William C Dudley: The US economic outlook and the implications for monetary policy

Remarks by Mr William C Dudley, President and Chief Executive Officer of the Federal Reserve Bank of New York, at the ABNY (Association for a Better New York) Breakfast, New York City, 5 December 2016.

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It is a great pleasure to be here and have the opportunity to talk about the U.S. economic outlook. I want to thank the Association for a Better New York (ABNY) for sponsoring today's event. This is an excellent venue to speak about what we can do to improve our country's economic performance. As always, what I have to say reflects my own views and not necessarily those of the Federal Open Market Committee (FOMC) or the Federal Reserve System.

The U.S. economy—supported by solid gains in household spending—has expanded at a moderate rate in 2016. Job gains have been sturdy, and we have seen some firming in wage growth as the labor market has continued to tighten. Moreover, as the effects of earlier declines in energy prices have dissipated, the overall inflation rate has begun to move up closer to our 2 percent objective. As a consequence, economic conditions are not far from the Federal Reserve's dual mandate of maximum sustainable employment and price stability. And, I expect that we will make further progress toward these goals in 2017. So, from a cyclical perspective, the economy is in reasonably good shape.

Over the longer term, however, the U.S. economy faces significant challenges. On the positive side, economic expansions don't die of old age, and there appear to be few imbalances in the economy that could lead to the current expansion ending. But, in order for this to remain the case, it is important that fiscal policy and monetary policy are well aligned going forward.

It is also important that the United States retains sufficient fiscal capacity so that fiscal policy can support the economy when the next cyclical downturn does occur. If fiscal policy can play a greater role in promoting macroeconomic stability, it would likely reduce the need for monetary authorities to take extraordinary actions to support economic activity.

There are other structural issues worth noting. In particular, productivity growth has been anemic over the past few years, while income inequality has increased and income mobility remains low. As a consequence, the gains in living standards generated by the current business expansion have been modest compared to previous expansions, and these gains have not been widely shared. Much more could be done both locally and nationally to increase the economy's potential to perform better for a broader array of our citizens.

The outlook for growth and inflation

The U.S. economy has been expanding at a moderate rate. Growth has averaged about 1.8 percent this year and seems likely to continue at or slightly above this pace in 2017. The main driver of growth in 2016 has been the consumer, as real personal consumption expenditures have increased at a 2.9 percent annual rate during the first three quarters. This solid consumption growth has been supported by sturdy job gains and rising nominal wages. Payroll gains have averaged about 180,000 per month this year. While this is down somewhat from 2015's monthly pace of nearly 230,000, it is still considerably higher than the 75,000–110,000 monthly pace consistent with the likely long-term growth in the labor force. And wage gains, while still relatively muted, have begun to rise more rapidly as the labor market has continued to tighten.

Another positive factor for the economy is that household finances generally are in good shape. The household saving rate is 5.9 percent, which is a bit higher than one would expect based on historical relationships between household net worth and disposable income. And, after a long period of deleveraging, household debt has been growing, but very slowly. Over the last four quarters, household debt has risen by 2.4 percent. This slow pace, combined with low borrowing rates and an improving labor market, has pushed down the ratio of household debt service to income close to its lowest level since at least 1980. This suggests that households have the financial capacity to sustain their spending.

In contrast to consumer spending, many other areas of the economy have been considerably softer. Residential investment, after experiencing strong gains in 2015 and in the first quarter of 2016, fell during the past two quarters. However, increases in single-family housing starts and permits in October suggest that we are likely to see a reversal of this trend in the fourth quarter and into next year.

Business fixed investment has also been weak for some time. Part of this weakness reflects the collapse in oil and gas drilling activity following the plunge in crude oil prices during the second half of 2014. This adjustment now appears to be over, as oil and gas prices have recovered somewhat. But, even outside of this area, business fixed investment has been disappointing. Several factors may be at play here—including earlier uncertainty surrounding the presidential election outcome and the fact that capacity utilization rates remain unusually low at this point in the economic business cycle. While the election uncertainty has been resolved, I would expect business fixed investment to only rise slowly in the year ahead.

In contrast, the trade sector has performed surprisingly well in 2016. This sector had to contend with headwinds created by weak growth in final demand by our major foreign trading partners, as well as the impact of earlier dollar strength on the nation's export competitiveness. However, I'm not sure that I would take much signal from this performance. The improvement in trade seems to have been driven mainly by weakness in imports, particularly for capital goods, and by some one-off factors, such as the surge in soybean exports last quarter—both of which are unlikely to continue.

With respect to inflation, we are making progress in pushing toward our 2 percent objective. In particular, headline inflation has risen this year as the earlier declines in energy prices have dropped out of the year-over-year figures. And, core inflation has remained broadly steady, running at 1.7 percent over the past year—as measured by the personal consumption expenditures deflator that excludes food and energy. This stability is noteworthy, because one might have anticipated that lower energy prices and a firmer dollar would have pushed core inflation a bit lower. Also, household inflation expectations—which at times in 2015 appeared to be at risk of becoming unanchored to the downside—have been broadly stable. The University of Michigan long-term inflation expectations measure has generally remained in the 2.5-2.8 percent range of recent years. In addition, the New York Fed's Survey of Consumer Expectations measure of 3-year median inflation expectations has stabilized in 2016 in a range of 2.5-2.8 percent, after declining modestly over the course of 2014 and 2015.

Implications for monetary policy

If the economy grows at a pace slightly above its sustainable long-term rate, as I expect, the labor market should gradually tighten further, and the resulting pressure on resources should help push inflation toward our 2 percent objective over the next year or two. Assuming the economy stays on this trajectory, I would favor making monetary policy somewhat less accommodative over time by gradually pushing up the level of short-term interest rates.

Following this year's election, we have seen relatively large movements in financial asset prices.

In particular, the stock market has firmed, bond yields have risen and the dollar has appreciated. On balance, it appears that financial market conditions have tightened modestly. My personal interpretation of these developments is that market participants now anticipate that fiscal policy will turn more expansionary and that the FOMC will likely respond by tightening monetary policy a bit more quickly than previously anticipated. Assuming this expectation is realized, the recent modest tightening in financial market conditions seems broadly appropriate.

Let me emphasize here that I do not view the recent shift in financial market conditions as one that should prompt great concern. It is important to distinguish between a tightening of financial conditions that is driven by an increase in risk aversion from one that is driven by a greater likelihood of stronger near-term aggregate demand and less downside risk to the growth outlook. We experienced the former at the beginning of 2016, while the latter reflects current expectations of greater fiscal policy stimulus.

Obviously, there is still considerable uncertainty about how fiscal policy will evolve over the next few years. At this juncture, it is premature to reach firm conclusions about what will likely occur. As we get greater clarity over the coming year, I will update my assessment of the economic outlook and, with that, my views about the appropriate stance of monetary policy.

Monetary and fiscal policy in a low-rate environment

I also would like to highlight the limitations of monetary policy. One important factor contributing to such limits is that the real short-term interest rate consistent over the longer run with a neutral monetary policy stance appears to be very low, and is expected to remain so for some time. This has been helping to keep real inflation-adjusted interest rates lower than they have been historically. In part, this reflects anemic productivity growth as well as the slowing of labor force growth due to the aging of the population. An implication of this environment is that there will likely be less scope than there has been historically for the Federal Reserve to cut interest rates when needed in the face of an economic downturn. All else equal, this means a greater risk for short-term interest rates to be pinned at their effective lower bound and for inflation expectations to become unanchored to the downside. Although forward guidance and large scale asset purchase programs have expanded the ways in which the Federal Reserve can provide additional accommodation, these unconventional monetary policy tools also have their own limits. These limits suggest that fiscal policy may need to play a greater role in stabilizing the economy than has been the case in past decades.

What I have in mind here is putting in place stronger, more robust automatic fiscal stabilizers that would provide income support during economic downturns. By reducing fluctuations in disposable incomes, these types of fiscal actions would stabilize aggregate demand, thereby limiting the risk of monetary policy getting pinned at the zero lower bound for an extended period and the need for extraordinary monetary policy measures.

I favor automatic, rather than discretionary, fiscal actions because they would typically go into effect more quickly and would be better anticipated. Expectations matter greatly in affecting economic behavior. For example, if the economy were to weaken, the anticipation that strong fiscal stabilizers would kick in to support incomes should lead workers to be less fearful about losing their jobs, and businesses to be less concerned that demand for their products might fall precipitously. This, in turn, would make workers more confident that they could sustain their spending, and would make businesses more confident that they could keep workers on their payrolls.

What type of fiscal stabilizers would be most effective? I would turn first to those that Congress has implemented on a discretionary basis during past economic downturns, such as extensions of unemployment compensation and cuts in payroll taxes. For example, when the unemployment rate climbs, extensions of the duration of eligibility for unemployment compensation could be triggered automatically, helping to stabilize household income. Similarly, when the unemployment rate breaches certain thresholds, payroll tax cuts could be triggered, helping to support the disposable income of workers facing reductions in hours. Payroll tax cuts also have the advantage of skewing more toward low- and moderate-income workers, who typically have a higher propensity to consume out of current income.

Obviously, it is up to the incoming Administration and Congress to decide on the appropriate fiscal measures. But, the point that I want to highlight is that robust automatic fiscal stabilizers would complement monetary policy, and take some pressure off of the Federal Reserve to undertake extraordinary measures in situations where there is little scope for cutting short-term interest rates. This approach might also be superior to other proposals—such as raising the Federal Reserve's inflation objective—that are designed to reduce the risk of monetary policy being trapped at the zero lower bound.

For such fiscal actions to be sustainable over time, it is important that the United States retain sufficient fiscal capacity. This would also ensure that automatic fiscal stabilizers are viewed as fully credible. On this score, while significant progress has been made in recent years in stabilizing the country's fiscal situation, circumstances are likely to grow more challenging in the years ahead. There are three areas that I would highlight. First, the earnings that Federal Reserve returns to the U.S. Treasury Department each year are likely to fall in the future, as rising short-term interest rates narrow the gap between what the Federal Reserve pays on its liabilities—primarily currency and bank reserves—and what it earns on its portfolio of Treasuries and agency mortgage-backed securities. In recent years, the Federal Reserve's remittances to the Treasury have averaged about $90 billion per year, far above the $20–30 billion average prior to the Great Recession. Although the precise trajectory of future reimbursements is highly uncertain, the Congressional Budget Office (CBO) projects that Federal Reserve payments to the Treasury will drop from around 0.6 percent of GDP in fiscal 2016 to 0.3 percent of GDP by 2026.

Second, the Treasury's debt-service costs will likely grow as interest rates rise and the amount of outstanding debt held by the public continues to increase. While net outstanding Treasury debt held by the public has risen to $14.2 trillion from $4.8 trillion over the past decade, annual debt-service costs have only increased very modestly. Looking ahead, the CBO's baseline projection is that debt-service costs will rise from 1.4 percent of GDP in fiscal 2016 to 2.6 percent of GDP in 2026.

Third, the retirement of the baby boom generation will put significant upward pressure on Social Security and Medicare expenditures. Although the trend in Medicare expenditures has flattened out in recent years as healthcare inflation has moderated and utilization growth has slowed, the CBO nevertheless projects that such expenditures will rise from 3.2 percent of GDP in 2016 to about 4.0 percent of GDP in 2026. Consequently, significant pressures on the federal budget are still very much in train. It will be important that fiscal policy be managed so it retains the capacity to be used for macroeconomic stabilization.

Structural challenges

While we have made steady progress over the past year toward our twin goals of maximum sustainable employment and price stability, significant challenges remain for the economy that lay largely beyond the scope of monetary policy. The three I would highlight are the sharp slowdown in labor productivity growth, the increase in income inequality and the low rate of income mobility.

I draw attention to the slowdown in productivity growth for two reasons. First, productivity ultimately drives living standards and how people assess their economic well-being. Second, beyond ensuring a stable macroeconomic and financial environment, monetary policy can do little to improve productivity growth.

Annual productivity growth has averaged only 0.7 percent during the past five years, near the lowest 5-year pace since the early 1980s. There are a number of competing explanations for the slowdown. These include weak capital investment, a flattening out of educational attainment by new labor market entrants, less new business formation, understatement of quality improvements and, hence, output, and fewer ground-breaking innovations. I suspect that all of these factors play a role.

What public policy can do to address this issue is to ensure that the economy operates closer to the frontier of what is achievable. For example, more efforts to improve job skills would prove beneficial—through retraining and apprentice programs, and better alignment of education and training with business needs. Also, encouraging small business start-ups would help—by removing barriers for entrepreneurs to establish new businesses, and by creating more start-up incubator programs. I also suspect that well-targeted infrastructure spending would be advantageous if it addresses logistical bottlenecks and enables people to commute to areas with good job opportunities. For example, in the New York City metropolitan region, mass transit is old, slow and crowded. As a New Jersey resident, I'm still waiting for that second set of rail tunnels into New York City that should have been built years ago.

While higher productivity growth could support better living standards, the benefits for low- and middle-income households depend, in part, on how those gains are distributed between business and labor, and on how labor income is distributed across the workforce. Moreover, income distribution shouldn't be viewed as a static concept. It is important that people are able to move upward in income through their careers, regardless of their starting point.

Over the past several decades, three developments have been discouraging. First, the share of labor income relative to business income has fallen. Since 1970, the labor share of GDP in the United States has declined about 5 percentage points. Similar declines are evident in most developed and emerging market economies. Second, the distribution of labor income has become more skewed. Since 1970, the top 1 percent of households in the income distribution has more than doubled its share of the nation's income. Third, despite the notion of the American dream, income mobility in the United States remains relatively low compared to many other countries. Also, the potential for income mobility is not evenly distributed. Research has shown that where you are born and raised in the United States still has significant implications for your future prospects.

As a country, we need to address these issues. With respect to the labor share of income, maintaining the U.S. economy at full employment should help. As the unemployment rate has fallen over the past two years, the labor share of income has moved up almost 1.5 percentage points. Supporting maximum sustainable employment is part of the Fed's dual mandate, so we can play an important role here.

With respect to the rising concentration of income and the low level of income mobility, I think considerable improvements are also achievable. Income distribution can be influenced by tax policy and by educational opportunities. Income mobility can be influenced by local policies on education and housing. As Raj Chetty's pathbreaking work makes clear, income mobility depends on where one is born and lives. This suggests quite strongly that improved access to good education, childcare and affordable housing would help.

As I noted in a recent speech, an important aspect of a city's vitality is the ability of its residents to develop the skills necessary to be successful and achieve their dreams.[1] A big asset for New York City is its access to affordable education. Each year, tens of thousands of low-to-moderate-income New Yorkers send their children to one of the city's specialized high schools. When it comes time for college, many of these same students have access to the City University of New York (CUNY) and State University of New York (SUNY) systems. A recent highly regarded study assessed how much of an opportunity children born to less advantaged families in different parts of the United States have of moving up in the world. New York City ranked 10th out of the 50 largest U.S. metro areas.[2] This is a better than average performance, but I think New York City should aspire to do even better.

To conclude, while the near-term outlook for the U.S. economy is reasonably good, there is considerable work to do over the longer term to improve our nation's productive capacity and foster an environment in which the gains are spread more evenly. Monetary policy is limited in what it can do to address these broader structural issues. However, monetary policy will do its part to ensure the macroeconomic and financial stability that can help in achieving progress in these areas. Moreover, even with respect to macroeconomic stability, monetary policy could use an assist from fiscal policy. It is important that monetary policy and fiscal policy work together and not at cross purposes to be able to bolster the economy when it needs support.

Thank you for your kind attention. I would be happy to take a few questions.

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1 See New York City's Return from the Brink, Remarks at the Lotos Club, October 19, 2016.

2 Raj Chetty, Nathaniel Hendren, Patrick Kline and Emmanuel Saez. "Where is the Land of Opportunity? The Geography of Intergenerational Mobility in the United States." Quarterly Journal of Economics, Vol. 129, No. 4, 2014.