Remarks by Vice Chairman Roger W. Ferguson, Jr.

At the Executives' Club of Chicago, Chicago, Illinois
November 21, 2003

Economic Outlook

It is a pleasure to be with you today to speak about the U.S. economy. As always, the views I will be expressing are my own and do not necessarily represent those of the other members of the Board of Governors or the Federal Open Market Committee.

My last formal speech on the economy was in November 2002. And in preparing my remarks for today, I was struck both by how much has happened over the past year and by how much economic conditions have changed. Think back to the economic situation of a year ago. After growing moderately over the first three quarters of 2002, the economy was about to stall out. The lingering effects of the corporate governance scandals, rising oil prices, and growing uncertainties about the economic consequences of a possible war in Iraq were holding back the nascent recovery from the 2001 recession. The pessimism that had gripped the business community since the summer of 2000 intensified, and firms renewed their focus on restructuring rather than expanding their operations. The result was another round of job cuts and continued sluggishness in capital spending.

Intense geopolitical risks and uncertainties continued to weigh on the economy until major combat operations in Iraq ended this past spring. Shortly thereafter, the Congress enacted additional reductions in personal income taxes and extended the enhanced corporate expensing provisions for new investment. Moreover, the Federal Reserve eased monetary policy an additional 25 basis points in June. By early this summer, a significant amount of monetary and fiscal stimulus was in place, and although there was no evidence in hand at the time, most forecasters anticipated a step-up in the pace of economic activity.

In the event, the economy rebounded faster than even the most optimistic of prognosticators had predicted. Real gross domestic product rose at an annual rate of 3-1/4 percent in the second quarter of this year and surged at a rate of more than 7 percent in the third quarter. The labor market, which heretofore had continued to deteriorate, appears to have stabilized during the summer, and almost 300,000 new jobs were created over the July-to-October period.

Although the economy now appears to have turned the corner, much additional progress needs to be made before our country's labor and capital resources are fully utilized. Indeed, until the most recent employment report, many commentators had described this period as the "jobless recovery." Since the cyclical trough in November 2001, nonfarm payrolls have actually fallen 1/2 percent. This decline compares with a 1-1/4 percent rise over a period of comparable length in the preceding jobless recovery from the recession of 1990-91 and an average 7 percent increase in the other seven post-war recovery periods. A similar picture emerges for industrial production, which is up only 2 percent from its cyclical trough, compared with 6-1/2 percent in 1990-91 and almost 20 percent on average after the other

seven post-war recessions.

Are Jobless Recoveries Now the Norm?

These developments are striking departures from past cyclical behavior, and they raise the question of whether some facet of the U.S. economy has changed. Given the very slow employment growth in the two years after the past two recessions, should we consider "jobless recoveries" to be the new norm? Proponents of this view cite the widespread cost cutting and restructuring that has occurred in the past two recoveries, the continuing outsourcing of jobs overseas, and an ongoing focus of business decision makers on improving efficiency rather than expanding capacity. I suspect that the differential behavior of the past two recoveries reflects more the nature of the shocks that hit the economy during these periods than a fundamental shift in the structure of the economy. Let me elaborate on this hypothesis.

Glance at the textbook descriptions of business-cycle fluctuations between 1946 and 1990, and you will find repeated references to swings in aggregate demand induced by so-called "stop-go" economic policies--policies that alternated between being excessively stimulative and excessively restrictive. These descriptions often portray the Federal Reserve as one of the villains in this process, first by spiking the proverbial punch bowl to get the party rolling and then preemptively removing it once everyone was having a bit of fun. During this period, monetary policy attempted to manage cyclical shocks to aggregate demand and aggregate supply to first control inflation and then to confront any excess slack in resource utilization that might follow from these initial actions.

However, the recessions of 1990-1991 and 2001 were different than this prototypical postwar downturn. Both involved unusual economic circumstances that placed additional strains on the economy. In 1990, a credit crunch was layered on top of the usual cyclical dynamics. The collapse of savings and loan institutions and the need to repair the capital structure of the banking industry led to a period in which the flow of credit to businesses was impaired. Although the Federal Reserve cut interest rates to confront these "headwinds," a prolonged adjustment period was still needed to correct the financial imbalances that had emerged in the late 1980s. Facing limited access to the credit markets, businesses--especially small businesses--were unable to expand, and hiring lagged far behind that of the typical postwar recovery. In my view, this credit-supply shock and the associated efforts of businesses to repair their balance sheets proved to be the characteristic of the 1990-1991 recession-and-recovery period that distinguished it from earlier cycles and led to its jobless features.

The 2001 recession was an unusual investment-led downturn that followed the boom of the late 1990s and early 2000. The exuberance that accompanied the growth of information technology and the Internet led some to overestimate the potential of this revolutionary hardware and software to generate productivity gains and extra-normal rates of return. An important step-up in the rate of productivity growth occurred during this period, but not all players in the game were capable of achieving the extra-normal rates of return that flowed to some of the more innovative companies. Young start-up companies that had never made a profit (and never would) attracted copious amounts of financing from venture capitalists and the initial public offering market. Analysts began to question whether established "bricks and mortar" businesses could ever compete with this new Internet business model, and many of these more-traditional firms felt compelled to accelerate their own on-line strategies.

In the end, the bubble burst, but not before huge sums of money had been spent on new (and

subsequently unneeded) capacity. The ultimate fallout was severe, especially in segments of manufacturing that had geared up to satisfy the anticipated demand for high-technology products. The bursting of the bubble wiped out significant amounts of financial wealth, prompting adjustments throughout the economy. Firms slashed payrolls, and capital spending projects were abandoned. As with the process of adjustment to the 1990 credit crunch, a long period of time has been required to get employment and capacity back to more viable levels. And some industries--such as telecommunications--still appear to be struggling.

As a footnote, I should mention that the successful efforts of many companies to ready their computer systems for the year 2000 date change probably added to the length of this adjustment period in some high-technology industries. The new equipment and rewritten software that were put in place by the end of 1999 seem to have greatly exceeded expectations both in terms of longevity and associated productivity gains. We continue to hear from businesses that they have been able to extend the useful service life of this equipment and to reap additional productivity gains by fine-tuning their automation systems. Although this extended replacement and upgrade cycle has helped to support the profitability of technology-consuming businesses, it obviously has been bad for the bottom line of the producers of these high-tech goods and services.

Although the boom-bust in capital spending was a unique feature of the most recent business cycle, the U.S. economy was also hit by the terrorist attacks of 2001, the corporate governance scandals of 2002, and the 2003 war in Iraq. In hindsight, it is clear that such an uncertain and risky environment was not conducive either to the creation of new jobs or to the expansion of capacity. Indeed, I am amazed that the U.S. economy could cope with such a severe sequence of negative economic shocks without even greater economic pain. That, to me, is testimony to the underlying strength and flexibility of our economic system.

Current Conditions
Given the disappointments of the past two years, what do I see today in the economic data that makes me think that the economy has more likely than not turned the corner? The rate of growth of real GDP in the third quarter was impressive, and even more so, when you look at the contributions of final demand.

The household sector has been the driving force in this expansion. For example, in the third quarter, real personal consumption expenditures increased at an annual rate of 6-1/2 percent, while real residential investment surged 20 percent. Last quarter's strength in consumer spending was fueled by the midyear tax cuts, the waning influence of negative wealth effects from the past slide in equity prices, and some improvement in consumer sentiment from the war-related lows registered in March. In addition, very generous incentives on autos and light trucks boosted light vehicle sales to annual rate of 17-1/2 million units in the third quarter. After such substantial increases last quarter, it has not been surprising that consumer spending has softened as we moved into the fourth quarter. Still, the fundamental determinants of consumer spending remain favorable, and consumer sentiment is increasingly upbeat.

Housing markets remain very strong even though mortgage rates have moved up somewhat from the very low levels seen at the beginning of the summer. Single-family housing starts jumped to an annual rate of 1.62 million units in October, a record high for this series. Moreover, sales of both new and existing homes have also held near historical highs.

As I noted before, the business sector has been the locus of weakness in this expansion. However, the extreme caution that had been gripping firms now appears to be dissipating.

Real outlays for equipment and software rose at an annual rate of 15-1/2 percent in the third quarter, after an increase of 8-1/4 percent in the second quarter. Moreover, businesses also are hiring again. Private nonfarm payrolls increased at an average pace of about 120,000 per month in September and October, and further declines in initial claims for unemployment insurance suggest that this improvement in the labor market has continued into November. Finally, manufacturing production is perking up. Although light vehicle assemblies have slipped from the very high levels of the summer, production of other goods rose 0.2 percent in September and an additional 0.4 percent in October, reflecting fairly widespread gains across industries.

The sustainability of the recovery will depend importantly on future trends in employment, household spending, and business investment. Twice before in this recovery we have seen short periods of strong growth, followed by a return to sluggish, subpar growth. Given the strength of the incoming data that I have just outlined, the risk that the economy will again stall out must be given a smaller probability than that assigned just a few months ago, but the risk cannot be discounted completely. For example, the strength in consumer spending in the third quarter might prove to be temporary--a one-time surge related to the fiscal stimulus. Indeed, analysts who subscribe to this view would take some solace in the latest data on non-auto retail sales. Under these circumstances, businesses likely would remain very cautious about the demand conditions they expect to prevail in the year ahead. This would make them reluctant to expand and hire new workers--factors that would hold down economic expansion in 2004. While the consensus forecast for next year calls for a growth rate of 4 percent (on a fourth-quarter-to-fourth-quarter basis), which seems reasonable, a weaker outcome than that is not hard to imagine.

Productivity, Potential Growth, and Inflation

One of the most prominent characteristics of this economic expansion has been the rapid gains in labor productivity. Output per hour rose at an annual rate of 4-1/2 percent in the first half of this year and at an extraordinary 8 plus-percent rate in the third quarter. In part, these gains are cyclical and reflect firms' unwillingness, until recently, to expand their payrolls. In addition, the productivity gains have translated into an improvement in businesses' income statements: Real wages have not kept up with the growth in productivity, and with businesses generally reluctant to spend, corporate profitability has improved markedly this year. This development has allowed firms to reduce the debts inherited from the 1990s.

Some slowing in productivity growth from the third-quarter pace is almost inevitable. However, looking beyond the quarter-to-quarter movements, I remain optimistic that we have seen a permanent step-up in the underlying rate of labor productivity growth. As I noted before, businesses have achieved considerable efficiency gains through the information technology that they have installed since 1995. Moreover, as my Y2K example illustrated, I believe companies are continuing to adapt their operations to take advantage of the capabilities of these technologies and are seeing a payoff for these actions in their bottom lines.

The apparent step-up in the underlying rate of productivity growth in recent years implies that the nation's rate of potential output growth--the rate of growth in real GDP that is consistent over time with a stable rate of inflation--has also risen. That's good news because it means that the economy can grow at a faster pace than in the past without generating upward pressure on prices. Moreover, the level of potential output is still well above that of actual GDP, and this output gap is likely to persist for some time even if real GDP grows in

excess of its potential pace.

Finally, let me say a few words about inflation. Although the overall consumer price index has been buffeted by swings in food and energy prices, the core measure that excludes these components has slowed noticeably over the past year. The core CPI is up only 1-1/4 percent from its level of a year ago. This performance means that the U.S. economy has reached effective price stability. That is an achievement that owes to many factors: economic slack, faster productivity growth, stable inflation expectations, and the general public's belief that the Federal Reserve is committed to keeping inflation under control. Moreover, recent research has shown that, as inflation has been brought down over the past two decades, the sensitivity of prices to the level of resource utilization has also fallen. This finding implies that, unlike in past periods, the specter of rising inflation is less likely to haunt the economy as activity improves and the output gap shrinks. Indeed, inflation still seems more likely to move lower than to increase. Under these circumstances, the central bank has the luxury to monitor events before it has to confront the need to return the stance of policy to a neutral position.

Conclusion
In conclusion, the macroeconomic fundamentals seem to be in place for an increase in the pace of economic growth. Although I do not expect a repetition of the extraordinary economic performance of the third quarter, I do expect growth to be sustained. However, this expectation will have to be reexamined periodically during the upcoming period--in light of evolving economic circumstances. Even if the growth is sufficient to make meaningful progress in reducing the slack in our nation's labor and capital resources, that pool of underutilized resources is large and it will take some time to be worked off completely. Fortunately, as the economy has experienced cyclical turns and surprising shocks, it has proved to be quite resilient, and we have benefited from a step-up in productivity that has left the economy well positioned to provide for the long-term welfare of our fellow citizens.

▲ Return to top

2003 Speeches