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U.S. Economic Outlook

After a long period in which the news was mostly disappointing, the economy has picked up momentum. The Commerce Department reported that real GDP grew at an annualized rate of 7.2% in the third quarter, the fastest rate in nearly 20 years.

This rapid pace of growth has even led some analysts to raise concerns about increasing inflation. I'll explain in more detail later why I think such concerns are premature. But, in short, one rain shower doesn't end a drought, and it takes a few days of rain before we have to worry about flooding. Even though growth last quarter was exceptionally strong, we are still likely quite a ways from seeing the kinds of pressure on labor and capital resources that often signal an increase in inflation.

This morning, I'd like to explain the policy challenge facing the Federal Reserve, review how the economy got into the current situation, and talk about the outlook for growth and inflation.

Challenge for monetary policymakers

As you are aware, one of my duties as president of the Chicago Fed is to sit on the Federal Open Market Committee, or FOMC. At each FOMC meeting, Committee members discuss the outlook and debate policy options for the national economy. Based on its discussion, the FOMC decides where to set its target for the federal funds rate. We have two goals in setting monetary policy: maximum sustainable economic growth and price stability.

These two goals are not entirely independent; there is a relationship between economic activity and inflation. Most economists agree that, in the short run, monetary policy influences real economic activity.

While we commonly talk about economic activity in terms of growth rates-for example the 7.2% growth in the third quarter-it is important to remember that there is a level of real output behind that growth rate.

Along with this level of actual output, the economy also has a level of potential output-the amount of goods and services that the economy is able to produce given its labor and capital resources. The growth rate of potential output is determined by changes in two variables: the labor force and productivity, or output per worker. Economists have been estimating the growth rate of potential output as ranging between 3 and 3½ percent.

In the long run, the Federal Reserve has little or no power to influence the labor force or productivity, so it has no power to effect potential output. If the Fed consistently tried to push economic output above its potential for an extended period of time, resources would become scarce and the economy would generate increasing inflationary pressures. Similarly, if actual economic output persistently grew less than its potential, the economy would develop excess labor and capital resources, and these would exert a downward influence on inflation.

Economists refer to this second scenario as an output gap, because the level of actual output lingers below the level of potential output. To close the output gap and utilize the excess resources, the economy needs to grow faster than potential for a time, which then neutralizes the downward inflationary pressures. Despite recent strengthening in activity, the level of actual output is still well below the level of potential output, so there is still an output gap. Today, part of the Fed's policy challenge is to help stimulate economic activity in order to close this output gap.

Recent economic conditions

The origins of this output gap can be traced back to the recent recession, which began in March 2001. Real GDP declined as businesses significantly cutback on their capital investments and inventory spending. By historical standards, the recession was mild, both in terms of its duration and its effect on total output. The recession ended 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 the other recessions since 1960.

The current recovery began at a moderate pace and was restrained, in part, because of the mild nature of the recession and, in part, because of a series of shocks that hit the economy. The start of the war on terrorism, revelations of corporate malfeasance, and the buildup to the war in Iraq all led to heightened uncertainty and diminished confidence about the economy.

As a result, while we had a few short spurts of strong demand growth in 2002, the economy failed to sustain a vigorous pace of expansion. Between the first quarter of 2001 and the first quarter of 2003, real GDP growth averaged 1.4 percent, well below its potential. So, even though the economy stopped shrinking at the end of 2001, the output gap continued to grow.

Subsequently, we have seen signs of improvement as we've moved through 2003. Household spending rose solidly in the second and third quarters. Business spending on equipment and software has shown solid increases after a long period of stagnation.

Furthermore, business confidence has been improving. The general tone of our contacts' reports on business conditions is noticeably better than it was a couple of months ago. Which is not to say that all the reports have been 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. For example, the Midwest seems to be lagging the nation a little in the recovery.

Importantly, the recent increases in demand and confidence are starting to show through to employment gains, and the economy added a quarter million jobs over the last three months. However, labor markets are still a key area of weakness. Payrolls are still more than two million jobs below their peak in February 2001. And, at 6.0 percent, the unemployment rate is relatively high when compared to recent years-suggesting that there are still plenty of workers who would work if they could find a job.

Growth outlook

Going forward, the big question is whether the most recent surge of demand will sustain itself and lead to substantial job growth, or whether this one will falter like the spurts we saw in 2002. Although there are always uncertainties, 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, although some of the recent job losses are attributed to efficiency gains, strong productivity growth has historically been good for employment in the long run. Productivity generates extra income, and extra income creates new jobs. This takes time, but it is widely accepted that the eventual effect on employment is positive.

Second, the recent round of tax cuts should also support growth. According to Administration estimates, these tax cuts will put nearly $150 billion into consumers' and businesses' pockets in 2003 and 2004.

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

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. All told, these conditions lay the foundation for strong growth. The consensus of private sector economists now expects GDP growth to average nearly 4 percent through the end of 2004. My own expectation is that the economy will, on average, grow above potential through the end of 2004, creating conditions for businesses to increase their hiring.

Inflation outlook

On the inflation front, even though the outlook calls for strong GDP growth, so long as the output gap persists and there are diminished pressures on resources, inflation rates are unlikely to increase significantly.

Often, such as in the late-1990s, above-potential growth rates have signaled rising inflation. In this case, the level of economic output was at or above the economy's potential, and rapid growth would only place additional strain on the economy's resources and lead to higher inflation.

However, this is not the case now. Today, the unemployment rate is elevated and industrial capacity utilization is low-both evidence of excess resources. Even with the solid growth expected as we move forward,

slack resources could persist for some time. To be sure, the downward influence on inflation from such slack could be offset to some degree if unused resources do not move efficiently to the sectors where demand is growing fastest. This is something to be watchful for-as are other factors that could potentially boost inflation. But, as the FOMC said last month, "…the probability, though minor, of an unwelcome fall in inflation exceeds that of a rise in inflation from its already low level."

Policy implications

It has been a remarkable change for central bankers that we seem to be in the neighborhood of price stability and we now have to worry about the possibility of falling, as well as that of rising, inflation. It means that not only do we have to be vigilant to avoid the emergence of upward inflationary pressures, but we also need to watch for signs of unwelcome downward pressure on inflation.

This does not mean that price stability is bad. Just think of the resources households and businesses expended dealing with the high-inflation world in the 1970s and 1980s. Today, inflation is not a major concern when people and firms decide how much to spend or how to save and invest for the future. And price stability has allowed the Fed to maintain an accommodative monetary policy in order to assist the economy's return to sustainable growth.

Conclusion

In conclusion, I'd just like to say that this output gap-and its resultant elevated unemployment and excess capacity—is just one in a long line of challenges that the country has faced in its economic history. However, time and time again our economy has proven itself resilient in the face of these short-term challenges. For example, in 1991, we were in the midst of another jobless recovery, but it was a jobless recovery that launched a decade-long expansion, during which the economy created over 20 million new jobs. With an entrepreneurial culture, market-based principles, and continuing technological advances, I am confident that our economy has the ability to handle its current challenges and the foundation to enjoy solid growth and price stability in the years ahead.