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U.S. Economic Outlook

In early 2001, the economy fell into a mild recession, then struggled to recover as a series of shocks dampened the expansion in its infancy. But, last summer, activity began to pick up momentum. Real Gross Domestic Product, or GDP, grew at an annualized rate of 6.1 percent in the second half of 2003, the fastest rate in any six-month period since 1984. 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 in the second half was exceptionally strong, we have yet to see the kinds of pressure on labor and capital resources that often signal an increase in inflation. And certainly our most recent numbers confirm that inflation is still extremely low.

This morning, I'd like to explain the policy challenges facing the Federal Reserve, review recent economic developments, and talk about the outlook for economic growth and inflation.

Challenges for monetary policymakers

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—the overnight lending rate banks charge each other to borrow reserves. This short-term interest rate influences the amount of liquidity or funds available for spending and investing.

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 activity in terms of growth rates—for example the 6.1 percent growth in the second half of last year — 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 it can produce on a sustained basis, given its labor and capital resources and how productively it uses them. The level of potential output expands over time. Currently, economists believe that it grows between 3 and 3½ percent each year. These estimates are significantly higher than they were when I joined the Fed nine years ago, largely because of the recent trend of higher productivity growth.

The level of actual economic output fluctuates above and below its potential. This difference between actual and potential output is what economists call an output gap. When the economy operates above its potential for an extended period of time, labor and capital resources tend to become scarcer, generating inflationary pressures. When the economy is below its potential, excess resources tend to reduce inflation.

In the long-run, the Federal Reserve has no power to affect potential output, because it cannot affect the size of the labor force or the level of productivity. But, it can influence actual economic activity and try to narrow the output gap.

Today, even with the recent pick-up in activity, it appears that the level of actual output is still below potential. To close this output gap, the economy needs to grow faster than potential—which is to say, faster than 3 to 3½ percent—for a time. Part of the Fed's policy challenge is to help accommodate economic activity so it can close this output gap, without—sometime down the road—overshooting the level of potential output and generating inflationary pressures.

Recent economic conditions

The origins of our current output gap can be traced back to the recession, which began in March 2001. During this period, Real GDP declined as businesses significantly cutback on their capital investments and inventory spending. By historical standards, the recession itself was mild, both in terms of its duration and its effect on total output. It ended just eight months after it began, and real GDP contracted only ½ 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, 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 experienced a few short spurts of strong demand growth early in the recovery, the economy failed to sustain a vigorous pace of expansion. During 2001 and 2002, real GDP growth averaged just under 1½ percent, well below its potential. So, even though the economy stopped shrinking at the end of 2001, the output gap continued to grow.

Subsequently, as we've moved through 2003, we have seen signs of improvement in several key sectors of the economy. Household spending has held up quite well throughout the recovery. But, more importantly, business spending on investment rose strongly in the second half of 2003 and spending on inventories increased in the fourth quarter.

Furthermore, business confidence has been improving. The general tone of our contacts' reports on business conditions is noticeably better than it was during the summer.

The recent increase in demand and confidence is starting to show through in hiring. But labor markets are still a key area of weakness. Although the unemployment rate is down a half percentage point from its recent peak in May, employment growth has been disappointing. The economy has added only a quarter million jobs over the last five months, and payrolls are more than two million jobs below their peak in February 2001.

Of course, in an economy as big and diverse as ours, there are always some sectors and geographic regions that are doing well and some that are not. For example, much of the weakness in the economy over the past few years has been centered in the manufacturing sector. Because manufacturing is a larger part of the Midwest economy, the recession had a bigger impact here than in the rest of the country. Total employment in the Midwest has fallen 4 percent from its peak, nearly twice the decline in the nation as a whole.

Currently, the Midwest seems to be lagging the nation a little in the recovery. Our business contacts say conditions have improved modestly, but reports in other parts of the country are more positive. Furthermore, even though the nation has seen modest job growth, employment in the Midwest has yet to show any consistent improvement.

However, with manufacturing just now beginning to power up, the Midwest probably won't trail the nation for much longer. For the last four months, the Chicago Purchasing Managers' index—a key gauge of Midwest manufacturing activity—has been suggesting a strong pace of expansion. Some of the components of this measure—strong new orders, high order backlog, and low inventories—indicate that the pick-up in activity should continue in the coming months.

Growth outlook

For the U.S. economy as a whole, the big question going forward 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. There remains a discrepancy between this surge in demand on one hand and the lack of employment growth on the other. Employment has taken longer to pick up than we expected; even longer than it did following the previous recession of 1990-91, which was characterized as the "jobless recovery."

Some labor market indicators—such as unemployment insurance claims and the national purchasing managers' employment index—suggest that a pick-up might already be taking place. While there are always uncertainties, I think there are several reasons to be optimistic that employment will accelerate as economic growth remains 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 his-

torically 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 $100 billion into consumers' and businesses' pockets in 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.

Fourth, although there is still 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. To some degree, this process has already begun. High-tech investment strengthened during the second half of the year, and we've heard anecdotally that replacement demand is driving much of the increase.

Finally, improving conditions abroad should provide some additional support for the expansion. Most of our trading partners—particularly those in Asia, which account for a quarter of our exports—experienced significantly stronger growth in the second half of last year. As these countries grow faster, they typically demand more of our exports, and, in turn, contribute to the growth of our economy overall. In fact, export growth has already contributed to stronger GDP growth during the second half of 2003.

All told, these conditions lay the foundation for strong economic growth. The consensus of private sector economists now expects real GDP growth to average around 4 percent in 2004. However, I wouldn't be surprised to see the economy grow at an even faster rate than the consensus forecast. Such a pace of growth, which is well above potential, would create conditions for businesses to increase hiring and utilize much of the economy's excess capacity.

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. At that time, the level of output was at or above the economy's potential, and any 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 below average—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, this downward influence on inflation could be neutralized from other factors. For example, unused resources might not move efficiently to the sectors where demand is growing fastest. Or, the recent fall in the dollar could raise the price of imported goods.

While these and other factors are risks to be mindful of, we believe the effect of slack resources remains predominant at this time. So, as the FOMC indicated last week, we expect inflation to remain low.

Policy implications

It has been a remarkable change for central bankers that we seem to be operating 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. In contrast, inflation now 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 the 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, to its credit, 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, yet it was a jobless recovery that launched a decade-long expansion, during which the economy created over 20 million new jobs. With its entrepreneurial culture, market-based principles, and continuing technological advances, I am confident that our economy has the ability to handle its current challenges and to enjoy solid growth and has the foundation to enjoy price stability in the years ahead.