Speeches

Resolving the Unknowns of a Changing Economy

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I'm glad to be here, and I appreciate the chance to speak to this group of dynamic business and community leaders. As someone who's spent more than 40 years working for one large public policy organization, I'm certainly no entrepreneur. But I admire those of you who are and who have the guts, tenacity, and work ethic to succeed while leading your organizations in a market economy that is continually changing and becoming more and more competitive.

In many ways, small businesses are the heart and soul of our economy. We hear a lot of news about big corporations. But small businesses do much of the cutting-edge work—the innovation, the risk taking, and, yes, the hiring. According to the U.S. Small Business Administration, half of all private sector jobs are created by small business.

All of us—no matter where we're employed—have a stake in the path of the overall economy. So for the next few minutes, I'd like to talk about the broad economic outlook. First, I'd like us to recall the very solid expansion leading up to Hurricanes Katrina and Rita. Then I'd like to give you my views on the national economic impact of these costly natural disasters. Finally, I'd like to share my personal observations on recent developments and monetary policy.

The measure we call gross domestic product, or GDP, provides the best and most familiar gauge of overall economic output. For the second quarter of this year, ending in June, GDP growth was a solid 3.3 percent. In fact, GDP growth in the United States for the past eight quarters averaged more than 4 percent—a record that exceeds the boom years of the late 1990s. This most recent growth reflects strong gains in business spending and steady advances in consumer spending—all during a time of rising energy prices and other setbacks.

Labor markets are another barometer of economic performance, and this year we saw a strong employment climate. In the 12 months from August 2004 to August 2005, the economy added more than 2.3 million jobs for an average of 194,000 new jobs per month. This steady pace of job growth was better than commonly acknowledged and enough to lower the unemployment rate for August to 4.9 percent, the lowest since 2001.

To complete the picture of our economy leading up to Hurricanes Katrina and Rita, let's recall this past summer's inflation situation. Earlier this year, there were some notable increases in broad-based measures of inflation, and these higher costs related mostly to energy. The statement following the Federal Open Market Committee's August 9 meeting took note of this trend, acknowledging that pressures on inflation stayed elevated. But the narrower core measures of inflation, excluding volatile food and energy prices, had increased only moderately from a very low base. Of course, by this time, the Fed was moving to guard against an unwelcome increase in inflation through a series of gradual steps to remove the extremely accommodative policy that was put in place to cushion the recession of 2001. Later, I'll come back to some more thoughts on our monetary policy path.

After the storms
So, all in all, the economy was in pretty good shape in late August. Then Hurricane Katrina roared through the Gulf of Mexico and wrecked a big part of our nation's energy production and distribution network. A few weeks later, Hurricane Rita caused more damage. At this point, I think it's fair to describe these two storms as a serious economic shock to the region, and many of us have worked hard to determine the impact of these hurricanes on our broader economy.

The sheer scope of the tragedy in Louisiana and Mississippi is huge. In addition to human suffering and economic dislocation, there has been great loss of individual and business capital. My organization has an office in New Orleans, so I have seen first-hand the tough work of recovery. Our New Orleans branch escaped the widespread flooding, and recently we restarted limited operations there. But it took us a while to find our staff of 176 employees who had fled to more than a dozen states. As of today, about half of our employees in the New Orleans area still can't inhabit their homes. And I've heard story after story from other businesses with similar—or more difficult—problems trying to restart operations.

Because our region is the hurricane-prone Southeast, the Atlanta Fed is familiar with the pattern that follows these kinds of disasters. Immediately after these storms there is significant loss of jobs, income, and spending in the affected local area. But on a national basis, such storms—even the very big ones—typically don't take a big toll on the broad measures of national employment and spending. Most economic forecasters guess that Katrina and Rita—because of the devastation—will subtract approximately half a percentage point from the GDP growth we would have seen in the third and fourth quarters of 2005, and I believe these estimates are reasonable. But then federal government and insurance payments will flow and begin to give the local economy a kick. I also concur with those who forecast that post-hurricane reconstruction spending will boost national economic output early next year by a comparable amount, maybe half a percentage point.

So I expect the negative economic impact of Katrina will be temporary, and for the next few months we'll also see an adverse effect on the data that we rely on to judge economic performance. As you can imagine, it's hard to collect information in storm-ravaged areas, and in recent weeks economists scrambled to make "best-guess Katrina adjustments" to a variety of newly released economic statistics. As an example, the September payroll data showed a small job loss after Katrina—less of an impact than some forecasters estimated—but still a deviation from the pattern of growth we had seen. At this point, however, we simply don't know the true impact on employment. In the coming months, I think we'll need to be especially cautious about how we interpret much of the incoming economic data.

And the hurricanes added more doubts with regard to the availability and price of energy. Before Katrina, U.S. refineries were near capacity, with demand for refined petroleum products already high because of strong economic growth worldwide. Then, the storms temporarily knocked out a big share of this country's limited refinery capacity, leading to an immediate run-up of gasoline and other petroleum product prices. While gasoline supplies have improved recently, the outlook for natural gas is still in question. As of last week, it was our understanding that much of the oil and gas pipeline systems crisscrossing the affected areas of the Gulf region was still being evaluated for damage or under repair.

There's also a lot we don't know about how individuals and businesses will adjust to the higher energy costs that are now working their way through the economy. From past experience, we have observed that rising energy prices in the short term tend to reduce spending on other goods and services. For the past three years, many households have managed to withstand additional energy expenses, and personal consumption expenditures have grown at rates comparable to GDP. I am reluctant to bet against the strength of the American consumer. But with gasoline at or near $3 a gallon recently and other energy costs such as natural gas almost doubling in the past year, consumers may face tough choices in how they allocate their spending. In the final months of 2005, consumer spending could slow a bit if caution causes households to reduce borrowing or increase the rate of savings.

Another important concern is how elevated energy costs might affect business spending. Nonresidential fixed investment has been a source of strength in the economy since 2003. But so far this year, this key measure of business spending has been a bit weaker than expected, especially given a favorable background of growing sales, strong business balance sheets, and high corporate profitability. I suspect higher energy prices may be causing a temporary spell of caution among businesses, leading them to protect profit margins during a time of uncertainty. But in the months ahead, with good global growth and other fundamentals in place, stronger business investment growth could very well resume.

Price pressures and inflation risks

As I noted earlier, for the past year, I have been concerned about a discernible upward drift in some measures of inflation. The overall Consumer Price Index (CPI) in September was 4.7 percent above the year-ago level—and up from about 3 percent early this year because of the steep increase in energy prices. On the other hand, core CPI (excluding food and energy) increased 2 percent last month, about the same as early this year. At present, core inflation is still within the upper end of what I view as an acceptable range.

Now, I have to admit that when it comes to inflation, I generally tend to worry—it's my job as a central banker. I've been telling people that our staff economists at times have made forecasts that overestimate the risks of rising inflation. You see, our forecasting models don't always capture the relentless competitive pressures that work beneath the surface to constrain price increases. Retailers play an important role in the price equation by partnering with low-cost suppliers and refusing to accept higher prices for finished goods. Also, manufacturers continue to come up with new and ingenious ways to leverage technology and control costs. These are deeply ingrained and permanent trends that help to ease inflationary pressures.

In this recent climate of growing economic demand and shrinking excess capacity, many businesses have tried to make price increases stick. After Katrina, I heard more and more reports of businesses straining to cover higher shipping costs with rail and truck networks near capacity. Fuel surcharges are yet another budget buster. Moreover, prices for other materials, such as steel and plywood, spiked significantly last month. At some point—and you in the audience would know better than I do—businesses will likely reach the limit when they can no longer absorb all of the higher costs, and there will be additional pressure to increase prices.

But even more important than price readings is how individuals and businesses perceive the likely path of inflation. Our research tells us that expectations of future inflation are more important to the inflation outlook than short-term rising prices. Rising energy costs probably won't lead to a persistent and broad-based rise in inflation if—as is the case, in my view—the marketplace does not perceive the general price level to be increasing. So energy prices have been rising, but other important prices have not. What we want to avoid is the emergence of the perception that prices across the board are continually rising faster and thus get embedded in the expectations of businesses and consumers. Recent evidence shows that core inflation is relatively low. Although it's difficult to judge how much of the current inflation risks will ultimately become realized in core inflation in the coming months, I'm reasonably confident that today's inflation pressures—as with much of the fallout from the hurricanes—will turn out to be mostly temporary.

Monetary policy implications

Given these issues, you can probably imagine that we faced some tough questions about inflation and inflation expectations as the FOMC met last month for the first time after Katrina. As you probably know, the Fed during that meeting voted to increase the fed funds target rate for the eleventh time in 15 months. I supported our decision to bump up this important short-term target rate to 3.75 percent, and I'd like to take a few moments to explain my thinking.

Looking at the economic impact of the hurricanes and the daunting task of rebuilding along the Gulf Coast, I believe our nation has a moral responsibility to lend a hand to those victims who are trying to resume productive lives. In thinking about how that support could best be provided, it was also clear that monetary policy was not the best way to help. As they teach in college economics courses, monetary policy is a blunt instrument—one that works with a time lag and cannot quickly be directed to one particular economic sector or geographic region. On the other hand, fiscal policy can be tailored to specific circumstances, and the federal government has pledged to spend what's necessary to rebuild the Gulf region. The point I want to emphasize is that the shock from hurricanes to aggregate demand is likely temporary, and growth should pick up again pretty quickly as rebuilding starts and money flows to rebuild homes and infrastructure.

With indications emerging that the economic expansion would continue even after the hurricanes, the FOMC chose to take a longer-term view and to continue on the path of removing the monetary policy accommodation that was no longer needed. For those of you who try to anticipate our future actions, I believe it's helpful to remember the fundamental role of Fed policy. Our mandate is to foster a climate of full employment and low and stable inflation. We can respond to economic weakness or financial market stress by lowering our fed funds target rate. And as satisfactory economic expansion resumes, we can return the target rate to a so-called "neutral" setting, which neither stimulates nor restrains the economy.

Looking ahead, it's my belief that—despite the effects of the hurricanes—the most likely path of the economy for the next several quarters is ongoing respectable growth of GDP, employment, and income. That pattern suggests to me that we should continue to move toward a neutral setting for monetary policy. The Fed already has moved interest rates a long way toward a more normal level consistent with sustainable growth. By most conventional measures, however, policy is still accommodative. So I believe the continued removal of that monetary accommodation is appropriate for now. And I will submit that our gradual course has been far preferable to pausing and risking more drastic—and painful—moves later.

Monetary policy involves balancing risks, and we continually forecast the probability that the economy will get a negative surprise on either output or inflation. Then we have to weigh the consequences of such an unwelcome outcome—even if the odds of either event happening are judged to be low. In evaluating the costs of a potential drop in the rate of output growth or an unwelcome rise in inflation, I believe that a significant acceleration of inflation would be the larger and more troubling outcome in the period ahead. A rapid increase in inflation can distort decisions in the marketplace and, once unleashed, become extremely costly to the real economy and difficult to contain. This heavy toll reinforces the importance in my mind of leaning against the possible emergence of unwelcome inflation and inflation expectations so the marketplace is not allowed to ratify continued rapid price increases.

For some time now we have provided reasonably specific guidance on the future path of monetary policy, and we have seen the value in this more open approach to communication with the public. Over the last few months, the guidance we have been able to provide on the likely path of policy has been well received in the marketplace. But we have moved into a new—and in some ways more difficult—period of greater uncertainty, and all of us will have to be ready to respond to new developments.

I want to note that our recent post-FOMC meeting statements came with a caveat that reads: “The Committee will respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability.” To me, this language means that while we’re working to gradually remove the remaining policy accommodation in this time of elevated inflation risks, we also must watch carefully for unexpected developments in the economy, especially how individuals and businesses respond to the continuing rise in energy costs.

In closing, let me briefly recap what I hope you’ll take away from my remarks. The economy was in the midst of very solid growth midsummer before the hurricanes. These storms were devastating to the Gulf region but, from a national perspective, have not significantly altered our mostly positive economic path. In the wake of the hurricanes, our economy faces new uncertainties related to higher energy costs and economic data that may be harder to interpret. Clearly, the risks to inflation are elevated, but I believe price increases are likely transitory and will not significantly change the long-term inflation outlook. At this point, I believe inflation and inflation expectations will be largely contained by competitive market forces and continuing adjustments to the stance of monetary policy.

It’s been said that liberty is granted to us on the condition of eternal vigilance. In many ways, I believe the same is true for monetary policy as we continually guard against economic threats. The U.S. economy is the most dynamic and resilient in the world, and there is good reason to believe our economy will keep adjusting in ways that make low and stable inflation and continuing growth the most likely outcomes. But in this time of change and uncertainty, we can take nothing for granted. Today and tomorrow, we’re committed to eternal vigilance.

Press Release

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