Speeches

Rebalancing the Economy for Long-Term Growth

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Once again, it's an honor for me to share my thoughts with you on the economic outlook at the start of the new year.

Over the holidays, I spent some time with my children and grandchildren at our family's cabin in the North Georgia mountains. And while enjoying the peace and quiet I began to reflect on comments from certain business leaders in Atlanta including some of you in this room. We all know this city is a great place for business. But the 2001 recession was tough on our community, and we can all think of local industries and organizations that are still adjusting to the 21st century. Business leaders in Atlanta and elsewhere value the importance of making hard choices now to grow stronger later, and I was reminded that in many ways this theme of understanding the ongoing changes in our economy and thinking for the long term applies to policymakers as well.

Looking at today's economy, there is a lot of good news to report. Up front, I'm pleased to say that 2004 turned out to be a very solid year. We can look back on many positive developments in the real economy, including improved labor markets, strong business spending growth, and continuing low inflation. And I want to leave you with the impression that I expect this momentum to continue this year and beyond.

As a way of thinking about some of the most important economic forces at work, I want to discuss four key stories from 2004. In no particular order, these are: renewed employment growth, energy prices, our nation's worsening current account and fiscal deficits, and the changing stance of monetary policy.

2004 labor markets
Let's start with jobs: 2004 was the year that labor markets moved out of the rut of jobless recovery and onto the path of growth—finally. Over the past 12 months, the U.S. economy gained 2.2 million jobs, averaging about 186,000 jobs each month. And the unemployment rate declined from 5.7 to 5.4 percent.

While job growth last year was less than we were accustomed to seeing in the late 1990s, we should remember how much the business climate has changed during the past five years. Some factors to keep in mind are the recession, terrorist attacks on U.S. soil and two subsequent wars, accounting scandals and greater scrutiny of corporate governance, and steep increases in energy and health care costs.

Together, these major developments have shaped business attitudes and help to explain lingering caution among business leaders. In today's climate of unrelenting competition, it is understandable that businesses have been obsessed with efficiency and have been reluctant to hire at a pace that many had expected.

Other structural factors have been at play in U.S. labor markets as well. Since 2000, growth in the number of people entering the labor force slowed to less than 1 percent a year, which is the lowest sustained rate of growth since World War II. By comparison during the 1970s, the labor force grew at more than twice that pace.

Our Atlanta Fed economists have been analyzing the labor supply, which varies depending on many factors such as immigration and demographics. And in recent years these and other broad factors have acted to restrain labor force growth.

As a result, even though last year's hiring was not up to the pace seen in the late 1990s, there were more than enough new jobs created to absorb the flow of people entering the labor force and to nudge down the unemployment rate.

Energy
The second big economic story of 2004 was energy. You'll recall that oil prices began 2004 at about $34 a barrel and by October had leaped to a record $55 a barrel. While oil prices have fallen back somewhat since that peak, they remain well above what many thought were long-term levels.

For much of last year, geopolitical troubles in the oil-rich Middle East altered energy supplies. Then, in the third quarter, Hurricane Ivan disrupted oil production in the Gulf of Mexico. On the demand side, strong economic growth in China and other major economies helped to boost energy consumption around the world.

All of these factors led to a run-up in energy prices that dampened overall economic growth last year, by some estimates subtracting approximately three quarters of a percentage point from last year's GDP growth of about 4 percent.

But there was another story within the story of last year's energy price shock, and that is the resilience of the U.S. economy. When higher gas prices took spending away from other goods and services, consumers did not panic. And when many businesses were hit with unanticipated energy costs, most were able to absorb or offset the added costs without widespread price increases that could have fueled inflationary pressures.

Certainly, energy costs remain a wild card as we go into 2005, even though it looks like the economy has and will continue to become more energy efficient and will adjust to new price levels. But if oil prices stay high as oil futures suggest, then I expect we will hear new calls to reform energy policies and invest in new energy technologies.

Moreover, let's keep in mind that many of our oil supplies and future oil reserves are found in parts of the world that are not the most politically stable. All of these factors suggest we continue to keep a wary eye on energy as a pivotal economic issue and potential source of risk.

Deficits

My third big economic story of 2004 concerns the so-called twin deficits—the current account deficit and our fiscal deficit. Basically, the current account deficit is jargon that means the United States is buying more goods and services from abroad than it's selling there.

When such a deficit occurs, it has to be financed, and in recent years we have done so by borrowing from abroad. In 2004, total outstanding credit extended to the United States by foreigners was $4.5 trillion, up from $1.2 trillion in 1994. During the past decade, the percentage of total outstanding credit extended by foreign lenders in U.S. capital markets increased from 7 percent to almost 13 percent.

Now, borrowing isn't necessarily bad, especially when the proceeds are used to purchase capital goods. During the late 1990s, U.S. borrowing served to increase our country's productive capacity and productivity. But I'm concerned to see this pattern has changed.

For the first half of the 1990s the United States' current account deficit amounted to less than 2 percent of GDP. Today the current account deficit is near 6 percent of GDP and rising. So our country is going deeper into debt to pay for consumption instead of investment, and in my view this trend is undesirable and at some point unsustainable.

If our current account deficit continues to grow, foreign investors can't be counted on to keep lending to the United States on the same terms as in the past. Indeed, investors in 2004 began to diversify their dollar holdings. As they did so, from June through December the dollar fell about 10 percent relative to the euro.

These pressures are made even more worrisome because we are using part of the proceeds from borrowing abroad to finance our current account deficit while we are also using part to finance our growing domestic fiscal deficit—the other twin.

In 2005, our fiscal policymakers have an excellent chance to strengthen the nation's economic foundations by demonstrating a renewed commitment to reducing the federal budget deficit. Also, we face the more daunting task to confront looming deficits for Social Security and even more costly medical programs.

Large fiscal deficit spending may boost the economy in the short-term. But history has not been kind to countries that run excessive fiscal deficits. At some point, too much fiscal deficit spending increases risks to economic growth and potentially constrains the effectiveness of monetary policy.

Speaking of monetary policy, I would add a fourth 2004 economic development that I am sure has not gone unnoticed—the Fed's decision to begin the process of withdrawing some of the extraordinarily accommodative monetary policy that had been in place for the better part of 4 years. With the Fed funds rate at a 40-year low level of 1 percent, the Fed's Open Market Committee last June announced the first 25 basis point increase. Then there were additional adjustments at our meetings in August, September, November and December, bringing the Fed funds target rate to its current 2 ¼ percent rate.

The movement back toward a more neutral interest rate environment should contribute to a more sustainable and balanced economic environment. I might describe our recent policy actions as a form of preventive maintenance that helps to ensure low inflation in the future while facilitating a transition toward other desirable outcomes such as less borrowing and more saving. The adjustment we began in 2004 so far has gone smoothly and, I would submit, has been much less disruptive than the alternative of waiting for risks to emerge and then having to move rates up more reactively and more aggressively.

2005 outlook

Looking into 2005, I think our economy is positioned nicely to continue solid growth. I'm comfortable with consensus forecasts for annualized GDP growth for this year of about 3 ½ to 4 percent. That projected output growth rate is in line with the past 11 quarters, although GDP growth has picked up recently and averaged about 4 ½ percent for the past 6 quarters—about the same as the late 1990s. I would say that our recent output growth has been and should remain pretty doggone good.

Let me mention some of the other economic issues I'm watching in 2005. Consumer spending last year grew at just under 4 percent, and this year we'll see how consumers adjust to interest rates consistent with a strengthening economy and high levels of household debt. But I am reluctant to bet against the American consumer, and I expect consumer spending growth for 2005 to keep supporting our economic expansion, especially if energy prices continue to moderate.

Even if the growth in consumer spending eases a bit, most of corporate America is flush with cash. During the third quarter, non-financial corporations increased their liquid assets by 14 percent to more than $1.3 trillion.

Slowly but surely, this liquidity will make its way into the economy. Business investment in equipment and facilities increased about 9 percent in 2004, and computer and software spending rose 16 percent. Forecasts of continued strong business spending growth in 2005 are, in my view, entirely plausible.

And continued business spending growth should help sustain further employment growth.

Monetary policy

Clearly, full employment is a desirable outcome, but it is not the Fed's only objective. Indeed, most central bankers would argue that price stability should be their primary focus since inflation is most directly affected by monetary policy actions. In recent years, inflation has been well contained. For example, the core personal consumption expenditure (PCE) deflator increased at a 1.5 percent rate last year, compared with 1.3 percent in 2003.

But good central bankers stay alert to change in the inflation outlook. Although I do not think a significant pickup in inflation is imminent, I continue to be struck by talk of price increases that my business contacts say they are planning as the economy expands. Low capacity utilization is often cited as a factor that helps to keep prices down. But capacity utilization has been rising steadily and may be underestimated given the number of obsolete factories that have been shut down and are not expected to reopen. Moreover, there probably is a limit to how long businesses can leverage productivity gains to hold prices down.

Other potential inflationary pressures in the year ahead could come from past energy cost increases and higher prices of some imported goods. Labor costs are yet another variable. Although we still have a large supply of unemployed workers, I am now hearing more about shortages of skilled workers and that wages for some of those jobs are beginning to climb. For all of these reasons, I will be closely watching prices and inflation expectations.

Communication changes

You may have noticed that markets have taken the Fed's recent policy moves pretty much in stride. And I am inclined to think our recent steps to communicate more openly have eased the adjustment to our policy changes.

The Fed has not always been so transparent. Until 1994 there was no announcement after each FOMC meeting. This approach gave rise to a cottage industry of "Fed watchers" devoted to interpreting our policy actions and likely policy direction.

Now, on the afternoon of each FOMC meeting, we announce our action and provide brief comments on the most important economic developments and economic outlook. And in 2003, our statements began offering some insights into the likely path of policy.

This forward-looking information is clearly helpful to financial markets. And let me add that I support our movement toward greater transparency. But the additional language has limitations and some potential drawbacks. First, the short post-meeting statements cannot possibly convey the full range of views expressed by 19 men and women who take part in the FOMC policy discussions.

We are aware of this limitation and recently moved to fill the potential information gap. Just last week the Fed for the first time released the detailed minutes 3 weeks after a meeting instead of waiting 6–8 weeks. It is my hope that the speedier release of our discussion will underscore the wide range of views and vigorous debate that shape our monetary policy.

But the timing of the minutes is unlikely to redress a second drawback to the FOMC's brief post-meeting statement. That is, the risk that some might perceive our forward-looking language on policy as a pre-commitment to some very specific policy path.

As we know well, we can be surprised by developments as they actually unfold. Even the best data often get revised. Trends get misread. And economic shocks are a fact of life. It is not possible for the Fed to remove all "policy risk" from financial markets. And with this potential for uncertainty the Fed in June added a phrase to our post-meeting statement that reads, "The Committee will respond to changes in economic prospects as needed to fulfill its obligation to price stability."

Still, I read a report in the media just a few weeks ago that referred to the Fed "keeping its pledge" for a "measured pace" of rate increases. Guess what? I don't think the Fed ever made such a pledge, and I think it's unfortunate that our effort to offer some insight into our policy inclination is sometimes misconstrued.

Even with a very capable staff of economists, the best forecasting models we know how to build, mountains of economic data and very helpful grassroots' insights from business and community leaders, the FOMC like everyone else can be surprised by events. And it is vital that we maintain the flexibility to respond with the best policy action that comes from each FOMC discussion, even if sometimes that has the potential to surprise some in financial markets.

Finally, let me say that I cannot and will not speculate on future policy moves. That's why we hold our regular FOMC meetings. Although the basic direction of policy has been more obvious than usual for the last year or so, it will likely become less clear and perhaps more difficult to communicate as we approach the equilibrium or neutral interest rate that is consistent with economic activity at its potential and with low and stable inflation.

There has been a lot of talk about the neutral or equilibrium rate, and I expect many of you are asking, "Are we there yet?" My personal view is that if the economy stays on the present path of solid growth, then rates have not yet returned to equilibrium. As I noted earlier, I do not see an imminent threat of inflation, and I am comfortable with our gradual monetary policy adjustments—at least for now.

Facing the future

I hope that I have stressed that our future policy hinges on the performance of the real economy. And I hope I have left you with a broad picture of an economy moving into 2005 with steady output growth, with labor markets gaining strength, with solid business spending growth and with inflation under control.

Of course, our work is never done. And as we are tested, I would also hope that fiscal and monetary policy will work in tandem, and I would urge policymakers to learn from business leaders who have already made hard choices to prepare for the long term.

Spending time over the holidays with the kids and grandkids at our place in the Blue Ridge mountains really brought home to me what the future is all about. And as we move ahead let's get the right things done to build a solid economic foundation for today and tomorrow.

Press Release

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