## Speeches

# Growth in a Time of Low Interest Rates

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I'm honored to speak to a room full of the top real estate folks in Atlanta. You're a special group because, without your vision, creativity, and risk taking, the Atlanta area would not be what it is today. The Atlanta real estate market is one of the nation's 10 largest, with well over a half million square feet of office and industrial space. As you well know, commercial real estate, perhaps more than almost any sector of our economy, is subject to wild swings — from great booms to painful adjustments. And I know there's a lot of vacant space out there now. But in a popular and growing place like Atlanta, your investments serve a larger purpose. The abundance of quality real estate in this market is a big draw for businesses that are willing and able to relocate and make Atlanta their new home.

I'll come back to real estate during my remarks, but I think you would agree that an expanding and vibrant economy is key to ensuring that your industry can continue to grow and prosper. My plan this evening is to share with you my outlook for the U.S. economy, and, speaking for myself as a participant on the Federal Open Market Committee, I want to discuss the role of monetary policy in helping to reach our broad goals for the economy in this time of unusually low interest rates.

**2004 economic outlook**

This is an opportune time to talk about the economy because, two months into 2004, there now appears to be a clear pattern of solid and sustainable growth. According to the latest available numbers, 2003 turned out to be a decent year, economically speaking, with year-over-year gross domestic product growth (GDP) of about 4.3 percent — better than the average rate during the expansion of the 1990s.

Probably the most important economic story of 2003 was the resurgence of business investment spending in the second half of the year. While the consumer continued to carry us in the first six months, spending on equipment and software in the second half rose sharply, at double-digit rates. Capital investment registered a nice gain of about 7 percent for the year overall, and equipment and software increased about 10 percent.

While last year's economic momentum appears to be carrying forward, I expect the composition of growth to be somewhat different in 2004. Residential investment and spending on durable goods — cars, refrigerators, furniture and other kinds of items that are sensitive to interest rates — shouldered a disproportionately large share of last year's overall growth. And it's clear that low interest rates, tax cuts and tax refunds helped to fuel aggressive spending by households. While I see no reason to expect a sharp falloff in housing and durable goods spending this year, I don't think we can expect to see these sectors continue to grow at some of the rates we saw last year.

But early indications are that business investment spending will grow stronger this year and begin to account for a larger proportion of overall growth. Renewed business investment is vital because it plants the seeds for future growth in output and employment. The key to a surge in investment spending lies in corporate profits, which are the major source of funding for investment.

Corporate profits increased in recent quarters — growing 21 percent and an estimated 28 percent year over year in the third and fourth quarters of 2003, respectively. Analysts at First Call are estimating an increase of about 14 percent year over year during the first half of 2004. Businesses have been more profitable in large part because they cut costs relentlessly and in many industries have worked off much of the excess capacity that developed in the 1990s. But more recently there are increasing signs that demand growth is beginning to contribute importantly to profits as well.

You'll recall that rising business investment spending in the latter half of the 1990s spurred the acceleration of growth in output and employment. With that investment also came acceleration in productivity growth that has been extraordinary by historical standards. What is unusual is that productivity growth picked up during the recession and continues to accelerate today. Since 2000, productivity increased an average of about 4 percent per year. To put this in perspective, productivity gains averaged about 3 percent during the 25-year period from 1948 to 1973 and then fell to 1.4 percent over 23 years between 1973 and 1996. Productivity gains between 1996 and 2000 were 2.6 percent, still well short of what we've seen lately.

Rising productivity ultimately leads to a higher standard of living, but it also helps explain the slow progress we've made on the job front so far. As output per hour increases, there is less pressure to add to the workforce.

Although the 2001 recession was largely a story of the pullback of business investment, which includes technology and software spending, I must say that I'm encouraged by the recent trends of business spending. Businesses over the last two quarters have poured money back into operations in a way that suggests they have not forgotten how to plan for the future and that the entrepreneurial spirit is still very much alive and well.

**Looking for job growth**

While businesses have become aggressive when it comes to upgrading machinery, they've been cautious when it comes to human capital. I think the biggest disappointment in our still unfolding economic recovery remains job growth. Growth in employment has historically lagged an upturn in the economy coming out of a recession, and we clearly saw that trend after the previous recession in 1990–91. But this time the lag is turning out to be even longer. The payroll numbers turned positive in September 2003 and held that positive tone through the end of the year. But the U.S. economy managed to add an average of little more than 60,000 new jobs per month over the last four months of the year.

Because we typically average 120,000 to 150,000 new entrants into the job market each month, we'll need monthly gains to exceed those numbers before we begin to replace the jobs lost since 2001. My own view is that job growth will pick up in coming months, and the unemployment rate will continue to drop. At the same time, I don't foresee a dramatic slowing of productivity gains, and therefore I expect that businesses may add new employees at a pace somewhat less rapid than in other recent cycles.

Despite the uncertain pace of job growth, there's evidence that businesses are feeling more pressure to expand payrolls. On top of continued strength in consumer spending and renewed vigor in business capital spending, we're starting to see rebuilding of inventories — a sign of expanding final demand. Exports also appear poised to grow further after a strong fourth quarter. The economies of many of our trading partners are now improving nicely. Overall, I think 2004 will be a good year.

**The role for monetary policy**

One of the main reasons I'm optimistic about the outlook for the economy is low inflation. Low inflation ushered in the era of high productivity growth in the 1990s that I mentioned earlier, and it continues to drive innovation in subtle ways. For example, low inflation allows firms to focus on long-run projects, raising real returns because investments are allowed ample time to bear fruit. One of the Fed's goals with regard to inflation is to remove it as a factor in the economy so that you don't have to think about it or adjust your plans because of large and unexpected changes in inflation or interest rates.

In theory, monetary policy works best when it stays out of the way of the real work of building and growing our economy. But as a practical matter, monetary policy sometimes can help to ease the adjustment process.

I'm sure you remember the Fed intervened aggressively beginning in 2001. There were 13 policy-easing moves in all that brought the fed funds target rate from 6-1/2 percent in mid-2001 to its present and unusually low rate of 1 percent. The evidence is pretty convincing that these actions helped measurably to ease the pain of a weak economy. Lower interest rates have undoubtedly bolstered interest-sensitive sectors like housing and consumer durables. And the strength in those sectors helped to keep the recession, at least as measured by GDP growth, both short and shallow.

In large part, the Fed was able to ease policy decisively because of low inflation. For the past two years, core inflation has declined consistently to where it now hovers just above one percent, at the lowest rate since the 1960s. In contrast to the erratic and troublesome inflationary period of the 1970s, our economy now has a track record of stable prices. The general expectation is that low inflation will continue because the Fed is perceived to be committed to a long-term policy of price stability.

Monetary policy has been accommodative for a while. While we've seen how accommodative monetary policy can cushion the downside of an economic cycle, it will be appropriate at some point to get back to a more neutral policy setting consistent with an expanding economy. The steep interest rate cuts of 2001 and 2002 were not neutral monetary policy; rates were reduced in response to a substantially weakened economy. As the economy returns to more normal rates of growth, interest rates will adjust in response to more robust conditions.

Put another way, just as I don't want concerns about future inflation to play a major role in business decision making, I also don't want businesses to build their plans on expectations of a continuation of accommodative monetary policy without regard to prospective economic conditions.

Following our last FOMC meeting, our statement said, "With inflation quite low and resource use slack, the committee believes it can be patient in removing its policy accommodation." Because of low inflation and low inflation expectations, the FOMC has more leeway in calibrating monetary policy. Yet as rates remain low and I think about the future path of policy, I remind myself it is also important to watch for unintended consequences of keeping monetary policy too accommodative for too long.

I think it might be helpful to describe the monetary policy situation in medical terms. When a patient is seriously ill, the situation may call for prescribing a strong dose of medication. As the patient begins to recover, however, there is a need to recalibrate the dosage or to stop prescribing it entirely to avoid potential side effects.

The same concerns apply to monetary policy. A prompt response to the possibility of an economic downturn, such as the FOMC made around the time of the onset of the 2001 recession, was appropriate. But just as a doctor shouldn't overmedicate the patient, one always should be sensitive to the potential for unintended side effects of maintaining an accommodative policy for too long. Put differently, if my forecast for robust economic growth materializes, then, at some point, a fed funds rate of 1 percent will no longer be the best policy.

At the risk of bringing this caution closer home to you and your businesses, let's think about commercial real estate. Coming off the building boom of the late 1990s, the economic downturn in 2001 was an unpleasant surprise. Office vacancy rates in the Atlanta area swelled to well over 20 percent as businesses began to slash payrolls and emptied large amounts of office and industrial space.

As it happened, low interest rates eased carrying costs and encouraged ongoing investment despite the high vacancies. I expect the Fed's accommodative policy is popular with many in this room, but some in your industry have stressed to me that at some point it will be appropriate, and helpful, to allow interest rates to return to more normal levels so that the market sorts itself out in an orderly way and returns to balance. As I said earlier, I want to avoid a situation where businesses begin to assume that policy, which was put in place to deal with a temporary economic circumstance, mistakenly becomes incorporated into business planning as the normal policy environment.

Another example strikes even closer to home for me. My son, Mike, after some terrific years with Charlie Brown and Rick O'Brien in commercial real estate development, moved into residential development in 1997. If I think about the six years Mike has now been in residential development, I realize he has not seen a downturn in the business and in fact has been riding the wave of low mortgage rates and historical rates of home building. As you might guess, Mike and I have had some interesting father-son talks about the seductive lures of such an extraordinary period. I think, at least I hope, Mike understands that, as rates move back to more typical levels at some point, some part of his business may be vulnerable — that part induced by temporarily low rates alone. I hope he and others in the business have not assumed in their long-term business plans that this extraordinary period will continue indefinitely. And let's hope they are not creating new pockets of excess capacity that will have to be worked off as conditions return to normal.

**Getting to balanced growth and reasonable expectations**

I began my remarks with what I intended to be an optimistic 2004 outlook for the U.S. economy. And I've shared my views as to why we have good reason to expect more balanced growth and a sustainable period of expansion in the quarters ahead. I've addressed the role of monetary policy in cushioning a recessionary period and have cited the evidence that low rates have worked well in this economic cycle. I've also suggested it is important to eventually return to more normal interest rates as the economy gains strength.

Perhaps most importantly, I've tried to emphasize that low and stable inflation, and the dynamic business climate it engenders, has fueled many of the gains that we've enjoyed, from high productivity to continued strength in housing.

It is indeed a luxury to have an inflation environment in which policymakers can be patient in ensuring the economy has gained a solid footing. That said, luxury comes with a price tag, and patience is not unlimited. The old truism that "there's no such thing as a free lunch" applies today, as always.

The same advice I mentioned earlier to my son Mike I think applies to all of us — as individuals, business leaders and policymakers. I suggest we keep our heads up and follow a path that leads to the best outcome over the longer term.

Press release text


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