An Economic Outlook

The Lyons Companies and the University of Delaware's
Center for Economic Education & Entrepreneurship
Newark, DE

February 16, 2016

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OF PHILADELPHIA

The views expressed today are my own and not necessarily
those of the Federal Reserve System or the FOMC.

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Good morning. It is always great to be back on a college campus. I have spent 30 years of my career on university campuses, and nothing matches their innovation and knowledge creation anywhere. As it was for the time I served as the University of Delaware's president, it is an honor to be here today and once again to be part of an event that has been a great source of pride for the college over the past decade.

I would like to thank David Lyons and the University of Delaware's Center for Economic Education & Entrepreneurship for inviting me here today.

I would also like to congratulate Dean Weber and the Alfred Lerner College of Business & Economics. Its JPMorgan Chase Innovation Center was recently selected by the Association to Advance Collegiate Schools of Business — the AACSB — as an award-winning example of where "inspirational work is being done by business schools around the world." Garnering such an award in competition with so many strong and well-resourced peer business schools is the result of the outstanding efforts of many people at the University of Delaware. So, congratulations again.

An Economic Outlook

Today I would like to offer my views on the economic outlook for the U.S. economy and monetary policy and to discuss what I am sure are the issues on all of your minds: interest rates and the path they are on, how we can get to full economic health, and what approach we should consider to make full use of our District's incredible potential.

As always, my views are mine alone and do not reflect those of my colleagues at the Federal Open Market Committee (FOMC) or anyone else in the Federal Reserve System.

After expressing my views on our nation's economic health and prospects, I would like to offer a few observations about the economic conditions a bit closer to home, concentrating on what I believe are the inherent strengths and challenges in Delaware's economy.

Then, I would like to take a few minutes to address my stance on monetary policy based on my assessment of inflation and economic activity over the coming year. If the economy evolves in a materially different way from what I anticipate, my policy views would likewise change.

As Chair Janet Yellen and many of my colleagues have emphasized, I likewise view decisions about economic policy as data dependent, meaning that as we review the data coming in, our opinions about the appropriate timing of normalization shift appropriately. Furthermore, the conversations and interactions we have every day in the communities we serve also factor into these decisions.

An Economic Snapshot

Despite a fairly weak fourth quarter when real GDP increased by a paltry 0.7 percent, I remain upbeat. Economic fundamentals are sound, and our financial system is in good shape. Labor markets remain dynamic, income growth is solid, and consumer spending continues to increase at a solid pace.

If there is anything that I believe would pose any risk to the forecast I will deliver, it would be the recent events on Wall Street coupled with the strong dollar and weakening growth in China. The effects that these developments may have on the U.S. economy are something that we continue to watch closely.

Employment

I am stepping into the Fed at a time when our business climate maintains a steady and gradual improvement, and though challenges remain, we continue making strides.

Robust employment growth, increased disposable income, and fairly healthy household balance sheets should cause consumption to grow in the coming year by 2.7 percent, and it is the consumer who will underpin the economic progress in my forecast.

One of the fundamental strengths supporting this economic growth will be the continued strength in job growth.

Each of the past three years has witnessed the creation of more than 2 million net new jobs, and many of these jobs were in high-skilled professions. Although I expect that employment growth will slow somewhat, I am still expecting a year when the economy creates in the neighborhood of 2 million net new jobs.

The number of job openings remains high, and in my meetings around the District, I often hear leaders lament about the difficulty in finding the right workers. The latest employment report for January is broadly consistent with that expectation.

As job growth continues, labor market slack will diminish. I, therefore, anticipate stronger wage growth than the 2 percent or so that we achieved last year.

I also believe that we will see more people return to the labor market and that the participation rate will rise modestly to around 63 percent.

Our participation rate was hit hard by the recession, but it is a number that is also heavily influenced by demographics and social shifts as well as by the number of discouraged workers. For instance, in the 1960s and ’70s, women entered the workforce in greater numbers, so we saw the participation rate spike. While 63 percent is still low by historical standards, the participation rate has been trending down for some time. Although I believe we will see a small cyclical uptick, the strength in job growth could bring the unemployment rate down to 4.7 percent by year-end.

Equity Markets

As I mentioned earlier, equity markets have been extremely volatile as of late, and we have seen a large sell-off and close to a 10 percent drop in equity prices.

Much of the current unease we are experiencing could be due in part to worry regarding China. Taken together, slower Chinese growth and declining share values embeds some downside risk to my assessment of future economic activity.

That said, China is not our major trading partner, and it may well be that as the U.S. economy proves its resilience, equity markets are expected to calm down and reverse direction.

I do anticipate that the loss in wealth arising from the dramatic sell-off will offset some of our economy’s fundamental strength, but I do not feel it will overwhelm it. Thus, although declines in asset prices have tempered the view I had of the economy a few months ago, the recent declines have not fundamentally changed it. As a policymaker, I think it is important to take a long-term view rather than react to short-term volatility and, thus, to consider an array of data and longer-term trends in forming our policy stance.

Real Estate

Switching to real estate, I am fairly optimistic about residential investment. The demand for housing has picked up, and prices of both houses and especially rentals are growing strongly.

Permits for single-family homes are at their highest level since the recovery began, and plans for building in the multifamily sector remain robust. That underlying strength was also reflected in December's healthy report on new single-family homes that grew by 544,000 at an annualized rate — the strongest performance since February 2015.

Nonresidential investment is a bit more problematic, however. I say this because I feel it is unlikely that we will see strong growth in business fixed investments — such as new structures, equipment, and software — due in part to the strong dollar adversely affecting manufacturing, and therefore, the demand for equipment. That said, I foresee manufacturers continuing to struggle in the coming year and anticipate investment growth of only 2.5 percent or so.

Inflation

Let me now turn to another important component of the U.S. economy that significantly influences monetary policy, and that is inflation. As you know, inflation continued to run below the FOMC's 2 percent target in 2015. Both the fall in energy prices and, to a lesser extent, the appreciation of the dollar, have held down headline inflation, or total inflation, which includes commodities such as food and energy prices.

Inflation measures that remove these more volatile components are not far from our goal of 2 percent. I believe that once energy prices stabilize and start reversing, inflation will return to our 2 percent target. I see headline inflation accelerating at an annual average pace of 1.5 percent by the second half of this year.

But as Chair Yellen has emphasized, inflation expectations are also a crucial ingredient in formulating monetary policy, and she has noted that "[c]onvincing evidence that longer-run inflation expectations have moved lower would be a concern." This is because that would make attaining our inflation target harder to achieve.

So far, survey evidence, like that obtained from the Philadelphia Fed's *Survey of Professional Forecasters*, does not indicate any unanchoring of inflation expectations. However, market-based measures are showing that investors are seeking less compensation for inflation.

But there are downside risks to my baseline forecast. In particular, we have been below our inflation target for all but two years since 2008. Consistently below-target outcomes will eventually lead to a lack of credibility for our 2 percent goal. Hence, it may be worth erring on the side of accommodation to ensure against that outcome.

However, there are also risks to the upside. There is a good deal of anecdotal evidence that firms are planning to raise wages, especially for jobs that are proving to be hard to fill. I do expect some faster wage growth going forward, and accelerating wage growth could translate into more robust inflation. Additionally, it is unlikely that oil prices will continue to drop, and eventually, they will become a contributor rather than a detractor from inflation.

Monetary Policy

My approach to policy is to conduct it in ways that will best serve our dual mandate of maximum employment and price stability.

Given the behavior of oil prices, inflation is likely to be quite low in the first quarter of the year, probably even negative. Regarding the employment side of our mandate, I believe we will attain it early this year, if we have not attained it already.

Over the medium term, I remain confident that inflation will return to target. Arithmetic is in our favor: Energy prices would need to fall again and, by a similar magnitude, to renew their downward pressure on inflation. In other words, even if energy prices remain at very low levels, inflation should naturally rebound as current prices become the base on which price increases are computed.

Similarly, import prices should stabilize as the dollar does, removing another source of downward pressure on inflation. Granted, this process will take some time as the price cuts are transmitted across the economy. Thus, my outlook sees inflation returning to target only gradually, more gradually than I thought just a few months ago.

It is also fair to say that the risks to my outlook are tilted to the downside. The nervousness in the financial markets and the increased caution that it may cause for economic decision-makers, both households and firms, could imply somewhat slower growth, at least in the first half of the year.

Also, inflation is not likely to pick up substantially until the second half of the year, although, for the reasons I have discussed, I remain confident that inflation will move toward the Committee's long-run objective of 2 percent.

These considerations make me a bit more conservative in my approach to policy, at least in the very near term. Although I cannot give you a definitive path for how policy will evolve, it might prove prudent to wait until the inflation data are stronger before we undertake a second rate hike. Thus, I am approaching near-term policy a bit more cautiously than I did a few months ago. That is part of being data dependent. And attentiveness to the data will be a key factor in all of my future policy recommendations as well. If financial headwinds dissipate quickly and inflation picks up a bit more aggressively, it will require a slightly more aggressive approach to policy.

I believe as we move into the second half of the year with economic activity growing at trend or slightly above trend, the unemployment rate below its natural rate, and price pressures starting to assert themselves, policy can truly normalize. I mean this in the sense that we can move away meaningfully from the zero lower bound and that our reaction to incoming data can return to a more historical pattern.

That would not necessarily imply an overly aggressive path for policy. Thus, it will take fewer rate hikes to attain neutrality in policy than it would have 15 years ago. By historical standards, that in itself implies a somewhat shallower path for interest rates than was typical of past recoveries.

Delaware

So, what does this all mean for our District and its challenges? As we know, Delaware is fighting to maintain its edge in attracting and retaining corporate headquarters in the state. The recent loss of DuPont represents a stark reminder of a shrinking corporate sector. Fortunately, we have seen rapid growth in education and health services, and the state's thought leaders have their sights focused on innovation.

We can look to the opening of the University of Delaware's STAR Campus as an example of how this region knows how to combine its strengths of the public and private sectors to grow and shape the economy of the 21st century.

Universities like the University of Delaware fuel innovations that shape modern life, from life-saving medicines to life-changing technology. And so, in 2008, when the Chrysler plant finally closed and left behind an aged industrial complex — a reminder of our District's past — we chose to invest our expertise and resources to build what now stands there and represents our future.

We recycled 140 million pounds of steel, 5,000 tons of concrete, 40,000 light bulbs, and almost 4 million pounds of copper, aluminum, and stainless steel.

Today, more than 400 patients a week come to STAR’s health centers, and thriving inside is a spirit of entrepreneurship and innovation. Cybersecurity, Bloom Energy, SevOne, and grid-integrated vehicle systems are being worked on over there. There is a lab focused on providing kids with disabilities the mobility they need to socialize, learn, and grow. Please excuse my excitement; after all, I am an engineer. But what I am trying to drive home, in this room filled with all kinds of leaders, is that the investment we all make in human capital, research, and innovation will never stop giving. It will keep us relevant, it will create jobs, and it will sustain our economy.

Conclusion

So, in closing, my overall view of the economy remains upbeat. Our financial system is in good shape, our economic fundamentals are sound, our labor markets remain dynamic, our income growth is solid, and consumer spending is increasing at a solid pace. We continue to face our challenges head on, and in doing so, we have made significant economic strides as a nation.

Thank you.