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The Economy: Where is it Headed and When?

Remarks by

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to the

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It is a pleasure to be with you this evening, and a pleasure to serve as Longwood's Executive-in-Residence earlier today. I've spoken at Longwood before, but it was several years ago. I would like to think that I am older and wiser now, and that my comments therefore might be more useful to you now than my earlier ones were to your predecessors. But I can't promise that. In most professions, the more experience you have, the more effective a practitioner you become. In contrast, I sometimes think that the more experienced economists become, the more confused we become, not because economists are dumber than other professionals, but because each business cycle we go through is at least a little different from earlier cycles. Let me caution you, however, not to sell economics or economists short. There are regularities in the behavior of economies that economists have identified, and there are economic principles that have stood the test of time. I've taken considerable satisfaction from watching these principles in action during my career at the Fed, and I've enjoyed observing their reiteration in the economics classes I attended this afternoon.

I want to speak to you tonight about the condition of the national economy and its near-term prospects. The Richmond Fed that I am privileged to lead is one of 12 Federal Reserve Banks around the country, and we each serve a particular region. Our Bank serves the Fifth Federal Reserve District, which includes Maryland, the District of Columbia, Virginia, the Carolinas, and most of West Virginia. Consequently, much of our focus is regional rather than national. In my personal role as a member of the Fed's monetary policymaking Federal Open Market Committee, however, I have to focus primarily on national economic and financial conditions, and this is what – I hope – qualifies me to focus on the national picture tonight. Let me just say at the outset that the comments I will make this evening are my own views and not necessarily those of anyone else in the Fed.

I will follow the format I usually employ in talks like this. I'll begin with a little background on the current state of the economy. Following that, I will offer a few remarks about the outlook – say, through the end of next year. Then, finally, I will make a few broad comments about Fed policy. Over the years, I have learned that economists should never speak too long in the evening. So I will give you my Domino's pizza speech: if I don't finish in 25 minutes or so, you don't have to pay me.

Background

Obviously, the last several years have been challenging for the U.S. economy. After four years of strong growth in GDP and jobs in the late 1990s, the economy slowed sharply in the second half of the year 2000. It fell into a recession in early 2001 that lasted through the third quarter of that year and therefore included the immediate economic fallout from September 11.

In the final quarter of 2001 the economy began to recover. But until quite recently, the recovery was so tepid that many economists weren't sure that it was actually happening. There were a few strong quarters, like the first and third quarters of last year, when strong new car sales in response to aggressive incentive programs temporarily pumped up GDP growth. On average, however, the recovery has been sluggish. Real GDP rose at only a 2½ percent annual rate from the end of 2001 through the first quarter of this year, below our longer-term potential growth rate, and well below the sharp acceleration of growth typical of the early phases of recoveries from recessions in most post-World War II business cycles. Perhaps most importantly, over this same period well over half a million jobs were lost. The decline in jobs was more than accounted for by job losses in the manufacturing sector of the economy, especially traditional manufacturing industries like the textile and furniture industries in the southern part of our Federal Reserve District. Many of these job losses, of course, are permanent, structural job losses. But these structural losses were probably accelerated by the weak recovery. As I'm sure you're aware, in addition to its sluggishness, this recovery has been quite uneven across sectors of the economy. Housing construction and sales have been robust, which has reflected the lowest mortgage rates in a generation. And consumer spending has held up reasonably well, sustained by strong refinancing activity spawned by these same low mortgage rates. Business spending, however, has been generally soft, as many businesses have attempted to work down the excess capacity built up in part by what – in retrospect – appears to be excessively robust investment in both plant and equipment in the late '90s.

So, again, the recovery was sluggish through the first quarter of 2003. More recently, though, things have been looking up. Real GDP grew at about a 3¼ percent annual rate in the second quarter, considerably faster than expected. Business investment in this report, in particular, posted its largest increase since the second quarter of 2000, and activity appears to have accelerated further in the current, third quarter. Consumer spending rose strongly in July, and it appears to have held up well in August, perhaps in response to the federal income tax cuts that went into effect at mid-year. New car sales have been especially robust. They exceeded 19 million units at an annual rate in August, the third highest total on record. Moreover, monthly indicators of business investment, like new shipments and orders for equipment, have strengthened on balance over the last several months. Consequently, many forecasters now expect GDP growth for the quarter to come in around 4½ to 5 percent at an annual rate, or possibly even higher, when the figure is announced late next month.

There's one part of the economy, however, that is still not playing ball, and that's the job market. There is still not much of a pulse in labor markets, at least not yet. The latest jobs data are for the month of August. With household and business spending apparently strengthening at least a bit, many people were looking for a modest increase in jobs last month. It didn't happen; 93 thousand more jobs were lost according to the monthly survey of establishments. That's the seventh consecutive monthly decline in employment by this measure. Ironically, the continuing decline in jobs was apparently due at least in part to exceptionally strong productivity growth. I say ironically because the strong productivity growth, arguably, is the brightest element in the longer-term outlook for the U.S. economy, and I'll come back to this point in just a moment. The Labor Department will release the job report for September this Friday.

So in summary on the present situation: the economy is recovering, but it's a jobless recovery like the recovery from the 1990-91 recession. And, if anything, this jobless recovery appears to be even more jobless than the last one.

The Outlook

So far we have been looking backwards and sideways. Let's look forward. Where is the economy headed over the next 15 months or so? If I wanted to be completely candid, I would simply confess that I don’t know and sit down. But economists are not authorized to do that, so let me briefly outline a couple of alternative scenarios that probably a majority of economists would agree are among the more likely actual outcomes.

The baseline scenario I would offer is the latest Blue Chip consensus forecast. This is an average of about 50 forecasts of individual private forecasters. I'll call it the "consensus" forecast for short. The consensus calls for GDP growth at a 4½ percent annual rate in the current quarter. Subsequently, it sees growth at just under a 4 percent rate in the fourth quarter and through 2004. Many economists currently believe that the U.S. economy can sustain growth over the longer haul at about a 3½ percent annual rate, given the longer-term growth of productivity and the labor force. If this is correct, and real GDP does in fact grow at about a 4 percent rate over the next several quarters, as the consensus projects, actual GDP growth would exceed potential growth. But it would not exceed potential by much – only about a half percentage point at an annual rate. Consequently, excess capacity in the economy – including excess capacity in the job market – would decline. It would decline only gradually, however, with the unemployment rate – currently at 6.1 percent – dropping only to about 5¾ percent by the end of next year, which is above most estimates of effective full employment. Therefore, we would still have some slack in labor markets at the end of next year, according to the consensus. Finally, since the current, so-called "output gap" between the level of potential GDP and the level of actual GDP would also diminish only gradually going forward, and would not be fully closed by year-end 2004, inflation, as measured by the broad GDP price index, would remain well-contained at about a 1½ percent annual rate through next year despite the strengthening in economic activity.

Now this consensus forecast, which essentially calls for a modest firming and acceleration of the recovery, is quite plausible. Probably a majority of economists currently regard it as the most likely actual outcome among the array of possible outcomes in the period ahead, because it is a sensible forecast with a sensible rationale.

Let me briefly summarize this rationale. The projected acceleration in the recovery is driven largely by stronger consumer spending and business investment. With respect to consumer spending, again, robust mortgage refinancing activity generated by low mortgage rates has helped buoy household outlays so far in this recovery. The recent uptick in rates may reduce the stimulus from this source in the near-term future, but the tax cuts are expected to help sustain the recent, remarkably healthy growth of real disposable household income. Moreover, spending will also be supported by a significant improvement in the overall financial condition of the average American household over the last year or so. Household net worth has been rising recently due to the stock market rally. On the liability side of their balance sheets, in particular, the refis have enabled many households to substitute low rate, tax-advantaged home equity debt for higher cost credit card and installment debt. And while delinquency rates on household debt are at relatively high levels by historical standards, they have edged off most recently. I don't want to sound cavalier about household debt. Consumers have taken on a lot of it recently, and this could create problems over the longer term. But for now, stronger household financial conditions are clearly a positive in the outlook for consumer spending, and therefore for the overall economic outlook, since consumer spending is about two-thirds of GDP. The main risk to consumer spending comes from the weak job market, to which I'll return.

As I mentioned, the other main element in the rationale supporting the relatively favorable consensus outlook is expected stronger business investment, especially for various kinds of machinery, software and other productive equipment. Again, some of the leading indicators of business outlays, like orders and shipments for capital goods, have been pointing in this direction over the last several months. Beyond this, financial conditions in the business sector, as in the household sector, have improved considerably. Many businesses have refunded short-term debt at significantly lower rates in the corporate bond market in recent months. Further, risk spreads on lower-rated credits have narrowed, and the stock market rally has reduced the cost of equity capital. Perhaps most importantly, these more favorable financial conditions, in conjunction with the recently enhanced federal partial-expensing tax provision on equipment purchases that remains in effect through next year, are expected to sustain the marked increase in business profits (after adjustment for depreciation and inventory valuation) and cash flow recorded in the second quarter. All of these things are expected to help business decision-makers shed some of their caution and commit to equipment purchases oriented towards brighter profit opportunities, as distinct from routine replacements of outmoded computer and other high-tech equipment.

Again, I think this consensus forecast is plausible, and I think it is the most likely actual outcome for the economy over the next year and a quarter, given what we know now. Obviously, though, it is not the only possible outcome. At one end of the spectrum of possible outcomes, the economy could accelerate more sharply than the consensus predicts, with a more rapid reduction in unemployment. This could happen, for example, if stronger consumer spending stimulated a swifter and larger acceleration of business investment than the consensus projects.

There is also, however, the risk that activity may pick up less rapidly than in the consensus projection. Most state and local governments face significant budgetary challenges due to weak revenue growth over the last several years, especially reduced revenues from capital gains taxes as a result of the end of the stock market boom of the late '90s. These problems will ease as the economy strengthens, but broad improvement in state and local fiscal and financial conditions is expected to come gradually. Elsewhere, while stronger economic growth globally – especially in Japan and China – may increase the demand for U.S. exports, imports will likely grow more rapidly. Consequently, foreign trade is expected to be a negative, on net, in the U.S. economic picture for the foreseeable future.

Probably the biggest downside risk in the near- and intermediate-term U.S. economic outlook, however, is the current weak job market and the possibility it may remain weak. I have already summarized the persistent decline in employment in this recovery, and I won't belabor it. Back in the ebullient late 1990s, high productivity growth generated expectations of higher future incomes, which boosted the current demand for goods and services, production and the demand for workers. You may recall how tight labor markets were in that period. In today's much more subdued economic environment, however, strong productivity growth has not yet stimulated similar expectations, and demand growth has remained moderate. Moreover, the high productivity growth has enabled many firms to meet this moderate demand growth without rehiring laid-off workers or hiring new ones. The risk going forward is that continued strong productivity growth may keep the job market soft, which may retard the growth of disposable income, even as the initial positive impact of the tax cuts begins to wane. Productivity, of course, is just the output produced by an average American worker in an average hour of work. It rose at an extraordinary 7 percent annual rate in the second quarter, and it appears to have continued to rise rapidly in the current quarter. Again, high productivity growth is good for the longer term – obviously. But if it fails to stimulate demand more strongly in the near term, its restrictive effect on job growth could hold overall economic growth below the consensus forecast in the period ahead. Once again, I believe the consensus projection is the most likely outcome for the reasons I outlined earlier. But a weaker performance can't be ruled out until job growth revives.

Monetary Policy

Let me segue from this to a few closing remarks about Fed monetary policy – which is what I am actually supposed to know something about. I haven't said anything yet about inflation, deflation, or disinflation. (Disinflation is the word people use now to denote a positive but diminishing inflation rate. I think the word was invented recently, because whenever I key it into my computer, the word processor tells me it is misspelled.) In any case, all of these terms have to do with the behavior of the general level of prices for goods and services, and they are properly a central focus of Fed monetary policy, since these are the things that the Fed can confidently address over time: whether it's to stabilize them, contain them or prevent them. Arguably the Fed's most important contribution to the health of the U.S. economy in the post-World War II era was our success in helping break the high inflation of the 1970s and early 1980s, and subsequently bringing it down to its current low rate in the 1980s and 90s, which helped provide the foundation for the economy's strong performance over much of the last 20 years.

As measured by the so called "core" personal consumption expenditures – or PCE – index, which many economists now consider the most reliable inflation indicator, the underlying trend inflation rate is currently probably somewhere in the range of 1-1½ percent annually. In my view – and here I should emphasize especially strongly that this is my personal view and not necessarily shared by others in the Fed – this range is probably close to where inflation should be over the long haul, particularly since there is about a half percentage point upward bias in the core PCE.

The challenge now is to hold the inflation rate in this neighborhood, because doing so would likely provide the best monetary foundation for sustainable growth in output and jobs. Interestingly, if you follow Fed policy closely, you know that our policy statements following each of our last three Federal Open Market Committee policy meetings have all noted the Committee's current assessment that, at the moment, the risk inflation may fall further – that is, that we'll experience further disinflation – exceeds the risk that inflation will accelerate. Why is this, especially since economic activity is expected to accelerate?

There are several ways this could happen. As I see it, the main risk is that longer-term, so-called "structural" productivity growth may accelerate to an even higher rate than its already fairly elevated rate as business managers learn to use recent technological innovations even more effectively in increasing production. Structural productivity growth is now estimated by most economists at about 2½ percent at an annual rate. That may seem high, especially compared to the 1½ percent average annual rate between the mid-'70s and the mid-'90s, but it is only a little higher than the average rate of productivity growth in the U.S. economy over the last century. Consequently, productivity growth could rise further for a few years. I referred to this possibility a minute ago as a "risk." That probably didn't sound quite right to many of you, so let me be clear here. High productivity growth is the best thing that can happen to our economy over the longer run since it allows living standards to rise more rapidly. But a further acceleration from here could be challenging in the transition to the higher rate, since it would increase the economy's potential growth rate and possibly retard the reduction in the "output gap" I mentioned earlier between the level of potential GDP and the level of actual GDP implicit in the consensus forecast. Again, this could occur if the acceleration fails to stimulate expectations of higher future income, and hence fails to stimulate stronger current demand. A persistent output gap – in plainer language, persistent excess capacity – could produce further disinflation, which would be unwelcome at this point, since inflation is already quite low.

In any case, given the possibility of continued high productivity growth, the assessment in our recent policy statements that the risks in the outlook for inflation are weighted toward further disinflation makes sense in my view. Let me emphasize, though, that this does not imply that actual further disinflation is inevitable, or that the Fed can't address it effectively with monetary policy. On the contrary, the prescription for a disinflation risk is accommodative monetary policy. That's Fedspeak for relatively easy monetary policy, and monetary policy is now – and has been for some time – accommodative. Moreover, our recent policy statements have been unusually candid in indicating that we expect to remain accommodative for a "considerable" period. Consequently, I am confident that the Fed can sustain the environment of price stability we fought so long and hard to achieve. That, in turn, makes me optimistic about both the near- and longer-term outlooks for the overall economy.

When I fire up my lawn mower each weekend, the engine usually runs a little roughly for a minute before it breaks into a hum. I believe, and many of my business contacts now believe, that the economy is poised to hum – not to roar, but to hum.

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