The U.S. Economy in 2003

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It's a pleasure to be here in Denver. And thank you for the opportunity to speak to you about the U.S. economic outlook and monetary policy.

You might not know it, and it certainly may not feel like it, but the U.S. economy is in a recovery. Until recently, unusually large uncertainties about the prospects for war in Iraq contributed to a dampening of economic growth. Now, with many of those uncertainties resolved, oil prices have fallen, debt and equity markets have strengthened, and consumer confidence has rebounded. But indicators of production and employment—most of which reflect decisions made before the conclusion of hostilities in Iraq—have proved disappointing. For example, real GDP grew at only a 1.6 percent rate in the first quarter, and the unemployment rate rose to 6 percent in April. Indeed, my most often asked question is: "What recovery?"

My short answer to that question is that the pace of the recovery has, in fact, been very sluggish. However, with the lifting of some of geopolitical uncertainties, we should soon begin to see the economy pick up speed. But rather than oversimplify my response to "what recovery," I want to first look back at the last couple of years to see how we got to where we are. Then, I want to look forward at the outlook for this year. And, finally, I will conclude with a brief discussion of the risks to the economy and monetary policy's role in ensuring the recovery continues.

Looking Back

As you probably recall—wistfully perhaps—growth in the late 1990s was exceptionally strong. Between 1996 and 2000, real GDP grew at an annual rate of 4 percent and unemployment fell to 3.9 percent (April and October, 2000). The strong growth reflects the rapid growth in productivity. After rising at a sluggish 1.5 percent rate between 1973 and 1995, productivity grew 2.6 percent in the second half of the 1990s (1996–1999). Much of the faster growth in productivity reflected strong investment spending, especially in equipment and software. And, as you all know, the stock market boomed.

Unfortunately, such strong growth could not continue forever. The stock market's rise ended in March 2000. At that point oil prices also began to rise, and later that year, businesses began dramatically cutting back their spending on new plants and equipment. According to the official arbiters of recession dating, the recession began the following year, in March 2001.

Throughout the recession, the economy showed amazing resilience. Despite the terrorist attacks of September 11, increased geopolitical risk, and the accounting scandals, the recession was a very mild one. During the first three quarters of 2001, real GDP fell at a modest 0.8 percent rate and the unemployment rate remained well below 6 percent (although it subsequently rose). One reason for the mild recession was that the Federal Reserve eased monetary policy aggressively, even before the recession began, when it became apparent that a variety of forces, including adverse wealth effects associated with the collapse of stock prices, were putting downward pressure on both output and inflation.

While an end to the recession has not yet been officially declared, most economists believe it ended in December 2001. Since then, the economy has been growing, but at a sluggish pace. Last year, for example, real GDP grew 2.9 percent. That's not fast enough to create a lot of new jobs, but it was fast enough to increase the incomes of most workers. More recently, in the last two quarters, growth slowed to below 2 percent, as uncertainties about whether and when we would go to war with Iraq caused consumers to remain cautious and businesses to postpone investing in new plants and equipment.

Given that this uncertainty has only recently been resolved, it is not surprising that we have not yet seen clear signals in the data that the recovery is again gaining momentum. While the accommodative stance of monetary policy and the ongoing faster growth of productivity should foster an improving economic climate over time, the timing and extent of that improvement is still uncertain.

Economic outlook for 2003

Looking ahead, my own view is that the recovery will continue at a moderate pace, picking up speed gradually over the remainder of this year and into next year. Real GDP is likely to grow at about a 2 percent rate over the first half of this year and then strengthen in the second half, putting growth for 2003 as a whole around 3 percent. But, there are some important cross-currents affecting the outlook—both negatively and positively.

Factors inhibiting growth

Several factors suggest that the recovery could remain sluggish for a while longer. One reason is the fact that we had a very mild recession, and mild recessions are typically followed by weak recoveries. That's because mild recessions don't create much pent-up demand for new houses, cars, and other consumer goods. And, in this business cycle, low interest rates in the form of near record-low mortgage rates and zero percent auto financing meant housing and auto sales were strong throughout, making it difficult for these sectors to generate a strong bounce.

More importantly, business spending could remain sluggish due, in part, to the overhang of investment that occurred in the late 1990s. For example, factories are operating at low levels of capacity utilization—capacity utilization in the high-tech sector is 62 percent, compared with its peak of 89 percent in the mid-1990s. While spending on equipment and software has risen moderately since the second quarter of last year (3 percent annual rate), its rise was offset by a large decline in investment in structures (-13 percent annual rate).

But that is not all. There are some other factors contributing to the sluggishness of the recovery. First, as you are all acutely aware, some of the strength coming from increased federal government spending is being offset by spending cuts at the state and local levels. Second, whereas in the past stock prices have risen sharply in the first year of a recovery, they have so far failed to register much of a rebound in this recovery. For the moment, the decline in household wealth from equities has been offset to an important extent by rising house prices. And since the equity in owner-occupied housing can be tapped through cash-out mortgage refinancing, the overall impact of lower stock prices on spending has been more muted than one would otherwise expect.

A final restraining factor is something that I refer to as the "anchor of uncertainty," which is slowing the U.S. and global economic ships. This anchor, moreover, has several aspects to it and is reflected in the volatility we have seen in the stock market. The uncertainty is related to the possibility of another terrorist attack, some continuing concern about the costs of the war with Iraq, alarm about nuclear armament in the Korean peninsula, and concern over further revelations of accounting irregularities and corporate greed. This uncertainty is particularly difficult to quantify and incorporate into business planning and may result in businesses and consumers continuing to take a cautious approach to major spending initiatives.

Positive factors going forward

On the positive side, several factors will support economic activity as we go forward. The rapid and successful end to the war in Iraq may help to lessen some of the weight of the anchor of uncertainty and allow the economic ship to move ahead more rapidly. Since it became clear that the Iraqi regime would topple fairly quickly, we have seen some recovery in stock prices, decreases in the price of crude oil, and some apparent improvement in consumer confidence. As more postwar data come in, we should be able to judge somewhat better the extent to which the war has been holding down consumer and business spending.

In addition, both fiscal and monetary policy are highly accommodative. Even without a new tax package, fiscal policy is stimulative. The tax cuts from 2001 and the additional fiscal stimulus last year are still contributing to growth.

And, we are likely to get another boost from fiscal stimulus this year, although it is far too soon to say what Congress will actually do. The elimination of the taxation of dividends has been a centerpiece of the Bush Administration’s plan, and this proposal is far and away the most controversial part of the plan. By repealing the double taxation of dividends, investment spending should rise for two reasons. First, it would reduce the effective tax rate on corporate earnings. Second, it would reduce two tax distortions that arise because we currently tax debt and equity financing at different rates, and we tax retained earnings and dividends at different rates. Increasingly, though, it appears that this part of the Bush tax plan might be scaled back or possibly not enacted at all.

Other parts of the President's plan, however, are more likely to be passed by Congress. If enacted quickly, these features would provide a modest boost to output this year and next, helping to ensure the recovery continues. Features of the plan that would have an impact this year include: accelerating future legislated cuts in personal income tax rates, reducing the marriage tax penalty, raising the child tax credit, expanding the lowest 10 percent tax bracket much more quickly than now legislated, extending emergency unemployment insurance benefits, and increasing investment incentives for small business.

A critical issue, though, is the revenue impact of the program. Even the scaled-back plans that are currently being discussed could have a 10-year budget impact of $350 billion to $550 billion. And given the current sluggish growth, budget deficits could easily top $300 billion this year and next year. As a share of GDP, deficits of that size would equal roughly 2 ¾ percent of GDP—a significant number, but still less than the record deficits of the 1980s that rose as high as 6 percent of GDP (1983). A bigger concern than one year's deficit of 2 to 3 percent of GDP would be a return to chronic deficits "as far as the eye can see." If this happens, and if the demand for capital were to strengthen as the economy recovers, long-term interest rates could rise, reducing somewhat investment in new plants and equipment. The extent of this interest rate effect, though, is widely debated.

Another positive factor is accommodative monetary policy. The federal funds rate—a very short-term overnight interest rate that anchors the maturity structure of interest rates—is only 1¼ percent. With an inflation rate of roughly 2 percent, the inflation-adjusted federal funds rate is negative, which is providing substantial support to the outlook. As mentioned earlier, such low interest rates have kept housing and auto sales robust.

So, given the countervailing forces playing within the world economy, how do I see this year settling?

Although the economy's overall growth rate is expected to be about the same as last year, the sources of growth in 2003 will shift. Consumer spending will continue to be an important source of strength in the economy. But, residential investment spending is likely to slow from its rapid pace and high historical level, as whatever remaining pent-up demand for new housing is exhausted.

In contrast, inventory investment and business spending are likely to pick up speed. Inventories, which have bottomed out at all stages of the economy's supply chain, will contribute importantly to production in 2003. In addition, the pre-conditions for businesses to step up their investment spending are beginning to fall into place. Profit margins are improving as businesses have managed to further boost productivity and hold wage costs in check. Excess capacity in the information technology sector is gradually being absorbed as a lot of the computer hardware and software purchased around Y2K is becoming economically obsolete. And, financial conditions have become more favorable with credit spreads declining. Also, the lower dollar should help manufacturers.

Risks to the outlook

Given the countervailing forces within the economy, how do I judge the risks for the outlook? The uncertain economic and political environments make it difficult to be overly confident about any forecast.

There are a number of downside risks related to geopolitical developments. I have already identified terrorism and recent tensions with North Korea as risks to the forecast.

Another economic risk is that consumers could retrench and cut back their spending. Household debt is growing at a rapid pace, resulting in increased financial stress in the consumer sector. Bankruptcy filings are already at or near record highs, as are mortgage foreclosure rates and auto loan repossession rates. Because of the refinancing boom, owner's equity share of household real estate is near record lows. These conditions could lead to an increase in consumers' savings rate—a good thing for the long term—but a short-term drag when we are counting on consumers to help support a recovery in its early stages.

Yet another risk to the outlook is the possibility that business will respond even more cautiously than expected to the uncertainty that clouds the outlook. Despite rising profits, businesses may hold back their investment in new plants and equipment until some of the more dominant geopolitical risks are resolved. That said, the reduced uncertainty related to the Iraqi conflict and recent declines in oil prices may be enough for businesses to unleash enough new spending to propel the economy into a much faster recovery than currently anticipated.

The inflation outlook

Despite these risks, I continue to believe the most likely outcome for the U.S. economy is continued moderate growth, with the economy picking up steam as the year progresses. This moderate growth scenario—along with continued strong productivity growth—should help keep inflation in check. To be specific, the rise in the core CPI should stay about 2 percent, or possibly move even lower, this year.

Over the long run, of course, policy will need to retrace some of its steps. That is because, in the long run, inflation is determined by monetary policy. Currently, monetary policy is highly accommodative with a federal funds rate target of 1¼ percent. This level of the funds rate cannot be maintained forever without eventually generating inflationary pressures, especially if the recovery proceeds as expected. But, the fact is inflation is not an immediate threat.

Monetary policy

That brings me to the final part of my presentation—the role of monetary policy in promoting sustainable economic growth with price stability. And here, I will be brief. The task of monetary policy is to provide enough liquidity in the short run to make sure the economic recovery is sustained. Equally important, though, is to know when to begin withdrawing this liquidity to make sure inflation remains in check.

Some people have argued that the U.S. economy is at risk of falling into the same kind of deflationary spiral that the Japanese economy has experienced. In my view, deflation is a remote possibility in the U.S. economy today. And, the risk of the U.S.

falling into a Japanese-style deflationary spiral is even more remote. First, aggressive easing of policy that has already occurred should prevent the United States from experiencing a falling price level. Second, the U.S. banking system is in far better shape than is Japan's system. Thus, as credit needs grow in the coming months, U.S. banks are well-positioned to meet the need. Japanese banks are not. But, if further monetary actions were called for, there are a number of things the Federal Reserve could do, including lowering the federal funds rate further, purchasing longer term Treasury bonds in order to drive long-term interest rates lower, or taking a quantitative approach to monetary policy by targeting the supply of reserves to the banking system.

A more likely challenge for policymakers in my view, though, is knowing when to begin reversing the easing moves that we have made. This is a difficult issue because it involves forecasting the outlook for economic activity and inflation at a time when making such forecasts is so very difficult.

Conclusion

Let me conclude by repeating that I think the economy will experience another year of moderate economic growth. Moreover, as the anchor of uncertainty is lifted, all of the pieces are in place for what should eventually become a robust recovery.

Thank you very much.