RISK MANAGEMENT ASSOCIATION AND NATIONAL FUNDING ASSOCIATION

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U.S. Economic Outlook

If you were here when I addressed the RMA two years ago, you know that monetary policy can be a very challenging job. At that time, you may recall, the economy was struggling to recover from a mild recession, but heightened uncertainty after the terrorist attacks on September 11 kept activity restrained. Since then, the revelations of corporate malfeasance and the start of the war in Iraq also dampened the expansion, but activity finally began to pick up momentum last summer. 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; and growth this quarter is expected to be solid as well.

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 of last year was exceptionally strong, at the macro level, we have yet to see the kinds of pressure on labor and capital resources that would likely lead to a worrisome increase in inflation. And while there is always the potential for imbalances in certain sectors, recent numbers confirm that inflation is still extremely low.

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

Challenges for monetary policymakers

At each Federal Open Market Committee (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 activity in terms of growth rates—for example the 6.1 percent growth in the second half of last year —we need to think about the level of output, as well as its 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 technology, labor, and capital and how productively it uses them. The level of potential output expands over time. Currently, many 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.

Now, the level of actual economic output fluctuates above and below its potential. This difference between the two 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, in the short-run, it can influence actual economic activity and try to narrow the output gap. Today, even with the recent pickup in activity, it appears that the level of actual output is still below potential. To close this output gap, the economy needs to grow, for a time, faster than potential—which is to say, faster than 3 to 3½ percent.

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. To be sure, as the aggregate economy moves into balance, individual sectors or industries may develop imbalances. Policymakers must consider whether the imbalances in particular sectors pose a risk to the economy at large. But monetary policy is a blunt tool that is wholly incapable of addressing the concerns of individual sectors of the economy—it can only be used try to influence the balance of resources at a macro level, taking into account the aggregate impact of the individual sectors.

Recent economic conditions

Our current output gap can be traced back to the recent 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. The recession 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 the 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 2002, real GDP growth averaged about 2¾ percent—a rate that is below its potential. So, even though the economy stopped shrinking at the end of 2001, the output gap continued to widen.

Subsequently, as we moved through 2003, we saw signs of improvement in several key sectors of the economy. Household spending, which had held up quite well throughout the recovery, posted solid gains. But, more importantly, business spending on capital equipment rose strongly in the second half of 2003 and appears to have increased at a brisk pace so far this year. Inventory investment has also increased.

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

The recent increase in demand and confidence has started to show through in hiring, but labor markets are still a key area of weakness. Although the unemployment rate is down about ¾ of a percentage point from its recent high in June, employment growth has been disappointing and payrolls are still more than two million jobs below their peak in March 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. And 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, 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 above 60, suggesting a solid pace of expansion. Some of the components of this survey—strong new orders, high order backlog, and low inventories—indicate that the pickup 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. There remains a discrepancy between this surge in demand on one hand and slow employment growth on the other.

Unemployment insurance claims have declined, which — along with other indicators — suggests that the pace of layoffs has slowed substantially. But, business executives say they remain focused on improving earnings by controlling costs and increasing productivity, and they would like to see a longer trail of sales and earnings growth before expanding their work forces. As a result, even though layoffs are down, new hiring has taken longer to pick up than it has in the past.

The recession ended in November 2001, but payrolls are still more than 700,000 jobs below where they were at that point. Now, compare that to the recovery from the 1990-91 recession, which is known as the "jobless recovery." In June 1993, the recovery had been underway for just as long — 27 months— yet employment had surpassed not only its level at the end of that recession, but also its previous peak.

Nonetheless, many of our business contacts have indicated that they will have to hire soon if demand holds up. So, I am optimistic that employment will accelerate, because I believe that economic growth will remain solid. Why? I have five reasons.

The first 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. To be sure, some of the recent job losses are attributable to efficiency gains. But, higher productivity generates higher income, higher income generates higher spending, and the higher spending helps create the new jobs that eventually put unemployed workers back on payrolls.

It is impossible to say now what some of these new jobs will be, because new jobs are often the result of unforeseeable innovations in technology. For example, GE Healthcare recently announced plans to expand their Information Technology and Ultrasound operations in Wauwatosa, Wisconsin. As many as 2500 employees at the new facility will engineer and manufacture innovative medical equipment, including computed tomography, or CT systems. These products allow doctors to readily diagnose health problems like cancer or aneurysms without exploratory surgery, and the machines are now more widely available than they were when the CT technology was first developed. It would have been virtually impossible to anticipate these jobs five years ago, because one cannot predict how technology will evolve.

The second reason economic growth should remain solid is last year's round of tax cuts. According to Administration estimates, these tax cuts will put nearly $100 billion into consumers' and businesses' pockets in 2004.

Third, the Federal Reserve's highly accommodative monetary policy stance, combined with improved financial balance sheets, should help keep financing costs for consumers and businesses at low levels.

Fourth, although there is still excess capacity in some industries, the pickup in capital spending should continue. Capital equipment depreciates—and does so very rapidly for computers and many other high-tech investments. As technological innovation makes older machines obsolete, firms will replace them with more modern equipment.

Even in industries often thought of as "low-tech," machines are now very sophisticated. For example, think about tool shops. Thirty years ago, milling machines—which form and shape parts and components-were controlled manually. Today, these machines are integrated with computers, and the operator controls the machine by programming a computer. As a result, the machines aren't considered old simply by their age, they become outdated when they become technologically obsolete—which happens more quickly. (Also, the high-tech nature of the equipment means that the shop's employees need a different set of skills than in the past. But with these machines and skills, the operators are more productive.)

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—have experienced significantly stronger growth recently. 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 solid economic growth. The consensus of private sector economists now expects real GDP growth to average around 4¼ percent in 2004. In the Fed's recent Monetary Policy Report to Congress, the central tendency forecast is somewhat stronger and calls for real GDP to rise 4½ to 5 percent this year. Such a pace of growth should foster improved labor market conditions. As a result, the Fed's forecast has the unemployment rate falling to the 5¼ to 5½ percent range by the end of this year.

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. But 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, some questions raise the possibility that this downward influence on inflation could be neutralized by other factors. For example, could unused resources fail to move efficiently to the sectors where demand is growing fastest? Or, could the fall in the dollar raise the price of imported goods further? Or, could the recent run-up in raw materials prices increase inflationary pressures somewhat?

While these are risks to be mindful of, they are not the most likely outcome. The effect of currency depreciation on domestic prices is often limited because, among other reasons, foreign producers may reduce their prices and take smaller profit margins in order to maintain market share. And, concerns about raw material prices are not as great as in the past, because, today, materials comprise a smaller portion of the cost of final goods and services.

We believe the effect of slack resources remains predominant at this time and we expect inflation to remain low this year—somewhere in the range of 1 to 1¼ percent (as measured by the PCE chain-type price index).

With inflation low, the Fed can be patient in removing its policy accommodation. However, this stance cannot be maintained indefinitely. The federal funds rate is currently very low, but the real funds rate (that is, adjusting for inflation) is also low by historical standards—in fact, today it is negative. As the economy picks up and the output gap narrows, the real funds rate will have to rise to a level more compatible with sustainable economic 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. In spite of the jobless recovery of the early nineties, the expansion lasted a decade and created over 24 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 the foundation to enjoy solid growth and price stability in the years ahead.