First, I want to lay the groundwork for my remarks with a look at the current economic performance. Then, I want to reflect on the discernible upward drift in inflation we've seen over the last two years. Finally, I want to share with you my personal thoughts about monetary policy and the Federal Reserve's mission to foster sustainable growth, with low and stable inflation, and strong employment growth.

The economic fundamentals

Let's start by looking at the broadest measure of growth in economic output: gross domestic product. Given what seems to be a fixation with the latest piece of data, you might have overlooked that U.S. economic growth last year was 4.4 percent. And over the three and a half years since we came out of the relatively short and shallow 2001 recession, our economy has experienced GDP growth on average of 3.5 percent. About three weeks ago, we saw an advance estimate of first quarter 2005 GDP growth, which was 3.1 percent—below expectations, but still respectable. More recent data suggest that growth remains solid, and many analysts expect the first quarter GDP estimate to be revised upward. In any event, I am inclined to attribute at least some of the recent softness in growth to general skillfulness about the springtime run-up of energy prices, which I'll discuss in a moment.

Looking ahead, I expect GDP growth will remain on a very positive path. I think the forecast I made early this year of growth for all of 2005 in the range of 3.5 to 4 percent still seems reasonable.

Looking at the components of GDP growth, the data confirm what most of you already know—residential investment has remained strong, growing on a year-over-year basis during the first quarter by 6.7 percent. In fact, overall consumer spending growth during the first quarter was 3.5 percent—down slightly from a year ago—but still solid and roughly in line with overall economic output.

At the same time, business investment spending continues to underpin good economic growth. Some businesses during the early part of this year may have postponed certain investment spending decisions because of high energy costs. But there has been no sense of panic. Rather, more recent data suggest investment spending—and business spending plans—remain firm. It's important to note that many businesses are flush with cash and motivated to improve their efficiency while growing their markets. This trend was evident as we saw equipment and software spending last quarter increase on a year-over-year basis by more than 14 percent, following very strong investment spending growth in 2004. I expect businesses will continue to upgrade equipment that helps them to leverage the talents of their employees so they can compete in global markets and capitalize on new business opportunities.

An important factor in the outlook is the job market. After a slow recovery in job growth following the 2001 recession, labor market developments have improved considerably. For the first four months of 2005, the U.S. economy added some 844,000 nonfarm jobs, or an average of more than 200,000 jobs per month. Looking at the characteristics of recent job growth, hiring has become broad based across most sectors of the economy. Construction has been especially strong, with 430,000 jobs added over the past 16 months. And we've seen solid job growth in business services, leisure and hospitality, and retail, among other industries. These additional paychecks are crucial to keeping growth on track.

While prospects for job seekers have improved, the labor market still has some weaknesses. Manufacturing employment has declined by more than 3 million since 2000 and by another 6,000 jobs in April. But much of the loss over the past five years is what economists call "structural" changes, recognizing that some of that job loss is the result of firms moving manufacturing to other parts of the world. Also, the average duration of unemployment remains stubbornly high at about 20 weeks compared with less than 13 weeks during the hiring boom of the late 1990s. This information suggests that some people continue to have a hard time finding the right job. Still, it's important to keep in mind that job growth has picked up nicely over the past 18 months and is now growing at a pace that I believe will continue to lower the unemployment rate.

Related to this point, there has been a lot of research and discussion on the amount of job growth needed to sustain economic growth and push the unemployment rate lower. Two key factors are the rate of increase in labor productivity and growth in the labor supply. And I'd like to share some analysis on the labor supply done by several of our Atlanta Fed economists. Since June 2003, the U.S. unemployment rate has declined from 6.3 percent to the present level of 5.2 percent. This substantial drop in the percentage of unemployed has occurred despite only modest payroll expansion of about 156,000 jobs per month. Previously, we would not expect that pace of job growth to lead to a decline in the unemployment rate. So, our staff asked, if the economy is creating only a modest number of new jobs per month, why has the unemployment rate continued to fall?

Part of the answer, we believe, is found in something economists call the labor force participation rate. The participation rate, defined as the percent of the civilian population working or actively seeking work, climbed steadily during the 1990s, but then the pattern changed. Since 2000, the participation rate has declined by about a percentage point and currently stands at 66 percent. That slight decrease makes a big difference in how job growth affects the unemployment rate. It's tough to say why fewer people are entering the job market, but experience suggests that in the early stages of an economic recovery some workers get discouraged by their job...
prospects, drop out of the labor force temporarily and are, therefore, not counted as unemployed. But new evidence suggests others may be leaving the job market due to social factors, such as women with young children deciding to stay at home. If the recent trends with the participation rate persist, the economy would need to create only 100,000 to 150,000 jobs per month to keep the unemployment rate moving downward.

Price pressures in context
For a monetary policymaker like me, I’m always looking at the pace of output growth in the economy, which I’ve been discussing. But I also have to watch price developments—or more precisely, inflation. And during the last two years, various price measures have been trending higher, thus signaling moderately rising inflation. Let’s consider some broad measures of inflation that reflect year-over-year price changes. The core personal consumption expenditure, or PCE, price index, which excludes volatile food and energy components, in March increased 1.7 percent. By comparison, the core PCE index in May 2003 increased just slightly more than 1 percent. And looking at a more familiar measure of inflation, the Consumer Price Index in April increased 3.5 percent. Two years ago, the CPI increased slightly more than 2 percent.

And it’s a similar story with the more volatile Producer Price Index for inflation, which last month was up 4.8 percent. In May 2003, the PPI index was up just 2.5 percent. And while inflation data may fluctuate month to month, you can see more indications of rising prices by looking at various intermediate goods, which can affect the price of finished goods, such as housing. In the past 12 months, for instance, the price of gypsum (used in wallboard) is up more than 15 percent; scrap steel is up 22 percent; cement (if you can get it) is up 10 percent. Looking at a broad mix of construction materials, prices in the past year have increased 6.4 percent. And it now appears there has been more pass through of energy costs than I earlier expected. My point is that all of the inflation measures over the past seven or eight quarters show a similar—but distinct—upward tilt.

Underlying the price increases has been strong economic growth worldwide, which has boosted the demand for many commodities, and put pressure on their prices. For example, the energy story should be familiar to everyone. Starting in early 2004, the price of crude oil rose steadily from about $35 per barrel to more than $50 per barrel. Ordinarily, higher prices lead to more production and eventually greater supply and perhaps stabilizing and lower prices. But, when it comes to energy, the invisible hand of the market works in mysterious ways. China and other developing economies have become voracious consumers of energy, helping to drive up demand and in the process helping to push prices to current levels. But those businesses involved in the production of oil know that the world’s appetite for energy could decline in the event of a slowdown in global GDP growth. Oil exploration costs are huge, and businesses have been slow to invest in new energy production facilities. Adding to the uncertainty with respect to energy prices is this country’s continued reliance on oil imported from politically unstable regions such as the Persian Gulf, where more than half of the world’s proven oil reserves are found. Given these complex dynamics, oil futures markets are indicating that higher energy prices may well be with us for quite a while. And how businesses and individuals react to this energy price outlook—both short and long term—is a key economic uncertainty.

One factor that has helped to keep prices in check is expanded world trade. With the spread of lower tariffs and freer trade, our global economy has become more competitive. In response, businesses have continuously found new ways to leverage technology and lower costs. As consumers, we benefit from lower prices and a greater variety of goods and services. Global trade’s competitive pressures also have contributed to the past decade’s remarkable increase in U.S. productivity. Since 2002, U.S. productivity growth annually has averaged more than 4 percent. That figure compares with an average, which had prevailed for several decades, of less than 3 percent. So it’s important to remember we have external factors such as trade combining with related productivity gains to help keep inflation muted.

Keeping an eye on housing
The recent period of moderately rising inflation has unfolded during an extended period of very low interest rates. Since we came out of the 2001 recession, we have seen rapid growth in a number of sectors of the economy. Residential construction has been strong for some time. In the past few years, the homeownership rate has climbed to nearly 70 percent nationwide, a record high level. And that situation is unlikely to change as long as mortgage rates remain attractive to homebuyers. Moreover, new jobs and income growth should lend additional support to our economy’s residential sector.

In this climate, it would be easy to take the housing market growth for granted. But many of you in this room have felt the woes of prior housing cycles, and you realize that problems can ensue when supply outpaces demand. Housing is a local business. And in several markets across the country, housing prices in the past year have appreciated more than 30 percent, a rate that in my view is unsustainable. There are submarkets in our Southeast region—notably in coastal Florida—where you hear about speculators buying housing units—sometimes multiple units—just to flip them for a quick profit. And it seems like every week brings new stories about aggressive financing arrangements that encourage and enable such real estate transactions. I have to tell you that some of these stories we’re hearing about residential speculation make me uncomfortable, and the potential imbalance of supply and demand in housing in some markets is something I have been speaking out about for more than a year. You all know better than I do that real estate is ultimately driven by fundamental factors such as general economic growth, demographics, and household income.

Monetary policy implications
Of course, residential construction is just one of many sectors we follow and discuss every six to eight weeks when the members of the Federal Open Market Committee meet in Washington. As you probably know, the FOMC earlier this month raised the federal funds rate target to 3 percent. Since last June when short-term rates were at a 40-year low of 1 percent, the FOMC has bumped up its rate target in eight consecutive meetings.

While I doubt everyone in this room welcomes higher short-term interest rates, let me share with you some of my personal thoughts on the Fed’s recent policy moves. I have strongly supported the Fed’s actions to gradually remove our policy accommodation. I believe our strategy to act before the appearance of widespread price increases is sound and necessary to keep inflation and inflation expectations firmly in check. The gradual rate hikes at this stage of the economic recovery also reduce the chances that the Fed will later need to take a more painful path of steep hikes. The Fed is not raising rates to stifle economic growth, but to ensure an environment of stable prices and sustainable growth over the long term.

I’m often asked what the end game is for the policy adjustment process. Going forward, we are approaching an increasingly uncertain time for monetary policy. The Fed’s goal is to achieve what’s often referred to as a neutral policy setting, where rates are at a level that promotes growth without the likelihood of a run-up in inflation. Of course, as economic fundamentals shift over time, our view of neutrality may change. Given my current outlook for the economy, my personal view is that we’ve not yet reached a neutral policy stance. While I see no signs of an imminent and substantial pickup in inflation, we will need to be especially sensitive to incoming data and new developments on prices.

There are other issues that warrant close attention. Although it is not something we can directly address through monetary policy, the growing federal deficit has become a long-term concern. Excessive fiscal spending tends to boost output in the short run but eventually adds risks to our economy and restricts the effectiveness
of monetary policy. The fundamental issues of how to deal with Social Security and rising retiree health care costs only serve to complicate our challenges with fiscal policy.

In addition to our widening fiscal deficit, there's the situation with private debt. As interest rates declined during and after the recession, many households were able to shore up balance sheets by consolidating credit card and other debt into lower-cost loans backed by home equity. This refinancing trend has boosted economic growth, mostly by encouraging consumer spending. But low interest rates are more conducive to consumption than savings, and in recent years we have seen plenty of the former and too little of the latter. Fortunately, the Fed's policy of slowly raising short-term interest rates could have the desirable side effect of reducing the brisk pace of borrowing to fuel consumption while boosting savings.

In closing, let me emphasize that I believe the economy remains on a solid and sustainable path of growth. As I mentioned earlier, businesses continue to ramp up their investment spending. And consumer spending keeps chugging along. Labor markets are improving at a solid pace, and the additional paychecks will help fuel more growth. Taken as a whole, these and other factors suggest that our economy has ample strength to withstand further removal of accommodative monetary policy—in my view, a step that is needed to sustain economic growth.

Over the past few years, our economy has demonstrated great resilience and growing balance. We have overcome several negative shocks and now have many factors working in our favor. And as economic momentum continues, I remain convinced that the best course is to stay on a monetary policy path that helps reduce the risks ahead and supports a continuing pattern of solid growth and low inflation.

Press Release

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