

## Speeches

### Look to the Long Term

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I've decided to organize my thoughts today a bit differently than I have in the past. First, I'd like to look back briefly at the year we've just come through and tell you what I think were the most remarkable, and most important, developments of 2003. I'll then turn to the year ahead and share some thoughts as to what I think will most significantly shape the economic outlook. And finally, speaking for myself, I will share as much as I can about my thinking on monetary policy.

#### **2003 in review**

Let's start with 2003. Overall, I think we have to be pretty pleased with the strength and the breadth of the economic expansion we had over the last half of the year. Although fourth quarter performance is still being counted, it looks like GDP growth in 2003 was similar to the growth seen during the record-long expansion of the 1990s. But it was a very uneven year, both across the four quarters and by economic sector. There are lots of ways to think about these last 12 months, but I want to discuss what I view as the three most significant developments of 2003.

The first is consumer spending, which accounts for about 70 percent of GDP. This time last year, and throughout 2003, I was saying that I thought consumers would "hang in there" and push spending steadily higher. Looking back, however, I have to admit I probably underestimated the sheer resilience of consumer spending and especially its strength in the face of weak employment growth.

Tax cuts and low interest rates certainly helped put extra cash in consumers' pockets last year. But it was hard to forecast what consumers would do with the money, how much they would spend or save, or the ultimate impact on the economy. Now, we can look back and see that these highly stimulative policies led to a powerful chain reaction in the economy. Consumer spending surged nearly 7 percent during the third quarter, and GDP roared ahead at more than 8 percent, the highest quarterly growth rate in more than 20 years.

The second remarkable development last year, in my mind, was the way businesses continued to cut costs, in wave after wave, as they strived to become more efficient and maintain profitability during a period of sluggish revenue growth. As you'll probably recall, the National Bureau of Economic Research declared that the recession officially ended in November 2001. But for many businesses, anemic growth extended through 2002 and into 2003. Many firms are just now beginning to emerge from a difficult period when some of them did well just to survive.

Over this time, business leaders had immediate concerns. Think about a ship at sea in a sudden and violent storm. The captain is not worried about the long term while the ship is pitching and rolling and taking on water. The captain is focused on keeping the ship afloat. And it's only after the clouds lift and the seas calm that a view of the horizon emerges.

Given the rough waters during and after the recession, it should come as no surprise that many businesses changed course by radically altering plans and slashing overhead. Business leaders became extremely risk averse, and it seems many businesses began to subscribe to a new culture of efficiency. As they cut, many businesses discovered that they had far more excess than they had realized.

But this relentless pursuit of efficiency has a human cost. The rate of job destruction last year was quite intense. And, despite some recent gains, the job market remains tough. I think this employment squeeze and aggressive cost-cutting also were remarkable because they led to a great deal of angst and unease, casting a shadow even as the economy gained momentum.

While all of the knife wielding certainly has been painful, I think it has positioned many businesses to compete even better in today's extremely demanding economy. And I would cite this renewed vigor in the corporate sector that has now emerged as a third important economic development of 2003.

As the year unfolded, many businesses became not just more efficient but more effective. More businesses reported higher profits in 2003 compared with the prior year. As the year progressed, revenues also started to increase as firms moved to capitalize on new opportunities and growth.

New confidence on the business front began to surface noticeably last spring with the end of major combat in Iraq. Businesses began to purchase new equipment, financed mostly through retained earnings. Much of that renewed investment spending went to pay for new computer hardware and software geared to make operations more efficient. But in business areas experiencing revenue growth, we also began to see other investments to prepare for longer-term expansion. Admittedly, real business investment remains below the peak levels of 2000, and corporate borrowing remained tepid until late 2003. But my sense is that the pace of business spending overall has clearly picked up. The good base of efficiency and profitability that has been achieved should engender more growth and more spending — and in the long run more jobs.

#### **The year ahead**

Now, just because we've turned the calendar doesn't mean we can put to rest the economic forces that were so important in 2003. Indeed, I expect many of the same factors I just cited from 2003 to be pivotal in the year ahead. But before I delve into the outlook, I'd like to tell you up front that I am very comfortable with mainstream forecasts of 3-1/2 to 4 percent GDP growth in 2004. As I've already suggested, we came out of 2003 with growth that appears to be spreading across sectors, including travel and tourism, business services and even manufacturing. And it looks like the stalwarts of housing, healthcare and education will keep chugging along as well.

So, although I think strong and broad-based growth is the most likely course for the economy in the new year, I'd like to frame my thoughts on the year ahead by posing several questions that I think are key to the economy in 2004.

The first is, Will the brisk pace of business spending continue?

The answer, I believe, is yes. As we move past the storms, most managers in 2004 are now positioned to plan for future growth. And with more confidence and more efficient operations, I expect business managers to make more long-term investments.

Spending on equipment and software has grown for six straight quarters, surging at an annual rate of 18 percent in the third quarter. As old equipment depreciates and new businesses come on line, I expect this tide of business investment will carry forward and the nature of the spending will become increasingly broad and sustainable.

I want to emphasize this return of business confidence and spending because it was the collapse of capital spending in late 2000, as much as anything else, that put us on a recession course. It's encouraging to see such spending coming back because business spending is crucial in nearly all forecasts for strong growth in 2004.

And that brings to mind my next question: Will consumer spending continue to grow?

I think the answer here is yes, also, but perhaps at a more modest pace than in 2003. As background, I would point to some analysis done by our Atlanta Fed staff. They observe that about 40 percent of GDP growth in the eight quarters since the trough of the recession in 2001 came from interest rate-sensitive consumer spending. That figure includes autos, homes, furniture and other durables. This proportion of growth is substantially higher than observed during other recovery periods since 1960.

Certainly, low interest rates have helped many households borrow more money and keep up their rate of spending even as employment has sagged. Following a recession, debt levels typically decline as incomes increase, and, indeed, household debt service levels have eased a bit since 2001, when they were at historically high levels. I would expect household debt to moderate some more as growth occurs and incomes increase in the quarters ahead.

Housing is another important component of GDP. Housing held up during the recession and has grown at an impressive rate since 2001. With low interest rates, many consumers have been able to not only buy a first house or to move to a higher-priced home but also to refinance at lower rates. Home price appreciation and the extraction of equity through cash-outs have supported other consumer spending. Overall, housing demand looks solid for 2004, especially in growing areas like the Southeast. That's because housing is supported by long-term fundamentals such as favorable demographics and rising incomes. But as mortgage rates edge higher, as they likely will at some point, the short-term spending induced by historically low mortgage rates will probably wane.

Sustained consumer spending will depend to a large extent on the answer to my third question, which is, Will labor markets gain further momentum in 2004?

The good news for hiring is that business spending is picking up. I'm encouraged that businesses are stepping up their investments for the future, and I think it's likely the new equipment that's coming on line will require more people eventually to produce, install, manage and operate it.

The bad news is the economy has a lot of catching up to do when it comes to employment. There are still more than two million fewer jobs than there were at the start of 2001, and there are some 700,000 fewer jobs than there were at the end of the recession. The economy must add jobs at a more rapid rate, not just to make up for the losses, but to provide work for the continuous stream of new people who enter the labor market, about 120,000 on average each month.

Labor markets and the demand for skills continue to adjust to the new culture of efficiency that I mentioned earlier. Relentless innovation — the cost of doing business in today's economy — has altered employment with regard to productivity. Simply put, businesses have been able to do more with less.

Estimating future productivity gains, however, is difficult. It is reasonable to expect technology and better management processes to yield further productivity gains. But it is important to remember that job creation and job destruction is an ongoing process in our free market economy, one that takes place even during periods of strong economic growth.

Although it may be tempting in the short term, I suggest we try to resist calls to insulate specific sectors of our economy from change and risk. I believe such an approach for the United States would be extremely shortsighted. Our nation's capacity to innovate and redeploy labor is a huge competitive advantage, and it would be a shame to squander it. While I think it's good public policy to invest in helping workers learn new skills and adjust to changes, I think we should be wary of policies that could wind up inhibiting the long-term job creation that goes along with short-term job destruction. I do not expect us to fall into this trap, but I think we need to continually remind ourselves to watch for the dangers of unintended consequences.

To recap, 2003 was a pivotal year as business spending joined with consumer spending to help lift the economy out of the doldrums. For 2004, the brisk pace of consumer spending could decrease a bit as fiscal stimulus eases and households are more careful about adding to their debt. But, in many ways, the economic expansion is, and should continue to be, more broad based and resilient this year as growth continues to expand across industries and as labor markets improve.

#### **Reflections on monetary policy**

When I began my remarks, I said I would share my personal thinking on monetary policy. In many respects, my focus as a policymaker has not differed from that of business leaders. I am among those who believe that while monetary policy should be anchored in clear, long-term objectives, it can and should be used to cushion short-term economic swings. Like the adjustments that are made by those on the bridge of the ship in a bad storm, the Fed began in early 2001 to recalibrate monetary policy to the rough seas around us.

What has been somewhat different in this economic cycle from others in recent decades is low inflation and low inflation expectations. With prices stable, the Fed was able to aggressively ease policy through 13 separate easing actions that moved the fed funds rate from 6-1/2 percent in late 2000 to the very accommodative rate of 1 percent that is still in place today.

Given today's global economy and complex financial markets, some have questioned the efficacy of monetary policy and its linkage to longer-term interest rates. But in response I would point again to the huge role that housing and durables played over the last several years. Spending in these interest rate-sensitive sectors, spurred by low rates, was vital in keeping the 2001 recession relatively mild and reasonably short.

Now, I'm not in the business of speculating about future monetary policy actions or the direction of interest rates. That's what our Federal Reserve FOMC meetings

every six to eight weeks are all about — continually updating and refining our longer-term forecast to take account of how things are unfolding. These regular meetings provide an opportunity to review new data and to share grassroots information from across the country. That process helps us develop the best possible view of what's likely ahead and to make informed decisions on the timing and direction of future monetary policy changes.

Certainly, our current policy is very accommodative. One indication of that is the real funds rate, which is simply the nominal rate minus the current rate of inflation. The real funds rate is now at, or even below, zero, which means money is very cheap. If the economic expansion continues to build momentum and breadth, it will be appropriate at some point to bring policy back to a longer-run setting that is more consistent with noninflationary, sustainable growth. That's what central banking is all about.

Again, we are reaping the rewards of price stability. And most measures of inflation expectations clearly suggest that financial markets and decision makers expect us to do what we can and should to hold onto those gains if they are threatened. Now, at the risk of disappointing some folks who might wish to profit from advance hints about the exact timing of future monetary policy changes, I would suggest that the timing of policy actions should not hinge on "calendar time," but rather "economic time." Given the forecasts we have at this time, I want to emphasize that I see little threat that inflation is poised to rise significantly.

One reason most forecasters are not expecting a quick turnaround in the inflation outlook is the considerable amount of so-called slack that is judged to exist in many product and service markets. And today we have to think in terms of world capacity and world slack. Slack means that there are no shortages of plants, equipment or labor, and this unused capacity helps stabilize the price of output from these resources. But what complicates this way of thinking is the great difficulty of measuring the actual amount of slack. As we've seen, this measure can change quickly as some excess capacity is determined to be economically obsolete and closed down or written off. But how quickly current slack will be absorbed, or taken out of the market, depends upon both the rate of growth of final demand and technological developments.

As I wrap up my thoughts today, I want to stress my view that it's our role and responsibility as monetary policymakers to make sure we keep sight of the longer run. The Fed's mandate is to use monetary policy to help sustain long-term, noninflationary economic growth, which in turn serves our other policy goals of job creation and an improved standard of living.

This time last year, it wasn't clear how quickly we would get back on a course toward those broad goals. The economic outlook was murky and confusing. But during 2003, I think the fog began to lift. Especially over the past few months, there have been more and more signs that growth is gaining strength and has become more broad based. Today, I hope I have conveyed to you my sense that the economy is now moving in a good direction. 2004 should be a good year. Thank you for your attention.

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