

The U.S. Economic Outlook and Monetary Policy

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Good evening. It's a pleasure to be with you today to talk about the U.S. economic outlook and monetary policy. As you know, economists tell us that the recent recession ended in November 2001 and that we have been in an economic recovery for nearly two years. Since the recovery began, real GDP has grown at a 2.7 percent annual rate but 1 million workers have lost their jobs. So, 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 sluggish. Simply put, real GDP growing at a 2.7 percent rate is not fast enough to create, on net, more jobs when we face such strong productivity growth, and when important sectors of the economy are undergoing substantial restructuring in response to overcapacity and increased global competition.

Looking forward, however, I believe many of the headwinds facing the economy are diminishing and the economy is poised for more significant improvement. Tonight, I want to explain why I expect stronger growth over the next year-and-a-half, growth that should lead to sustainable increases in

employment. Along the way, I want to recognize the risks to the outlook and the challenges we face. I will close with some brief remarks about monetary policy.

THE ECONOMIC OUTLOOK

In my view, the “most likely” economic outcome is accelerating growth with low inflation. I expect real GDP to grow about 4 ½ percent over the rest of this year and 4 percent next year. We are already seeing signs of a recovery in investment spending. And, as investment spending recovers and the economy grows, I expect to see employment rise. Finally, I expect core inflation to remain modest over the next several months. Over the last year, the core CPI rose just 1.3 percent and I expect the increase over the next year-and-a-half to be about the same.

Factors supporting growth

The U.S. economy has many factors that should propel it forward. First, the economy has proven to be amazingly resilient. The recession was relatively short and mild, spanning only the first three quarters of 2001 and experiencing a modest dip in real GDP—just 0.8 percent. Since then, the economy has grown 2.7 percent and unemployment has remained under 6 ½ percent. While these numbers may not be a cause for celebration, we

achieved these results despite the stock market collapse, the excess capacity built up during the late 1990s, and a rash of corporate governance scandals. In addition, the economy endured terrorist attacks on September 11, continuing concerns about weapons of mass destruction, wars in Afghanistan and Iraq, and now a host of new challenges in rebuilding Iraq. The remarkable resilience of the U.S. economy I believe should be a source of pride and comfort for us all.

Another positive factor is that fiscal policy should be a significant stimulant over the next year-and-a-half. The recently enacted Jobs and Growth Tax Relief Reconciliation Act will provide approximately \$150 billion of stimulus this fiscal year (which began on October 1). The act reduces marginal tax rates, boosts the child tax credit, reduces the marriage tax penalty, reduces taxation of dividends and capital gains, and expands and extends the partial-expensing provision for equipment investment that was enacted last year.

We are already seeing some of the effects of the tax package: Employers have adjusted withholding, and a round of advance refund checks went out between July 25 and August 8. As a result, household spendable income is projected to increase about \$120 billion. Indeed, some estimates

suggest that fiscal policy will contribute about 1 percentage point to growth in (calendar years) 2003 and 2004.

Before the issues come up during Q&A, let me address two fiscal policy questions. First, I recognize there have been spending cuts and tax increases at the state and local levels. Still, the federal stimulus should more than offset the drag from the state and local budget gaps. In addition, concerns have been raised about the rise in the budget deficit. It is important to recognize that they are helpful in the short run because the fiscal stimulus is needed, but they could pose problems for longer run growth if they are not reduced when the economy recovers.

Financial conditions are also supporting economic growth. Importantly, monetary policy remains very accommodative. The federal funds rate—the very short-term, overnight, interest rate that anchors the maturity structure of interest rates—is only 1 percent. With an inflation rate of 1.3 percent, the inflation-adjusted federal funds rate is actually negative, which provides a substantial boost to the nation's economic outlook.

Also, more general financial conditions are supporting growth. For example, long-term corporate rates are still lower than at the end of last year, and credit spreads have declined. Recently, the S&P 500 stock price index

recorded its highest close in over 14 months and is now 27 percent higher than its low point back in March.

With these positive forces in play, I suggest we can achieve relatively robust growth over the next year-and-a-half. Let me turn now and provide a little more detail into how this might unfold.

How does the economy play out?

First, consumers will likely remain an important source of strength to the economy. While consumer attitudes have recovered since the war-related jitters earlier this year, the Conference Board's consumer confidence index remains below levels observed earlier this year and during the boom in the late 1990s. And, realistically, we can't expect consumers to express much greater confidence until labor market conditions improve. Tax cuts, however, should lead to greater consumer spending and low interest rates should boost spending on durables—like cars, appliances, and furniture. In fact, in recent months, consumers have continued to spend. Retail sales rose 0.6 percent in August, while personal consumption expenditures rose 0.8 percent.

Housing continues to be a mainstay of the economy, thanks to low mortgage rates. Housing is likely to slow from its rapid pace and high

historical levels as recent strong demand for new housing is met and future demand moderates. Still, sales of both new and existing homes should remain strong.

In addition, inventory investment and business spending are likely to pick up speed. Inventories actually declined last quarter, weakening growth; but lean inventories should be a positive force for growth in the future. If domestic spending stays firm, many businesses should begin to add to their inventories, leading to increased orders and production in the manufacturing sector. Supporting this view, factory orders rose solidly in June and July, and purchasing managers reported a strong gain in manufacturing activity for August.

As you know, an overhang of investment was created in the late 1990s, which inhibited spending for much of the recovery. Some of the excess capacity is being absorbed. For example, excess capacity in the IT sector is gradually diminishing as computer hardware and software purchased around Y2K are becoming economically obsolete. Nonetheless, the overhang could still pose a risk to the outlook by inhibiting investment spending going forward.

Despite this risk, it is important to point out that the pre-conditions for businesses to step up their capital spending plans also are falling into place.

For example, CEO business confidence appears to be improving. The Economy.com index of business confidence dropped sharply in March as war-related uncertainties grew. But since then, the index has more than doubled and is 40 percent higher than at the beginning of the year. Profit margins are also improving as businesses have managed to further boost productivity and hold wage costs in check. Finally, the overall cost of capital has declined, which should stimulate spending. Interest rates and credit spreads have fallen, the stock market has risen, and the changes in tax laws I noted earlier provide important incentives for firms to invest in new plant and equipment.

In light of these favorable developments, we are beginning to see signs of life returning to manufacturing and capital spending. Production of computers and office equipment is up 22 percent over the past year and orders and shipments of nondefense capital goods (excluding aircraft) have recently been rising. Overall business fixed investment climbed 7.3 percent in the second quarter and is expected to strengthen over the balance of the year and into 2004.

The inflation outlook

Turning to the inflation outlook, I would like to make a couple of brief points.

First, the obvious: core inflation is quite low. Core CPI inflation has averaged 1.2 percent over the last 3 months and 1.3 percent over the last 12 months. The last time core inflation was this low was in January 1966. In addition, core inflation has fallen about $\frac{1}{2}$ percentage point since the end of last year.

Second, the most likely outcome is for inflation to remain around 1- $\frac{1}{4}$ percent over the next year-and-a-half. While recent declines in the dollar could impart some upward pressure on inflation, continued strong productivity growth should offset these effects to an important degree. Overall, with the growth scenario I laid out earlier, inflation should remain stable, neither accelerating nor decelerating significantly over the next several months.

CHALLENGES TO THE OUTLOOK

Even though I have presented a relatively optimistic forecast, I recognize that the economy faces some significant risks and challenges. Let me now turn to a brief look at two of the more difficult challenges: job creation and trade policy.

The challenge of job creation

Despite signs of a rebound, the economy continues to lose jobs. For example, the economy lost 336,000 jobs this year as layoffs and business closures in some sectors of the economy exceeded job creation in other sectors. The civilian unemployment rate remained steady in September at 6.1 percent. That compares with a recent peak of 6.4 percent in June. We will need to see job growth before we can say that we have a sustainable recovery—which is, after all, one of our objectives.

How do you reconcile job losses with growth in the nation's output? To a large extent, the answer is that U.S. firms have met the increased demand for goods and services by using the existing workforce more effectively—that is, by productivity increases rather than by employment increases. The second quarter illustrates this point. In the second quarter we saw real GDP grow 3.3 percent but productivity grew significantly faster—6.8 percent. As a result, the economy was able to meet the 3.3 percent increase in demand with 241,000 fewer workers.

But the explanation is more complex than simply noting rapid productivity growth. In today's economy—with low inflation, increased competition from abroad, deregulation at home and abroad, and technological change—firms are forced to become more efficient in order to compete and make money. They can no longer count on higher prices to

increase revenues. They must improve profits by increasing productivity, which affects job growth in the short run.

Also, all recoveries reflect cyclical and structural changes in the economy. In a typical cyclical recession and recovery, workers lose their jobs and then are rehired when the economy picks up—by the same firm or in the same industry. But, this time around, we have seen structural changes in the economy. Firms must adjust to permanent falls in demand (such as in the airline and telecomm industries) and to technological changes (such as the high-speed Internet). Businesses often reorganize production processes or make significant changes to their business plans. They often outsource jobs—sometimes locally but increasingly globally. In this new environment, job losses are more likely to be permanent.

While I am confident that people will find new jobs, they are more likely to be in a new industry that requires new skills. But this will take time and involve more than simply returning to the old job or the old way of doing things. Still, as I suggested earlier, as growth rebounds and CEOs become more confident, firms should begin hiring and training more workers. I expect this process will begin yet this year, but I recognize the situation remains a risk to the outlook.

The challenge of maintaining a commitment to free trade

An ongoing challenge to the economic outlook is the world's willingness to remain committed to more open trade. I am concerned about a potential step backward from more open trade as suggested by the collapse of the WTO talks in Cancun and by a rise in "protectionist" views among many.

Indeed, I suspect the debate over free and open trade will only intensify in the coming months, especially if we continue to experience job losses. Some critics claim open trade is the primary cause of the joblessness, and they question the wisdom of open markets. But when we consider the facts, we learn that while it can be difficult to adjust to more open trade, on balance it creates wealth for all the countries involved.

In 1995, well known economist Jeffrey Sachs and his colleague Andrew Warner studied the effects of trade policies in dozens of countries. Among the countries reviewed, he and Warner found that developed nations with open economies grew about 2 ¼ percent annually from 1970 to 1990, while developed nations with closed economies grew a meager 0.7 percent. The contrast among developing nations is even starker. Developing nations with open economies grew about 4 ½ percent, while developing nations with closed economies grew less than 1 percent. Countries that switched from closed to open economies saw their growth rates climb on average by more

than a full percentage point a year. While this study is now somewhat dated, its conclusions remain important.

Consequently, I believe that we should resist calls for increased protectionism and should remain involved in developing workable and fair trading rules through the WTO. I believe any other approach risks a reduction in world and U.S. growth in the future.

MONETARY POLICY ISSUES

Let me conclude by briefly addressing two monetary policy issues: the stance of monetary policy and the importance of clear communication.

The first monetary policy issue is choosing a stance of policy that is consistent with meeting our objectives of sustainable growth and long-run price stability. In my view, the current stance of policy is consistent with achieving these objectives. Growth above the economy's long-run potential will be needed to achieve job growth and reduce the unemployment rate, essential for achieving sustainable growth. While maintaining such a growth rate, say above 4 percent, over the long-run may not be sustainable, it is achievable and desirable over the next year-and-a-half. The economy must grow faster than productivity in order to create new jobs, and it must grow

faster than potential in order to reduce the unemployment rate. In my view, a 1 percent federal funds rate is consistent with these objectives.

Of course, if job losses intensify or if the economy was at risk of slipping back into recession, a more accommodative monetary policy might be appropriate. However, I think this outcome is unlikely. And, once the economy achieves sustainable growth with sustained increases in employment, and with upward price pressures a less accommodative policy would become more appropriate. But as I said earlier, this is certainly not an immediate issue.

A second monetary policy issue is insuring that the Fed and financial markets communicate clearly, which is important for avoiding unnecessary interest rate and asset price volatility. There was considerable discussion this summer about FOMC communication, with some analysts suggesting that the financial market volatility we saw this summer reflected communication errors. Because of this concern, the FOMC met a couple weeks ago (September 15) “to review its practices regarding the communication of its policy decisions and its assessment of the risks to its objectives of fostering sustainable economic growth and price stability.” It is important to recognize that the Committee communicates in a variety of ways—through press announcements as well as the published minutes of our

meetings (with about a 6 week delay). Alan Greenspan also testifies before Congress, and members of the Committee give speeches at Economic Forums such as this one.

In outlining our communication practices and policy, we need first to define the goal. My objective, for example, is to help enhance the public's general understanding of the various aspects of the FOMC's policy-making process, its reasons, actions, and economic objectives.

The FOMC announcement must communicate what was decided. At the end of each meeting, the FOMC votes on two issues – the target for the federal funds rate and an assessment of the risks to the outlook as seen by the Committee. Both issues are communicated in the press announcement. The target for the funds rate provides the anchor for the entire term structure of interest rates. The Committee also presents its views on the risks to the attainment of sustainable growth and to an increase or decrease in inflation. Keep in mind, though, that the risk assessment is based on information available to the Committee at the time of the meeting.

The announcement must also communicate why the action was taken. In many ways “why” is the most important element of the announcement

because it provides the rationale for the decision and gives insight into the FOMC's thinking about the key economic issues leading to the decision.

Finally, the press announcement must say who voted for the action and who (if anyone) dissented and voted against the action.

Beyond this basic information, we must tread carefully in anticipating the future, because as much as I might like to know the economy's future, it is not possible.

CONCLUSION

Let me conclude by repeating that I think the economy will show stronger growth in the second half of this year and next year. Fundamental economic forces currently in place should drive the economy toward sustainable economic growth with modest inflation. Growth of 4 to 4 ½ percent should be sufficient to lead to job creation and lower unemployment—that is, for achieving sustainable economic growth. Job creation and strong growth should also help to renew our traditional commitment to negotiated open trade. Finally, I expect inflation to remain modest—with core CPI inflation averaging about 1-¼ percent over the next year-and-a-half.