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U.S. Economic Outlook

Challenge for monetary policymakers

The economy often sends us mixed signals, and the current economic climate is no exception. Spending and output appear to be rising at a solid rate, but we have yet to see any gains in payroll employment. This is certainly a cautionary flag for now. Some analysts worry that lack of job growth might undermine confidence and lead households and businesses to scale back spending. While such scenarios are of concern, they seem less likely than one in which demand continues to grow at a solid pace and employment eventually rebounds.

Why? In short, the economy currently has three pillars of support: strong productivity growth, fiscal stimulus, and accommodative monetary policy. Going forward, strong productivity growth should contribute to income gains and fiscal stimulus should support spending for some time. And inflationary pressures are not a significant near-term worry so it should be possible to maintain accommodative monetary conditions for a considerable period.

Recent Economic Conditions

But, before I get into too much detail on my perspective of the economy, let me review how we got where we are today.

The longest economic expansion of the post-World War II era ended in March 2001 when the economy entered a recession. By historical standards, this recession was mild, both in terms of its duration and its effect on total output. The recession ended in November 2001, just eight months after it began. And, real GDP contracted only 0.6 percent between its peak and trough, about one-quarter the average decline during recessions since 1960.

Normally, sales of light vehicles and homes drop off sharply during a recession. But, in 2001, low interest rates helped keep them strong. As a result, real household spending never actually contracted and that, in turn, cushioned the decline in GDP.

While this was a blessing in the recession, it helped lay the groundwork for a moderate recovery. Part of this dampening was quite natural: spending dropped less than in other recessions, so there was less reason to expect a big bounceback. Given the strength of light vehicle and home sales during the recession, there wasn't the usual pent-up demand as the recovery began.

But, in part, the moderate pace of this recovery has also been due to a series of shocks that hit the economy. The start of the war on terrorism, corporate malfeasance, and the buildup to the war in Iraq all led to heightened uncertainty about the economy. As a result, while we had a few short bursts of strong demand growth, the economy failed to sustain a vigorous pace of expansion.

Over the last several months we have seen another burst of strong demand growth. Both household and business spending rose solidly in the second quarter of this year and appear to have done so again in the third quarter. Home sales have set new records, light vehicle sales have been very impressive, and business spending on equipment and software has shown increases after a long period of stagnation.

To be sure, there are sectors where demand is still weak. For instance, high vacancy rates and excess capacity have contributed to weak business spending on structures, such as office buildings and factories. And, as one of our contacts in commercial real estate noted, "If tenants aren't adding workers, they don't need more space."

Weaknesses like this notwithstanding, by and large, final domestic demand appears to be rising at a good clip.

But, much of the increase in demand has been met by imports and by businesses drawing down inventories rather than increasing their production. So second-quarter real GDP growth was less than the demand increase — 3¼ percent versus 5 percent. Output growth in the third quarter looks to have been considerably higher, even though current evidence suggests that businesses continued to liquidate inventories.

And the pickup in demand growth has not yet shown through to employment gains. Indeed, over a million jobs have been lost since the end of the recession, and payrolls declined in each month from February to August.

Most fundamentally, the apparent disconnect between expanding output and falling employment is explained by remarkably strong productivity growth.

Even this far after the employment peak, businesses continue to find ways to get more production per hour of work. In fact, the second and third quarters will likely be the second strongest back-to-back quarters for productivity growth since the early 1980s.

All of these data seem to jibe well with anecdotes that we at the Chicago Fed hear from our business contacts — many of whom are CEOs like yourselves. The general tone of their reports is noticeably better than it was a couple of months ago. Which is not to say that all the reports are positive. In an economy as big and diverse as ours, there are always some sectors that are doing well and some that are not. The diversity cuts across geography as well as industries. In recent months, the Midwest seems to be lagging the nation a little.

But, on balance, the trend of all reports has been pretty clearly towards more optimism. As one contact aptly put it, businesses seem ready to "emerge from survival mode."

Growth Outlook

Going forward, the big question is whether the most recent burst of demand will sustain itself through the end of this year and beyond, or whether, this one will falter like the previous bursts that we have seen. As Yogi Berra said, it's dangerous to make predictions, especially about the future. But, let me say that I think there are reasons to be optimistic that growth will remain solid.

The first reason is productivity. Strong productivity gains have kept real personal incomes rising throughout the recession and recovery, and should continue to be a key foundation for growth into the future. And, even though some of the recent job losses are attributed to efficiency gains, strong productivity growth has historically been good for employment. Productivity generates extra income, and income creates new jobs. This takes time — some research suggests that there can be a lag of several quarters — but it is widely accepted that the eventual effect on employment is positive.

Second, the recent round of tax cuts should also stimulate growth. According to Administration estimates, these tax cuts will put nearly $150 billion into consumers' and businesses' pockets between this summer and the end of next year.

Third, the Federal Reserve's ability to maintain an accommodative monetary policy should help keep financing costs for consumers and businesses at low levels.

Furthermore, many of the factors that have hindered business spending — including worries about terrorism, corporate governance issues, and excess capacity — should have a diminishing impact moving forward.

Terrorism remains a real concern, but companies have been tightening their security and taking steps to reduce the potential impact of any new attacks. On the corporate governance front, many issues continue to be addressed by various regulatory agencies and by increased diligence in corporate offices and boardrooms. While we still hear of some improprieties, their revelation is more symptomatic of good, not bad, governance.

Finally, although there are still appreciable amounts of excess capacity in some industries, this will change over time. Capital equipment depreciates — and does so very rapidly for computers and many other high-tech investments. Thus, much of the excess will be reduced — a good portion of it as technological innovation makes older machines obsolete.

With all of these reasons for optimism, forecasts of real GDP growth have increased since the summer. The consensus of private sector economists now has growth averaging 4¼ percent during the second half of 2003, up from 2¼ percent in the first half. They also expect growth to average just a little under 4 percent next year. The bottom line is that growth this year should be stronger than it was last year, and growth next year should be stronger than it will be this year.

But, it is important to remember that the economy always faces risks of shocks — both positive and negative. On the upside, business sentiment could rebound more dramatically than expected and produce a pop-up in spending. On the downside, there is the risk that weak labor market conditions could cause consumer spending to lose its forward momentum. While this isn't the most likely scenario, I have to admit that until we actually book a couple of quarters of solid output growth and see the beginning of an employment rebound, there will be some doubts in my mind whether we are, at last, out of the woods.

Inflation Outlook

At the same time that the outlook calls for strong GDP growth, inflation rates should change relatively little. Often, such as in the late-1990s, above-trend growth rates — like those forecast by private sector economists — have signaled rising inflationary pressures. However, this is not the case today.

In the late-1990s, the level of output was close to the economy's full potential. Unemployment rates were low and capacity usage rates were above average — both signaling that the economy was straining to produce all it could, given its labor and capital resources. In this case, rapid growth would only place additional strain on the economy and lead to higher inflation. Today, an elevated unemployment rate and low capacity utilization both signal that economic output is below its potential. Indeed, even with the solid growth economists expect for the remainder of this year and 2004, significant slack could persist for some time. This could put further downward pressure on inflation.

The chances of inflation actually turning negative are remote, but we can't ignore the possibility. It's been a remarkable change for central bankers that we now have to worry about the possibility of unwelcome disinflation as well as that of inflation. It means that we don't have to scrutinize every uptick in growth for signs of inflationary pressures. But we do need to watch for signs of weakness in the economy that might place more downward pressure on inflation. However, as I noted earlier, this puts the Fed in a position to maintain accommodative monetary policy for a considerable period.

Conclusion

In closing, let me just say that the road to recovery is often bumpy and this time has been no exception.

I'll admit that it is relatively easy for me — as a policymaker — to preach confidence and patience to you — executives looking at order books that might not be as full as they were just three years ago.

But, time and time again our economy has proven itself resilient in the face of short-term adversity. In 1991, we were in the midst of another jobless recovery, but it was a jobless recovery that launched a decade-long expansion. With an entrepreneurial culture, market-based principles, and continuing technological advances, our economy has the ability to handle its current challenges and the foundation to enjoy solid growth and price stability in the years ahead.

The views presented here are my own, and are not necessarily those of the Federal Open Market Committee or the Federal Reserve System.