FEDERAL RESERVE BANK OF BOSTON™

"The Economic Outlook"

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I appreciate having been invited to speak again to the Providence Chamber of Commerce. As all of you know, Rhode Island was one of the states most severely impacted by the recession, and it remains one of the hardest-hit states even at this point in the economic recovery. Rhode Island is one of only two states that as of November continued to have a state unemployment rate in excess of 10 percent.

Persistently high unemployment rates have enormous personal and societal costs. So in my view it is critical that public policy continues to actively support the economy's return to full employment.

Today I would like to highlight that the Federal Reserve's approach to monetary policy has played an important role in the recovery we have seen to date. And I would like to explain why I consider it imperative that monetary policy continue to actively support the economy at present – since we continue to have an unacceptably high unemployment rate while, at the same time, inflation is *under*shooting the Federal Reserve's 2-percent target.[1]

As always, I would note that my remarks encompass my own views, not necessarily those of my colleagues at the Federal Reserve Board or on the Federal Open Market Committee (the FOMC).

Economic Conditions

The U.S. economy has grown at an average 2.2 percent annual rate since the recovery officially began in June of 2009. Data suggest that growth was likely a bit below that rate for the most recent quarter, and the employment report for December showed that the national economy continues to only gradually improve. Given that many businesses and households were deferring decisions until there was more clarity on the fiscal outlook, the emerging picture of the fourth quarter (stemming from sources such as the employment report) is encouraging. The national fiscal uncertainty cast a shadow on the economy, but it seems there have been some signs of underlying strength.

I consider it particularly encouraging that some interest-sensitive sectors, which are likely to be especially responsive to monetary stimulus, are clearly showing themselves to be "on the mend." Both the housing sector and purchases of consumer durables have been recovering, in part as a response to the accommodative monetary policy the Federal Reserve has been pursuing.

Unfortunately, recent economic improvements have been partially offset by the deferral of spending decisions by households and firms. In all likelihood, these deferrals result in part from uncertainty over national fiscal policy, as well as from the impact of fiscal austerity that has already taken place – particularly at the state and local government levels. If some of the "headwinds" from fiscal austerity discussions here and in Europe abate, we should begin to see growth come in at a pace that is above the economy's long-run potential growth rate. Such growth would bring about both economic expansion and improvements in labor markets.

Interest sensitive sectors are responding to monetary policy

The sectors of the economy that are showing the most improvement recently are those that economists generally consider to be the most responsive to monetary policy and interest rates. Particularly notable is the improvement in the outlook for the housing market. **Figure 1** shows growth in real residential investment compared to growth in real GDP. Over the past year real GDP growth has averaged 2.6 percent. In contrast, growth in residential investment occurred at much higher rates, and I expect this positive momentum to continue through 2013.

Figure 2 provides the rationale for my optimism about residential investment. Housing prices in many parts of the country have begun to rise, and although it is not broken out on the chart, this includes prices in some of the areas that were hardest hit by declines in housing prices. In addition, mortgage rates remain near their cyclical lows and well below the average mortgage rate experienced over the past 25 years. With prices edging up and interest rates at historic lows, there is now something of an incentive for a potential home buyer to actively pursue buying a home. This is the case because both mortgage rates and house prices could be higher if potential buyers delay their purchase decisions.

This current dynamic substantially improves the outlook for housing in my view, together with the fact that houses have become more affordable. The ratio of house prices to rents – a summary measure of the cost of owning versus renting – has fallen back to traditional levels after rising to significant heights during the housing bubble. Finally, in the wake of the financial crisis and recession, many people postponed creating new households as they sought to improve their financial position. But there has been an improvement in household formation recently and many of these new households will be potential home buyers.

Figure 3 shows that consumer-durable purchases have also increased, in part as a result of the very low interest rate environment. Consumer-durable purchases have been a source of strength over the past year, and have grown much more quickly than real GDP. I expect consumer-durable purchases to continue to be a source of strength over 2013.

One particular area of rapid growth has been new car purchases (**Figure 4**). Recent purchases may have something to do with the fact that the average age of cars on the road is now 11.1 years.[2] Some potential car buyers surely postponed decisions until the economic outlook was clearer. So we are seeing a need to replace some aging cars, along with particularly attractive terms available because of the low interest rate environment. The result was purchases of cars and light trucks at a seasonally adjusted annual rate of well over 15 million in November and December. However, a potential concern is that the payroll tax increases that were part of the recent tax agreement will impact the real disposable income of potential buyers. Partially offsetting this had been the lower average gas prices in the fourth quarter, although they have risen somewhat, recently.

So overall, I see monetary policy having an impact, in encouraging the purchase of interest-sensitive assets like homes, cars, and consumer durables. The most interest-sensitive sectors have been responding to the monetary stimulus from the Fed, and this stimulus has provided a major source of strength for the economy last year. And it is likely to be a source of support in 2013.

Unfortunately, the strength in interest-sensitive sectors is partially offset by weakness in other areas of the economy. In particular, while the country certainly needs to get to a sustainable long-term fiscal path, the direct and indirect impacts of recent fiscal austerity deliberations have in my view been one reason that the economy has not snapped back more quickly.

Fiscal policy, policy uncertainty, and Europe remain potential constraints

Indeed, a major source of economic weakness during the recovery has been the need for state and local governments to cut budgets.[3] Whatever your views on the political economy of government spending, in the short term fiscal austerity removes spending from the economy. In many cases this drop in public spending increases unemployment as teachers, police, and other workers are laid off.

In part due to the weakness in housing that strained state and local government finances, state and local government spending has been a large drag on the economy. This spending accounts for close to 12 percent of the goods and services purchased in the economy.

As **Figure 5** illustrates, while state and local government spending remained a drag in late 2011 and the first half of last year, there was actually a slight increase in real state and local government spending in the third quarter of last year. Many expect that state and local spending will increase modestly this year, too. Federal spending has been more volatile, but generally has been a source of weakness as a component of economic activity as well.

Since federal spending accounts for roughly 8 percent of the goods and services purchased in the economy, this is a major source of uncertainty for 2013. Given the large fiscal deficits still being run, the process by which the nation can reach a more sustainable long-term fiscal policy remains rather uncertain. What does seem certain is that there will be cuts in government spending which, like higher taxes, will by the simple math of the GDP calculation slow down overall economic growth.

There is substantial uncertainty over the fate of federal government grants to state and local governments.[4] Substantial cutbacks in these grants would have a ripple effect on the economy. Similarly, there is the issue of potential federal tax base broadening in order to reduce the federal budget deficit. This will have implications for business and family budgets.

While the need for long-run sustainable fiscal policy is both clear and uncontroversial, I believe it is important to achieve sustainability in a way that does not risk the tentative economic improvements we have experienced to date.

One area that has probably been impacted by the uncertainty surrounding fiscal policy has been business investment, shown in **Figure 6**. Nationally, business investment had been a source of strength in the early stages of the recovery, but capital spending by firms weakened significantly in the third quarter of last year – as many firms sought more clarity on government tax and spending decisions before committing to long-term investments. Fiscal uncertainty therefore accounts for at least some share of the recent weakness in business spending, and unfortunately this potential cause for weakness in business spending is likely to persist this year.

A third source of weakness remains the weak outlook for many of our trading partners, as shown in **Figure 7**. Both Japan and Europe have grown more slowly than the United States. Additionally, Japan still struggles with a serious deflation problem, and Europe continues to address fiscal imbalances in many of its peripheral countries. Both regions are also experiencing aging populations, demographically speaking, which brings some difficult fiscal and economic challenges.

Despite these headwinds at home and abroad, I do expect improvement in U.S. economic growth this year. While in the first half of 2013 I think the economy is likely to grow at roughly its potential level of growth, I expect growth in the second half of the year to be closer to 3 percent – assuming that headwinds from fiscal imbalances around the world are not resolved in economically disruptive ways.

Both inflation and unemployment remain far from long-run FOMC estimates

Figure 8 shows the U.S. inflation experience since 2003. While many critics of monetary policy have been concerned with inflationary pressures, through most of the recovery core PCE inflation has remained below the Federal Reserve's 2 percent target. Notably, despite the rapid growth of the central bank's balance sheet in 2008, as well as the balance sheet's continued growth more recently, there has been no upward trend in inflation. *Total* PCE inflation is only 1.4 percent over the past year and *core* PCE inflation is at 1.5 percent.

So current inflation is well below the Fed's target, and expected inflation[5] is well below levels that the FOMC has stated would generate a discussion of lifting short-term rates.[6] Being more than half a percent below our target for PCE inflation highlights why I believe aggressive monetary policy remains appropriate, given that the 7.8 percent unemployment rate is well above where the FOMC expects the unemployment rate to settle in the longer run.

The national unemployment rate has fallen during the recovery, as shown in **Figure 9**, and in fact payroll employment growth has averaged 151,000 jobs over the past three months.

Nonetheless, the societal costs to elevated unemployment rates that are falling only slowly show why accommodative monetary policy is both appropriate and needed.

Figure 10 shows employment in the construction and consumer durable sectors as a share of the U.S. labor force. By our calculation, if construction employment returned to its 2004 levels and durable goods manufacturing regained *half* of the jobs lost since 2004, the unemployment rate would be 6.5 percent (meaning an additional 2.1 million people would be employed).[7]

While interest-sensitive sectors are one of the areas of growth, a more rapid return to the more normal employment shares for those sectors would significantly improve job prospects for workers that have been unemployed or underemployed. Construction and durable goods are both industries that have provided employment opportunities for some with less educational attainment, an area of particularly elevated unemployment rates (as shown in **Figure 11)**. A faster recovery in construction and durable goods would help re-employ those working in sectors of the economy that have suffered greatly during the recession and the painfully slow recovery.

Concluding Observations

In conclusion I would just reiterate my view that continued monetary accommodation is absolutely appropriate and indeed needed as long as we are projected to miss on both elements of the Fed's dual mandate, inflation and employment. Currently inflation is somewhat below our 2 percent target, and unemployment is well above a longer-run sustainable rate.

As the recent FOMC statement highlighted, monetary policy should be guided by current and future economic outcomes, not calendar dates. Interest-sensitive sectors have been responding to accommodative policy, and we should all continue to encourage a quicker recovery in those sectors. If we were able to see construction and durable-goods production return to a more normalized share of the workforce, it would have a meaningful impact on potential employees in those interest-sensitive sectors and also on the broader national labor markets.

Again I thank you for inviting me to speak with you today. And particularly in light of the challenges Rhode Island has encountered in recent years, I wish you all an improved year in 2013.

Thank you.

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[1] As measured by Personal Consumption Expenditures or PCE.

[2] As of July 2011.

[3] A new report from the Rockefeller Institute presents information on "unprecedented" cuts in state-local government employment [http://www.rockinst.org/pdf/government_finance/2013-01-09-State-Local_Government_Employment.pdf]. The report notes that reductions in state and local government employment between August 2008 and November 2012 in Rhode Island were second largest of all the states in percentage terms (see Table 4 of the report). Connecticut and Vermont were also in the top 10 in this regard.

[4] The Pew Center on the States calculates that the federal grants subject to sequestration amount to about 6.5 percent of state government revenues nationwide.

[5] The statement refers to a situation where "…inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee's 2 percent longer-run goal, and longer-term inflation expectations continue to be well anchored."

[6] http://www.federalreserve.gov/newsevents/press/monetary/20121212a.htm

[7] This considers that there is a secular decline in durable-goods manufacturing. If durable goods employment returned to its 2004 levels as well, the unemployment rate would fall further, to 6.0 percent.