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Update on the Economy and Monetary Policy

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to the

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These remarks update other recent speeches Mr. Broaddus has made regarding the U.S. economic outlook.

It is a pleasure to welcome all of you to Virginia, and to have an opportunity to share a few thoughts about the economy and the economic outlook. I will follow my usual format that I think many of you are familiar with. I'll start with a little background information and try to specify as precisely as I can where the economy stands right now. Here I will repeat some things I've said in several talks I've given recently, since the background has not changed much, but I will also update this part with a few observations about developments over the last several weeks. Then I'll speculate a little about the outlook, and finally wind up with a few remarks about Fed policy.

By way of background, the recovery from the recession in 2001 started late that year. (We now know this, since last week the National Bureau of Economic Research, which dates U.S. business cycles, declared that the 2001 recession ended in November 2001.) The recovery has continued since then. But it has been a very different kind of recovery from most other recent recovery periods. First and foremost, it has been an exceptionally tepid recovery. Real GDP grew only 2.9 percent last year, fourth quarter to fourth quarter, and it grew at only about a 1½ percent annual rate in the first quarter of this year. This is very modest growth for the early stages of a recovery.

This recovery also has been very uneven over time and across sectors of the economy. Growth accelerated temporarily in a couple of quarters last year, due primarily to the periodic introductions of highly attractive new car sales incentive programs, but it quickly dropped back again when these programs were withdrawn or downgraded. Across sectors, housing activity has been very strong, and consumer spending has held up pretty well, as has federal government spending due especially to increased defense and homeland security outlays. But business investment has been soft. Moreover, state and local government spending has been restrained by declining revenues and budget constraints, and, in the international arena, a rising current account deficit has been a continuing drag on U.S. growth.

So there have been some differences between this recovery and other recoveries. In one respect, however, this recovery has paralleled the early stages of the last recovery in 1991, 1992, and the first half of 1993. Job growth was very sluggish in that period. You may recall that the early ‘90s recovery was called the "jobless recovery," and the job market also has been very weak so far in this recovery. Indeed, as measured by non-farm payroll employment – the usual benchmark – there hasn't been any job growth at all. On the contrary, employment has declined by about 940,000 jobs since the end of the recession. Of particular interest to our Federal Reserve District, manufacturing employment has declined by more than 1.1 <u>million</u> jobs nationally since the end of the recession. Manufacturing is still an important and highly visible part of our regional economic base. Ironically, one of the main positives in the current economic environment – strong productivity growth – now appears to be at least partly responsible for the labor market's present softness, and I will come back to this point a little later. The unemployment rate has remained steady in the neighborhood of 6 percent through most of this recovery. But it moved up a few notches in June to 6.4 percent.

Focusing in a little more closely on developments during the last several weeks, it has been a really mixed picture. As I am sure you know, many people were hoping that the extraordinarily quick and successful conclusion of the initial phase of the conflict in Iraq, and the removal of the immediate risk of a major disruption of oil supplies, might give the recovery a boost. And it may have. Some of the economic reports released in recent weeks have been quite positive. The Conference Board’s consumer confidence index jumped up sharply in April and has held on to that gain in May and June. The confidence index published by the University of Michigan also rose strongly in April and May, and edged back only marginally in June. And, in fact, the latest data on actual retail sales of goods, which is for June, suggest that consumer spending entered the current, third quarter of the year on a reasonably positive note. Also on a positive note, in June production in manufacturing posted its biggest increase since January. And the new orders component of the index published each month by the Institute for Supply Management rose nicely in May and June, which hinted at stronger factory output going forward. Elsewhere, though, the news was less encouraging. Most importantly, payroll employment declined for the fifth consecutive month in June, and, as I noted earlier, the unemployment rate rose to 6.4 percent last month, which is its highest level since April 1994. As you may know, yesterday the Labor Department reported that new claims for unemployment insurance dropped sharply in the latest reported week, and this is encouraging. These weekly new claims numbers, however, bounce around a good bit from week to week, so we will need additional information before we can be confident that the job market is firming.

Again, a mixed bag. To sum up on the current state of the economy, there are a few signs in the recently released data that the recovery <u>may</u> be gaining strength. But in my view there is not much hard evidence that this is happening yet – certainly no compelling evidence of the pronounced post-Iraq-war boost to activity that many people, myself included, had anticipated.

Let me shift focus now explicitly to the future. You've heard me speculate on the economic outlook before. Yet you're here, nonetheless. This ranks right up there with the regularity of the Old Faithful geyser as an amazing but not well-understood phenomenon. In any case, let me share a few thoughts on the outlook for whatever they may be worth. As usual, I'll use the latest Blue Chip consensus forecast as a benchmark. As you probably know, the consensus calls for 1½ percent GDP growth at an annual rate in the current quarter, followed by a moderate acceleration to a 3½ percent rate, or possibly a little higher, from the middle of this year through the end of 2004. Since the growth of potential output in the economy appears to be about 3½ percent at present, actual growth at this rate would keep the current gap between potential and actual GDP approximately constant, and hence keep the unemployment rate from rising significantly further from the current 6.4 percent rate I mentioned earlier.

Personally, I think this is a plausible forecast and the most likely outcome. It is maybe even a little more important than usual at this juncture, however, to recognize that this most likely outcome is only one of several possible actual outcomes in the months ahead.

There are several reasons to expect at least a moderate acceleration in economic activity going forward. First, while we don't have much evidence of a post-Iraq-war boost yet, it could still eventually happen. While there is obviously still plenty of uncertainty in the outlook, prospects for the economy are less problematic now than before the war, even taking account of recent developments in Iraq, and this may become more evident in the period ahead.

Second, and more fundamentally, I believe that solid monetary and fiscal policy foundations have been laid for stronger growth. On the monetary side, the Fed's longer-term success in reducing inflation and inflation expectations, the resulting decline in mortgage rates and other long-term interest rates, and our short-term policy easings over the last 2½ years have helped produce a financial environment that should sustain spending in the housing sector, where it is already strong, and encourage increased spending by both consumers and business firms. On the fiscal side, the recently enacted tax cut, which is quite substantial and is currently being implemented, should reinforce the monetary stimulus, at least in the near term.

Looking at the positives by expenditure categories, with respect to consumers, the extraordinary recent mortgage refinancing activity has allowed many households to substitute low-rate, tax-advantaged home equity debt for ordinary consumer installment debt and credit card debt, which has reduced the debt service burden for many households and increased their capacity to take on additional debt to support spending. And as Chairman Greenspan pointed out in his testimony before Congress last week, the net worth of American households rose about 4½ percent in the first half of 2003, due in particular to rising home values. The sluggish job growth to date in this recovery obviously raises questions about the near-term prospects for consumer spending, and I'll come back to this point. But financial conditions at the household level are currently quite conducive to increased spending, and the tax cut will help. Again, the most recent data on consumer spending are moderately encouraging.

The story is similar with respect to business spending. The outlook for business investment – especially for new equipment and software – is a key to the recovery's overall prospects. A sharp deceleration in business spending in the second half of 2000 led the economy into recession, and the recovery won't grow real legs until business investment revives. Here, too, financial conditions are favorable. Many business firms have already strengthened their balance sheets by refunding short debt in bond markets. Low long-term rates generally and narrowing risk spreads in corporate bond markets, along with the recent rise in stock prices, have reduced the cost of capital for a wide range of smaller- and mid-sized firms. Moreover, rising productivity and strenuous cost containment have increased profits and cash flow substantially since the middle of last year, which has generated more internal funds for investment. And the tax cuts for dividends and capital gains along with a more generous partial expensing provision in the new tax law should add additional stimulus as time passes. So business firms, by and large, are well positioned to increase equipment and software investment, and, most recently, order backlogs for new equipment have in fact been rising.

These points constitute the case for the moderate acceleration of aggregate demand and GDP growth projected by the consensus forecast. Again, I think this is a plausible forecast and the most likely actual outcome. Conceivably, we could even get somewhat stronger growth than the consensus. That would be very nice if it happened. It would provide greater assurance that actual GDP growth will exceed the growth of potential GDP, which, in turn, would provide greater assurance that job growth will revive. And stronger job growth, in my view, is another key to the near-term outlook.

Having said these things on the positive side of the ledger, however, let me quickly acknowledge that the relatively favorable outcome in the consensus forecast is by no means a sure thing. There are still significant downside risks in the outlook. Perhaps most importantly, labor markets have remained generally soft across the country and across the economy. As I noted earlier, non-farm payroll employment declined for five consecutive months through June. The manufacturing sector has lost jobs for 35 consecutive months, including 325,000 jobs since the beginning of the year. We will receive the July job report two weeks from today. Hopefully it will show some firming, and the decline in new unemployment insurance claims reported yesterday that I mentioned earlier is a hopeful sign. Again, though, this is only one weekly figure in a fairly volatile data series, so we will need additional confirmation before drawing any strong conclusions.

As I also noted earlier, the recent weakness in the job market reflects one of the principal longer-term strengths in the U.S. economy, rapidly rising productivity, and the extent to which the growth of potential GDP, bolstered by this strong productivity growth, currently exceeds the growth of demand for goods and services. The apparently continued strong productivity growth holds great promise for the longer-term future, especially as the baby boomers begin to retire. But it raises practical questions in the here and now, since many firms can meet the moderate current increases in demand for their products without hiring new workers, and, in some cases, while laying workers off. The risk, of course, is that sluggish job growth – or worse – continued job losses in the near term could undercut the apparent recent revival of consumer confidence, since confidence depends in no small measure on people's perceptions about their job prospects, whether they are currently employed or not. Reduced confidence, in turn, could undermine the moderate strength of consumer spending, which would undercut any significant increase in business investment beyond ordinary replacement spending. And of course those who make business investment decisions already appear to be quite cautious about committing to new outlays in the more risk averse atmosphere created by the lingering effects of the corporate governance crisis.

To sum up the outlook, in all candor, this is one of the more difficult situations to evaluate we've seen in recent years. We in the Fed will need to monitor emerging developments carefully going forward, and I can assure you that we will. I am personally still optimistic. But it would be comforting to see more concrete evidence of the step-up in activity we've been anticipating and predicting. Maybe yesterday's unemployment insurance report is a precursor of better reports to come. I certainly hope so.

Let me close with just a few broader remarks about monetary policy. The last time I spoke to you I made you sit through a sort of mini-sermon on the evils of inflation and why you needed to support the Fed in driving it out of our financial system. You won't get such a sermon this morning. The inflation rate as measured by the personal consumption expenditures index less food and energy – so called "core" inflation, and arguably the best measure of underlying inflation – has been below 2 percent for almost 6 years. And over the last 6 months, inflation by this measure has declined to below 1 percent at an annual rate, the lowest rate since 1963. Moreover, since there is about a half percentage point upward bias in this measure, true inflation currently is quite close to zero. It seems abundantly clear at this point that we have achieved the price level stability we sought for so many years. Back on April 30, for the first time I'm aware of, Chairman Greenspan more or less declared victory in the long war against inflation when he referred to the possibility of a further decline in inflation as "unwelcome." This is as close to high drama as we get in conducting monetary policy, and it was a moment of considerable satisfaction to old inflation hawks like me.

Now that we have price stability, however, we at the Fed have a new task: to sustain it. I never thought much about sustaining price stability back in the bad old high inflation days. I just wanted to get to price stability. And I am glad, to put it mildly, that we finally have it, since price stability is a necessary condition for maximum growth in output and jobs over the long haul. But now that we have price stability, I am naturally more focused on the challenges involved in holding on to it than I was several years ago when high inflation was the problem. The key difference – an obvious difference, but the key one – between fighting an entrenched inflation and sustaining price stability is that, with price stability, the risk is two-sided. When inflation was high, all the risk was on the upside, that is, on the possibility that the inflation rate might rise even further. Any decline in inflation was all to the good. Now, with the very low inflation that characterizes an era of price stability, we have to guard against both a reacceleration of inflation <u>and</u> an excessive further decline in inflation that conceivably could lead at some point to <u>de</u>flation, which is no better than excessive <u>in</u>flation.

In recent weeks, the Fed has been chided a little for talking a fair amount lately about deflation and possibly frightening some Americans into thinking we are about to sink into a deflation. With this in mind, let me repeat something I've said publicly before: I don't see deflation as an immediate threat. At the same time, though, I think it is appropriate and important to assure the public – which after all has not experienced deflation for over a generation – that we at the Fed are aware of the downside as well as the upside risks associated with price stability, that we have studied these risks, and that we know how to approach them if we ever need to. With our recent public statements regarding the undesirability of further disinflation, we have acted to put a floor under inflation expectations, just as in the past we worked to place a ceiling over these expectations when we were fighting to bring inflation down. And I am confident that, if necessary, we could put effective strategies in place to prevent further significant disinflation or deflation from developing. Because of this – and because we haven't forgotten how to contain <u>in</u>flation – I am confident we can sustain the price stability we fought so long and hard to achieve, and this bodes well indeed for the longer-term outlook for the U.S. economy.

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