

Speeches

Sustainable Growth and Monetary Policy

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Thanks, Steven, for inviting me here this morning. I'm especially pleased to speak in an academic setting, at the Center for Banking at East Tennessee State University. Standing here this morning I find myself reflecting back on my college days, which, as Steven just mentioned, were spent just up Interstate 81 in Blacksburg, Virginia. I can remember the excitement and, yes, the anxiety that those of you who are students may be experiencing as you get ready to start your careers.

After the record long period of economic expansion in the late 1990s, the U.S. economy went through a "soft patch," to borrow a phrase from Fed Chairman Alan Greenspan. For the past few years, manufacturing job losses have been especially hard on many areas, including yours here in east Tennessee, where offsetting jobs gains have been somewhat slow to materialize. But the U.S. economy is now improving and changing, with new opportunities emerging, particularly in banking, finance, health care and other service industries.

To the students here who will soon be joining an increasingly global workforce, I would suggest it's a good idea to stay flexible and build your career for the long term so that you're able to adjust to the inevitable changes that will come along over the course of your career. No matter where you go, I'm sure you'll find the investment you've made in your education will pay off immeasurably.

I understand some business people also are here this morning. Whether you're a student preparing to enter the workforce or you're sitting across the desk as an employer, one of the things we all have in common is the importance of understanding the economic environment we face together. My plan over the next few moments 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 say a few words about 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 assess the economy. We're nearly three months into 2004, and there now appears to be a clearer pattern of solid and sustainable growth. According to the latest available numbers, 2003 turned out to be a pretty good year, economically speaking, with year-over-year gross domestic product growth (GDP) in the fourth quarter of about 4.3 percent. To put the situation in context, this output growth in 2003 was better than the 3.6 percent average rate during the historic expansion of the 1990s.

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 consumer 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 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 the rates we saw in some quarters last year.

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

Corporate profits have been remarkably strong 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, a financial information company, are estimating an increase of about 15 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 from the late 1990s. But more recently there are signs that demand growth is beginning to help boost profits as well.

You might 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 extraordinary acceleration in productivity. What's been unusual is that productivity growth actually picked up during the 2001 recession and continues today. I'll talk more about productivity in a moment, but at this point I want to stress that business investment is once again playing a critical role in our recovery, and its recent resurgence suggests the entrepreneurial spirit that is so important to growth remains alive and well.

Looking for job growth

While businesses now have become aggressive again when it comes to upgrading equipment, they remain cautious when it comes to human capital. By far the biggest disappointment in our still unfolding economic recovery remains job growth. Historically, employment growth has 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 finally turned positive in September 2003 and have held that positive tone marginally through February. During the past six months, the U.S. economy managed to add a total of 364,000 jobs, averaging about 61,000 new payroll jobs per month.

Our FOMC statement from last week noted that "new hiring has lagged." Yet, even with weak job growth and the constant influx of new job seekers, the current unemployment rate of 5.6 percent is lower than it was at this same point in the recovery from the previous recession in 1990–91. And the unemployment rate is slightly below the average unemployment rate we experienced over the decade of the 1990s.

But I think it's important to acknowledge that part of the reason for the relatively low unemployment rate is the recent decline in the rate of participation in the labor market, which was on an upward trend in the 1990s. Indeed, labor force participation in February of this year was at its lowest level since 1988. People have left the labor market for various reasons, such as continuing education or retraining. And there's an increasing percentage of people who have become discouraged about near-term job prospects.

As we try to understand today's murky employment picture, I think it's helpful to think about how productivity continues to reshape our labor markets. Simply put, if output per worker hour is increasing faster than final demand there is less pressure to add to the workforce.

Productivity gains have touched many sectors of the economy, but perhaps none more so than manufacturing. Average labor productivity growth in U.S. manufacturing is higher than most other sectors of the economy, because many of the jobs are easily automated. And as we have observed in recent decades, and especially over the last few years, production has shifted to other regions of the world where labor costs and productivity are relatively low. Going forward, I expect that manufacturers will continue to leverage new technology to control costs and operate more efficiently. I'm willing to venture that a decade from now, when all of you students here are established in your careers, we'll see a much higher value of manufacturing output in the United States, but the actual number of manufacturing jobs might not have returned to levels we saw before the 2001 recession.

In contrast, the service-producing sectors of the economy, such as education, health care, tourism, and so on, tend to require the addition of more people as service demand increases. As a result, growth in services tends to translate fairly directly into increased demand for labor. So, as you might expect, much of the job growth over the past two years has been in service-producing industries.

I think that ongoing gains in labor productivity could act to constrain the overall pace of new hiring for a little while longer — but not indefinitely.

Although it's difficult to judge when we'll see a significant broad pickup in new job creation, there's evidence some businesses are beginning to expand payrolls and final demand is growing. For instance, we're seeing some businesses starting to rebuild inventories. And the economies of many of our trading partners are now improving nicely, so exports appear poised to grow further after a strong fourth quarter. Overall, I think 2004 will be another good year for the U.S. economy.

Importance of low inflation

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.

But, as a practical matter, monetary policy sometimes can help to ease the adjustment process when unforeseen shocks hit the economy or a downturn occurs. I expect most of 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-2000 to its present and unusually low rate of 1 percent. The evidence is pretty convincing that these actions helped to measurably ease the pain of a weak economy. Certainly, lower interest rates have 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 1 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 low and stable inflation. And 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.

But price stability does not mean that prices won't change. Some prices will increase at the same time others decrease. Recently, I've heard anecdotal reports of increased prices in service industries such as trucking, tourism and auditing. And as you probably have noticed, health care and insurance prices have been rising for some time now.

On the commodity side, prices for steel and other metals have risen sharply in recent months, and the prices of some finished goods dependent on these inputs have been increasing as well. In addition, energy prices have moved up, leading to higher costs for fuel, chemicals and fertilizers, among other items.

As a central banker, my focus is on avoiding conditions that contribute to persistent and widespread price increases across sectors. At this time, I do not believe the kinds of isolated price increases I have just described threaten low overall inflation. But, as always, I think it's important to watch price developments.

The role for monetary policy

We've seen how accommodative monetary policy can cushion the downside of an economic cycle, and policy has been especially accommodative for a while now. 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, market interest rates should adjust in response to more robust conditions and policy will need to adjust as well.

I expect the Fed's accommodative policy, and the low interest rates it has helped to engender, is popular with many in this room. Following last week's FOMC meeting, our statement again concluded by saying, "the Committee believes it can be patient in removing its policy accommodation." 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. Indeed, some of my contacts in various industries 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 markets can sort themselves out in an orderly way and return to balance.

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 or the necessary policy changes that may need to accompany them.

To illustrate what I'm talking about, let me tell you about my son, Mike, who has been developing lots for residential builders in the Atlanta area since 1997. If I think about the years Mike has been in residential real estate, I realize he has not seen a downturn in the business and in fact has been riding the wave of low mortgage rates and historic 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 business have not assumed in their long-term plans that this extraordinary period will continue indefinitely.

Another way to think about our monetary policy situation is 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.

Of course, as I mentioned earlier, our prompt response in 2001 to an emerging economic downturn, and the strong dose of monetary policy easing we administered, was appropriate. But just as a doctor shouldn't overmedicate the patient, one should always be sensitive to the potential for creating imbalances, which could be costly to correct. The same concerns apply to monetary policy. Over the longer run, I believe that monetary policy works best when it stays out of the way of the real work of building and growing our economy.

Given disappointing employment growth, slack resource use and muted increases in core consumer prices, the Fed has good reason to maintain its accommodative policy, at least for now. But if my forecast for more robust economic growth materializes, then, at some point, a fed funds rate of 1 percent will no longer be the best policy.

Getting to balanced growth and reasonable expectations

I began my remarks with an optimistic 2004 outlook for the U.S. economy. And I've shared my views as to why we have reason to expect more balanced growth 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 said it's 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 offered earlier to the students here — to stay flexible and forward looking — I think applies to all of us, as individuals, business leaders and policymakers. While we should keep one eye on today's issues and challenges, we should also look ahead for the path that leads to the best outcome over the longer term.

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