

Statement

Subcommittee on Economic Growth, Tax and Capital Access of the House Committee on Small Business

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Good morning, I am honored to speak to the subcommittee this afternoon regarding the economic outlook. In my comments today, I will share with you some of my thoughts on the factors affecting economic conditions in the nation, as well as in South Carolina, and what that may portend for the remainder of 2014. Before I do any of that, however, please note the views I express in this testimony are my own and do not represent the views of the Federal Reserve System.

Many of the broad measures of the nation's economic activity have been coming in slightly better than expected in recent months. Most notable among those were the robust readings of total output in the third quarter of 2013 and a material decrease in the nation's unemployment rate over the second half of the year. Real gross domestic product, the best measure of the production of goods and services in our economy, advanced more than 4 percent in the third quarter, the fastest pace in two years. And factory output has recently regained its footing, an important development for South Carolina, which has a heavy concentration in manufacturing industries. Meanwhile, the nation's unemployment rate fell in December to 6.7 percent and, while still elevated, was the lowest it's been since October 2008. With relatively solid readings in consumer and business confidence, and a material increase in equity market values, there is a renewed optimism among some economic forecasters that growth in 2014 is finally going to break out of the low-trajectory GDP growth that has been the norm over the course of this now four-and-a-half-year recovery.

I, however, do not see sufficient evidence that a meaningfully stronger economic recovery is on the near-term horizon. A more detailed examination of some of the broad economic indicators alluded to earlier indicate that growth may remain constrained moving forward. Moreover, the most basic underlying economic fundamentals for 2014 are not materially different than those that have dominated since the recovery got under way in the summer of 2009. These factors have tempered my own outlook for growth, which calls for a continuation of recent trends in output growth accompanied by modest improvements in labor market conditions. South Carolina's economic prospects are slightly better than the national average, but the state cannot completely escape the gravitational pull of those factors that are weighing on economic growth nationally. For this reason, I will begin by talking about those national trends.

A closer examination of the broadest measure of national economic activity, real gross domestic product, is revealing. In its simplest form, real GDP is the sum of household purchases and residential

construction, business investment, our purchases from and our sales to the rest of the global economy, and government spending and investment. This is illustrated in Chart 1 of the appendix, which shows real GDP growth in the second and third quarters of 2013, as well as the contributions to growth from the various segments of the economy – personal consumption expenditures (PCE), business investment in structures (Nres), business investment in equipment (Equip), residential investment (Res), changes in business inventory (Inv), exports (Ex), imports (Im), and government spending and investment (Gov).

With the exception of imports, each of these categories made a positive contribution to real GDP growth in the third quarter. However, it is readily evident that changes in business inventories (Inv) accounted for more growth than any of the other breakouts (1.7 percent of the 4.1 percent total GDP growth). That suggests firms produced more goods in the third quarter than were sold during the period. If that is indeed the case, then firms will have to adjust their production plans going forward to bring inventories back in line with their sales (and sales expectations). Another perspective on the robustness of the domestic economy can be attained by examining sales rather than output. By accounting for the inventory build, as well as the demand from overseas (exports), the government can calculate real final sales to domestic purchasers – that is, the total sales of all goods and services within the geographic bounds of the United States. At times, this measure can provide a better sense of domestic economic activity. In the third quarter, real final sales to domestic purchasers advanced 2.1 percent, a very small acceleration from the 2.0 percent pace recorded in the second quarter (Chart 2).

Personal consumption expenditures (PCE) comprises the largest component of sales in the economy and accounts for roughly 70 percent of GDP. Real PCE is the aggregation of all household spending, which falls into three broad categories – durable goods (such as automobiles and computers), nondurable goods (such as food and clothing), and services (such as dry cleaning and hair cutting). Over the course of the recovery, increases in real PCE have averaged 2.2 percent, with slightly smaller gains in 2013. More recent monthly data is mixed on the outlook for consumer spending. Chart 3 in the appendix shows the percent change in real PCE over the year and the percent change in real disposable personal income. On the one hand, growth in consumer spending (given by the dark blue solid line on this graph) picked up the pace in October and November and would point toward a bigger contribution from PCE to GDP growth in the fourth quarter. Households have seen some restoration in wealth as equity and home prices have risen, and they are feeling a little more confident about their situations as reflected in various measures of consumer confidence.

On the other hand, however, growth in real disposable personal income (total income adjusted for changes in prices and taxes) has remained weak in recent months. Even though year-over-year growth in such income accelerated through the first half of 2013 (as illustrated by the dashed red line in Chart 3), it accelerated up to about only 2 percent before easing in the second half of the year. While the rise in asset prices has boosted confidence, consumers' spending decisions are primarily driven by income growth and expectations for income growth in the future. Prior to the Great Recession, during a roughly quarter-century period known as the Great Moderation, growth in real income increased 3.3 percent on average, the same as GDP. With little evidence to suggest that real income growth is poised to accelerate, and households still reluctant to borrow, my own outlook for PCE growth is for a continuation of recent trends.

Residential investment (another part of household outlays) continues to trend up, albeit at a slower pace than what persisted early in 2013. Existing home sales appeared to bounce up toward the end of the year following a soft patch in the fall that was at least partly due to potential homebuyers adjusting to increases in mortgage interest rates. Inventories continue to move toward balance in the market, which is helping to restore pricing for existing homes, adding a self-sustaining element to the housing recovery. New home sales also moved higher toward the end of 2013, and residential construction, as evidenced by single-family housing starts (see Chart 4), is up more than 20 percent over last year, although both remain well below pre-recession levels. With relatively healthy job gains, growth in residential investment is likely to continue throughout 2014 at a pace that is slightly constrained by higher mortgage interest rates.

Businesses continue to report firming demand for the goods and services they produce, but their investment in structures and equipment has grown only modestly of late as firms continue to deal with uncertainties surrounding the strength of the economic expansion, the course of monetary policy, near-term tax and regulatory policy, and longer-term fiscal imbalances. Growth in business investment in equipment, which had been a major contributor to GDP growth during the first two years of the expansion, slowed considerably in the latter half of 2012 and remained softer throughout 2013 (Chart 5). The fundamentals that drive equipment spending are profitability, the outlook for revenue growth, and the availability of credit; there has been little change in those areas recently.

Business investment in structures grew modestly in 2013 and is likely to continue doing so throughout 2014. Nationally, vacancy rates are still moving lower in office, industrial, and commercial properties, which has firmed rents and improved cash flow for landlords. As was the case in residential construction, nonresidential investment remains well below pre-recession levels in spite of recent gains.

The uncertainties cited above contribute to a persistent cautiousness that may be manifesting itself not only in investment decisions, but also in hiring decisions. We are now four and a half years into the expansion and have not yet recovered all of the jobs that were lost as a result of it. And that is as true for South Carolina as it is for the nation. Payroll employment growth in the nation was above the long-term average rate for most of 2013, and it has been relatively broad based across industry and geographic breakouts. Yet, it still feels ungratifying after losing about 8.7 million jobs nationally during the Great Recession. In South Carolina, the recession led to a net loss of nearly 170,000 jobs. Relative to the nation, South Carolina lost a larger share of its employment during the downturn (see Chart 6), a phenomenon attributable in part to the state's reliance on manufacturing and construction heading into the recession. Over the past year, job growth in the state has mostly surpassed that of the nation, but because it's coming out of a deeper trough, South Carolina still has a longer way to go to reach pre-recession levels of payroll employment.

The general outlook for job growth remains favorable as business surveys (including the Federal Reserve Bank of Richmond's Carolinas Business Activity survey) suggest that firms continue to hire; temporary help employment rises; and job destruction (as illustrated in initial unemployment claims data) remains very low.

As mentioned earlier, the nation's unemployment rate is currently at its lowest point since October 2008. Yet it's still more than 2 percent higher than it was prior to the onset of the downturn, and other measures of duress in the labor markets (the incidence of long-term unemployment, involuntary part-time employment, discouraged workers, etc.) remain elevated. Moreover, there has been a disconcerting trend

toward lower labor force participation. In fact, the nation's labor force participation rate continued to fall even after the recovery began and today remains near the lowest it has been since the late 1970s. In South Carolina, similar trends have been evident and, most recently, even more pronounced. The state's unemployment rate has fallen to within 0.1 percent of the national rate, which is quite a development considering it stood more than 2 percentage points higher during the worst of the downturn (Chart 7). Like the nation, the decrease in South Carolina's unemployment rate has been accompanied by a decrease in the labor force. In fact, of the 40 counties in the state that showed year-over-year declines in their unemployment rates in November, 34 saw an accompanying decrease in labor force participation. While the decline in unemployment is a welcome development, lower labor force participation will ultimately hamper longer-term growth potential by limiting the available pool of labor. And this decline comes at a time when employers here in South Carolina and elsewhere around the country lament a dearth of qualified workers to fill open positions.

Finally, if we look past the plethora of economic indicators that can often send mixed signals about the economy and focus on the most basic of economic fundamentals, the U.S. economy (as well as South Carolina's) has a built-in speed limit. And that speed limit is a function of two factors: how fast labor inputs are increasing, and how fast productivity (our ability to produce goods and services in a given period of time) is changing. Since the beginning of 2011, employment has increased at an average of a little more than 1 percent per year, and productivity rose, on average, a little less than 1 percent. There are many factors that affect flows into the labor force (population growth, skills attainment, demographics, etc.), as well as a plethora of reasons that productivity can change (technological advances, process improvements, regulations, etc.). Most of them, however, only change slowly over time.

Admittedly, it is very difficult to predict changes in labor force participation and productivity, but there is no evidence to suggest that there is something on the near-term horizon that will materially alter the national dynamics that have weighed on economic growth over the past three years. Thus, the most likely outcome for 2014 is a continuation of recent trends – a little more than 2 percent GDP growth nationally accompanied by modest improvements in payroll employment and the unemployment rate. The outlook for South Carolina's economy is a little better than average due to its low cost of doing business, positive migration trends, and recent high-profile successes (such as attracting Boeing, Bridgestone, Continental, etc.), but it too will be hamstrung by the same forces that are adversely affecting the national economy.

Once again, I'd like to thank the committee for inviting me to testify today.

Chart 1 - Real GDP and Sector Contributions

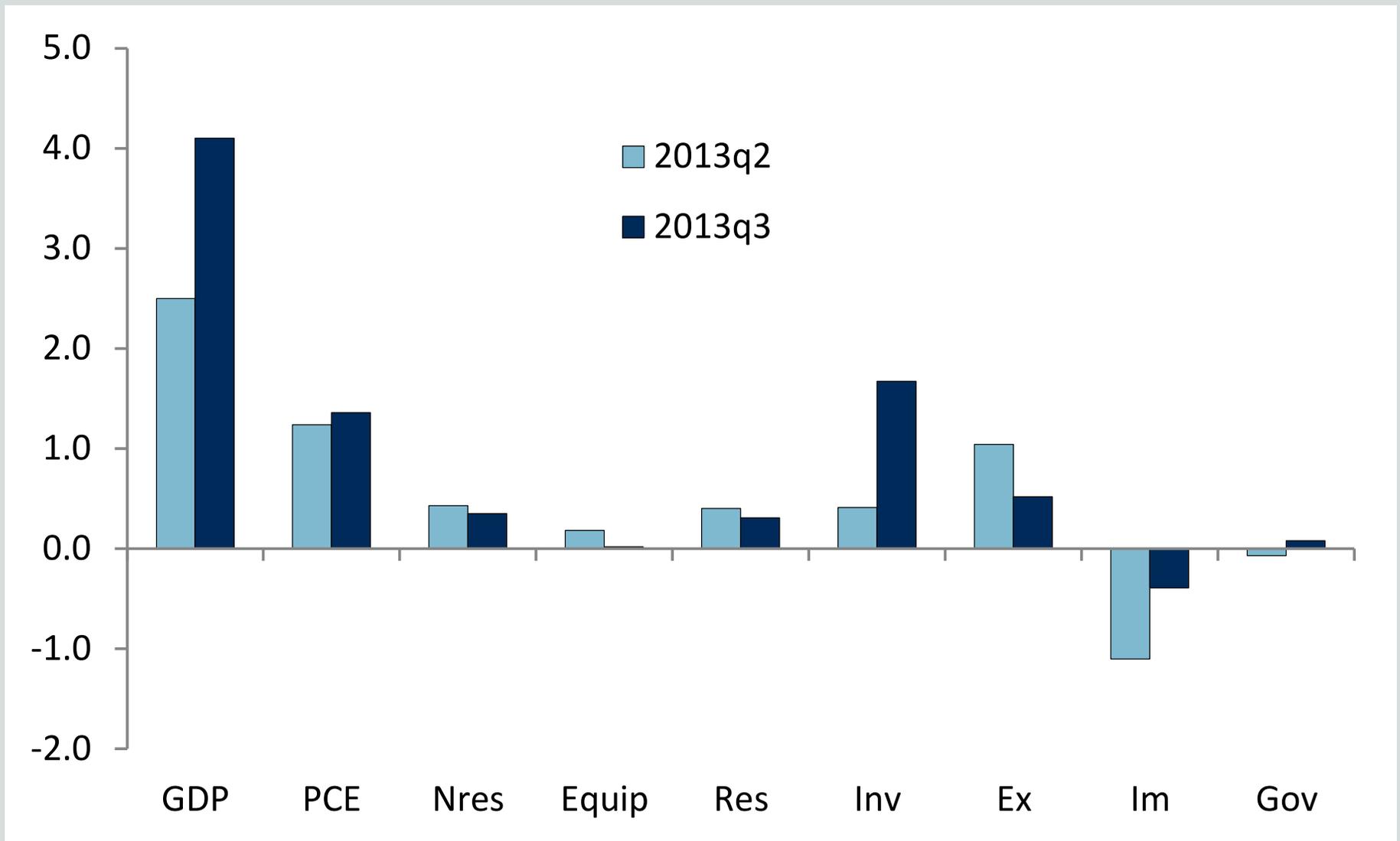


Chart 2 – Real GDP and Domestic Sales

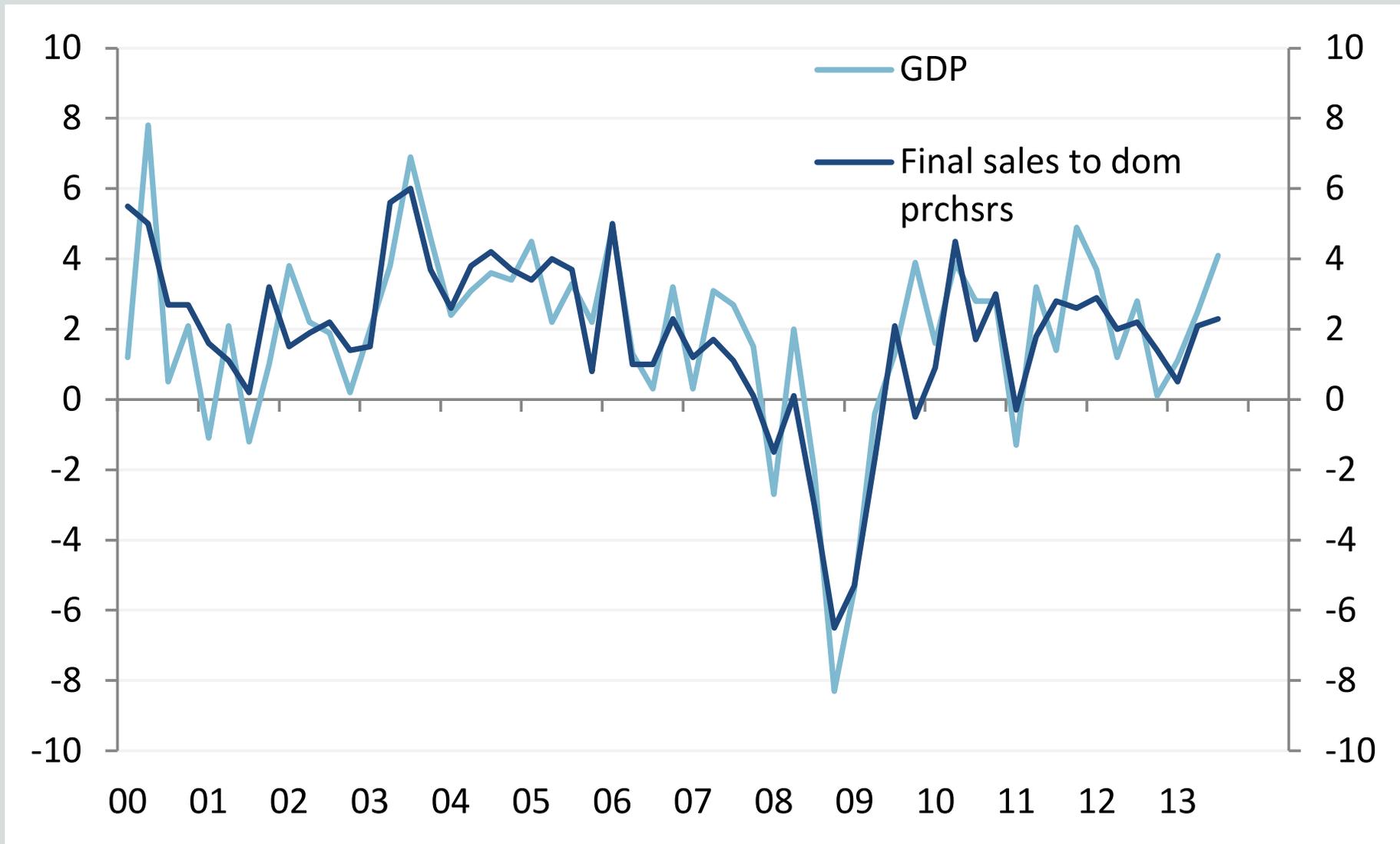


Chart 3 - Disposable Personal Income & Expenditures

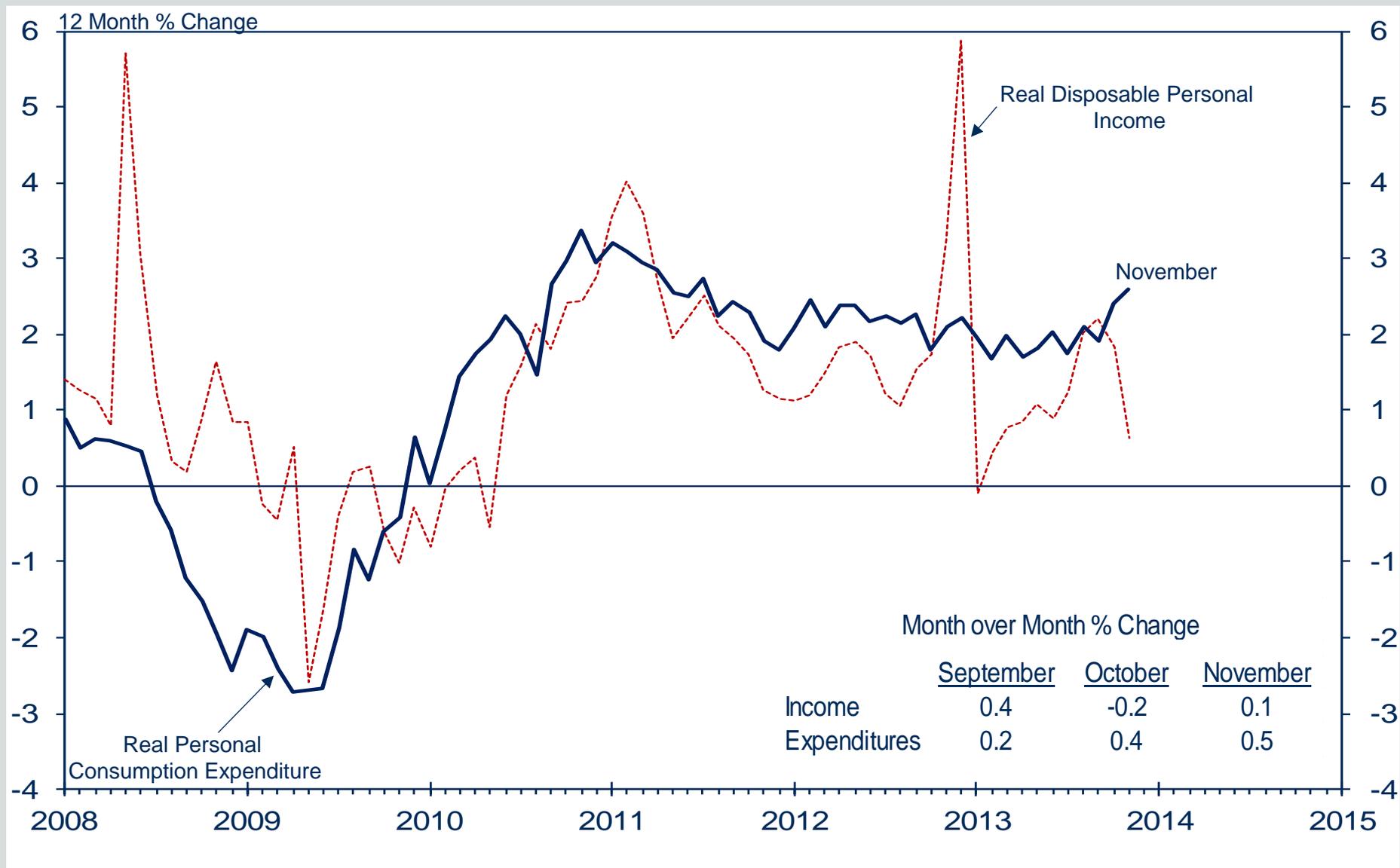


Chart 4 - Private Single-Family Starts & Permits

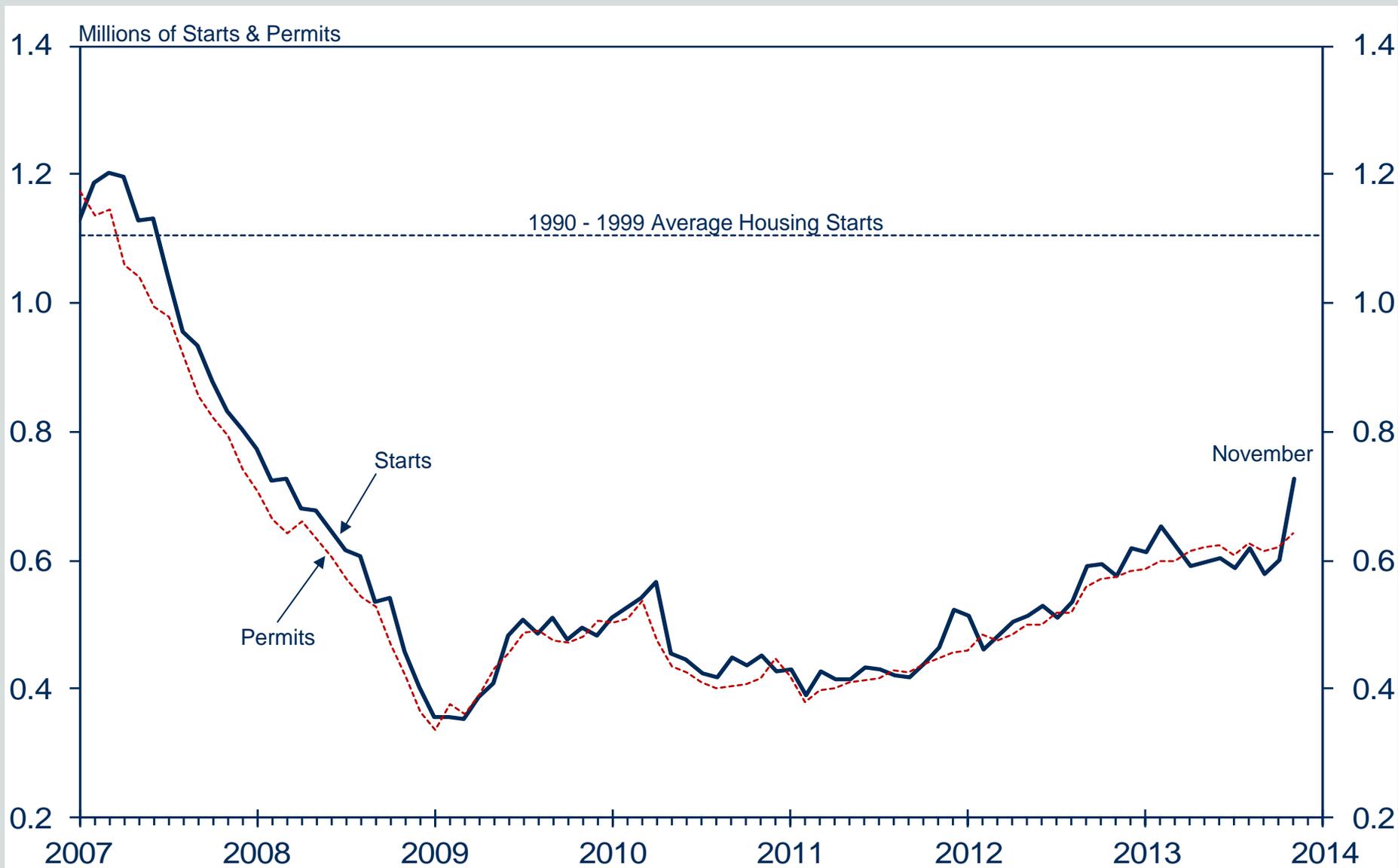


Chart 5 - Real Investment in Equipment

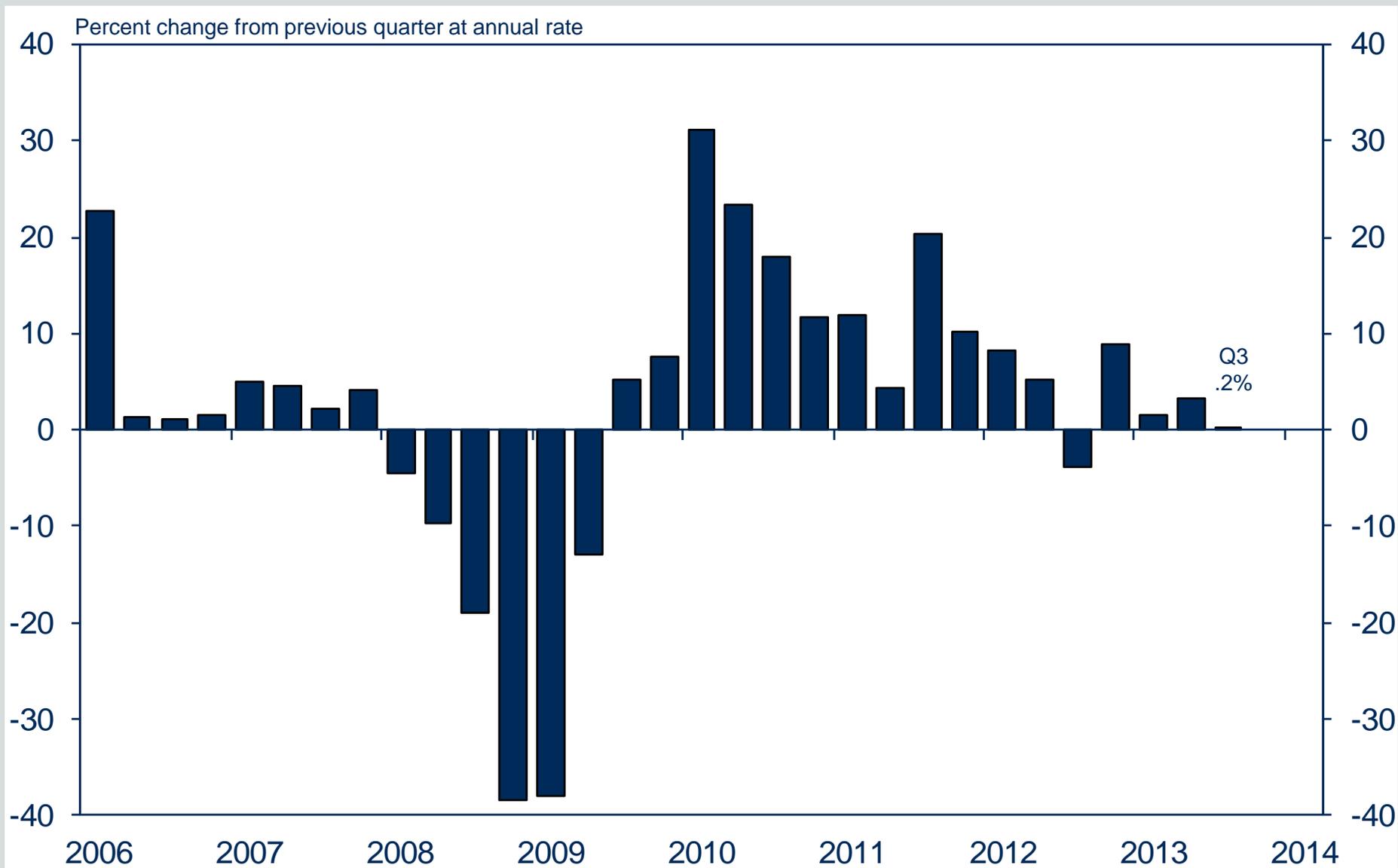


Chart 6 - Payroll Employment

Index, Dec. 2007 = 100

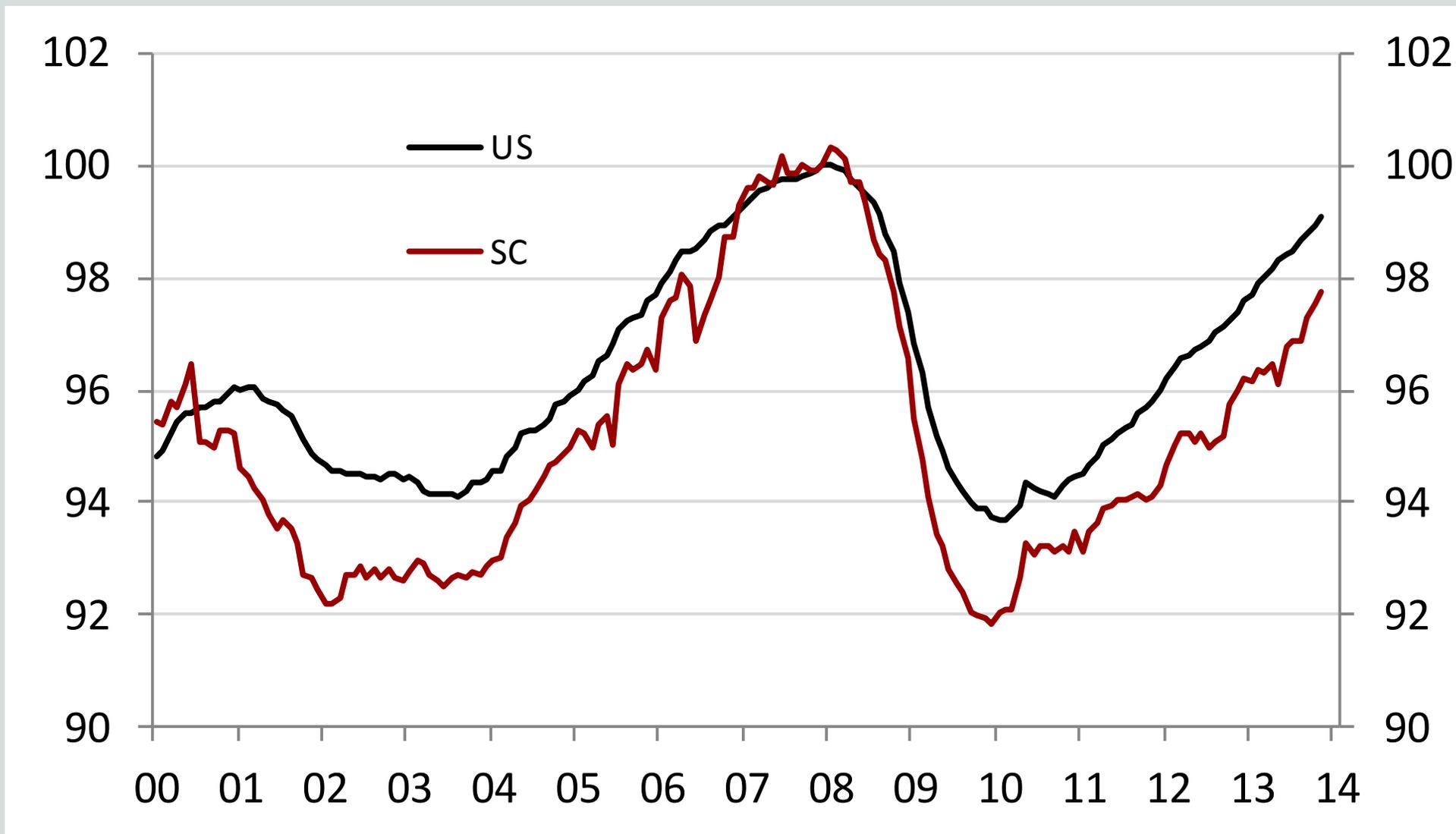


Chart 7 - Civilian Unemployment Rates

Percent of Labor Force

