

An Economic Outlook

The Bond Club of Philadelphia, the CFA Society of Philadelphia,
and the Philadelphia Council for Business Economics

Philadelphia, PA

May 23, 2016

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President and CEO
Federal Reserve Bank of Philadelphia



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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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Introduction

Good evening. Thanks, Luke, for that kind introduction. It's always good to see familiar faces from the Fed.

I would also like to thank Howard Trauger and the Bond Club of Philadelphia as well as Jeremy Bach of the CFA Society of Philadelphia for inviting me here to speak with you.

An Economic Outlook

Today, I would like to offer my views on the economy and how they influence my assessment of appropriate monetary policy.

I believe that normalization of monetary policy is an important aspect for guaranteeing that the U.S. economy remains on a solid path, but the timing of that normalization is also key in ensuring continued economic growth and a return of inflation to target. It is also important for participants on the Federal Open Market Committee (FOMC) to express their views on the policy process as well as how they anticipate that process will unfold.

Transparency is a central feature of policy. It helps align the public's views with those of the FOMC's, allowing policy to proceed more efficiently. Further, it helps avoid unanticipated outcomes that could interfere with the intentions of policymakers like me.

Before offering my views on the outlook for the U.S. economy and how I believe monetary policy should evolve, I need to provide the following small disclaimer: These views are mine alone and do not necessarily reflect those of my colleagues on the FOMC or anyone else in the Federal Reserve System.

Economic activity of late, at least as measured by headline GDP, has slowed noticeably. After a subdued fourth quarter when real output increased by 1.4 percent, the advance estimate for the first quarter indicated that the economy grew at a mere 0.5 percent.

Perhaps most troubling was the loss of momentum in consumer spending, which grew at an unexpectedly modest rate of 1.9 percent. This growth was significantly weaker than the healthy 3.10 percent growth achieved last year.

Investment was also exceptionally weak, declining by 5.9 percent at an annual rate, but I, like many economic commentators, believe this is temporary and largely induced by two factors: (1) the weakness in mining and drilling and (2) the waning drag of a fairly significant appreciation of the dollar that's had a negative impact on our manufacturing sector.

An important question is: How much of the weakness in the first quarter GDP report is due to residual problems in seasonal adjustment that have long plagued this series? For example, first quarters, from 1985 through 2015, have experienced the lowest annualized growth of any quarter in 16 of the 31 years. This is a definite statistical anomaly.

Moreover, first quarter growth has averaged more than a percentage point less than the growth rates we have witnessed in the succeeding three quarters. Again, a statistically significant magnitude.

If the problem of seasonal adjustment remains, which I am of the opinion that it does, the growth over the rest of the year should be considerably more upbeat than what transpired in the first quarter.

A measure we construct at the Philadelphia Fed that incorporates data both on expenditures and income, referred to as GDPplus, is immune from seasonality problems and has a number of other attractive properties. It indicates that first quarter growth was 1.25 percent, which is admittedly not an overwhelming growth rate, but it is nowhere as troubling as the advance GDP estimate.

With some of the near term weakness, I remain guardedly optimistic about our economic prospects. The labor market remains extraordinarily dynamic.

Although the latest employment report of 160,000 net new jobs surprised most commentators to the downside — and although this figure is less than the 200,000 jobs growth we have become accustomed to — I believe much of the apparent decline can be attributed to unseasonably cold weather in April. A so-called unseasonal seasonal.

Work done at the Philadelphia Fed on “Weather Adjusting for Economic Data” indicates that a more accurate reading of April employment growth would place that number at around 229,000 net new jobs, implying that the labor market continues to add jobs at a long-run unsustainable rate.

That number is also more in line with the view obtained from looking at the “Job Openings and Labor Turnover Survey” (JOLTS) data, where job opening rates are at near-record levels. In addition, quit rates are approximately at their prerecession levels, and hiring rates remain at very healthy levels.

Likewise, we are beginning to see some acceleration in wage growth, especially among those remaining in the same job. Anecdotes abound about the difficulty in finding skilled workers in certain job categories. Furthermore, many economic fundamentals remain sound, and our financial system is in good shape. Income growth is solid, and household balance sheets remain healthy. The latest retail sales numbers confirm the underlying strength of consumers. Also, the housing market continues to grow slowly and steadily, and house prices continue to appreciate.

I believe it is worth noting that the U.S. economy just weathered a series of very negative headwinds and still continues to grow, for the most part, shrugging off what would probably throw a weaker economy into recession.

Slowing growth in China has depressed commodity prices and has led to a pronounced retrenchment in investment and employment in our energy sectors. The appreciation of the dollar has weighed heavily on manufacturing, but even here, there are signs that this sector has bottomed out.

The Institute of Supply Management Manufacturing Index has nudged into expansionary territory over the past two months, confirming, at the national level, the improvement that has been seen in several regional surveys. And the sharp and volatile decline we witnessed in equity markets earlier in the year has subsided, and market indices are now higher on the year. Finally, the price of oil appears to have stabilized at roughly 40 percent above the lows we saw earlier this year. With solid fundamentals and a calming in first quarter headwinds, I anticipate continued modest economic improvement over the rest of the year.

Let me also emphasize, that as a policymaker, I think it is important to take a long-term view rather than react to short-term volatility and, thus, consider an array of data and longer-term trends in forming my policy stance. As I said, over the longer run, I am relatively optimistic about the health of our economy.

Focus on the Region

While much of my take on the economy is based on analyzing national economic statistics and evaluating their implications through the lenses of other models, I also rely heavily on

information gained closer to home. It is often more timely, and, when it comes from our many diverse contacts in the region, it is imbued with a richer texture than mere numbers can provide.

Conditions in the Philadelphia area¹ have closely tracked national trends throughout the current recovery. Although the area was not hit as hard as the nation during the recession, it has recovered a bit more slowly, taking about one year longer to recover jobs that were lost.

But recent job growth has been robust, with around 25,000 jobs — seasonally adjusted — in the first quarter of this year. This is among the region's top-10 fastest growth rates for any three-month period since 1990.

Contacts in the region say that it seems wage pressures are building, especially among jobs in skilled occupations. Further, firms continue to anticipate solid job growth throughout the year. These types of interactions have served to buttress my view that the economy remains on solid footing.

The national resurgence of cities and a desire for urban living among millennials and retirees alike has had a noticeable impact on Center City Philadelphia and the region as a whole.

We've seen significant construction activity on projects for multifamily residential, commercial retail, new office space, and industrial warehousing.

Looking at this behavior happening in my own backyard has helped me interpret the evolving nature of the construction industry. There are deep structural changes occurring in this industry and changes we need to better understand if we will react appropriately as policymakers.

¹The Philadelphia-Camden-Wilmington, PA-NJ-DE-MD-MSA includes Bucks, Chester, Delaware, Montgomery, and Philadelphia counties, PA; Burlington, Camden, Gloucester, and Salem counties, NJ; New Castle County, DE; and Cecil County, MD.

Urban projects that are already in the pipeline will keep local construction workers busy for several years and have made me more optimistic that both residential and nonresidential construction will contribute to economic growth going forward.

Inflation Target

Let me now turn to another important component of the U.S. economy that significantly influences monetary policy, and that is inflation. This continues to run below the FOMC's 2 percent target, especially when considering the headline numbers.

Over the past 12 months, headline PCE has been growing at only 0.8 percent, while the less volatile core measure has been increasing at a closer-to-target 1.6 percent. Both the decline in energy prices and, to a lesser extent, the appreciation of the dollar, have held down headline inflation.

Other measures of inflation that also remove the more volatile and transitory components of price changes, and thus, reflect a more accurate reading on price pressures, have remained closer to the FOMC's long-run target. For example, a series the Dallas Fed uses to measure PCE inflation — which I highly regard — has inflation growing by 1.8 percent over the past 12 months.

I believe that, once energy prices stabilize and start reversing, inflation will return to our 2 percent target by sometime next year. The latest CPI report appears to confirm this view as headline CPI rose by a greater-than-expected 0.4 percent in April, and the details of the report suggest that we will see significant firming in the core PCE index this quarter as well.

But as Fed Chair Janet Yellen has emphasized, inflation expectations are also a crucial ingredient in formulating monetary policy. This is because a divergence of expectations from our target 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. And while market-

based measures of inflation expectations are a bit on the low side, they have rebounded somewhat of late and should continue to rebound as inflation returns to target.

That said, inflation has been consistently below target for a number of years, and the difficulty in bringing inflation back to target does call for careful monitoring of our progress on this front. Failure to attain our target — even with the degree of monetary accommodation that has characterized recent monetary policy — could be considered a downside risk to my fairly optimistic view that inflation will return to target relatively quickly.

However, there are also risks to the upside. I believe that wage pressures are building and will continue to do so as the labor market moves beyond full employment. With productivity somewhat weak, unit labor costs will accelerate, and, at some point, firms will have no choice but to start passing these price pressures onto consumers. Additionally, the rise in energy prices, although they should remain at low levels for some time, will contribute to 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. Regarding the employment side of our mandate, I believe we have, for the most part, attained our goal already and that the labor market is basically functioning at full employment.

Over the medium term, I remain confident that inflation will return to target. Energy prices have rebounded a bit, and with the dollar depreciating slightly as of late, the math is in our favor. This means that these factors will no longer exert a deflationary impact. Thus, I see headline measures falling in line with the more stable core-type measures, and I see upward pressure on these measures as well.

As actual inflation rises, so will market-based measures of inflation expectations, and so the current low readings will recover and eliminate one of the risks to normalizing policy. If the economy follows the path I expect it to follow, monetary policy will be overly accommodative by historical standards. That will set in motion the possibility of another risk, which is accelerating inflation and the need for aggressive policy actions.

These types of actions that have typically been necessary to rein in accelerating inflation have also been associated with negative economic outcomes. Therefore, we need to minimize the possibility that we could once again find ourselves in that predicament.

Although I cannot give you a definitive path for how policy will evolve, I can easily see the possibility of two or three rate hikes over the remainder of the year. That said, all forecasts are subject to fairly wide confidence bands, and mine is no exception.

So, even though I am aware that many of you are growing tired of the phrase “data dependent,” that is exactly what I will be. In the end, it is the tried-and-true way for conducting monetary policy.

Closing

In summary, I believe that 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 meaningfully move away 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. As I said, there will likely be two or perhaps even three rate hikes over the course of the year.

We should proceed slowly for two reasons: (1) because it may take some time for inflation to begin moving up in a sustainable fashion and (2) because the neutral funds rate is probably a good deal lower than it was 15 years ago. Thus, it will take fewer rate hikes to attain neutrality in policy. By historical standards, that in itself implies a somewhat shallower path for interest rates than was typical of past recoveries.

Thank you. I believe we have some time for questions.