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Comments on the Economy and Monetary Policy

Remarks by

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It's a great pleasure as always to be with you folks. I don't recall exactly when I was first invited to speak to the Association, but it may have been as long as 15 years ago. Imagine that — an economist invited back to speak to the same group 15 years in a row. I can think of two alternative explanations for this extraordinary occurrence. One is that you all have serious memory problems — both short-term memory and long-term memory — and you keep forgetting how bad my jokes are. Another is that, after hearing my first speech, you felt sorry for me and have invited me back every year since to demonstrate conclusively that financial market professionals can be compassionate, stereotypes to the contrary notwithstanding. Whatever the reason, it's good to be back in Washington once again, although you still have to be a little careful here late at night. Not too long ago, somewhere in downtown Washington, a mugger in a ski mask confronted a well-dressed man and said, "Give me all your money!" The man responded, "You can't do that. I'm a United States Congressman." "In that case," the mugger said, "give me all my money." See what I mean about bad jokes?!

Seriously, it's great to be back with you once again. As always, I'm looking forward to — and hopefully am adequately prepared for — the question Bert Ely will ask when I finish. As usual I'll begin with a recap of recent developments in the economy to put the outlook in perspective. Then I'll comment on the outlook — as others see it and I see it — and finally I'll conclude with a few remarks about monetary policy.

Background

As you all know, the 2001 recession ended in November of that year. The early recovery from the recession through 2002 and the first half of 2003, was quite tepid. Real GDP rose at only a 2.7 percent annual rate over this period. Growth accelerated in the second half of last year, however, to a 6.2 percent rate, and the expansion has continued and become more balanced and broad-based so far this year. In particular, while aggregate household and business demand for goods and services accelerated nicely after mid-year last year, the labor market remained remarkably soft through February. The average monthly increase in payroll employment from August through February was about 70 thousand jobs. In the three months since then, however, almost a million new jobs have been created — 316 thousand new jobs on average per month, to be precise. Actually, the full extent of the recent firming in the labor market did not become apparent until the report for May was released a few days ago. In addition to a further increase in jobs that month, the report also indicated substantial upward revisions in the March and April numbers. In any case, the phrase "jobless recovery" that we were all hearing so frequently back in January and February is heard no longer.

Beyond the job numbers, much of the other recent monthly economic data confirm that the recovery has now morphed into a solid, self-sustaining economic expansion. The growth of real consumer spending so far this year has moderated somewhat from its exceptionally strong pace last fall and then again late last year. But it has still been solid, supported by strong growth in household income. Personal income rose almost 6 percent in the year ended in April, and the wages and salary component of income rose almost 5 percent. The growth in income, of course, has been driven in part by the upswing in job growth. We don't have complete data on consumer outlays in May yet. There is some anxiety about the potential impact of rising fuel prices on spending currently, but there's no hard evidence yet of significant damage. Indeed, new car sales, including SUV's, rose very robustly last month in response to new incentive programs. And while rising mortgage rates have apparently had some negative impact on new home sales most recently, residential construction activity as measured by housing starts and permits has remained at a high level.

So household outlays are providing a firm foundation for the expansion currently. Beyond this, a key element in the acceleration of aggregate demand over the last four quarters has been revived business investment — especially in new equipment and software — after several weak years that likely reflected fallout from excessive investment in the 1990s as well as the recession. The growth of equipment spending surged at double-digit rates in the second half of last year, and remained close to a 10 percent annual rate in the first quarter. New orders for nondefense capital goods excluding aircraft — probably the best monthly indicator of equipment spending — declined in April, the latest month for which we have data. But this series is volatile month-to-month, and the longer-term trend in these orders recently has been consistent with continued strong equipment spending in the current quarter. Related to this, the manufacturing sector of the economy is currently enjoying a welcome revival. After several years of uninterrupted declines, factory jobs have now increased at least moderately for three consecutive months. This is good news for our Fifth Federal Reserve District, where manufacturing is a sizable part of the economic base.

So to sum up this first part of my remarks, the general economy seems clearly to be in a much stronger condition right now than it was a year ago or even at the beginning of this year. This improvement has been reinforced by the lagged effect of the tax cuts put in place last summer, and the stimulus to business equipment investment provided by the partial expensing tax incentive introduced in 2002. The improvement also reflects accommodative monetary policy in which the nominal federal funds rate has been held at the historically low level of 1 percent since June 2003. The acceleration in growth hasn't gone unnoticed in financial markets. While the funds rate has remained at one percent, market participants now widely expect the FOMC to begin tightening monetary policy at the Committee's meeting in late June with further increases later in the year. I realize I haven't said anything about inflation yet, and I'll come back to this topic in just a moment.

The Outlook

Let me turn now to the future. One of the things I like most about this Association — and am most grateful for — is that over all the years I've spoken to you, I don't think anyone has ever been unkind enough to remind me of what I said about the outlook for the economy the year before. As you know, I'm a consumer of forecasts rather than a producer of them. Consequently, at these meetings I typically report the current consensus forecast of the professional forecasting industry and then offer a few observations about the risks in the consensus. This approach seems to work pretty well, and I'll follow it again this year if I may.

The latest monthly Blue Chip consensus projection of about 60 forecasters — which was released last week and is therefore pretty up-to-date — calls for real GDP growth to decelerate gradually from the almost 4½ percent rate registered in the first quarter of this year to about 4 percent in the fourth quarter. It's expected to decelerate further to about 3½ percent over the four quarters of 2005, which would reflect the reduced fiscal stimulus from earlier tax cuts, the intermediate- and longer-term interest rate increases that have already occurred, and the prospect of Fed monetary policy tightening over the second half of 2004 I alluded to a minute ago. Growth at these rates is projected to bring the unemployment rate, currently 5.6 percent, down further to 5.2 percent in the final quarter of next year. This would still be a little above most economists' estimates of effective full employment, but not much. Finally, inflation as measured by the CPI — the total index as opposed to the "core" index excluding food and energy prices — is expected to decelerate from its elevated 3.5 percent annual rate in the first quarter to about 2 percent by the end of the year and hold at that rate through 2005.

This is a fairly optimistic forecast and a plausible forecast, but it's obviously not the only possible outcome. There are risks to the forecast, as always, on both the upside and downside. Let me reflect a little on these risks, with the usual understanding that these are my personal views and not necessarily the views of any of my Fed colleagues. And like the Federal Open Market Committee's post-meeting policy statements under our current procedures, let me consider the risks to real growth and inflation separately.

With respect to growth, there are certainly some downside risks. The one that's getting the greatest attention at the moment is the possibility that further increases in gasoline prices may reduce both consumer confidence and the disposable income left to spend on other items, which in turn could reduce the growth of total real consumer outlays, at least for a while. Since consumer outlays account for about two-thirds of GDP, this is a reasonable concern, and if weaker household outlays persisted, businesses would eventually cut back investment. Beyond this, a sharper than anticipated unwinding of the economic boom in China could undercut the recent impressive growth of U.S. exports, which has been a not inconsiderable source of stimulus over the last 12 months as a whole. Finally on the downside, any further escalation of actual terrorist activity or the threat of it — obviously — could reduce both household and business confidence and spending and GDP growth along with it.

These downside risks to growth, however, have to be balanced against upside risks — or maybe I should say upside possibilities — in the consensus outlook, and there are a number of these. Futures markets are signaling some possibility that fuel prices may be peaking. And the recent firming in the Japanese economy should offset at least in part the impact of any softening in Chinese demand for U.S. exports. Most importantly, however, the impressive recent increases in jobs and in both household and business income are likely to at least sustain the increase in aggregate demand and GDP growth over the last several quarters, and they could produce a further acceleration in growth.

Weighing these various considerations as best I can, I conclude that the downside and upside risks to the consensus projection for growth are generally balanced. The downside risks, not surprisingly, get considerable attention in the media. But the upside possibilities presented by the striking recent turn in the job market are, in my view, at least equally compelling. I recognize that this isn't a particularly surprising or striking conclusion, but I think it's a readily defensible conclusion, which I hope will compensate for its lack of drama.

Let me turn now to the risks in the outlook for inflation. I've spent much of my career in the Fed focused on the risk of excessive inflation. Over the last several years, and as recently as early this year, the actual behavior of inflation has caused me to shift my focus to the risk of excessive disinflation — i.e., the risk that the inflation rate might drop too low.

Lately, however, my focus has shifted direction once again back to the, for me, more familiar ground of concern about inflation. The incoming inflation data so far this year have surprised me, as well as many other people. The personal consumption expenditures (PCE) price index — widely regarded as a relatively reliable inflation index — rose 1.4 percent in the 12 months ended last December. The increase accelerated to 1.9 percent in the 12 months ended in April. This acceleration in the total index, which includes food and energy, is not so surprising given the run-ups in food and especially fuel and other energy prices this year. What is surprising is the similar acceleration in the core PCE index, which excludes food and energy, from 0.8 percent in the 12 months ended in December to 1.4 percent in the 12 months ended in April. This sizable increase in core inflation has been duly noted by many analysts and policymakers, including my Fed colleagues Chairman Greenspan and Governor Kohn in recent speeches. It has also played a central role in recent financial market speculation about the future course of Fed policy.

The question, of course, is whether this recent acceleration will persist or not. Less optimistic observers worry that the recent rise in fuel and other commodity prices, and the effect of the recent decline in the dollar on import prices, will increasingly pass through to the prices of items in the core index. They also argue that measures of slack in labor markets and excess capacity in the industrial and manufacturing sectors may exaggerate the degree of resource underutilization in the economy currently, and therefore understate the risk of higher inflation. Specifically, skill requirements for many jobs in the U.S. economy may be advancing more rapidly than actual skill levels of many workers, so that the availability of hirable workers may be overstated by some labor market data. Similarly, capacity utilization may not adequately reflect actual closings of obsolescent plants. More optimistic observers note the recent easing of fuel prices in futures markets I noted earlier. They also question the assertion that capacity utilization data overstate actual excess capacity, and they point out that measures of slack in labor markets such as the unemployment rate may understate the actual degree of slack since they do not take full account of previously discouraged workers now re-entering the labor force.

So, as in the case of the consensus forecast for GDP growth, there are upside and downside risks in the consensus inflation projections. Where do I come out? I'm going to come out where the FOMC did at its last meeting and where several of my colleagues have come out in public statements since then: I think — indeed, I'm confident — that inflation will remain well contained. Some of the reasoning in this direction I just summarized is part of the basis for my confidence. The main reason, though, is that we at the Fed remember the period of high inflation in the late 1970s and in the 1980s. Older Fed people like me remember it especially vividly, and we all remember how painfully difficult it was to bring it down to the still very low rate that has prevailed since roughly the mid-1990s. To use a word that has a technical connotation in this context, we now have credibility for low inflation, and we aren't about to give it up. Our latest policy statement, issued following our meeting on May 4, said that, looking forward from then, the FOMC expected to be able to remove its accommodative policy "…at a pace that is likely to be measured." In a speech to an international monetary conference in London June 8, Chairman Greenspan added the following: "Should that judgment [as expressed in the policy statement] prove misplaced, … the FOMC is prepared to do what is required to fulfill our obligation to achieve the maintenance of price stability so as to ensure maximum sustainable economic growth." Well said.

Concluding Thoughts

This gives me a nice segue to the final points I want to make this evening, and these comments also focus on the Fed's responsibility to stabilize inflation — and also avoid deflation, which I would argue was a risk a few quarters back, but which we have now, thankfully, put behind us. The goal of monetary policy, as the Chairman's statement I just quoted pointed out, is maximum sustainable economic growth. But as a practical matter, the main thing the Fed can do to help the nation achieve that goal is to maintain price stability — no excessive inflation or disinflation. Since I joined the Fed in 1970, I've watched inflation rise from a moderate rate to a dangerously high rate, then come down — again, painfully — over an extended period, flirt briefly a couple of years ago with deflation, and finally move back up to its current very moderate rate somewhere in the neighborhood of 1½ percent on the core PCE. We need to sustain this price stability we've achieved — and here, "we" means the country, not just the Fed.

Since I'm near retirement, I hope you will allow me to indulge in a little self-promotion. My long-time colleague and friend, Marvin Goodfriend, and I recently completed a paper on "Sustaining Price Stability," which is the feature article in our Bank's Annual Report for 2003. Among other things, the article presents a framework for thinking about sustaining price stability based on the "new neoclassical synthesis" macroeconomic model. Don't worry; I'm not going to delve into a lot of technical detail here. But just briefly: our approach focuses on the price-setting behavior of business firms, which, after all, set and change prices in our market economy. We introduce a fundamental principle of price stability, that "…inflation will remain low and stable if and only if departures from profit maximizing markups [of price over marginal cost] are expected to be relatively small and transitory across firms." The key phrase here is the one about the expectation that departures from profit maximizing price markups will be small and transitory. That expectation, in turn, depends critically on how much confidence the average firm has in the Fed's determination to act — preemptively if necessary — to prevent rising unit labor costs from compressing mark-ups excessively, which would be inflationary, or, alternatively, to prevent falling unit labor costs from widening mark-ups, which would be deflationary. In other words, it depends on the Fed's credibility. Conversely, as our article shows, if the Fed has credibility — and I believe we do now — the Fed will have the time needed to identify emerging inflation or deflation risks and effectively contain them.

Finally, while maintaining credibility for price stability ultimately depends on the Fed's "walking the walk," i.e., acting decisively when we need to, in this case "talking the talk" can also be constructive. Clear, transparent, and continuous communication by the Fed of its evolving assessment of the economy's condition and the balance of risks in that assessment, coupled with frequent reminders of the Fed's longer-term inflation objective, can help financial markets, households, and business decision-makers form their economic and policy expectations efficiently and in this way minimize unnecessary short-term disturbances in the economy. As a parting shot, let me just note again my personal view that an explicit, numerical inflation target would help us communicate more effectively. In this regard, the article I just cited argues that some of the problems the Fed encountered last year in communicating its concern about the risk of deflation might have been reduced if an explicit inflation target had been in place.

It has been a great pleasure and privilege for me to be invited back to meet with you for so many years. This annual meeting has been a wonderful fixture on my calendar. I have to confess that in recent years I've often penciled it in in hopeful anticipation before I actually received your call. I'm sure I'll cross paths with many of you again in the future, and I look forward to that. Godspeed and good luck.

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