The Energy Sector, U.S. Economic Outlook and Monetary Policy

Remarks by

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November 18, 2016
Oil and the Economy: Adapting to a New Reality
A Joint Conference of the Federal Reserve Banks of Dallas and Kansas City
Houston, Texas

Thank you. I am pleased to join Rob Kaplan for this conference co-sponsored by the Dallas and Kansas City Federal Reserve Banks. The oil and gas sector features prominently in the economies of our respective regions, making the focus of this conference "Adapting to a New Reality" highly relevant to our work as policymakers.

Understanding the dynamics of this market is critical. As such, we have long studied trends in the sector and how they affect economic and banking conditions. As the shale boom intensified this decade, and the oil and gas industry grew to its largest share of regional economic activity since the early 1980s, we have devoted more resources to understanding this important aspect of the regional, national and global economy. Additionally, and importantly, we rely on business contacts – nearly 80 percent of the energy companies in the Fortune 1000 are located in our two Federal Reserve Districts. Some of these companies are represented in our surveys, participate in roundtables and serve as directors on our boards of directors. This key input is essential to our understanding of the broader economy and an important contribution to our policy deliberations.

In my remarks this morning, I'll talk about how regional insight feeds into policymakers' understanding of the national economy. I'll also offer my perspective on the outlook for the U.S. economy and the current stance of monetary policy.

These are my views – not Rob's, nor others within the Federal Reserve System.

Insights from Fed Regional Surveys

The Federal Reserve's Beige Book provides the public and Fed policymakers with regional views on the economy eight times a year. In addition, as it pertains to energy, the Federal Reserve Banks of Dallas and Kansas City conduct quarterly surveys of oil and gas firms headquartered in our Districts. The surveys gather information on current business activity, capital spending plans, employment, price expectations, and other key indicators. The most recent results, for the third quarter of 2016, were somewhat encouraging, showing an expansion of business activity and expectations for increased capital spending, but still slight reductions in employment.

A particularly useful piece of information has been the price of oil that firms tell us they need to be profitable and also what prices they need to substantially increase drilling activity. We've asked questions along these lines in the Kansas City survey since 2014. At that time, the average price needed to be profitable was $79/barrel. Since then, with reductions in services costs, as well as advancements in technology and productivity, firms' average profitable price has fallen by a third, to $53/barrel in third quarter 2016. That price is still slightly higher than recently prevailing prices, but not considerably so. With the most recent range of profitable prices reported by firms ranging from $40 to $75/barrel, drilling is now profitable for some companies in some places, which is evident in the recent uptick in rig counts.

But what will it take to substantially increase drilling activity? The most recent responses to the Kansas City Fed survey noted $64/barrel on average, and for the Dallas Fed survey it was $60/barrel, both well above recent oil prices, although some firms reported needing only $50/barrel to sizably increase drilling. We also asked firms in the Kansas City District about the prices needed to significantly increase natural gas drilling, and the results were similarly above current levels. Firms on average needed $3.65/mbtu, considerably higher than recent prices, although some firms did say they could significantly increase drilling for as low as $3.00/mbtu. Taken together, these results suggest increased drilling activity is likely to be relatively moderate until prices reach and sustain a higher level.

Another key source of information about the energy sector comes from insights provided directly by oil and gas executives, as I mentioned earlier. Both Reserve Banks have energy executives on our Boards of Directors, several of whom are with us today. In addition to their broad oversight of Reserve Bank operations, their specific knowledge of key aspects of the energy sector, including the real activity and the financial perspective, provides us with greater insights than we are able to gather from our surveys. We also regularly host individual meetings and roundtable discussions with oil and gas executives. Our ability to directly and immediately interact with this important sector of the global economy is one example of the role regional Federal Reserve Banks play in monitoring current economic activity and understanding expectations for future activity. This type of insight is an especially important contribution to the Federal Reserve's policy deliberations and our understanding of the individual components that influence the broad economy.

The Energy Sector and Broader Economic Activity

Turning to the broad economy, even though oil prices have risen from the lows we saw earlier this year, they are still considerably below their mid-2014 peak. Not surprisingly, given the important role of the energy sector in this part of the country, the decline in oil prices had a negative effect on economic activity from a regional perspective.

What is surprising, though, is that the decline in oil prices did not provide a significant boost to the national economy. Although declining oil prices did support consumer spending and sectors that are heavily reliant on energy, some researchers have concluded these benefits may have been offset by a reduction in investment and employment in the energy sector.

In general, the positive and negative effects appear to be largely offsetting, which has often not been the case in years past. One obvious reason for the difference is that the size of the energy sector has increased significantly, so a decline in activity is large enough today to be notable on a national scale. In early 2014, the U.S. mining sector, comprised primarily of oil and gas, accounted for 2.8 percent of U.S. gross domestic product (GDP), up from less than 1 percent in the late 1990s. By early 2016, it had shrunk by about half, to 1.2 percent of GDP. In terms of employment, over 150,000 generally high-paying jobs have been lost in the U.S. oil and gas sector since the fall of 2014, a decline of nearly 30 percent. There also have been thousands of associated job losses in manufacturing, transportation, and other related sectors in energy-intensive areas of the country.

On the demand side, it is possible that the benefits from lower oil prices are now smaller. For example, gasoline as a share of total consumption, has fallen from about 4 percent in 1986 to about 2 ¼ percent in 2015. On net, today it does seem to be the case that the direct effects of oil price swings are larger on the investment and employment side, but smaller on the consumer side.

Looking forward, I continue to expect developments in the energy sector to affect the economic outlook. If energy prices were to increase, then I would expect that new drilling activities will expand, and the additional oil rigs will contribute to overall investment in structures. While I now view business investment as being poised to make a modest contribution to growth over the medium-term, a potential retreat in energy prices poses a downside risk. This could occur if the OPEC deal expected at the end of the month does not materialize.

In terms of oil prices, I currently see the potential for new drilling activities within the U.S., as well as the potential to bring idle wells back online, which would alter the path of oil prices going forward. With a large amount of oil production ready to come online if prices were to advance through the mid-$50 range, I do not see as much room for price appreciation, especially as global economic growth continues at a moderate pace. Among the anecdotes we've heard from directors and other executives this year is that there is a considerable amount of "money on the sidelines" looking to invest in oil and gas opportunities if prices continue to stabilize. This is despite some of the profitability concerns that I noted earlier, and may be reflective of a general "reach for yield" among investors, something we continue to monitor.

U.S. Economic Outlook

Turning to the national economic outlook, I continue to expect a moderate pace of growth, supported by consumer spending and stable business fixed investment. Consumers generally remain confident about the economy, and going forward, I expect continued job gains and increases in wages to support consumer spending. Overall, the labor market is near full employment, and inflation is approaching the Federal Reserve's 2 percent target.

Indeed, over the past year we have seen a fast pace of growth in labor utilization that removed a substantial amount of labor market slack. For example, the U.S. economy added more than 3 million people to the labor force since last September, which is the fastest pace of growth since the year 2000. The additional workers joining the labor force in the past 12 months were accompanied by payroll growth that averaged 200,000 jobs per month, so that total employment has grown by about 2.5 million jobs on net. With strong growth in the labor force accompanied by rapid employment, the jobless rate has remained at 4.9 percent, near my assessment of its natural rate.

Although labor utilization has grown rapidly during the last year, the rising labor force participation rate does not suggest that a previously untapped group of workers has been pulled in from the sidelines. In fact, since a year ago, the number of workers entering the labor force each month has remained flat, if not slightly lower. Also, the number of people leaving the labor force each month has fallen substantially. For example, the trend in the number of workers exiting the labor force each month fell from 6.6 million to 6.2 million over the past year. These developments indicate that workers are better attached to the labor force – that is, they appear less likely to get discouraged by spells of unemployment, and wage growth has encouraged them to remain active in the labor market.[1] This attachment to the work force is a good sign.

Even as labor markets have improved at a healthy pace, inflation has been restrained, in part reflecting the downturn in oil prices. Recently, these effects have begun to diminish. As oil prices stabilized, inflation has increased from 0.2 percent to 1.3 percent over the past year.

Monetary Policy

Considering the rise in the labor force participation rate, increases in employment, and signs of higher compensation, policymakers must judge what stance of monetary policy will support the substantial gains achieved in the last year and keep the economy near its maximum sustainable employment level. Interest rates have remained at historically low levels and the Federal Open Market Committee (FOMC) has signaled a gradual path toward more normal settings. At its most recent meeting, the FOMC statement noted that the case for an increase in the federal funds rate has continued to strengthen but decided, for the time being, to wait for some further evidence of continued progress toward its objectives.

[1] Didem Tuzemen and Jon Willis, "What is Behind the Recent Increase in Labor Force Participation?" *Macro Bulletin*, Nov. 14, 2016.

As a voting member of the Committee, I dissented in favor of a modest 25-basis point increase. My view is that monetary policy should avoid deliberately stoking the risks that come with overheating the U.S. economy and instead, slowly raise the federal funds rate to promote maximum employment commensurate with the economy's long-run potential to increase production.

Supporting conditions that bring more people into the workforce is certainly a desirable objective. However, over the last 55 years, there have been occasions where the unemployment rate has fallen below a level that is consistent with the maximum sustainable level of employment. In these cases, the U.S. economy soon after faced a period of substantial and prolonged increases in unemployment. The effect of allowing the economy to overheat in these cases produced short-term gains, but ultimately with longer-term costs. Consequently, I see moving sooner, rather than later, as taking into account the long and variable lags with which monetary policy operates, and reduces the potential for "go-stop" types of policies that create volatility, rather than subdue it.

Closing

Decisions about monetary policy, of course, ultimately depend on how the U.S. and global economies unfold. Understanding the effects of lower oil prices is critical in this regard, and I look forward to the important insights and perspectives to be explored at today's conference.