Speeches

Nearing a Sustainable Balance of Economic Growth

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It's a pleasure to be back in Nashville. The last time I spoke here, my colleagues gave me a pretty rough time about speaking at some place called the Wildhorse Saloon. Who knows what they imagined about this audience? But I assured them I was honoring a request to speak to the top business and civic leaders of Nashville, which of course was and still is the case.

And let me add that Paula Lovell has been a terrific representative of your community in her work with us at the Atlanta Fed. For more than 10 and a half years serving on both the Nashville and Atlanta boards and as our 2003 chairman of the Atlanta board, she brought us invaluable grassroots insights on the local and national economies. Her perspective—and the views from other business and community leaders who serve as Fed directors across the country—are vital to our monetary policymaking process. So, Paula, thank you again for all the time you spent with us.

It's been four years since I spoke to your group, and over that time, our economy has seen pretty dramatic changes—and challenges. My intent today is to not only describe an economy that continues to show solid growth and momentum but also to talk about some of the uncertainties and risks that all of us—as business leaders and policymakers—need to follow and understand.

Economic activity strong
Just last Friday, we got our first official measure of overall economic activity in the first quarter of this year. The advance estimate of gross domestic product (GDP), which is our broadest and most familiar measure of economic output, came in at 4.8 percent. That strong reading confirms our sense that the weakness in GDP growth in the last quarter of 2005 was not a turning point. As it turned out, slowdowns in auto sales and government spending and some loss of activity following Hurricane Katrina were just temporary factors.

In evaluating the path of the U.S. economy, it's more telling to realize that we are now in the fifth year of this economic expansion, with annual GDP growth averaging close to 4 percent over the past three years. In fact today's performance compares favorably to the long expansion of the 1990s.

While it's always helpful to reflect on the past, it's more important—and challenging—to look ahead to the rest of 2006 and beyond. In my remarks to other groups over the last few months, I have said that I expect the period ahead to bring us continued solid growth and favorable inflation experience. And that's still my outlook. But, as I indicated earlier, there are some significant uncertainties that could shape our economic outlook and help to inform how Fed policy should evolve.

Let me elaborate. I like to begin my analysis of the economy with a look at consumer and household spending, which represents about two-thirds of GDP. Consumer spending has grown steadily and was strong again for the first quarter of this year. And this performance was achieved in spite of somewhat higher interest rates and the drag from higher energy prices—a point I'll return to in a moment. But these headwinds were buffered by strong growth in employment and personal income, which has helped to bolster consumer spending.

During the first quarter, the monthly average for new job creation was nearly 200,000. That rate of hiring is strong and follows nearly 4½ million new jobs created in 2004 and 2005. The unemployment rate in March declined to 4.7 percent, a relatively low level by historical standards. And recent unemployment claims data and surveys of business hiring plans suggest good job growth should continue. In contrast to a few years ago, when people were concerned about a jobless recovery, some employers are now having a hard time filling many skilled jobs.

There are other important contributors to growth, such as business spending. While this category accounts for only about 10 percent of GDP, it serves as an important contributor to both gains in productivity and employment. You'll recall the collapse of business spending was a big factor in the 2001 recession. But in recent years business spending has been strong and after a bit of a lull late last year recovered in the first quarter of this year with a gain of more than 14 percent. Growth in new orders for durable goods this year has been especially notable.

In today's climate of strong aggregate demand and worldwide growth, businesses have not only the will but also the means to finance aggressive capital spending. Corporate profits increased more than 16 percent in 2005, following gains during the prior year of more than 12 percent. Also, financial markets are still relatively accommodative—despite some recent upward movement in longer-term interest rates—so the business climate is very supportive for capital spending.

Evaluating uncertainties, including housing
While the outlook is favorable, I want to point out several risks that could materially affect how the economy evolves. For the next few moments, I'd like to talk about some of these risks, starting with the much-anticipated adjustments in residential real estate.

Last year was a record one for housing construction, sales, and price appreciation. In fact, for the past few years, housing activity has been supported by low mortgage rates, job growth, and strong demand. But in recent months, there is growing evidence of a cooling in many housing markets across the country.

In some of the hottest coastal markets in the Southeast, I've heard of sharp adjustments and sudden reversals of the frenzied speculation we saw earlier, with prices falling sharply in some of those markets. Some projects have been canceled, and I've heard more reports of standoffs between buyers and sellers as buyers wait for prices to adjust further.

Clearly, higher mortgage rates, while still historically low, have muted housing activity. In most markets, home sales are still relatively strong, but not strong enough to keep pace with properties coming on the market. So the inventory of unsold homes has climbed steadily to about 5½ months' supply at the current sales pace.

Looking ahead, continued job growth and underlying demographics suggest the underpinning for housing over the longer term is solid. But the market is changing, and the impact of the housing adjustment on overall economic activity is not yet fully evident. Some slowdown in housing is built into almost everyone's forecast. But housing could turn out—once again—to be more resilient than expected, or the adjustment could turn out to be more extensive than anticipated.

What's also vexing for observers of housing is that longer-term interest rates have not responded to steady increases in short-term rates the way they have in the past. A number of explanations have been offered for the nontraditional behavior of short- vs. long-term interest rates, but it is yet to be seen whether this worldwide development will persist.

I can't help but recall other unusual developments a few years ago that were described as a "new economy," suggesting some fundamental economic principles had changed permanently. In hindsight, we now know that historical relationships prevailed. I won't venture to predict the ultimate resolution of the short-term/long-term interest rate conundrum, but my staff is continuing to research the economic implications of a return to more familiar patterns with higher long-term interest rates.

Adjusting to energy costs

Since we're on the subject of uncertainties, let me also share my thoughts on energy prices. The last time I was here, four years ago, oil cost about $20 a barrel. In fact, despite volatility in energy prices, we used to think that oil would settle back over time to around $25–$30 a barrel.

But our experience for the past two years has changed that expectation, at least in the view of futures markets. With oil prices persistently above $70 a barrel, households and businesses face new costs that must be absorbed, offset, or passed along if possible. Although difficult to measure, these higher energy costs have forced households to reallocate spending and could dampen consumer spending in the future.

At the same time, because of elevated energy prices, businesses face intense pressure to cut their other costs, raise prices, or both, depending on the circumstances. While energy is increasingly cited as a justification for price increases, many businesses—especially goods producers—can't or won't pass along higher costs. In part, that's because global competition helps keep prices down and thus induces businesses to improve efficiency to maintain profits. The result is higher productivity, which helps to offset increased costs, including energy.

Manufacturing and globalization

This trend is quite evident in manufacturing, which as you know is an important sector in middle Tennessee with the auto industry nearby. Much has been written about the supposed demise of U.S. factories. Yes, we have lost some four million manufacturing jobs in the past 15 years, and many of those lower-skilled jobs have moved overseas.

People are quick to blame globalization for painful adjustments in nondurable manufacturing industries such as apparel, where overseas makers have the advantage of lower labor costs. But you may find it surprising that, even with many factories shedding low-skilled jobs, manufacturing output in the United States is growing at about the same pace as the overall economy—even faster for makers of information technology equipment, aircraft, and other high-quality durables where skilled labor and technology are a necessary part of the process.

In fact, the United States remains the largest producer of manufactured goods in the world—bigger than even China or Japan. And the total employment in manufacturing is still an important part of the U.S. employment base, with some 14 million workers still employed in manufacturing, or about 13 percent of the total work force. Even as less-productive manufacturing jobs go away, the total wage bill in manufacturing is increasing as managers bid up wages for high-quality, technically skilled workers.

Keeping an eye on inflation

Bidding up wages prompts me to consider another factor that's critical for our central bank mission. As monetary policymakers, our challenge is twofold: to provide a climate that is conducive to sustainable GDP growth and to create a financial environment that should sustain low and stable prices.

Over the years, we've learned hard and painful lessons—both in the United States and elsewhere—about the disruptive and destabilizing nature of rising and unstable inflation. Even more insidious at times has been the emergence of expectations of rising inflation, which leads to all sorts of irrational and unproductive marketplace decisions. Some of you with gray hair like mine may recall the high inflation of the 1970s and the double-digit mortgage rates many of us carried.

Trust me, we don't want to go there again—and the Fed is firmly committed to resisting unwelcome rises in inflation. My colleagues and I place a very high value on Fed credibility in the fight against inflation, which was earned through steadfast actions to ensure price stability. Part of our job is to adjust monetary policy as needed to achieve that objective and to explain our actions in ways that inspire public confidence in our determination to lean against conditions that could lead to the increase of inflation expectations.

Let's talk about our recent inflation experience. For the first three months of 2006, the familiar and frequently cited consumer price index (CPI) has increased at an annual rate of 4.3 percent. This number includes food and energy prices and is a significant increase from 2005 CPI growth of 3.4 percent. As I said earlier, a major factor in this unwelcome rise in overall inflation is, of course, energy, which has a direct bearing on the price of gasoline and natural gas, among other vital commodity inputs.

The core measures of inflation, excluding food and energy, have been less volatile. Core CPI was 2.8 percent for the first three months of 2006, and another measure we often use, core personal consumption expenditures, or core PCE, was about 2 percent measured on a year-over-year basis. On the other hand, three- and six-month measures have edged up recently. While these measures are still relatively low, I don't want to see inflation move measurably higher.

Lately, my staff and I have pored through reams of data and talked to many business contacts to try to determine the extent of energy cost pass-through. We're finding the impact on transportation costs is large, and the spillover effect of higher energy costs affects various industries in different ways.

For instance, as I mentioned earlier, most goods producers have found offsets for energy price increases. Productivity improvements have been less of a factor for service providers, such as accountants or medical professionals, and so price increases have shown through more in the services sector than in the goods sector.

While there's every reason to believe that competitive pressures will remain a major factor in the global marketplace, we don't know how long and how extensively these forces will continue to mute overall price increases.

Considering monetary policy

I want to spend my last few minutes giving you my personal thoughts on the question, What's the likely path for future Fed policy? As you know, the Fed has been steadily raising short-term interest rates since June 2004. Over this nearly two-year period, there have been 15 rate increases, taking the Fed funds target rate to its current 4¾ percent. We have been able to stay on this steady and well-anticipated policy path as the economy has maintained momentum.

With demand increasing for several years, recent surveys suggest that wage gains are now becoming more widespread. While I think it's important to watch for cost pressures from wages, I'm not among those who subscribe to the theory that a certain level of low unemployment triggers an outbreak of wage-induced inflation. In fact, our experience from the 1990s and more recently tells us that there's little if any measurable correlation between tight labor markets and inflation.

When calibrating monetary policy, the Fed takes account of various risks to its baseline forecasts. Over the period ahead, as the full effects of the sequence of monetary policy moves plays out, I expect that output growth will settle on a path that is somewhat below what we saw in the first quarter of this year, probably growing at close to the economy's potential. I believe that monetary policy adjustments that have already been made, along with other factors such as continuing productivity improvements, should also help to contain elevated inflation pressures.

If—and I emphasize if—my most likely forecast of sustainable output growth and modest inflation is right, then I am of the view that we are very close to having Fed policy properly calibrated for now. At the same time, we are at a point that requires careful analysis of new economic data, especially data that might signal an uptick of inflation or increase in inflation expectations that would affect our projections for the likely course for the economy. And I will also give particular weight to the forward-looking anecdotal information we get from our many contacts—the Paula Lovells of the world, who help to keep us in touch with the real world of business decisions.

During the last four years, our economy has evolved in unexpected ways and has been more stable than some might have predicted. I expect the next four years will be no less fascinating. One of the lessons we've learned—or at least relearned—is that surprises are inevitable. We can't know the shock of the next hurricane, terrorist attack, or political crisis in an oil-producing region. Layered on top of these potential shocks are the risks I've just described: potential adjustments in housing, unknown consequences of high and volatile energy prices, and unprecedented global capital flows, among other uncertainties. Given the wide range of possibilities ahead, I believe this is not a time for the Fed to precommit to a particular course of policy.

But the U.S. economy is flexible and resilient, and most of what we know suggests the outlook is positive. So today I believe that growth is on track. And furthermore I know—and I hope you know—that the Fed is committed to keeping inflation and inflation expectations anchored for the long term.

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