

The U.S. Economy: 2005 and Beyond

by Cathy E. Minehan, President & Chief Executive Officer
York County Economic Development Summit
April 1, 2005

As we come to the end of a long, snowy winter, I am delighted to see the start of spring, a time of renewal and rebirth. In a sense the U.S. economy has had a bit of renewal over the past six months or so. Today, I will focus my comments on the current state of the economy and what we might expect for the balance of 2005. What are the prospects for the economy over the remainder of the year, what are the risks, and what are the implications for monetary policy? To preview: the prospects for near-term growth look very favorable for the nation, and here locally in Maine. However, for both Maine and the nation, long-term challenges exist. For Maine, these challenges lie in the evolving structure of the state's economy and in its demographics. For the United States, the challenges involve a continuing low rate of national savings. I want to conclude by sharing a few thoughts on the significant issues raised by this worrisome trend.

Let me begin with the renewal of the U.S. economy. Perhaps I am taking a bit of poetic license, but we've seen quite a turnaround compared with last spring when employment growth was faltering; oil price increases were beginning to take a bite out of consumption, and business investment growth looked questionable. At that point, the economy was bolstered by highly accommodative monetary policy and the remains of the fiscal impetus of the 2003 tax cuts. Now, monetary policy is less accommodative, and the last of the recent tax changes-the partial expensing tax credit-has expired as well. The economy has become solidly self-sustaining, with annual GDP growth for the last half of 2004 better than 4 percent. This is a pace above what most economists see as the economy's steady state potential and more than its average annual growth rate over the past 50 years. It seems to me that this transition occurred for three reasons: (1) consumers kept spending; (2) businesses started spending (and hiring); and (3) the remarkable growth in U.S. productivity allowed this to occur without major inflationary pressures-inflation worries to be sure, but I will get to that later.

Let me start with the consumer. Throughout most of 2004, households continued to spend on homes and automobiles, buoyed by rising house prices, low interest rates, and later in the year by a surging stock market. Consumers were able to accumulate new wealth simply by watching the prices of their houses and stocks rise. This was one likely reason that consumers reduced their new savings as a share of disposable income to close to zero. As I noted earlier, this low rate of savings poses problems in the long run, but the American consumer's continued confidence and willingness to spend was helpful in sustaining overall demand and production in 2004.

Consumer confidence also rose as more consumers found jobs. Labor market conditions had posed something of a puzzle as job growth over the three years from 2001 to 2004 remained slow by historic standards. In post-war history it had never taken as long to regain the jobs lost during a recession, not to mention to begin creating the additional jobs needed for an expanding labor force. Fortunately during the last half of 2004, job growth picked up and in the past 6 months, employment growth has averaged about 180,000 per month. February unemployment stood at a reasonably low 5.4 percent, down from 5.7 percent at year-end 2003. Not the levels we experienced in the late 1990s perhaps, but the low 4's of those years may reflect a cyclical boom in labor demand that may be hard to equal without significant cost pressures.

How much additional slack remains in labor markets? That's hard to say, but evidence supporting the view that slack remains includes the relatively muted increases in wages and prices to date, as well as low labor force participation rates. Participation rates for prime-age workers - especially women - are lower than one would expect given the growth of the overall economy. Although we are not certain that the reasons for this are cyclical in nature, these historically

low participation levels do suggest the presence of additional underused labor resources available to the economy going forward.

Supportive financial conditions and improved business confidence transformed business spending from a "what-if?" to a strong contributor to the continuing economic expansion. In 2004, businesses focused attention on restoring profitability and healthy balance sheets, and they were quite successful in doing so. Firms translated impressive increases in labor productivity into strong profits. This left them at year-end 2004 with plenty of cash to sustain healthy spending rates into 2005, and to suggest the possibility of even more rapid capital investment. Indeed, investment spending, which was widely forecast to slow in the first quarter after the expiration of the partial expensing tax credit, appears to be growing at double-digit rates, according to the most recent data on shipments of capital goods.

And what about productivity? After a truly stupendous 5 percent pace of growth in early 2004, the rate of productivity growth slowed a bit, but only to a more than healthy 3 percent for the year as a whole. The constant refrain I hear from regional business people about the need to do more with less and to invest in technology to achieve new levels of efficiency and innovation seems to be reflected in the national numbers as well. As you know, the major surge in underlying structural productivity that we have seen in the U.S. economy over the last 10 years or so can have a remarkable impact in raising standards of living over time. And in the very near term, productivity growth has been key to the economy's good track record on inflation.

At this time last year, price pressures seemed for all intents and purposes nonexistent. But surges in energy prices and non-oil import prices beginning in second quarter 2004 fed through to core measures of inflation, that is, those excluding energy and food, with core CPI rising at about 2-1/4 percent over the past 12 months. That's about a percentage point higher than the previous 12-month period. And with oil prices now back above \$50 a barrel, one can expect to see continued effects on headline and, to a lesser extent, core inflation. 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 for the remainder of 2005? In broad terms, I see real GDP growth of about 4 percent or so this year. I also expect to see a continuation of the recent acceleration in job creation as the economy continues to expand. And inflation, while elevated over its pace from a year ago, seems likely to be well behaved on the whole. But that said, as always, this depends on a number of things going right.

One of the enduring engines of recent U.S. economic growth through thick and thin has been the U.S. consumer. Indeed, among industrial countries, this hardiness of domestic demand is rare, with growth coming from exports more than domestic consumption. Foreign demand growth is likely to be modest again this year, with many forecasters expecting trade-weighted growth in the range of 3 percent. Just looking at Europe and Japan, growth is expected to be less than 2 percent.

Will U.S. household spending continue to support GDP growth at its current pace? With the impetus from 2003 tax cuts now little more than a memory and this year's fiscal policy not providing much new stimulus, growth in household disposable income—a major factor determining consumption—now depends more heavily on growth in employment. The good news is that recent hiring data are encouraging in this respect, and suggest that job creation will provide the income growth needed to support healthy consumer spending in 2005.

As always, there are some risks, though the risks to real GDP growth seem to me to be pretty balanced—that is, I think the economy is about as likely to grow above the 4 percent forecast as to fall short of it. Higher oil prices could once again affect consumption. Consumers could decide to retrench and moderately increase their savings, slowing growth. But they could also respond more strongly than anticipated to recent increases in wealth, as they did in the late 1990s. In this regard, the stimulus from the housing market is subject to considerable uncertainty. The high rate of increase in house prices of the past couple of years cannot continue indefinitely. If house prices increase at slower rates, this source of wealth creation could provide less support to consumer spending.

This brings me to the important issue of inflation in 2005. So far inflation in this recovery while on the uptick has been well behaved at least by historic standards. The year over year rate of core inflation reached a low of about 1 percent in late 2003, a rate not seen since the early 1960s. In 2004, however, inflation as measured by the core CPI accelerated to a 2.3 percent annual pace and it has ticked up again so far in 2005 as well. In large part, this reflected the pass through

of the rising cost of energy and other imported goods into core goods and services prices.

The risks to the inflation outlook fall into three broad categories. First, there is uncertainty about the degree of slack in the economy. Second, there are a number of cost pressures—from energy prices to benefits costs—that have proven more persistent than expected, although with effects that are likely to be transitory. And third, uncertainty about the pace of GDP growth this year also means that we can't be certain how fast any remaining slack will be exhausted.

As for the first risk, I am comfortable with my baseline assessment that some resource slack remains and that the pace of inflation will taper off. But as I suggested above, the range of uncertainty around this assessment is wide enough that we should recognize the possibility that the economy has somewhat less running room, which could imply a bit steeper trajectory for inflation. Again, that's not what I think is most likely, but it is a risk worth considering. In that regard, I take comfort in the continued good news on the productivity front, which should help to maintain some cushion if aggregate demand grows at its expected 4 percent pace.

As for rising costs, the prices of energy, employee benefits, and raw materials have posed challenges to businesses for several years now. To date, these cost increases have been largely buffered by rising productivity and sizable profit margins, so their pass-through to final goods prices has been limited. But more recently, I have heard stories from my business contacts telling me that increased prices can now be passed along. These stories may well only portend increasing prices for intermediate goods, with the final goods prices continuing to be well contained by productivity and profitability. But to my ear, these stories modestly raise the risk of rising inflation.

Finally, faster than expected economic growth could well tighten pressure on resources. Again, this is not my baseline projection, but it wasn't that long ago that the strength of the U.S. economy was a persistent surprise. I believe the most likely course for inflation is to settle around its current level in 2005, and I think this perspective is shared by most forecasts. But risks to inflation are what keep central bankers up at night, so I plan to retain my firm sense of vigilance in this area.

All in all, that leaves us in reasonably good shape for the rest of 2005—expecting relatively strong growth, continued hiring, solid business investment, and reasonably low inflation—albeit with a number of questions and concerns and some risks on both sides of that projection.

How will this rather favorable national picture play out in Maine? Maine's performance over the past four years has surpassed that of its New England neighbors and the country as a whole. Employment in Maine is already above its pre-recession peak, while employment in New England is still down nearly 3 percent. Maine's relatively good performance is also reflected in the unemployment figures. In February, the unemployment rate in Maine was 4.7 percent, about the same as the regional rate but well below the national figure of 5.4 percent. In the Portland area, which includes South Portland and Biddeford, the numbers were even stronger with unemployment at just above 3 percent in January.

Given the positive outlook that I have described for the nation, it seems likely that 2005 will be a reasonably good year for Maine as well. But there are a number of clouds on the horizon. The possibility that the BRAC Commission might select Brunswick Naval Air Station or the Portsmouth Naval Shipyard for closure is clearly worrisome. Many closed bases have been successfully redeveloped, with the Pease Air Force Base in Portsmouth, New Hampshire providing an example close at hand; but the redevelopment process can be difficult and lengthy.

A second concern is the continued loss of manufacturing jobs. While overall employment has held up relatively well in recent years, manufacturing employment has plummeted. The entire country has seen a reduction in manufacturing jobs, but the pace has been faster in Maine. Moreover, some of these manufacturing industries pay particularly well. The Maine economy seems to be increasingly dependent upon leisure and recreational activities, broadly defined. The implications of this are not clear, particularly in light of my third concern.

Maine has an old population. The fraction of the population that is over 65 is above that nationally and elsewhere in New England, and the fraction of children and young adults is lower. The rate of natural increase is extremely low, indicating that this situation is likely to persist. This has some short term advantages, such as less pressure on schools, but it also means that there will be relatively few young people entering the labor market in the years ahead. This could

undermine the vibrancy of the Maine economy over time.

Thus, Maine faces some longer-term structural challenges. But, in the near-term the local economy will continue to benefit most from solid growth at the national level. And as I noted earlier, my best guess is that prospects for such growth are quite good.

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 we can expect this resilience will continue. A more robust and self-sustaining economy, together with some modest upside risks to inflation imply less need for policy accommodation. How and when such accommodation is reduced, however, will depend on how the economy evolves, and, as always, that will be closely watched and evaluated.

And looking beyond 2005? In many ways, the health of the current economy contrasts sharply with challenges of the next few years. If we were to issue an economic report card, the nation would get great grades on its current performance, but would fail on what is necessary for the future—a strong rate of national savings. Households are barely saving at all, and the federal government is spending well beyond its means.

In my view, this is one of the most important macroeconomic problems confronting the U.S.—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, it is more typical for national savings to depend on two things—how much households put away, and the fiscal situation of the federal government. Currently, both present problems. Household savings as a share of disposable income is extremely 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, 6.3 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, it would be desirable for part of the adjustment in external balances worldwide to come from more rapid growth in domestic demand in other industrial countries, demand that would increase foreign growth and investment and U.S. exports. That doesn't seem likely anytime soon, but, more importantly, 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.

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 policymakers 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.

Related Links