

Speeches

Quest for Sustainable Growth

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Good morning, everyone. While preparing my remarks for you, I thought about some comments that I got in response to a speech I gave in March to, coincidentally, another Atlanta real estate audience. Maybe some of you were there. After I talked about the possible unintended consequences of keeping interest rates too low for too long, a number of people said to me, "Jack, we like rates just where they are, thanks. Please do what you can to keep them low."

As always, I appreciate the feedback, and I expect many of you here this morning might agree with that suggestion. Taking a bit of license in interpreting these comments, what I'm hearing is advice about using monetary policy to help keep the economy growing at a healthy pace.

While I share your concerns about sustaining growth, my perspective as a policymaker may be different from yours as a businessperson. Speaking only for myself, I will say more in a few moments about where I think we are in the current economic expansion. But at this point I would preface those remarks with the general observation that the economy now seems to have solid, broad-based momentum. This momentum brings with it a new set of issues that policymakers must understand and take into account.

Finally, job growth

First, let's talk more about the path the economy seems to be taking. By far the biggest positive story for the economy so far this year is job growth. During the first five months of 2004, the U.S. economy added nearly 1.2 million jobs, with monthly gains for the past three months averaging about 315,000. Since last August, when payrolls were at their weakest level, the economy has netted 1.4 million new jobs, making up more than half of the jobs lost since employment peaked in March 2001.

Now, don't get me wrong. Finding a job is still tough, especially for those who don't have skills in demand. But I'm encouraged that employment gains this year have been fairly broad based across sectors, from business services to leisure and hospitality, along with the stalwarts of health care and education.

Even the most beleaguered sectors of our economy appear to be on the mend. Despite all of the talk about jobs moving overseas, manufacturing employment actually has increased so far this year by 91,000, with particular strength in durable goods.

Yet despite the economy's good progress, there are at least some sectors that have not yet worked through all of their economic imbalances. And you're familiar with the still-elusive recovery in nonresidential construction, because of the relatively high vacancy rates for office and industrial space. But, as you know, commercial real estate is a business that tends to lag the overall economy.

Moreover, much of the economy's progress over the past two or three years has been driven by housing and consumer spending. And this growth was fueled not by business spending and job creation but instead by low-cost borrowing and increases in disposable income induced by tax cuts.

The economy finally began to gain traction in mid-2003. Increased business spending was a clear sign of progress. After two years of cutting costs and digesting technology investments from the late 1990s, business managers regained their confidence and began to look ahead to a new period of rising demand. Investment in equipment and software has been growing again for the past 8 quarters and increased on a year-to-year basis by 12.5 percent in the first quarter of 2004.

As business spending was picking up, the consumer also continued to spend at a surprisingly fast rate. With interest rates still very low, retailers offered cars and other big-ticket items with financing incentives including little or no money down. Consumers continued to open their wallets, which were flush with extra cash thanks to tax cuts and mortgage refinancing.

This new combination of consumer and business spending last fall gave us GDP growth of more than 8 percent in the third quarter, followed by GDP growth of 4.1 and 4.4 percent in the two most recent quarters. Over the past year, output has grown by 5 percent, exceeding the average rate of growth reached during the boom years of the mid and late 1990s.

But more than two years into the expansion following the 2001 recession, labor markets languished and observers of the economy, including me, struggled to explain why job growth was lagging strong GDP growth to such an extent. Fortunately, as I noted earlier, job growth has emerged following the improvement in business confidence and spending.

With broad-based economic expansion more solidly in place, most forecasters expect GDP growth of 4-5 percent over the rest of 2004 and into 2005.

Inflation outlook

Today, we face a new challenge as our economy goes through yet another phase of adjustment. Over the first half of this year, an important shift in price movements and the inflation outlook has occurred.

For much of last year, core consumer prices (excluding food and energy) continued to move lower, maintaining a pattern of disinflation that took core inflation to about 1 percent. Extremely low inflation in the context of a weakening economy can be a concern because it puts policymakers, along with our economy, in unfamiliar territory. As disinflation continued to emerge after 2001, some commentators recalled the Great Depression, when the Fed's efforts to stabilize the economy were ineffective. While such an extreme case of deflation was most unlikely during the past few years, I think it's understandable why the Fed became concerned when the

nominal interest rate fell toward zero.

About a year ago, in June 2003, our Federal Open Market Committee lowered the Fed funds target rate for the thirteenth time in 30 months, bringing that rate to where it stands today at one percent, a 40-year low. At that time, the FOMC statement cited a minor probability of an “unwelcome substantial fall in inflation.”

This year, a measurably different picture has emerged. Our strengthening economic expansion has brought a flurry of price increases and the apparent return of pricing power in some industries. That shift — from a period of disinflation to upward price movements — can be seen in various inflation measures, in anecdotal reports coming from our various contacts and in some measures of future inflation expectations. It is important for us to understand these forces, which help to shape our policy deliberations.

The price index for personal consumption expenditures, one of our preferred measures of inflation, has risen from 1.8 percent on average last year to a rate of about 3 percent so far this year. Over this same period, the core PCE index, which excludes the volatile food and energy components, moved from about .8 percent to 1.7 percent this year.

In addition to the formal measures of inflation, our Reserve Bank directors and other contacts have shared with us a growing list of higher prices, reduced discounts and newly found pricing power. For instance, over the past year, the price of lumber is up 22 percent, plywood has increased 52 percent and fabricated wire is up 22 percent. Some residential developers, where business has been so strong, have been able to pass along these higher prices to buyers, while those of you in commercial development with longer lead times have tended to absorb the increased costs.

The price of food also has increased sharply, with dairy products up 22 percent from a year ago and meats, poultry and fish increasing by an average of 10 percent. The list goes on: carbon scrap steel is up 65 percent, and with the price of oil up about 20 percent this year shipping and logistics costs have risen substantially. In many parts of the country including Atlanta, hotel room rates are higher.

So how are consumers and businesses supposed to react? Well, as buyers of goods and services, we have choices. We can buy fewer of the now-pricey items and substitute other purchases from other providers. For instance, underlying demand for larger SUVs has softened since last year as the price of gasoline has risen. At the same time, demand for smaller fuel-efficient vehicles has increased. And I've read reports that the waiting list for hybrid fuel cars has lengthened considerably.

Moreover, we often hear of price increases that don't "stick" with consumers. For instance, major airlines have been trying to raise fares but have often been unsuccessful because of competition from low-cost carriers. And so there are some forces that will work to resist price increases.

So, taking the statistical reports and anecdotal data together, where are we on the inflation front? When viewed in the historical context and measured in the aggregate, the rate of inflation we are currently seeing appears to be comparable to rates observed just prior to 2001. In my mind, these are acceptable levels for inflation and fall within my own definition of price stability.

At the same time, I don't want to dismiss the compelling evidence of rising prices. As I have tried to suggest, a great deal depends on how much of the recent spate of price increases turns out to be transitory. And I would conclude that these recent developments on the price front warrant significant attention in our analysis and policy debates.

Also critical is the human factor that economists refer to as inflation expectations. Following our May 4 FOMC meeting, our statement noted that long-term inflation expectations remain well contained. Simply put, financial markets and business decision makers do not seem to expect inflation to move appreciably higher over the longer term.

On the other hand, various near-term inflation forecasts have increased, suggesting there is some expectation that recent price pressures may persist, at least for a while. Not only is it important that we prevent appreciable price increases from taking hold, but it is vital that we maintain the Fed's credibility for following a policy path that keeps inflation in check over the long haul.

Policy implications

Policymakers on the FOMC are responsible for sorting out all of the developments I have just discussed as we continue to try to use monetary policy to help advance our long-run objective. And that objective, by the way, is sustainable economic growth with price stability and employment growth that contributes to a continuing improvement in our standard of living.

With my early career training in engineering, I still sometimes find myself wishing our economic forecasts and our understanding of the key variables were more concrete — more black and white, if you will. We have more economic data and more analytical tools than ever, but our economy today is more complex than ever.

For one thing, markets continue to become increasingly global and interconnected. In addition, technologies continue to improve at breakneck speed, with implications for improved productivity. And of course there is the ever-present risk of unexpected shocks of one kind or another. We cannot forecast oil shocks, terrorist attacks or geopolitical developments. But we must always be thinking about how wild-card events might affect our economy and be prepared for any contingencies.

In many ways I think it's appropriate to reflect, without gloating, on our economy's positive recent developments. We have worked our way through the 2001 recession with a relatively short and shallow falloff in output; we have returned to what looks like broad-based output growth; we are now getting decent employment growth; and we have inflation within the range most of us would define as acceptable. The trick now is to do what we can to stay on that path to sustainable growth and long-term price stability.

I, along with some others, have been talking for a while about the need to know when to say when. In my view, it has become increasingly clear that the economy is becoming less dependent on the extraordinary monetary policy stimulus of low interest rates. I will spare you this morning a repeat on my views on potential unintended consequences of policy that remains too accommodative for too long. At this point, I judge that financial markets, business leaders and consumers have a good sense of the need to get back to a more neutral monetary policy setting.

Yes, individual policymakers can have somewhat different ways of taking into account key elements of the economy. That range of views is, in fact, one of the

strengths of our FOMC mechanism for policymaking. There is more than one way to think about productivity, capacity utilization, economic slack and other economic variables. Clearly, there is room at this point for different views on the likely persistence of recent price pressures. But, importantly, I believe the individual public statements and speeches of Fed policymakers underscore a broad and unwavering commitment to price stability.

Most of us are old enough to remember the disastrous consequences of high inflation of the 1970s and early 1980s. And in recent decades all of us have reaped the benefits of a more disciplined monetary policy geared toward price stability.

Given the economic growth and rising prices now unfolding, the general direction of our next policy move should be clear — barring any unexpected events. But there has been a lot of speculation about one of the statements coming from our last FOMC meeting — that “policy accommodation can be removed at a pace that is likely to be measured.”

In my personal view, the word “measured” is more of a plan than a pledge. Based on what I know today, I’m comfortable with the notion that our path is unlikely to mirror 1994’s policy moves, when the Fed funds rate was raised sharply from 3 to 6 percent over 12 months. It’s important to keep in mind the differences between then and now, including a higher rate of inflation in 1994 and a healthier financial sector today.

I want to emphasize that I personally would not want our most recent FOMC statement to be construed as a rigid precommitment to any particular path. I believe our policy response should be dictated by how things eventually unfold, along with our best forecasts for the policy horizon.

The business of economics and monetary policymaking can get pretty academic and drab. Perhaps that’s why it’s sometimes called the dismal science. So I like to find other ways to make my point.

Let’s pretend you’re the driver of a car that’s rapidly moving along an unfamiliar highway, and there are patches of fog. Because your vision is partially obscured and you can’t be sure what hazards lie ahead, you don’t want to drive on cruise control. Also, you might want to slow down and maybe tap on the brakes so that you don’t roar ahead and then abruptly have to slam on the brakes, leaving skid marks and forcing others to swerve out of the way and possibly losing control of your direction.

I hope this traffic analogy helps to illustrate our economy’s somewhat unpredictable journey. I think it also reminds us that as Fed policymakers we need to stay alert and respond appropriately to what’s happening around us. The economy is moving forward nicely, and I’m feeling good about the last few miles on the road to sustainable growth.

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