

Monetary Policy and the Economic Outlook

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I appreciate this opportunity today to share my views on the economic outlook and monetary policy. Two years ago, here in Colorado and across the country, the outlook was highly uncertain. The economy had suffered the trauma of September 11, and the situation in Iraq was adding to uncertainty. Business confidence was low, and investment spending was declining.

Today, businesses are far more upbeat about their prospects, and we are seeing a rebound in investment spending on equipment and software. While uncertainty is always with us, I feel that the degree of uncertainty about the outlook has returned to a more normal level. And I am optimistic that the near-term prospects for the U.S. economy are bright.

Overall, the outlook for 2004 is favorable, with real output growth strong and employment growth strengthening. One and a quarter million jobs were added to the economy so far this year.

While today I want to focus on the outlook, I will touch on two important challenges that affect the outlook over the longer run—the twin deficits. These are shortfalls in our federal government budget and our trade accounts with foreign countries. The point I'd like to make is that we need to be proactive in addressing these issues if we want our economy as strong as it can be in the future.

Recent Economic Conditions

Let me begin by reviewing how the U.S. economy has been performing lately. Economic growth picked up substantially last year. Real GDP grew 4.3 percent because of continued solid spending by households and a recovery in business spending. Low mortgage rates produced an outstanding year for housing, and business spending on equipment and software rose about 10 percent. Moreover, businesses began building their inventories at the end of last year as they became more optimistic about the future and struggled to keep up with growing demand.

Two sectors that slowed last year were government spending and international trade. Although federal purchases grew nearly 6 percent, that was slower than the year before, and state and local government spending was flat. The trade deficit also worsened, although international trade was less of a drag on growth than in 2002. On a more positive note, our exports

grew much faster in the second half of last year, suggesting that the dollar's past depreciation, together with foreign economic recoveries, were boosting demand for American-made goods and services.

Although overall growth was strong last year, the labor market remained soft. Nonfarm payroll employment declined slightly in the third quarter of 2003 and grew by only about 60,000 jobs per month in the fourth quarter. The unemployment rate declined in that period, but part of the decline was due to people dropping out of the labor force rather than to brisk hiring. The unemployment rate in June was 5.6 percent, which is not unusually high by historical standards but still implies unused labor resources.

In looking at the sluggish pace of job creation in this economic recovery, I believe two factors have played predominant roles—rapid productivity growth and business caution. Rapid productivity growth means businesses have substantially boosted their output without adding many workers. Recent productivity growth has been well above its long-term trend because businesses are still finding ways to use their past IT investments to become more efficient. Along with their efforts to boost productivity, businesses have also been cautious about hiring and making other long-term commitments due to an uncertain economic outlook.

The weakness in labor markets, combined with rapid productivity growth last year, kept inflation in check. Despite gains in energy prices, consumer price inflation remained low. The consumer price index rose by a moderate 1.9 percent in 2003, and if you exclude volatile food and energy prices, core CPI inflation last year was only 1.2 percent.¹ However, this picture is changing and we are beginning to see inflation reassert itself in some economic sectors.

The Economic Outlook

Last year was the time for turnaround. This year is shaping up to be a time of expansion, with several contributing factors . Accommodative monetary policy remains a key factor. The federal funds rate at 1¼ percent is highly accommodative and remains near its lowest level in decades.

Fiscal policy is also a key factor. Lower federal tax rates have provided refunds for many households, and the tax code gives businesses an incentive to invest in equipment before the end of this year. Federal spending is also expected to grow solidly, and state and local government spending may pick up somewhat after a difficult year in 2003.

Other financial factors should also encourage solid economic growth this year. Corporations report very strong profits, some of the highest in

¹ The CPI rose 1.9 percent from the fourth quarter of 2002 to the fourth quarter of 2003, while the core CPI increased 1.2 percent over the same period. However, the CPI rose 3.1 percent over the 12 months ending in May, while core CPI inflation was 1.7 percent over that period.

years, and rising single-family home prices have boosted the net worth of many households. In addition, the foreign exchange value of the dollar against other major currencies has declined more than 20 percent from its peak in February 2002. A lower value for the dollar makes U.S. goods and services more competitive in foreign markets and foreign products less competitive here.

More important to an improving exports sector, though, is a further pickup in the economic growth of our major trading partners. On that front the outlook is generally good. The economic recovery in the industrial countries, which began in the second half of 2003, is expected to continue into 2005. The Euro area economy is likely to grow 2 to 2 ½ percent, which is sluggish by our standards but a pickup from their recent performance. The UK economy should continue to grow solidly, and Japan's economic recovery appears on track. More notably, perhaps, is the robust economic performance in Asia. The Chinese economy, in particular, is growing so rapidly that it's supporting growth throughout Asia.

Having mentioned China, I want to digress for a moment to comment on that country's expanding global role and its implications for the longer-run performance of the U.S. economy.

Over the last several years, the Chinese economy has grown 7 to 9 percent, and its share of world trade has risen to almost 6 percent. China is now the sixth-largest economy in the world and, according to the IMF, the fourth-largest world trader. Not only have their exports grown as a share of total world trade, but the Chinese have also become major importers of industrial commodities. This growing import demand has helped improve the economies of China's neighboring countries, in addition to helping to boost world commodity prices.

One fairly unique aspect of China's economic performance recently has been its tremendous rate of capital formation. China has consistently maintained high savings rates, allowing it to channel 46 percent of its GDP into investment spending.

Looking ahead, China is well on its way to becoming an important player in the world economy. Its growth is likely to continue, requiring a sustained pace of financial and structural reform and rapid absorption of rural labor into the modern sector of the economy. Under a set of long-run simulations carried out by the IMF, continued rapid growth of the Chinese economy implies further rapid growth in the other newly industrialized countries of South Asia.

Moreover, China's emergence as an economic powerhouse will have important implications for the economies of the United States and other industrialized countries. As a major importer of raw materials, China will continue to have a significant impact on world commodity prices. In recent years, it has accounted for 42 percent of global demand for coal, 27 percent of steel, and 34 percent of iron ore. And while a cooling off of the Chinese economy could lead to an equally sharp decline in commodity prices, it is possible that over the longer run, continued growth of the Chinese economy could raise the price of commodities for an extended period.

Another Chinese effect on the world economy is in the composition of global production. China's growing demand for imports of skill- and technology-intensive items, such as computers, will benefit industrial countries with a comparative advantage in these sectors. At the same time, as China captures a larger share of labor-intensive product markets, its burgeoning urban labor force may cause continued manufacturing job losses in industrialized countries. Importers of Chinese manufactured goods will benefit by paying less for these products, but importing countries may find their manufacturing sectors under constant cost pressures.

China is also likely to have a significant impact on U.S. agriculture. The Chinese represent a huge potential market that is well on its way to

becoming a classic “growth” market for food. As Chinese incomes rise, consumers will likely shift from cereals to protein, lifting demand for meat products and feed grains. Thus, China has considerable potential to import growing volumes of U.S. beef, pork, corn, and soybeans—all important products of our farm economy.

How all of this will shake out is not yet clear, except to say that China is now a global player. If trade issues are handled well by both China and the U.S., China’s emergence as a world economy can increase citizens’ wealth in both nations.

Turning back to the United States, our economy should continue to move ahead strongly for three reasons: an accommodative monetary and fiscal policy, favorable financial conditions, and an expanding global economy. Real GDP growth will likely be above 4.0 percent from the fourth quarter of 2003 to the fourth quarter of 2004. Household spending should grow solidly due to improved labor market conditions, gains in household wealth, and lower federal taxes. But the mix of spending in the U.S. is shifting this year, with more support for the recovery from the business sector. Business equipment purchases should rise briskly because of improved corporate profits, a favorable financial environment, and expiring tax incentives. In addition, business confidence has improved substantially.

In the second quarter of this year, the Conference Board's index of business confidence remained near its highest level in 20 years.

Economic growth above 4.0 percent should further lower the civilian unemployment rate this year. Hiring has picked up and should continue strong over the course of the year as productivity growth slows to a more sustainable pace. And recent statistics suggest some encouraging signs of improvement in the labor market. Payroll employment continues to grow, adding about 211,000 jobs per month in the first half of the year. In addition, initial claims for unemployment insurance are lower, suggesting that firms are laying off fewer workers, and help-wanted advertising is rising. Progress in reducing the unemployment rate may be limited by people reentering the labor force as they become more optimistic about job prospects. Still, I expect some further reduction in the unemployment rate, to about 5.5 percent in the fourth quarter.

Core CPI inflation is currently running in the 2 percent range. While this remains a modest rate, it is up from just above 1 percent in January. My view remains that price pressures will stabilize and that core CPI will stay at about the 2 percent number through this year and beyond. However, with stronger GDP growth, diminishing excess capacity, and strong money growth, there is some greater upside risk for inflation, which should not be

ignored. As I said earlier, monetary policy, even with its recent increase of a quarter point, remains highly accommodative with the federal funds rate target at 1¼ percent. While this increase reflects a move toward a more neutral rate, it remains well below what most economists would judge to be neutral.

The Twin Deficits

I want to close by briefly addressing the twin deficits and what they mean for the longer-run health of the U.S. economy.

The federal budget deficit poses more risks in the long term than the short term. As you know, the federal budget has swung sharply from surplus at the beginning of the decade to deficit today. In fiscal year 2003, the deficit came in at \$375 billion and will likely increase to more than \$400 billion for the 2004 fiscal year. In part, this wide swing reflects the economic slowdown and decline in equity values that accompanied the bursting of the high-tech stock market bubble. In addition, the swing reflects tax cuts, enacted to help stimulate economic growth, and spending increases associated with national security. More recently, we have also seen a breakdown in fiscal discipline and less restraint in discretionary spending.

To be sure, the tax cuts helped support economic activity in the recession and early stages of the recovery, and spending increases associated with national security were clearly warranted. In addition, as the economy continues to expand, tax revenues will increase and the deficit will tend to narrow for awhile. But even after abstracting from the effects of the business cycle, we are left with expectations of sizable budget deficits for years to come.

Moreover, looking further ahead, the deficits will likely widen again. And they could become unsustainably large as rising life expectancies and the retirement of the baby-boom generation lead to increases in entitlement spending. Social security spending is expected to increase from 4.3 percent of GDP in 2003 to 6.3 percent by 2030. Medicare spending is expected to rise from 2.6 percent of GDP to 7.0 percent over the same period. Without some change in these programs, the projected increases will make it exceedingly difficult for the federal government to provide even the most basic services unless tax rates rise to unprecedented and stifling levels.

While budget shortfalls are a long-run challenge, they are a challenge that is easier to address sooner rather than later. Acting sooner will permit less drastic changes in policies than waiting until a crisis is upon us. In addition, if investors become sufficiently concerned that policymakers will

not address the growing fiscal imbalance, we could see an undesirable surge in long-term interest rates. Such a surge would dampen investment spending and slow economic activity in housing and consumer durables. Rather than risking this unpleasant scenario, fiscal policymakers need to be thinking about solutions today.

The current account deficit poses another risk to the outlook. The current account is a broad measure of U.S. international transactions. It combines balances on trade in goods and services, international investment income, and net transfers. In recent years the deficit has been growing both in dollars and relative to the size of our economy. In 2003, the current account deficit was \$531 billion, or about 5 percent of GDP. To cover this deficit, our nation must borrow abroad or sell assets to foreigners.

In important ways, the large current account deficit reflects the strength of the American economy. In addition, our strength and willingness to spend on goods and services from abroad have aided world growth. A large part of that spending has gone to import capital goods that make our own economy more productive in the long run.

Nonetheless, the large and growing current account deficit deserves serious attention. It reflects our low savings rate as a nation, and if left unchecked at current levels, servicing it will one day require extensive

amounts of our national income. Most analysts believe the current account deficit will eventually correct itself. The risk is that if it does not self-correct in a reasonable period, its size will become difficult to manage and the eventual adjustment could be a difficult one.

As I have already mentioned, restoring fiscal discipline to the budgetary process would be a good policy move in itself. But it would also likely lead to a smaller current account deficit. When the budget deficit absorbs a large part of domestic savings, these savings are no longer available to finance private investment. If high levels of productive investment are to be sustained, U.S. companies and households increasingly would have to borrow abroad, raising the dollar's value and reducing the competitiveness of U.S. exports. Therefore, a lower fiscal deficit also means less dependence on foreign capital and a narrower current account deficit.

To date, the United States has not experienced difficulties in financing its current account deficit. Given the size of our economy, its attractive investment opportunities, and the dollar's importance as an international currency, we can carry these deficits for a considerable period. But to reduce the risk of harmful adjustments in the future, we would be wise to commit to the goal of reducing our federal budget deficit. Just as important would be

finding ways to boost our private and national savings, which, in effect, would at least partly address our current account deficit.

Summary

To summarize, recent U.S. economic performance has been good. Growth has been strong, inflation has been low, and even the labor market seems to be improving. Real GDP growth should be strong enough this year to lower the unemployment rate somewhat by year's end, and inflation should remain low. Monetary policy is currently highly accommodative. While monetary stimulus is helping reduce slack in the economy, the degree of stimulus must eventually be reduced or inflationary pressures will start to build.