Remarks by Vice Chairman Roger W. Ferguson, Jr.

At the Twelfth District Community Leaders Luncheon, Federal Reserve Bank of San Francisco, San Francisco, California
April 8, 2004

Macroeconomic Outlook and Uncertainties

It is a pleasure to be with you today to speak about the current state of the U.S. economy. As you know, the economy appears to be engaged in a gradual process of recovery. As has often been the case in previous recoveries, however, the pace and breadth of the expansion thus far have been uneven. In particular, production and aggregate income have increased strongly in the past few quarters, but the labor market has been surprisingly weak. The most recent data suggest that the labor market is improving gradually; but the question of whether this improvement is fundamental and durable will take some time to answer. Although prices for some commodities have risen, underlying consumer price inflation only now looks to be stabilizing at a low level after falling for some time. In the remainder of my time with you today, I will first sketch more fully some of the recent developments in the economy and what I believe to be the most likely path forward. Then I will discuss two uncertainties regarding that outlook that have garnered attention lately--namely the possibility that the labor market will continue to underperform and the possibility that financial stress in the household sector may cause the expansion to falter. As I will discuss in greater detail shortly, it seems to me that the evidence suggests that while neither risk can be ruled out, nor is either likely to come about. That said, of the two, the greater concern for me is the future performance of the labor market. As always, the views I will be expressing are my own and do not necessarily represent those of other members of the Board of Governors or the Federal Open Market Committee.

Recent Economic Developments
For the most part, the past year has been one of continued recovery in the U.S. economy. After averaging just 2-1/2 percent at an annual rate in the first half of last year, the pace of real GDP growth surged to more than 6 percent in the second half. For 2003 as a whole, the pace of growth was the fastest since 1999. As has been the case for some time, households in 2003 provided considerable impetus to the economy. Supported importantly by last summer's tax cuts, low interest rates, and rising household wealth, consumer spending continued to trend up, while low mortgage rates have kept both home sales and new housing starts close to record highs.

In addition, the economic environment now seems more conducive to business investment. For much of the past three years, businesses were reluctant to invest in new capital equipment. At first, the downturn in investment seemed to be a reaction to what in hindsight appears to have been a substantial overinvestment in high-tech equipment in the late 1990s. As business investment subsequently lagged the improvement in household spending, however, a marked degree of caution seemed to settle on the business community. This caution--which appears to have had its roots in the uncertainty associated with terrorism, geopolitical risks, and a wave of corporate governance scandals--induced firms to focus on restructuring rather than expanding their operations, and it left them quite hesitant to

increase their investment outlays.

By the middle of last year, however, firms were beginning to boost their capital spending. And, in the second half, real fixed investment rose more than 10 percent at an annual rate, the fastest two-quarter rate of increase since early 2000. To be sure, a sizable portion of the recent strength in investment has been for high-tech equipment, and much of it probably reflects replacement of outdated machines rather than an expansion of existing production capacity. However, spending on other types of equipment now seems to be picking up as well, and the caution that had previously restrained capital spending seems to be in the process of lifting.

Against this backdrop, inflation has remained quite low despite some sizable increases in energy prices. Overall, the consumer price index increased 1.7 percent over the twelve months ending in February, while the core index--which excludes the volatile food and energy components--increased only a little more than 1 percent.

Outlook and Labor Market Uncertainties

The consensus in the forecasting community is that GDP growth will not continue at the 6 percent pace posted in the second half of last year. But, with interest rates still quite low and fiscal policy generally stimulative, most forecasters are projecting relatively robust gains in output for the coming year, with ongoing increases in both household and business spending.

Continued strong economic expansion seems to me, as well, to be the most likely outcome. Nonetheless, the economic outlook still bears some important uncertainties, two of which I would like to focus on today. The first relates to the labor market. As has been widely recognized, one notable shortcoming of the current expansion has been the dearth of job creation over the past two years. Last week's report that employers added 308,000 workers to their payrolls in March was encouraging and may signal that the recovery in the labor market is gaining traction. Even so, the level of private employment remains more than 500,000--or 1/2 percent--below that at the trough of the recession in November 2001. The weak performance of the labor market over this period has been quite unusual by the standards of past economic recoveries, and, indeed, it is even weaker than during the infamous "jobless recovery" of the early 1990s. For example, employment rose about 2 percent in the twenty-eight months following the 1990-91 recession. And, in the other seven post-World War II recoveries, employment growth averaged more than 8 percent over a period of comparable length.

Economic forecasters' consensus is that, as the expansion matures, employment will continue to improve sufficiently to make noticeable gains in the utilization of labor resources. I judge that to be a reasonable assessment. Nonetheless, one cannot definitively rule out the possibility that hiring will fall short of expectations over the next several months as it had up until the most recent report. In particular, the lackluster performance we have seen in the labor market, even as real GDP has been moving up strongly, raises the question of whether an unusually large portion of the job cuts implemented by firms in recent years represent permanent layoffs that will only gradually be offset by job creation elsewhere in the economy.

A number of hypotheses have been put forth as potential causes of the generally disappointing performance of the labor market, and, indeed, it seems likely that several factors have contributed to the shortfall in hiring. But any meaningful explanation must account for the surprising strength in productivity growth in recent years. In particular, labor productivity in the nonfarm business sector rose 4-1/4 percent in 2002 and nearly 5-1/2

percent in 2003, the largest back-to-back increases since the early 1960s.

Let me review the major hypotheses advanced to explain labor market developments. One possibility is that the same factors that induced businesses to take an unusually cautious approach to capital spending also influenced their willingness to add new workers. If so, then some of the surprising weakness in employment growth and some of the strength in productivity may have reflected a tendency by employers to stretch their existing work forces beyond a level that is sustainable in the longer run. The sizable increase over the past year in employment at temporary help agencies--another potential margin of adjustment for firms unwilling to take on permanent employees--is consistent with this view. And, further supporting this hypothesis, one hears reports of longer hours worked by many white-collar and nonproduction workers.

If this hypothesis is correct, then the recent strength in business investment bodes well for an upturn in the labor market if the pickup in capital spending is an indication that businesses have become more optimistic about the future course of the economy. Indeed, according to this hypothesis, the improvement in hiring could be rapid as businesses respond not only to further increases in output but also hire to alleviate the growing strains on their more experienced workers.

The chief argument against this story is that the combination of a weak labor market and strong productivity growth has been ongoing for quite some time. And it certainly seems possible that a portion of the extraordinary productivity growth of recent years represents a permanent increase in efficiency. According to proponents of this view, some of these productivity improvements may have resulted from firms' focusing on restructuring and cost-cutting in ways that provide ongoing efficiencies. They may have been able to do so, in part, because they have realized a delayed efficiency payoff to the substantial investments in high-tech equipment in the late 1990s. Regardless of its source, however, the possibility that some of the productivity improvement--and some of the job cuts--of recent years are permanent suggests that the weak labor market may, in part, be associated with an increase in the economy's potential output. This possibility implies that a given rate of increase in GDP may be consistent with a more gradual pickup in hiring than in the preceding scenario.

Finally, a couple of other influences probably damped hiring somewhat but seem unlikely to have been major factors. For example, the recent sizable increases in health insurance costs and in pension costs are cited by some as a reason for businesses to avoid hiring new employees. In the aggregate, however, health insurance costs represent only about 6 percent of overall compensation costs, and many firms seem to have responded to these higher costs by reducing increases in either wages or other parts of the benefits package. Similarly, although a number of corporations have had to make sizable contributions to underfunded defined-benefit pension plans, the shrinking share of workers covered by these plans suggests that such contributions probably have not had a material affect on hiring decisions. Moreover, during the second half of the 1990s, when pension plans were overfunded and, in many cases, improving the bottom lines of firms, one rarely, if ever, heard anecdotes suggesting that low pension-funding costs were boosting employment.

Other observers have pointed to the outsourcing of production abroad as a reason for the weakness in the labor market. Again, however, the magnitude of this phenomenon seems too small to explain more than a small part of the decline in employment over the past two years. Private-sector estimates of outsourcing are on the order of 1 percent of the gross job losses that occur each year. Moreover, because outsourcing abroad represents a shift of both

production and labor input to a foreign country, outsourcing is probably not a major explanation for our recent history of elevated productivity growth.

What does all of this imply for economic policy? In the short-term, the weakness in the labor market reflects a shortfall of aggregate demand relative to the economy's potential, which is an important part of the rationale for the currently accommodative stance of monetary policy. The real federal funds rate is now close to zero, and market participants expect it to remain near that level for a while. Obviously, we monetary policy makers will have to determine the degree to which the improvements in the labor market signaled in the most recent report indicate that the economy is meaningfully closing the gap between aggregate demand and the economy's productive capability, and the pace with which that gap is being narrowed. As I said earlier, it will take some time to make that determination. But we also have to recognize that maintaining the current level of the funds rate for too long will eventually result in an unwelcome increase in inflationary pressures.

In the longer run, it is important that we as a society recognize the considerable economic benefits associated with sustainable increases in productivity and intensify our efforts to ensure that as many individuals as possible profit from the substantial productivity gains associated with innovation and increased competition. Unless we do so, the support of the population for flexible markets, technological change, and free and open trade--so crucial to the ongoing improvement of our standard of living--will erode further.

In my view, the best long-run response to the inevitable turbulence of a dynamic market economy is to increase our investment in the education and skills of the workforce. An improvement of this type would pay handsome dividends in many respects--allowing not only workers who retain their jobs to be more productive and earn higher wages but also allowing those who lose their jobs to gain reemployment in more stable jobs with less loss in earning power.

With experienced workers, society's challenge is to provide opportunities for those adversely affected by economic change to build on their previous work experience and to retool their skills to meet the changing requirements of the economy. An important source of such opportunity has been our community colleges, which have experienced sizable increases in enrollments since the early 1970s, particularly among adults. In addition, many four-year public colleges and universities now offer programs specifically tailored to the schedules of adults, many of whom are attempting to balance part-time schooling with family and work responsibilities. For our future workforce, we must ensure that our educational system is adequately equipping students with the greater skills demanded by employers operating in an increasingly complex economy.

I do not have the answers to these educational challenges. But I do know how important it is that we address them. And given our successes in the past, I am confident that we can.

Financial Health of Households

Let me now turn to a second important uncertainty in the outlook--namely, the financial health of U.S. households. As I mentioned earlier, a key element in the current cyclical expansion has been robust spending for consumption and housing. An oft-expressed concern has been that many households have become overextended, will eventually have to cut back on spending, and in doing so may short-circuit the expansion.

It is easy to see the basis for this concern. First, consider the rise in household debt. Relative to disposable income, debt has been hitting record highs annually since 1993. Indeed, with

house prices rising rapidly and interest rates at historically low levels, mortgage borrowing surged 12-1/2 percent in each of the past two years, twice the rate of growth of disposable income. Meanwhile, the personal bankruptcy rate, although relatively stable in recent quarters, is still near its record high.

Despite these ominous sounding numbers, and while remaining alert to the possibility of more acute financial distress, I believe that, in the aggregate, households fundamentally are in good financial shape. Even with the heavy borrowing they have undertaken, households have kept their debt-payment burdens in check. At the aggregate level, one can evaluate debt burdens in two ways. One measure is the debt service ratio. The numerator of this ratio is the minimum payment required on mortgage and consumer debt--for example, car loans, student loans, and credit card debt--and the denominator is after-tax income. The debt service ratio captures such things as the effects of changes in interest rates, loan maturities, and loan demand on the debt obligations of households.

A somewhat broader measure--and one that the Federal Reserve has only recently introduced--is the financial obligations ratio. This measure adds required payments on rent, auto leases, homeowners' insurance, and property taxes to debt service. This broader measure recognizes that both homeowners and renters have fixed financial obligations, and it recognizes that there is no essential difference between payments for an auto loan and those for an auto lease. Moreover, unlike the simple ratio of debt to income, both the debt service ratio and the financial obligations ratio have receded slightly, on net, from their respective peaks. Similarly, delinquency rates for a wide range of household loans turned down over the second half of 2003.

Those who are most concerned about the macroeconomic consequences of household debt argue that although these measures of financial stress have stopped getting worse, they still are at very high levels by historical standards; the risk, they argue, is that the household sector could be quite vulnerable to an adverse shock. This is a legitimate argument, but other factors limit my concern about this possibility. First, most debt is held by households that also have substantial assets. Indeed, according to the 2001 Survey of Consumer Finances, 96 percent of total debt is owned by households with positive net worth--that is, assets greater than their liabilities. Moreover, looking at the question from the perspective of the **number** of households, fully 90 percent of all households in 2001 had assets greater than their liabilities.

Even if one disaggregates these numbers further and focuses on the amount of debt held by lower-income households or by households particularly vulnerable to an adverse shock, the numbers are relatively small. For example, households in the lowest fifth of the income distribution hold only 3 percent of all household debt. Widening the scope to the entire lower half of the income distribution, these households have only about 20 percent of outstanding debt. In other words, 80 percent of debt is held by households in the upper half of the income distribution, and these are households that also hold substantial assets.

Reflecting these debt patterns, the bulk of the available statistical evidence suggests that adverse movements in broad indicators of household financial health do not have much incremental predictive power for overall consumer spending. In essence, the research says that--after taking account of current and expected income, wealth, and interest rates--debt burdens, delinquency rates, and the like do not provide significant additional value in explaining movements in consumer spending.

Some commentators have argued that the real fragility in the system will be exposed when interest rates return to more-normal levels. According to this argument, higher rates will boost required monthly payments, which in turn will lead to a jump in loan defaults, severe strains on financial institutions, and a sharp cutback in household spending.

It is important to recognize, however, that an increase in short-term interest rates does not automatically increase household debt payments across the board. A rise in rates will indeed increase borrowing costs on new credit extensions. However, most outstanding debt will not be affected by changes in the federal funds rate because the majority of mortgages carry a fixed rate, as do the bulk of other loans to consumers. Moreover, as short-term rates rise, households will take out smaller loans or take out loans with longer maturities. And households will trim their borrowing, preferring in some instances to pay for purchases with cash instead of credit. The empirical evidence suggests that, in the face of rising interest rates, households curb their use of debt enough to almost entirely offset the higher average cost of debt, leaving debt burdens little changed.

Another factor that tempers my concern is that interest rates will rise from their current low level only when the economic expansion is on more solid footing. Thus, while households very likely will, at some point in the future, face a higher cost of credit on new borrowing, they will also be undertaking that new borrowing against a backdrop of greater job security and continued strong growth of incomes. That said, if the increase in rates crimps spending more than anticipated, I can assure you that we will move once again, as we have done consistently throughout this cyclical episode, to provide appropriate support to the economic expansion.

Clearly some households have become burdened with excessive debt and may face considerable financial stress should their income become disrupted. Indeed, in order to help households like these acquire the information they need to make good financial decisions for themselves and their families, the Federal Reserve System in 2003 initiated a national campaign to raise the visibility and highlight the importance of financial education. But financially overextended households represent a small fraction of the total economy, and at the macroeconomic level, financial distress in the household sector seems unlikely to cut off the expansion.

Conclusion

Overall, the macroeconomic outlook for the United States is favorable. Over the past year, the economy has made considerable progress: Aggregate income is growing rapidly, business investment has begun to recover, the stock market has rebounded, and interest rates and inflation remain very low. To be sure, there are uncertainties regarding the outlook. While my concern about the labor market is somewhat alleviated by the most recent data, it remains at the top of my list. Another important uncertainty is the possibility that an adverse shock will expose an underlying weakness in the financial condition of households. But, I believe the economy most likely will steer clear of substantial damage from this source.

▲ Return to top

2004 Speeches