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The U.S. Economy: 2005 and Beyond

by Cathy E. Minehan, President & Chief Executive Officer
Connecticut Business and Industry Association
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It's always a pleasure to attend the Connecticut Business and Industry Association's Economic Summit and Outlook. It is a chance to share my own views and to hear from you --distinguished participants and guests --about what the economy looks like from your vantage point.

The beginning of a new year is always a good time to take stock - to look back and see where we have been; to look forward and anticipate where we are going. Today, I would like to do just that. First I would like to say a few words about the U.S. economy last year, in 2004. Then, I will talk about what we might expect in 2005: what are the prospects for the coming year, where are the risks, and what are the implications for policy? To preview: The prospects for near-term growth look favorable, but over the medium-term challenges exist related to this country's continuing low rate of national savings. I'll close with a few thoughts on that critical issue.

This past year was certainly eventful. Regionally, among other things, we were home to the "Reverse of the Curse" as well as a Super Bowl win by the Patriots. Nationally, the presidential election took center stage for much of the year. The ongoing war in Iraq brought with it continued challenges and significant human costs. Parts of the country suffered through the economic and human impact of several major hurricanes. Corporate scandals continued to make headlines. And, at year's end, the tragedy of the tsunamis across a wide area of southern Asia, India and Africa brought home how closely we are all linked in this ever smaller world.

Through all of this, the U.S. economy performed quite well, both in comparison to the rest of the industrialized world and in light of our own past record. As of the end of the third quarter, annual GDP growth was close to 4 percent, above what most economists think is the long run sustainable growth rate for the economy, and above the average annual growth rate over the past 50 years. Although things got a little bumpy at times -- remember the "soft patch" we thought we had in the summer? - overall it was a good performance.

Unemployment ticked down as well. The unemployment rate in December stood at 5.4 percent, down from 5.7 at year-end 2003. A long way from the low 4's we experienced in the boom of the late nineties, but a good number. The consumer proved a resilient source of demand for houses and cars, which said something about their confidence in the future. And supported by strong profits and buoyant financial markets, businesses began investing more, though perhaps not quite as much as expected.

This performance is even more impressive when one considers that both monetary and fiscal policy moved to less accommodative postures, and the economy faced other headwinds. The stimulative effect of last year's personal tax cuts wound down by mid-year. In line with growing economic strength, the Federal Open Market Committee moved the federal funds rate up 125 basis points to 2 and a quarter percent by year-end. And the economy also proved gratifyingly resilient in the face of sharply rising oil prices-- \$30 a barrel in late 2003 to \$55 a barrel in September to near \$40 a barrel more recently--a stress that so far has been weathered relatively well.

One area that continues to be an issue involves labor market conditions. They remain sluggish. We added jobs at a decent pace in 2004 - about 2.2 million over the year - but total payroll employment remains below its pre-recession high. This sets a record of sorts. In post-war history it has never taken this long to regain the jobs lost during a recession, not to mention to begin creating the additional jobs needed for an expanding labor force. At the same time,

participation in the labor force has declined over a three-year period. Again, very unusual. And spells of unemployment remain stubbornly high for an expansion that is in its fourth year. Yet, I continue to hear anecdotes about skilled labor being expensive and hard to find. So the labor market presents a puzzle - its slow pace of recovery likely reflects some excess capacity at present that is cyclical in nature. But we may be expecting too much if we think we can return to the late 90's combination of unemployment in the low 4's and low inflation.

Inflation was more of a concern in 2004 than it had been in the previous few years. Oil prices escalated in the spring, sending second quarter headline CPI growth to nearly 5 percent. Oil and other imported goods prices rose again in the fall. Some of these price increases fed through to core measures of inflation, that is, those excluding energy and food, with core CPI rising at a rate slightly better than 2.6 percent over the first half of the year. By year-end, however, core inflation moderated to a 1.5 - 2.0 percent pace depending on whether you use the PCE or the CPI index. Thus, the year ended with some good news on the price front.

However, I wouldn't be earning my pay as a central banker if I didn't worry about inflation. I do, and I'll say a bit more about that in a few minutes.

So what lies ahead of us in 2005? The most likely answer is the economy will grow again at about 4 percent or so. I also expect to see some acceleration in job creation as the economy continues to expand. And inflation seems likely to be well behaved, at least over the near term. But that said, as always, this depends on a number of things going right.

One big question is the consumer. Can household spending continue to support GDP growth at its current pace? While labor markets are certainly healthier than they were a couple of years ago, the pace of private sector hiring has been relatively modest, and growth in household disposable income-a major factor determining consumption-relatively muted. This raises a question about whether the consumption spending that is needed to support GDP growth at its current pace is achievable without a pick up in hiring and/or wages.

Through most of 2004, consumption growth seemed to be buoyed by rising housing prices and later in the year by a surging stock market. Further encouraged by low interest rates, consumers kept spending and reduced savings as a share of disposable income close to zero. This is problematic for the long run to be sure, but it was helpful in sustaining overall spending and production in the short run. Will consumers decide to retrench and moderately increase their savings in 2005? While this would have a number of positive implications for households and for the economy as a whole in the longer run, it presents a possible constraint on GDP in 2005.

Another risk to consumption spending arises from the housing market. The current high rate of increase in house prices cannot continue indefinitely. If housing prices increase at somewhat slower rates, this source of wealth creation will provide less support to consumer spending. Will consumption continue to grow briskly in that environment? That depends to a great degree on continued employment growth. As long as the economy produces jobs at a decent clip, growing wages and salaries should provide for growth in consumption. In that regard, it would be good to see monthly employment growth stay at its recent 3-month average of around 200,000 to provide some assurance of continued consumer strength.

Business spending is a question as well. So far businesses have been relatively restrained in their hiring and have focused attention on restoring profitability and a healthy balance sheet. And they have been quite successful in doing so. Labor productivity has continued to rise impressively since the late 1990s through both the recession and the recovery. In recent years, firms have successfully translated rising productivity into strong profits and balance sheets.

To my eye, this leaves businesses in a financially sound position to sustain spending at its relatively healthy recent pace. In fact, the strong balance sheets and cash positions of many firms suggest the possibility of more rapid capital spending. But will businesses continue to defer such spending as they had earlier in the cycle?

Perhaps so. Press reports this fall in the *Wall Street Journal* and other media outlets, suggest that some firms still have a fair amount of unused capacity embodied in the computers and other equipment they bought during the tech and Y2K spending booms of the late '90s.

According to a *Journal* story that appeared in early November, the CIO of Vanguard Group was preparing to invest in a

new computer back up system, a project that might have easily run into the millions of dollars. But when he analyzed the use of the company's servers, he found that many of them weren't being used to capacity. So instead of purchasing new equipment, he was able to squeeze more out of what he had, running two data centers "for the cost of one in 2001." Another executive from Hannaford Brothers, a New England company that operates 140 supermarkets, was quoted about why he wasn't planning on spending: "I haven't run out of ideas with the technology I have now." Examples such as these suggest that until businesses are sure that existing technology is being used efficiently, or old machines and software wear out and need to be replaced, or there is some new "killer-app" as the saying goes, new spending may remain somewhat restrained.

Another possibility is that in light of Sarbanes-Oxley and the increased scrutiny that firms face as a result of ongoing corporate and accounting scandals, companies have become more risk averse and less willing to commit themselves to new expenditures of capital or labor without a good deal of confidence that they will still "make their numbers." Certainly, I hear anecdotes about the time, attention and resources senior management must now apply to these issues, especially as the rules regarding how financial controls are monitored and managed are put into place.

The pattern of investment spending may be influenced by changes in tax policy as well. The accelerated depreciation allowance for equipment expired on December 31st. Logic suggests that firms responded to this tax incentive by shifting investment spending from 2005 back into 2004, so some forecasts predict slower growth in business spending in early 2005. However, if financial markets continue to be as accommodative as they have been, with low credit spreads and rising equity values, businesses may well find new spending attractive.

Lastly, there is the important issue of inflation. So far inflation in this recovery has been very well behaved by historic standards. Core inflation reached a low of about 1 percent in late 2003, a rate not seen since the early 1960s. As I noted earlier, core inflation picked up about a percentage point in 2004, reflecting the pass through of rising oil and gas prices into core goods and services which use energy as an input to production. The decline in the dollar may have also contributed, though our estimates suggest there has been a very limited pass-through from this channel. Productivity growth, a key reason for our earlier success on the inflation front, has slowed recently as well. The key question here is whether these factors, combined with the expected above trend rate of growth in 2005, will result in a more rapid pace of inflation than we now forecast. My best guess is that is possible but not likely.

There are good reasons to believe that the impact of last year's oil and gas price increases will be transient. As I noted earlier, core inflation was well-behaved at the end of 2004. Moreover, it is unlikely that we will experience the pace of oil price appreciation this year that we did last year. Certainly, energy futures markets do not expect such a movement. Productivity bounces around from quarter to quarter, but I continue to believe we have seen a significant uptick over time in its underlying strength. Economic growth could well tighten pressure on resources faster than I expect, but right now most of the ways we have to gauge whether that is occurring -- rates of employment and wage and salary growth, unit labor costs, profit margins and labor force participation -- suggest we have some way to go before we reach the yellow -- much less the red zone -- regarding inflation. Add to that the fact that inflation expectations remain well grounded, and a forecast of a continuation of core inflation at a 2 percent pace or so in 2005 seems more than reasonable. However, one has to be very humble about one's ability to peg exactly how the economy will operate in this phase of the cycle. Clearly, there are risks here and I retain a central banker's firm sense of vigilance.

So that leaves us in reasonably good shape in 2005 - expecting relatively strong growth, continued hiring, and low inflation - albeit with a number of questions and concerns and some risks on both the upside and the downside. What does that imply about policy? During 2004, the economy proved resilient in the face of less accommodative policy, both fiscal and monetary. The baseline forecast for 2005 that I have sketched out suggests such resilience will continue. This would imply less need for policy accommodation, but with risks on both sides of the forecast, a lot depends on how economic growth unfolds. I expect to be weighing the incoming data carefully.

But what lies beyond 2005? What are the challenges facing our economy in the next several years?

A lot can happen over that period, but, in my view, one of the most important macroeconomic problems confronting the U.S. is its current and persistent low level of net national savings. In the aggregate, the U.S. saves only about 1-2 percent of its GDP on an annual basis. This includes savings by households, businesses, and government, both state and

federal. Clearly this is much too low for an economy that is driven by technological progress and capital investment. In recent years, we have relied heavily on large inflows of foreign saving to supplement our meager domestic savings. This has made the U.S. the world's largest debtor country.

While businesses can be sources of saving, as they are now, typically national savings depend on two things -- how much households put away, and the fiscal situation of the federal government. Both present problems. Household savings as a share of disposable income is essentially zero, at or near an all time low. Dissaving at the federal level is an even larger issue. Moving from a budget surplus in the late 90s, the federal government is now running a deficit of about 3.5 percent of GDP. Looking ahead three to five years, and making reasonable assumptions about tax revenues and rates of discretionary spending, the deficit could well grow as a share of national output. And that says nothing about the potential impacts of funding social security and medicare, absent changes to current policy.

Our economy is already dependent on foreign capital to fund investment in domestic capital goods. Some inflow of foreign capital is both beneficial and likely welcome given the size of this country's capital markets and the rest of the world's desire to invest here. But the question is - how much is too much?

We now have an external deficit of unprecedented size, 5.6 percent of GDP-double what it was five years ago, and setting new records each month. In the 80's we used to refer to the fiscal and the trade deficits as the "Twin Deficits". As my colleague Ned Gramlich puts it, they may not be twins but they do share some DNA. And that DNA is the low rate of national savings.

How long can this situation continue? It is difficult to predict when and how adjustments might occur. Looking to the past, the United States has run a current account deficit throughout much of the last two decades. Although the sky has not fallen, I would argue that there's a big difference between the moderate external deficits of 2-3 percent of GDP that have characterized most of this period, and our current position.

Unavoidable economic logic suggests that eventually this situation will prove unsustainable: our deficit and other countries' surplus positions will come into better balance. The question is how. Clearly, one part of an adjustment in external balances worldwide should come from more rapid growth in domestic demand in other industrial countries, demand that would increase foreign growth and investment and U.S. exports. But the U.S. must be an important part of the solution as well. National savings need to grow.

One way to increase savings is to cut the federal deficit - that is, to reduce government dissaving by raising taxes or reducing spending. Another source of adjustment would be an increase in the personal savings rate. Either change would increase the pool of domestic savings available to fund investment. Rising productivity also could help us grow out of the problem, by increasing wages and incomes and making it easier to set aside more for savings. But it is likely wishful thinking to rely on faster productivity alone even if it is sustained at current levels. And it must be recognized that creating more domestic savings will not be cost-free. As personal savings rise, other things equal consumption growth must slow. As the federal government brings the budget into better balance, the fiscal situation will tighten. In that regard, it makes sense to make such adjustments when the economy is relatively strong. Since near-term prospects seem reasonably good, a strong case can be made to begin to address this issue sooner rather than later. And personally, I would start with the federal budget deficit.

In our ever more interconnected world, addressing this country's low level of national savings might also have positive implications for other nations. Economies that use less of their savings abroad to invest in the U.S., thereby funding our deficit, could find more ways to invest at home, expanding the productivity of local industries and raising GDP and local living standards. The development of larger and more resilient domestic markets could provide more homegrown support for domestic GDP and reduce reliance on U.S. exports for growth.

In closing, I have painted a rather positive baseline picture for 2005. It has its risks, of course, and policy-makers need to be watchful. But, over the longer term there is a major challenge to be addressed. In the long run, raising the low rate of national savings in the U.S. may be one of the best things that could be done to ensure lasting prosperity both here and around the world. Finding ways to curb the federal government deficit may be the best place to start on that laudable objective.

Thank you.

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