The Economic Outlook in 2004
Challenges for Monetary Policy

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I am pleased to be here to speak to you about the economic outlook and monetary policy. With the start of the New Year, it's a good time to reflect on the past and look forward to the future. A year from now, I suspect we will look back on 2003 as a transition year in which the economy moved from a sluggish to a more vibrant recovery. And, 2004 should be a year in which economic activity becomes more self-sustaining as it moves toward its long-run potential.

In this improved economic environment, I also think that monetary policy will be challenged to reach the best balance of actions needed to sustain the economy into 2005 while maintaining low and stable inflation.

The outlook for 2004

As you know, after a slow start at the beginning of last year, the economy picked up considerable momentum in the second half. Indeed, for 2003 as a whole, growth in real GDP is likely to be over 4 percent, a significant improvement over the preceding year. As we begin 2004, most forecasters, including me, believe that this momentum will continue and that real GDP will grow between 4 and 4½ percent. Moreover, as compared with the past two years, economic growth should be more balanced, with both business investment spending and exports making greater contributions to the economy, and housing making less of a contribution. We also are likely to see an improvement in labor markets as the year progresses. In the near term, inflation should remain low because of continued strong productivity growth, excess industrial capacity, and international competition for goods and services.

Reasons for optimism in 2004

There are many reasons to be positive about the U.S. economy in 2004. One key factor is that last year's tax package, the third in three years, will continue to provide stimulus this year. In particular, the expiration of the business expensing provision should provide further impetus to investment spending, especially late this year. Of course, tight state and local budgets may continue to offset some of the stimulus at the federal level, but on net, government spending will contribute to real GDP growth.

Financial conditions are another reason for optimism. Monetary policy remains accommodative. The federal funds rate—the overnight interest rate that anchors the maturity structure of interest rates—is only 1 percent. With an inflation rate of just over 1 percent, the inflation-adjusted federal funds rate is near zero, which provides a substantial boost to the nation’s economic outlook.

Also, general financial conditions are supportive of growth. For example, long-term corporate rates are lower than a year ago and credit spreads have declined. We also have seen strong gains in the stock market, with the S&P 500 stock price index 39 percent higher than its low point back in March.

The economic outlook in 2004

Having set the context for GDP growth this year, let me turn now to a discussion of some of its more important components. I’ll begin with consumer spending. It has supported, almost single handedly, economic activity during the recession and the first two years of the recovery. This is due in large part to low interest rates and tax cuts, which remain in place as we enter 2004. However, also supporting consumers this year will be expected growth in the number of jobs, increases in personal income, and an improved equity market. All of this bodes well for the consumer and the economy as we move through the year.

In 2004 I expect that the consumer will have more help from the business sector in supporting the economy. Spending by businesses is finally turning up and has become a contributor to growth. The low cost of capital, reflecting low interest rates and the current stock market, provides a good foundation for growth. Strong corporate profits are encouraging firms to undertake new investment projects. And, strong sales and lean business inventories suggest that many businesses will start rebuilding their inventories, leading to increased orders and production in the manufacturing sector. Finally, the tax expensing provision of last year's tax act is due to expire at the end of this year. The expiration of this provision will provide an incentive for firms to move business spending forward from early 2005 to 2004.

In addition to strong consumer and business spending, the past depreciation of the dollar and an improving economic outlook worldwide should contribute to expanding exports during 2004. Since the beginning of 2002, the dollar has declined on a trade-weighted basis. Moreover, most forecasters anticipate stronger growth worldwide, reflecting expected improvements in growth for Europe and most of Latin America and continued strong growth in much of Asia. Accordingly, we have begun to see increased export orders for manufactured goods and agricultural commodities. In saying this, I realize of course that with U.S. GDP growing at a good pace, we will continue to experience a large current account deficit. Still, the outlook is for an improving international environment for U.S. firms and the U.S. economy.

The outlook for inflation

Given this rather favorable outlook, let me make a couple of brief comments about inflation. Simply stated, the underlying inflation rate is quite low. The consumer price index increased by less than 2 percent over the 12-month period ending this past November. And, if you strip out the more volatile food and energy prices, the core CPI increased by an even more modest 1.1 percent. Among the components of the index, prices varied fairly widely, with some goods prices actually decreasing and services prices increasing sufficiently to keep the broad measures of the price level on an upward path. Overall, it appears that we have achieved a reasonable definition of price stability, and just as importantly, it appears that the near-term inflation outlook remains favorable.

Risks to the economic outlook

While the overall economic outlook is decidedly optimistic, there are risks. For example, the United States has growing current account and fiscal deficits, which, while manageable in the near term, must be dealt with in the long run if we are to maintain a vibrant economy. And, of course, it is always possible that the economy could be hit by any number of shocks or surprises, from terrorist attacks to an outbreak of mad cow disease. While such events can always alter the outlook, I think that as we enter 2004 the *known* risks to growth are reasonably balanced.

Will the economy achieve sustainable growth?

While I am forecasting strong growth and low inflation for 2004, I also recognize that an important question we face is whether this rather optimistic near-term outlook is sustainable. For me, the matter of sustainable economic growth will turn on the answers to at least two related questions. Is the economy moving systematically toward producing at its full potential? And, if so, are all sectors of the economy sharing in the expansion in a balanced fashion?

Before addressing these questions, let me point out that despite recent strong economic growth, output remains below potential due to the recession and slow recovery. With an unemployment rate of 5.9 percent in November, labor markets are still operating with considerable slack. And in manufacturing, excess capacity remains. The capacity utilization rate was 74.3 percent in November, which is well below the long-run historical average (1972–2002) of 80.2 percent.

Turning to the first question on sustainable growth, I believe that the economy is on the path to reaching the level of its long-run potential output. Output has increased relative to potential over the last two quarters, and the gap between the two should continue to narrow through the rest of this year. In particular, with growth projected to be nearly a percentage point above its long-run potential, the output gap should decline almost a percentage point this year.

A related signal indicating sustainability and defining how quickly we might be approaching the economy's potential will come from the labor market: Is the economy creating enough new jobs? Since this is a topic on almost everyone's mind these days, I want to spend just a minute discussing it in more detail.

As you know, for much of this recovery the economy lost jobs. Between November of 2001—the beginning of the recovery—and July of last year, the economy lost about 1 million jobs. Fortunately, though, it looks as though we stopped shedding jobs in August. In fact, between August and November, the economy added an average of 82,000 new jobs per month. This was a good start, but only a start.

There are different ways that we might judge the number of new jobs needed to sustain economic momentum. At a minimum, employment should increase at the rate of population growth. Since population grows about 1 percent per year, this would translate into nearly 110,000 new jobs per month. But given that considerable slack remains in labor markets, we currently need more than this number of net new jobs if we realistically expect to reduce the unemployment rate.

The "jobless recovery" of the early 1990s provides some insight regarding how many jobs might be expected as this recovery picks up momentum. Following the 1990-91 recession, it took a year before jobs were being created on a sustained basis (at least four consecutive months). Once this was achieved, employment grew about 2 percent during the next year and 3 percent during the following year. In today's job market, gains of 2 percent would translate into 217,000 new jobs per month and gains of 3 percent would translate into 325,000 new jobs per month.

Based on these observations, I would expect to see jobs grow between 100,000 and 300,000 per month over the next several months as a reflection of a broad, sustained recovery in the U.S. economy—numbers that are achievable.

I also would expect that accompanying these job numbers will be a systematic rise in the economy's capacity utilization rate back toward its long-run average of 80 percent.

Turning to the second question, evidence is mounting that economic growth has become more balanced—that is, improvement in performance is more evenly distributed across the various economic sectors. This is important because growth due solely to the consumer or, for that matter, solely to business investment is fraught with risks. Fortunately, though, we are now seeing growth spurred by both consumer and business spending, which markedly improves the prospects for a sustained upward movement in the economy.

As I noted earlier, improvement in the economy is more evident in improved profits, improved CEO confidence, and strengthening investment levels. Moreover, we are seeing growth in manufacturing output as firms build inventories and build for export markets. These events should further support employment growth, strengthening pre-tax personal income and consumption. Thus, as growth across sectors becomes more balanced, it also becomes more self-sustaining, requiring less need for fiscal and monetary policy to be the main stimulus.

In summary, with the economy moving closer to its potential and with a more balanced performance across sectors, I believe the economy can sustain this performance beyond the current year.

Conclusion

In discussions of monetary policy over the longer term, it is important to remember that price stability and sustainable economic growth are the dual objectives of monetary policy. Achieving and maintaining these dual objectives is always a key challenge for monetary policy, and it certainly will be so in 2004. Right now, my informed guess is that we will achieve good growth of 4 to 4½ percent this year and inflation will remain modest—at below 2 percent.