Speeches

Now Is the Time to Strengthen Our Economic Foundation

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Rotary Club of Atlanta
Charles Loudermilk Center
Atlanta, Ga.
January 9, 2006

It's always my pleasure to return to this familiar podium, and of course it's an honor to provide the Atlanta Fed's New Year economic outlook—a tradition for me that now goes back a decade.

Today, the U.S. economy is doing quite well, even better than many people seem to allow themselves to think. And let me say up front that I think 2006 should bring us another year of solid expansion, with perhaps a slightly different mix of economic factors. Over the next few minutes, I plan to give you my take on last year's economic performance along with a high-level outlook for this year. Then I want to talk about some long-term economic challenges before closing with some personal observations on inflation and monetary policy.

A look back at 2005

Let's begin with a look at the past year. As measured by gross domestic product (GDP), the most familiar gauge of broad economic growth, 2005 was a very good year overall. During the third quarter (the latest available), GDP increased 4.1 percent—a very solid number that would have been even higher if not for last year's terrible hurricanes.

While fourth quarter growth may turn out to have been a bit slower, in all likelihood overall growth for 2005 was more than 3.5 percent. To put this economic performance into perspective, GDP growth over the last 10 quarters was on average 3.8 percent—comparable to the booming late 1990s.

Clearly, one key to this positive economic story is the American consumer. During the first three quarters of 2005, personal consumption expenditures increased at an average rate of about 3.7 percent. That solid growth may have moderated some recently, reflecting in part the impact of higher energy costs and adjustments to incentive programs for cars and trucks. But overall consumer spending has been well maintained.

Importantly, higher energy costs do not seem to have dampened businesses' desire to hire new workers. Indeed, labor markets are stronger now than a year ago. The unemployment rate in 2005 declined from 5.4 to 4.9 percent, and the median duration of unemployment also declined. Additional hiring was broad-based, from construction to leisure and hospitality to business services. Late in the year, even manufacturing employment was positive.

In September, Hurricanes Katrina and Rita destroyed many jobs along the Gulf Coast, an area encompassing about half of 1 percent of the nation's employment base at the time. Based on what we've seen and heard, the negative impact on employment was confined to the Gulf Coast area. During 2005, about 2 million new jobs were added for an average of about 168,000 per month.

The outlook for 2006

When I spoke to you last January, payroll expansion was still uncertain. But now, after two years of steady job creation, I'm expecting more of the same: nonfarm payroll growth averaging 150,000 to 200,000 per month in 2006, with the unemployment rate holding near its current level of 4.9 percent or perhaps moving a bit lower.

Labor markets are always important to the economic outlook, but in 2006 another important factor is—once again—business spending. In a climate of strong competitive pressures, spending on equipment and software for much of last year grew at annual rates of more than 10 percent—a pace that I think is realistic to expect in 2006.

At the same time, painful restructuring continues in some industries, and spending on new commercial construction hasn't improved significantly. But, in general, businesses across the United States not only are adding to their productive capacity but also are continuing to make the capital investments required to improve efficiency. Moreover, most corporate balance sheets are flush with the cash needed to make these investments. Since 2003, corporate profits from current production have climbed rapidly and during the first nine months of last year were up about 15 percent.

As we move into 2006, activity in housing markets remains very strong. But there are signs that demand may be gradually returning to more normal and sustainable levels. In November, existing home sales declined, and the inventory of unsold existing homes increased to about five months. The pace of construction, especially condominiums, appears to have eased. At the same time, mortgage rates are still low by historical standards. While earlier forecasts of a housing slowdown turned out to have been premature, I expect to see more moderate growth of housing construction, sales, and price appreciation in 2006 compared with 2005.

Here in the Southeast, insurance and government money is beginning to flow into parts of the Gulf Coast region devastated by last year's hurricanes. To put things in perspective, Katrina and Rita destroyed more than 350,000 dwellings, with another 145,000 suffering major structural damage, according to recent estimates. Much of the spending so far has been for demolition and cleanup, which I saw firsthand during a visit to the area in October. The immense shortage of housing impedes recovery, with so many residents and businesses still living in (and operating from) other places, including Atlanta. For the hardest-hit areas, including New Orleans, where I spent more than 12 years of my Fed career, it pains me to say that substantial rebuilding may take longer than first thought—according to some estimates, perhaps five years or more. Effective coordination of local, state, and federal policies and resources is especially important to the ongoing rebuilding efforts.

For the overall U.S. economy, as I mentioned a moment ago, I think the outlook remains quite favorable for 2006, and I expect we'll enjoy a solid economic expansion

for a third straight year. But I also want to recognize a troubling disconnect between my mostly positive outlook and some less sanguine discourse on the economy. In one recent survey, a majority of U.S. investors described the current economy as “in a slowdown” or “in recession.” And despite the positive vital signs in the economy, a surprising number of our business contacts continue to express concern that trouble is lurking ahead.

Energy price volatility

For the next few moments I’d like to talk about three longer-range economic issues that seem to be gnawing at our public consciousness. And the first is energy. During the 1970s, you’ll recall, energy price shocks were accommodated by monetary policy that led to high inflation, followed by back-to-back recessions in the early 1980s as policy was corrected. Then, after new supplies of energy were found, oil prices fell to about $10 to $12 a barrel. In this era of cheap oil, energy producers had little incentive to increase supplies, and energy users had little incentive to conserve.

Until recently, our experience was that oil would revert to the range of about $20–$30 a barrel. But now, after two years of increasing energy prices, with strong worldwide demand and limits on new supply, oil futures markets and business decision makers seem to be concluding that the old equilibrium price no longer holds. In short, we may have to get used to a new era of higher and more volatile energy prices.

Energy costs are not something we can control, but we can adjust our thinking and our behavior to conform to increased economic uncertainties. Consumers can alter their energy consumption habits, and businesses can decide to invest in more fuel-efficient equipment. Policymakers can do their part by developing forward-looking and well-grounded policies for sustainable energy development and consumption. As for monetary policy, an important Fed imperative is to try to keep energy price increases from causing a general run-up of inflation, and I’ll have more to say in a few moments about our commitment to price stability.

Workforce issues

In addition to energy, a variety of workforce issues have confounded public opinion. As I said earlier, the U.S. economy is now creating a solid number of new jobs, and I repeatedly hear of shortages of skilled workers in industries such as construction, with wages for some jobs going up significantly.

But many workers have seen their job security evaporate in recent years. For instance, the U.S. apparel industry declined dramatically over the last decade because of competition from lower-paid workers in other countries. But job insecurity is not just a matter of global competition for low-skilled manufacturing jobs. U.S. airlines and automobile makers, for instance, confront cost pressures that have caused some employers to make deep cuts in payrolls—a development that hits home in the Atlanta area.

With businesses focused on cost cutting, there has been strong downward pressure on wage growth. Since the 2001 recession, growth in the average wage, as measured by the Employment Cost Index, has slowed. Moreover, employee and retiree benefit programs that have long been taken for granted are now being questioned. Adding to the uncertainty about the future, the federal government could begin to feel pressure to address shortfalls in private-sector retiree health care and pension obligations just as Congress is confronting its own funding challenges. And that brings me to the third source of perceived economic insecurity I want to discuss: the looming federal deficit.

Fiscal deficits

Last year, after the election, I expressed hope that that our fiscal policymakers would make progress in reducing the federal budget deficit. The 2005 deficit was $317 billion, much lower than the record high level of $412 billion in the prior year, according to the Congressional Budget Office. So we’ve seen improvement, but our fiscal deficits have persisted during this time of solid economic growth, and the extended outlook is very worrisome.

Our nation’s looming deficits are unlike anything we’ve seen before, with plausible baseline shortfalls measured not in billions but in trillions in the aggregate over the next decade. We’ve been reminded over and over that costs for Medicare and Social Security are projected to increase dramatically over the next decade and threaten federal government balance sheets, with the big hits beginning about 2012 and thereafter.

But there’s more. This year, a new and expanded Medicare prescription drug program takes effect at the same time that we face open-ended costs for ongoing wars, hurricane relief, and other spending programs.

My point is we need to make sure that deficits don’t get out of hand, especially with about 76 million baby boomers approaching retirement age. It’s hard to prove empirically that fiscal deficits cause inflation. Most research on the subject has looked at temporary deficits, not deficits due to permanent increases in entitlements like we are facing now. But history—and common sense—tells us that most inflation problems arise in economies with large fiscal deficits. In other countries, fiscal deficits have been associated with unwelcome rises in inflation. This year, I’m hopeful that the gravity of our long-term fiscal imbalance will soon lead to some tough decisions that will bring forth viable long-term solutions.

Inflation and monetary policy

Along with fiscal policy, monetary policy is another key component of our economic foundation. As you know, the Fed’s goal is to foster long-term economic growth and stable prices. While fiscal policy tends to take effect quickly—like a shot of adrenaline—monetary policy works with a lag. Both monetary and fiscal policy must be applied carefully and ideally should work together, as we saw in the 1990s, when fiscal deficits turned into surpluses and the economy enjoyed an extended period of solid growth and low and stable inflation. Fiscal and monetary policy also worked in tandem to help cushion the pain of the 2001 recession.

Let’s review our recent monetary policy path. When I spoke to you last January, the economic expansion was well under way. Our Federal Open Market Committee had raised the fed funds target from an extremely low 1 percent to 2¼ percent—and on several occasions last year I expressed uneasiness about the unintended consequences of leaving rates too low for too long. Now, after eight more rate hikes in 2005, the fed funds target rate is 4¼ percent.

So for me, the overriding policy consideration in 2005 was to lean against potential inflationary pressures. During the year, our business contacts suggested that elevated energy prices and other cost pressures were providing both the incentive and the determination to pass through those higher costs. As it turned out, the consumer price index did drift upward during the year. The core inflation measures, which exclude food and energy, were more stable. Core CPI on a year-over-year basis moved from about 1½ percent in early 2004 to 2¼ percent in 2005.

The good news is that core inflation measures have not moved noticeably higher in recent months. In my view, adjustments in monetary policy have helped to limit these inflationary pressures. Also, competitive market forces and strong productivity increases are contributing to our currently low inflationary environment. In our extremely competitive global economy, businesses must continually find new and better ways of providing goods and services at lower cost, and in many cases these

efforts are reflected in lower prices to consumers.

Even more important than maintaining acceptable levels of current inflation is containing future inflation expectations, which influence the behavior of business decision makers and financial markets. Deterioration in inflation expectations can be reflected quickly in current prices. Once unleashed, expectations of higher inflation can distort business decision making and erode market confidence. Once embedded in the marketplace, measurably higher inflation and inflation expectations are extremely hard and costly to reverse, as we experienced during the recession of 1981. It's vital that the Fed's words and actions clearly communicate our commitment to lean against the emergence of expectations of rising inflation.

In the minutes from our Dec. 13 meeting, we acknowledged the potential risks of rising inflation expectations in an environment of elevated energy costs and following a period of monetary policy that had been accommodative for some time. Also, we made it clear that considerable monetary accommodation had been removed and that we were approaching a more uncertain time in our process of recalibration.

Given the steady diet of "measured" rate hikes the Fed has provided in the past year and a half, many of you may be wondering when enough is enough. Let me first respond by saying the closer we get, the less explicit we can be on that point. One reason is that we don't yet know the full economic effect of the policy moves we have already made. So in the months ahead, we'll have to watch the data very carefully to make sure that growth is still on track and inflation expectations are well anchored.

For some additional insight into the FOMC's thinking, let me point to a phrase from our December meeting minutes, which were released last week. In those minutes, we said that in looking ahead "the number of additional firming steps required probably would not be large." While our policy direction has been quite clear over the past 18 months, in the less certain period ahead it's my personal opinion that as policymakers we should resist the temptation to say more than we know at any given time. And so I think it's appropriate that our post-meeting statements have come with the caveat that "the Committee will respond to changes in economic prospects as needed."

In a perfect world, the economy would continue to grow at a pace about equal to its longer-term potential, with inflation in a range that is relatively low and stable, and with inflation expectations well-anchored. And in the quarters ahead, we could experience such an ideal economic outcome. But of course we don't live in a perfect world.

Ten years ago, when I first spoke to this group, we were in what turned out to be the longest peacetime economic expansion in our nation's history. Since then, we've had some major economic setbacks. But after each blow—no matter how nasty or surprising—our economy recovered and recovered quickly. I believe one of the important lessons that has been reinforced is that monetary policy that is focused on low and stable inflation helps our economy stay resilient and strong.

And so we begin 2006 with an economy that in my view looks set to continue on a good path of sustainable GDP growth in the range of 3 to 4 percent. The economic fundamentals appear sound—consumer spending, business spending, and hiring should continue to grow at a solid pace. And inflation expectations should remain anchored.

Today, this economic strength gives us a crucial opportunity to respond effectively to the challenges of tomorrow: to develop sustainable energy policies, to build a workforce for the increasingly competitive economy of the 21st century, and to deal with our fiscal deficits. Crises do not often lead to good long-term economic policies. So let's do the right thing for future generations and act now when our economy is strong.

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