The U.S. Economy: Back on Course

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Introduction

It is a pleasure to be here this morning. I welcome the opportunity to share with you my views on the progress of the economic expansion in the U.S. I will begin today's remarks with an overview of the national economy and then turn to my perspectives on how monetary policy is playing out in this context. I think that you will find my views on both these subjects consistent with those presented by the Chairman in his Congressional testimony yesterday. Then, I will conclude with some insights on the economy here in our region.

The Outlook for the Economy

The U.S. economy finally seems to be back on course. Having weathered a series of setbacks, including the most recent recession, and having struggled through an unusually attenuated recovery, the economy now appears to be on a path of sustained expansion.

Economic performance has improved considerably over the past year, and I believe we are on track for solid growth this year and next. I expect real GDP to grow somewhere between 4 and 5 percent, slightly above its long-run potential. Some of the most recent data have been on the soft side, but I think this reflects the usual fits and starts in a dynamic economy, not a significant change for the broad outlook. The expansion still seems to have ample positive momentum.

Labor market conditions are improving. The unemployment rate has been trending down and currently stands at 5.6 percent. I expect nonfarm payroll employment to increase by about 200 thousand jobs per month over the balance of this year and into next, and that is strong enough job growth to continue the gradual decline in the unemployment rate.

As the expansion continues, several other positive trends are becoming more apparent as well. One is the renewed strength in business investment spending. Throughout the recession and recovery, consumer spending grew at a relatively healthy pace, but business spending fell sharply. Then, just about a year ago, business spending began to turn around, led by renewed investment in high-tech equipment and software. Now businesses, bolstered by strong profits and a more positive economic outlook, are in a good position to spend into expanding their productive capacity. High-tech spending will continue to lead the way, but spending on other forms of capital equipment will be picking up too, as the expansion unfolds.

As I mentioned a moment ago, continued growth in consumer spending has been the mainstay of the economy over the past several years. I expect consumer spending to continue expanding at a healthy pace. Importantly, however, a positive development in consumer spending will be the shift in the impetus for its growth.

During the recession and recovery, consumer spending was driven mostly by accommodative government policies: tax cuts and low interest rates. Going forward, consumer spending will be driven by better private-sector performance: stronger job growth and rising incomes. Indeed, making this transition is the essence of achieving a self-sustaining economic expansion.

I should add that solid income growth will support a healthy level of home sales and auto sales, but as interest rates rise, these sectors can be expected to contribute less to overall spending growth.

So, I expect the combination of moderate growth in consumer spending and strong growth in business spending to carry the expansion forward. Furthermore, I am optimistic that we may get some additional contribution to domestic demand from our international trading partners.

This is because, like the U.S. economy, the global economy also seems to be improving. Japan's economy is finally achieving a sustainable recovery, and a modest pickup is underway in Europe. Asia is also strong and should remain so--provided that China can negotiate a "soft landing" to a more sustainable growth rate.

An improving global economy has contributed to stronger U.S. export performance in recent months. It should help stabilize, or even modestly narrow, our trade deficit in the months and quarters ahead.

As the expansion unfolds, favorable trends in domestic and foreign demand will be matched by favorable trends on the supply side of the economy as well.

Growth in our economy's output of goods and services emanates from essentially two sources: growth in employment and growth in the productivity of those employed. During the boom years of the 1990s, we saw both strong growth in employment and strong growth in productivity associated with firms' heavy use of new information technologies. When the economy slowed down, businesses, uncertain about the future and pressed by competition, pushed hard to increase efficiency and cut costs. As a result, productivity accelerated even further and employment fell--not only during the recession, but during the early part of the recovery as well.

Now, the outsized cyclical productivity growth seems to be dissipating, and employment growth is returning. I expect that the combination of a gradual return to full employment and to trend productivity growth will allow output to grow at a 3-1/2 to 4 percent pace on a sustained basis.

Having emphasized the positive output growth associated with the current expansion, I want to turn to another development that deserves careful attention: shifting price pressures. Price pressures are an inevitable part of economic expansion, and it is incumbent upon the Fed to keep these pressures well-contained.

Prices have been rising a bit more rapidly in recent months. Part of the story is higher commodity prices. However, insofar as commodities are sold in competitive international markets, such price spikes have generally proved to be temporary. The rise in oil prices, however, may well persist for some time. As higher energy prices filter through the economy, they may precipitate increasing inflation pressure over the near term, and this must be watched closely.

Having said this, I think we must keep in mind that labor compensation is the most important component of production costs, and as a result, over the long run, product prices and unit labor costs have traditionally moved together.

Over the course of the past several years, this relationship has been working to drive inflation down. Strong growth in labor productivity, combined with relatively modest compensation growth in a weak labor market, reduced unit labor costs and thus fostered disinflation. Going forward, this dynamic will be reversed. As productivity growth slows and the labor market strengthens, some bargaining power will shift back to workers. So unit labor cost will be on the rise, and that means some upward pressure on inflation. How much pressure is not entirely clear.

Not all of the recent slowdown in unit labor cost growth translated into lower price inflation. Some went into improving firms' profit margins. So as the process reverses, some of the acceleration in unit labor costs could come at the expense of those margins, rather than in the form of higher inflation.

And there is another reason to believe that the current cycle may generate less inflationary pressure, namely, the reality that we operate in an increasingly global economy. Today, U.S. firms compete with firms around the world in the markets for both raw materials and final goods and services. In fact, much has recently been said about the fact that U.S. workers are competing with workers around the world for positions in a widening array of occupations and industries. This globalization of the marketplace, and the increased degree of competition that it brings, are powerful forces that could limit price pressure here in the U.S.

Beyond all these market considerations, there is the Federal Reserve's expressed commitment to respond to developments as necessary to fulfill our obligation to maintain price stability. Taking all these factors into consideration, I expect inflation expectations to remain well-contained and inflation to remain at an acceptable level as the expansion progresses.

The Path of Monetary Policy

Before turning to the economic outlook for our region, let me say a few more words about my own view of the stance of monetary policy and its likely evolution.

Now that recovery has given way to expansion, the Federal Reserve has begun the transition from an accommodative policy stance to a neutral one, more conducive to sustained economic growth. As you know, last month, the Federal Open Market Committee took the first step in the process, raising short-term interest rates by a quarter percentage point.

If the economy evolves as I expect over the next year or so--with output growth somewhat above its long-run potential, job growth sufficient to put us on a course toward full employment, and inflation reasonably low and stable--then I expect we will continue to move the federal funds rate up at a measured pace. But the precise course the Fed takes in moving monetary policy to a more neutral stance depends on the course the economy takes on the path to sustained expansion.

The economy rarely, if ever, evolves as smoothly as we forecast. As I mentioned at the outset, some recently released data have been on the soft side. That is not entirely surprising, given the strength of the earlier figures. But if such signs were to persist and the expansion seemed to be losing momentum, we would need to consider slowing the pace at which we remove our monetary accommodation. Conversely, until the most recent data were released, it seemed inflationary pressures might be accumulating. Were signs of price pressure to re-emerge on a consistent basis, we would need to consider quickening the pace at which we move toward policy neutrality.

In any case, given the likely pace of these policy adjustments and the Fed's commitment to transparency and clear communication about them, I expect the financial markets will continue to take Fed actions in stride, adjusting asset values accordingly. In turn, these financial market adjustments will help guide the overall economy along an orderly path of sustained expansion.

Regional Economy

That said, let me offer you some thoughts on how the national expansion is playing out here in our region. I am pleased to say the outlook for the region's economy is positive overall.

Each month, the Federal Reserve Bank of Philadelphia conducts what we call our Business Outlook Survey. We receive survey responses from over one-hundred manufacturing firms in our District--which encompasses eastern Pennsylvania, southern New Jersey, and Delaware--and ask them about current conditions in their business and about their expectations for the coming six months. Manufacturing, of course, is a cyclically sensitive sector, and our District's economy seems to be a microcosm of the nation's. As a result, the survey is recognized as a good barometer of national business cycle conditions.

In recent months, the survey has been sending positive signals about the progress of the expansion. Survey participants are telling us that demand for their products is on the increase and they expect additional increases in the months ahead.

They also tell us that capacity utilization is on the rise and plans are in place for adding employees. In fact, many of the firms surveyed suggest that they are operating at fairly high rates of utilization and are beginning to plan for expansion of operations. Moreover, they are finding that qualified workers are in relatively short supply, and a third of our respondents reported offering wage increases in the past three months to attract or retain workers.

The signals we are getting from other sectors are positive as well. The District retailers we contact expect year-over-year sales to continue to increase through the rest of the year. They note that stronger economic performance, and the improving employment situation in particular, are boosting sales of high-end items. Auto dealers are slightly less optimistic, but still expect sales to be in line with last year's.

Meanwhile, housing markets remain healthy. Residential real estate agents and home builders expect the demand for homes to remain strong in the near term, though they recognize that as mortgage interest rates rise, new and existing home sales may slow.

At the same time, commercial real estate markets continue to be somewhat lackluster. While firms in the region report that leasing activity increased recently as many office tenants renewed expiring leases, there has been no increase in space rented. The overall office vacancy rate actually rose slightly in most parts of the region as new buildings came on-line. The vacancy rate in the Philadelphia central business district edged up to around 14 percent, with the suburban vacancy rate even higher--above 20 percent. As a result, commercial real estate firms expect construction activity to slow as a number of new buildings are completed this year.

The region's general employment picture is brightening. Our region's unemployment rate is 5.2 percent, well below that of the nation as a whole. Employment grew in the second quarter in Pennsylvania, New Jersey, and Delaware, as it did in the nation.

Especially noteworthy is the concentration of New Jersey's job growth in the southern part of the state. South Jersey accounted for approximately one-half of the state's recent job gains, even though its labor markets are far smaller than those of central and northern New Jersey. The strength in South Jersey's labor market will benefit the region as a whole going forward.

Like the nation, the three states in our region lost jobs not only during the recession but also in the early part of the recovery. If national economic conditions improve as expected, our Bank's regional forecasting model projects all three states will regain their pre-recession employment levels by the fall.

Over the longer term, our nation's job growth will likely be strongest in the so-called "knowledge industries." Those industries--particularly education, health care, pharmaceuticals, and biotech--have strong representation here in our region and so should provide us with a powerful engine for new growth.

Indeed, the limits to growth in our region are not likely to come from the demand side but from the supply side. For our region to build on our current advantage in the knowledge industries, we will need to ensure a growing supply of knowledge industry workers--those with the professional background, skill, and experience that those industries require. This has been a challenge for us recently, given our slow growth in population and relatively low percentage of college graduates in the region. This suggests that we will need to encourage migration of knowledge workers from outside the region into the Delaware Valley, as well as improve our efforts to properly educate and retain the young people growing up here.

Let me broaden this challenge. While knowledge industries rightly command our attention because they represent the primary engines of growth, they are part of a well-diversified array of industries that make up our regional economy. This diversity imparts economic strength and stability to our region. But new information technologies are transforming production processes across all industries.

To survive and thrive in this technologically sophisticated environment, we need a large pool of willing workers with good basic skills--workers who are sufficiently literate and numerate to use new technologies productively. Again, the challenge is to improve our labor force by fostering in-migration and providing the education that will supply our region with the kinds of workers a growing economy will require.

If we can meet these challenges, I expect our regional economy will continue to improve along with the nation's, bringing more jobs and increasing our economic vitality.

Conclusion

With this let me conclude. The economy now appears to be on a path of sustained expansion. We expect healthy output growth supported by both a return to full employment of our labor force and continued strong trend growth in the productivity of that labor force.

If the economy evolves as I have expressed here today --with output growth somewhat above its long-run potential, job growth sufficient to put us on a course toward full employment, and inflation relatively low and stable--then I expect we at the Fed will continue to move the federal funds rate up at a measured pace. Of course, the precise path we take depends on the course the economy takes en route to sustained expansion.

For our region, strong steady growth in the national economy means greater opportunity to grow and develop our own resources--our infrastructure, our technology, and our people--making this an even better place to live and work.