

Speeches

The Importance of Price Stability

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Thank you for inviting me here today. I'm glad to be back at the Rotary Club of Birmingham, and I'm honored that you asked me to speak on the 100th anniversary of Rotary International. My own club in Atlanta is marking the same occasion as I speak. Having 100-year-old Jim Head preside over this meeting makes it a very special occasion. I don't know what you do, Jim, to reach 100, but you are amazing. I want to have a word with you and try to find out your secret to living a long life.

Speaking of longevity, I want to discuss today a topic that is sometimes taken for granted but is probably the single most important factor in our country's strong and long-lasting economic growth over the past two decades. And that topic is durable low inflation, or price stability.

Of course, our economy has experienced a number of significant shocks and surprises in recent years, but we have come a long way since the last time I spoke to you here in January 2002. And I want to begin my remarks with some background on the present U.S. economic situation and outlook.

The economy today

And I think we have to be pretty pleased with the economic picture that's developing. Gross domestic product (or GDP) last year on an annual basis grew 4.4 percent, with growth in the fourth quarter easing a bit. But the real story is the solid expansion of the past eight quarters, with output growing on average more than 4 percent. As a point of comparison, GDP in the late 1990s grew at about 4.5 percent.

Along with this solid growth in GDP, employment has now improved to the point where I think we can stop talking about the so-called jobless recovery. That's because 2.3 million jobs have been added since the beginning of 2004, enough to regain the employment losses since the onset of the 2001 recession.

Nonetheless, some people have been disappointed with our recent rate of job creation, and I'd agree the pattern of hiring is different from the late 1990s, when the pace of hiring for some industries resulted in acute labor shortages. Nonfarm payrolls in January increased by an estimated 146,000. Manufacturing employment last month was down, but new jobs were added in many other areas such as education and health care—a now familiar side story. For the past year, the labor market has been strong enough to absorb the steady stream of people looking for work. As a result, the unemployment rate has declined from 5.7 percent in January 2004 to 5.2 percent today.

So why is the labor market finally gaining traction? A major factor is stronger business investment spending. You'll remember that sharp business spending cutbacks contributed to the 2001 recession.

But over the past few years businesses have reevaluated, reorganized and retooled their operations in an effort to cut costs and remain competitive. And the tough decisions in the business world have begun to pay off. In 2003, earnings for S&P 500 businesses were up more than 18 percent, and 2004 was another good year, with earnings for benchmark businesses growing at about 20 percent.

Profit growth may ease somewhat this year, in part because businesses have been, and will likely continue, ramping up their spending in the wake of strong capital spending growth in 2004 of just over 10 percent. In their investments, businesses have been focused on upgrading technology to improve competitiveness and cost efficiency. In addition, it's especially encouraging to me that a large share of this investment spending now seems to be in anticipation of increasing sales and growth. Overall, my sense is that new opportunities are emerging as businesses continue to sort out imbalances and respond to global competitive pressure.

Our regional economy illustrates the dynamics of economic change as textile and apparel factories close, and we see the growth of a highly efficient automobile industry, especially here in Alabama. Businesses that assemble vehicles in our Sixth Federal Reserve District's Southeast region are responsible for more than 34,000 direct jobs and thousands more related jobs.

As businesses evolve, consumers are holding up their end of the economy, which accounts for about two-thirds of GDP. Consumer spending in recent quarters has grown at rates roughly on par with GDP growth. As I told another group recently, I am not inclined to bet against the American consumer.

Here's another way of looking at our current economic situation. After going through a foggy stretch of road with potholes and sharp turns, the economy seems to be in a stretch of more open highway. While there can always be surprises around the next corner, I would add that my near-term forecast is for more of the same: GDP growth in the 3 to 4 percent range, continued strong business spending growth, steady employment gains along with a continuing decline in the unemployment rates and low inflation as measured by the Consumer Price Index in the range of 2 ½ to 3 percent.

Risks as always...

But there is more to this picture, and I think we should remind ourselves that there are always risks on the road, and we should drive defensively. As examples, I would like to point out three hazards, each with the potential at some point to threaten our goal of sustainable and non-inflationary growth.

Let's start with the so-called twin deficits. On the private side, we face a rapidly growing current account deficit, which basically means that the United States is buying more goods and services from abroad than it's selling to other countries.

Our country has financed this deficit by borrowing more and more from abroad and using much of that debt to finance the purchase of consumer goods. Without belaboring the issue, I'll say that the accumulation of ever larger amounts of debt entails a level of risk that makes me uncomfortable. I believe it's important to

implement policies that encourage greater savings in our country so that we do not overextend ourselves and weaken our bargaining power.

Similar concerns apply on the public side as the nation's fiscal deficit continues to climb. In testimony to Congress last week, Chairman Greenspan described "the imperative to restore fiscal discipline" in the United States. It's too early to judge whether we'll quickly get greater discipline, but I'm encouraged that policymakers in Washington have started talking seriously about the nation's growing fiscal deficit. And the recent debate has emphasized that, without decisive action, we face the threat of even wider imbalances in the future as shortfalls in Social Security and national health care programs magnify the problem.

A second hazard I would point out is the price of energy, a now familiar culprit in dampening prior economic expansions. Last year, you'll recall that oil prices ran up to about \$55 per barrel, and the price is now slightly more than \$50. Mainstream forecasts call for oil prices to fall back to below \$40 a barrel as supply conditions improve and global demand stabilizes.

But energy markets are hard to predict; and sustained high oil prices have a negative impact on the economy. Even though energy prices are largely controlled in the short term by others, we'll have to continue to see how things develop.

A third set of risks has to do with the usual tendency of an economy that's been expanding for a while to develop bottlenecks and imbalances. In the absence of the appropriate policy response, these imbalances in turn can lead to unwelcome inflationary pressures, the subject of most of the rest of my comments to you today.

The Fed responds

These risks and others are taken into account as part of the Fed's policy-making process. Every six to eight weeks, the 19 members of the Federal Open Market Committee meet in Washington, D.C., with Fed Chairman Alan Greenspan. We talk about what recent data and grassroots insights seem to be telling us, and we talk about the likely path of the economy and the emerging economic issues of the day.

The FOMC's mandate is to foster stable growth, full employment, and a climate of low inflation. And our experience in this country and in other major economies around the world in recent decades has taught us that price stability—defined as low and stable inflation—should be a central bank's primary focus because inflation is most directly affected by monetary policy actions.

Beginning with Fed Chairman Paul Volcker's bold policy actions in the late 1970s to break the back of high inflation and continuing through Chairman Greenspan's 17-year tenure, the Fed has been effective in helping to create conditions that have kept inflation low and relatively steady. During that time, the U.S. economy has enjoyed strong economic growth and higher living standards. And I would submit that much of this success was built on the bedrock of low inflation, which I consider to be the state in which expected changes in the general price level do not effectively alter business or household decisions.

In January, the overall consumer price index (or CPI) including the volatile food and energy components, increased on a year-over-year basis by 3.0 percent. The CPI a year earlier was 1.9 percent, so the rate of inflation has been rising a bit, but it remains below where it was at the end of 2000, especially if you look at the core inflation data. By most measures, overall inflation today continues to be within the range I find consistent with the definition of price stability.

Well, you might be wondering, if inflation is not a problem, why has the Fed during the past 9 months been raising short-term interest rates?

And that's a fair question that I also have to ask myself as a participant in the FOMC policy-setting process. To start, let's briefly review the FOMC's recent policy actions. Last June, the Fed began to gradually increase the fed funds target rate from an extremely accommodative level of 1 percent. In six consecutive meetings, the FOMC bumped up the fed funds target rate to 2.5 percent. And the real rate, or the nominal rate less core inflation, has risen to about ½ percent.

In my opinion, the present fed funds rate is still accommodative, and with an economic expansion that now seems to be well established I believe the FOMC still has a ways to go in recalibrating monetary policy. But I won't speculate on future policy actions.

The situation with prices

Since last June, I believe the economy has adjusted well to the measured increases in short-term rates. As I mentioned earlier, GDP growth remains strong. But as one might expect at this point in the economic cycle, we now hear anecdotal reports in some specific industries of some prices starting to rise.

For instance, I have heard that over the last few months equipment shortages in truck and rail transportation have led to multiple price increases and that fuel surcharges and other cost increases are frequently being passed on to customers. I've been told that for the less profitable types of shipments some railroads are beginning to decline renewal of contracts. As you might expect, costs for shipping are felt in a wide range of industries.

In addition to higher shipping costs, prices of many industrial materials have risen. For instance, prices for steel, copper and aluminum have all increased dramatically in the last year as China and other developing countries have added to demand as they move to expand their industrial capacity.

While we still have many unemployed workers and pressures in unit labor costs have continued to be modest, there have been some reports of significant wage increases among higher-skilled and professional workers.

Also, rising health care costs are well known and show no sign of abatement as medical innovations and new drugs continue to come on line and are being used extensively. Of course, employers wind up paying for much of these higher medical costs, further adding to overall business cost pressures.

As a policymaker, these anecdotal reports remind me to stay alert. But it's important to keep in mind that isolated price increases are not the same as an unwelcome rise in average prices as measured by our inflation indexes. Because of fierce competition, many businesses that compete globally are in fact reluctant to pass along higher input costs. These pressures have made price increases for domestic services more prevalent than those for consumer goods.

Indeed, a low-price revolution has transformed many consumer markets. Because of productivity improvements and global supply chain innovations, prices have fallen and continue to decline for computers, electronics and many other mass-produced goods available in your local discount store.

Moreover, consumers always have the choice of responding to higher prices by scaling back purchases of that product or buying an alternative. In our flexible economy, this so-called substitution effect is a powerful deterrent to a broad-based rise in inflation.

Staying ahead of expectations

The trick to guarding against an unwelcome run-up of inflation is to prevent the spread of price increases across sectors where they show up in a basket of all prices. And that means preventing the emergence of the expectation of rising inflation, an insidious cycle where people rush to buy before prices rise further. In my view, the policy path we've been on has helped to restrain inflationary pressures—at least for now.

As we keep an eye on prices, it's important to keep in mind that monetary policy acts with a considerable lag, and economic circumstances can and do change quickly. If you wait to see concrete evidence that inflation has taken hold, then it's already too late to stop it.

To illustrate my point, let me use a football analogy. That is, the best defense is a good offense that maintains control of the ball. What does that mean for the Federal Reserve? I believe it means we must constantly anticipate and act to prevent problems from emerging. And if we are successful, we should never see problems with out-of-control rising prices. Our opponent is an unwelcome level of inflation, and in that game we don't want to play catch-up.

As price pressures begin to build, I believe appropriate increases in the fed funds target rate will help to prevent rising inflation and encourage desirable outcomes such as increased saving. The Fed must be willing to make the necessary policy moves, and that's what the FOMC has been doing since June of last year.

The era of low inflation

The era of low inflation has been with us for a while, so it's tempting to drift into complacency. And I must say that temptation concerns me. Certainly, the Fed plays an important role in helping to prevent unwelcome inflation, but we can't do it alone. Influential people like you also need to understand the high stakes involved.

Low inflation is important for many reasons. For one thing, rising and unstable prices erode business confidence and distort investment decisions. Unwelcome inflation wastes real resources as people expend time and effort to preserve their wealth, and it is an unfair tax. As the Nobel Prize-winning economist Milton Friedman once said, "Inflation is the one form of taxation that can be imposed without legislation." You can't find any examples of economies that have enjoyed sustainable growth and prosperity in a climate of steadily rising inflation.

Please don't get me wrong. Today the U.S. economy has a lot working in its favor. To recap the picture I have just tried to paint for you, I believe that on its present course our economy should continue to grow at a solid rate, that employment should strengthen and that inflation should remain under control.

Let me close by suggesting that we appreciate and enjoy low and stable inflation for what it is: the foundation supporting economic growth. And let's make sure we do what it takes to ensure price stability for the future.

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