterprise. Of course, many factors can influence these drivers. Various government policies can support productivity growth; others can dampen it. In this sense, societies face trade-offs and make choices. One way that I like to describe these choices is in a risk-reward framework. Investors, for example, can choose strategies that are risky, with asset prices or returns that can be quite volatile. Yet, the expected rewards for tolerating that volatility are higher over the longer term than those from adopting the safe or risk-free strategy.

A society can do the same thing. It can choose policies that potentially increase productivity over the longer run, but those choices may result in more volatility in economic outcomes over time or across citizens. Alternatively, a society can choose policies that are safe and that reduce economic volatility, but such choices could dampen expected growth.

So what effects will the Great Recession have on long-term economic growth or productivity? I think our policy choices and how they affect incentives will matter. Establishing training programs, investing in education, and adopting immigration reforms can increase the quality of our work force and enhance future productivity growth. But policies that reduce labor and capital mobility could harm longer-run growth. Attempting to eliminate volatility by creating an expanded safety net, if you

will, for both individuals and institutions could stifle innovation and distort risk-taking. This would likely be costly in terms of longer-run productivity growth. On the other hand, adopting policies that enhance the opportunity for all citizens to reap the rewards of their efforts could enhance productivity growth.

Of course, tax policies and spending priorities, as well as financial regulation and trade policy, will also play a role. For example, most economists see our tax code as almost byzantine, with its inefficient complexity, loopholes, and special interest provisions that distort incentives and the allocation of resources. Simplifying and enhancing the efficiency of our tax system by lowering tax rates, closing loopholes, and broadening the base could enhance productivity growth. Tax and government spending policies that put our fiscal affairs back on a sustainable path and increase incentives for private capital investment, R&D, and education and training would be very beneficial as well.

Financial regulations that work to ensure that markets are transparent can improve efficiency and enhance productivity. For example, investors are attracted to our financial markets when they know that the rules provide a level playing field rather than favoring one set of participants over another. Similarly, regulatory reforms that penalize excessive risk-taking and create incentives for the appropriate level of risk-taking in our financial markets could also improve longer-run growth prospects. But regulations and supervisory steps that dramatically reduce the risks of failure by financial or industrial firms are likely to reduce long-term growth. In my view, government regulation should seek to enhance the effectiveness and incentives of market participants to discipline the firm's risk-taking – not try to totally supplant it. That is, regulations should work to enhance market discipline. I would add that excessive compliance costs in either the tax system or the regulatory system can be sources of inefficiency and reduce productivity.

Thus, the choices that we make in response to the Great Recession can be a major factor in determining whether long-term productivity growth and the potential growth rate of the U.S. economy declines or not. This is not meant to be a pessimistic story. Indeed, I am generally an optimist and a strong believer in the resiliency of our market

economy. But we must choose wisely. Crises sometimes can lead to an over-reaction by policymakers and the public; we must seek to achieve an appropriate balance.

Conclusion

In summary, the U.S. economy is continuing to grow at a moderate pace. I expect annual growth of around 3 percent in 2013 and 2014.

Prospects for labor markets will continue to improve only gradually, but I believe we may see rates near 7 percent by the end of this year. I believe inflation expectations will be relatively stable and inflation will remain at moderate levels in the near term.

However, with the very accommodative stance of monetary policy in place for more than four years now, we must guard against the medium- and longer-term risks of inflation. How the economy and the standard of living of our citizens ultimately fare over the longer run will be determined by the policy choices we make in the aftermath of the Great Recession. Some of these policies could increase the quality of the country's labor force and make us more competitive; others, while they may reduce volatility, might also reduce our long-term growth prospects. It behooves us to choose wisely.