



## A National Economic Perspective

### Introduction

Standing here today, I have a much better appreciation for why this part of the country has inspired so many songwriters and artists over the years. I am hoping it will inspire me in my monetary policy responsibilities, because I have come to view that particular role as involving a good measure of art as well as science.

Everyone knows that we rely on economic data and theory in conducting monetary policy, but it is every bit as important to decide how to interpret those statistics and use those theories in a real-world, and real-time, context. And that's the point where the artwork of setting policy really emerges.

Bankers in the Fourth District have been providing me with invaluable information about our economy and banking issues for many years, and I always welcome your input. Recently, the advice that I have been getting from some bankers and businesspeople in my District is, "Don't raise interest rates too fast or too high," and many businesspeople have been telling me that they like these low interest rates.

Today I want to give you my perspective on why interest rates really can't stay this low forever—and why the Federal Reserve should not keep monetary policy accommodative indefinitely. First, I will talk about how the economic expansion has unfolded. Then I will turn to the economic outlook. Finally, I will discuss monetary policy and moving policy toward a more neutral position.

### The Unfolding Economic Expansion

So let me start by painting a picture of the economic expansion that began nearly three years ago. Back in the spring, when I first began thinking about the remarks I would share with you, the economic expansion was just beginning to get its legs. Two months later, as I started outlining this speech, the economy appeared poised for exceptional growth, with labor markets improving and the Midwest industrial economy regaining some luster. Last month, as I started writing this speech, I found myself curbing my enthusiasm somewhat.

So here we are, in early September, and I am continuing to fine-tune my remarks. Today I come to you with a picture of an economy growing at a respectable pace, and an economic expansion that continues to unfold in irregular and unpredictable ways. Why do I say irregular and unpredictable? No expansion unfolds in exactly the same way, but economists often take the average of past expansions and call it the "typical expansion." Using that as a benchmark, this expansion has been far from typical.

Let me point out several primary differences between this expansion

### Additional Information

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and the so-called typical expansion:

### **Consumer spending**

First, consumer spending remained stronger than usual during the recession itself, and it has remained strong. Consumers have been on a spending spree in this expansion, buying about a million new homes and 17 million new automobiles and light trucks in each of the past three years. That's a record pace.

### **Capital spending**

Capital spending is a second area that seems to be exhibiting some different behavior. Although it has picked up during the past four quarters, capital spending has lagged in this expansion to a greater extent than would be considered typical. The large run-up in investment spending during the "tech boom" that preceded the last recession has likely been a restraining factor in many industries.

### **Productivity growth**

Another difference in this expansion can be found in the productivity performance of most businesses. Productivity growth has been unusually high and remains so. Throughout the expansion we have seen exceptionally large year-over-year productivity increases in the overall economy, and productivity in the manufacturing sector has out-paced productivity gains in the overall economy. Companies have been able to achieve these strong productivity results by using new technologies and restructuring their business processes.

### **Business confidence**

The lag in capital spending might also have something to do with another difference on my list: business confidence. Even as the economy was picking up steam, business executives were still cautious about the future and therefore reluctant to invest in capital equipment. This caution on the part of businesspeople is not surprising. Not only did they experience a recession but they also faced terrorist attacks, accounting scandals, and wars in Afghanistan and Iraq. Confidence was shaken, and businesses reacted by avoiding risk.

### **Weak employment growth**

This brings me to perhaps the most pronounced difference between this expansion and the typical expansion -- the employment situation. In a typical expansion, employment returns to its pre-recession levels in roughly two years. We are now three years into this expansion, and we have yet to return to pre-recession employment levels. Part of the reason that employment growth has been weaker than usual is the strong productivity performance I just described. Last week, the Bureau of Labor Statistics released information about the August employment situation. Payroll employment increased by nearly 150,000 jobs, and the employment numbers for June and July were revised up. All in all, I found the report mildly encouraging, because it broke the recent pattern of meager employment growth. In addition, manufacturing employment registered a small gain for the month, and manufacturing employment is up overall for the year. This is a distinct reversal of the trend we saw in the previous couple of years.

## **The Economic Outlook**

Now that I have described several of this expansion's unusual characteristics, I'd like to tell you how I see economic conditions unfolding.

I am tempted to tell you that this is a particularly difficult time to interpret the economic indicators. But I know enough about policymaking to confess that predicting economic activity and charting a course for monetary policy have always been demanding.

Based on both the data and a considerable amount of anecdotal information, the national economy appears to be set on a path of sustained expansion. Through the first half of the year, GDP, adjusted for inflation, grew at an annual rate of nearly 4 percent, which is somewhat above its historical long-run average growth rate of 3.25 percent. I expect growth to remain at a solid pace for the foreseeable future. In addition, I am less concerned today than I was in the spring about the prospects of a sustained increase in inflation.

Let me explain how I've come to this view. First, the data: Although employment gains have been sluggish, personal incomes expanded at a 5 percent pace during the past year. Consumers still seem eager to buy houses and durable goods. Yes, the pace of spending might be slowing a bit, but sales remain at very high levels. Early reports about back-to-school sales, on the other hand, have been slightly downbeat. Judging from the data on capital goods orders, business spending for a wide range of equipment and computer software seems to be holding up fairly well.

The combination of strong demand and an unrelenting focus on productivity has yielded good profit growth in recent quarters. Many S&P 500 companies continue to report near-record profits. In northeast Ohio, 30 public companies just reported a rise in second-quarter profits—nearly four times the number reporting lower income or losses. One CEO declared that today's environment for industrial manufacturers is the best he has seen in more than three years. A group representing large manufacturers stated that 24 out of 27 industries showed improvement in new orders or production in the second quarter compared with a year ago.

In regard to inflation, it now seems clearer that commodity price increases have not, for the most part, been passed along into final goods prices to any significant degree. Furthermore, many commodity price increases themselves appear to have leveled off or declined recently.

Anecdotal evidence also leads me to think the expansion will be sustained at a respectable pace. My business contacts report reasonably solid growth in the demand for their goods and services. Business leaders across a broad array of industries tell me that they expect to see steady sales growth through the end of 2004. As orders and corporate profits have grown, many business executives are finally demonstrating renewed interest in expanding capacity. Businesses are more likely to make investments when corporate profits and productivity growth are strong, and these are the conditions we have today. Several of my contacts report paying higher prices for used equipment. This is a big change from a year ago, when equipment prices were being heavily discounted. Several bankers are also telling me that business borrowing has picked up, lending further support to my view that the economy will continue to expand at a solid pace.

But remember, I'm a central banker and I am paid to worry. So I also have a cautionary viewpoint to report. Some are questioning whether the expansion will be self-sustaining. The CEO of a large, global industrial company I spoke with recently told me that his company's orders have finally returned to their peak 1990s levels, but he does not believe that this level can be sustained, let alone surpassed. He can't point to any specific reason, but his concerns about oil prices, the situation in Iraq, and rising health care costs all add up to an uneasy feeling. I know that he is not alone in this belief.

Of the several concerns I just mentioned, the gyrating oil market tops my current list of "things to watch." Crude oil prices increased to more than \$45 per barrel last month, far above their January price

of about \$34 per barrel. Although this level is not unprecedented in real terms, the speed at which oil prices have risen this year has been a major surprise for businesses and households. On one hand, our nation uses less energy to produce a dollar of GDP than we did in the 1970s. On the other hand, we are producing less energy domestically and therefore our reliance on imported energy has not changed very much. We still import about the same share of energy per dollar of GDP as we did in the 1970s.

Historically, surges in energy prices have been followed by economic slowdowns and even recessions. Under certain conditions, energy price spikes can also set off inflationary pressures if the Federal Reserve does not adjust monetary policy accordingly. Fortunately, recent signs show that energy price pressures are abating, but I intend to continue to pay very close attention to the unfolding energy market situation.

## Monetary Policy

Let me now turn to monetary policy and how it has responded to economic conditions. As you know, in June, for the first time in more than four years, the Federal Reserve increased its target for the federal funds rate by 25 basis points. In mid-August, we moved that target up by another 25 basis points, to 1.5 percent. Each of these actions reflected a measured response to the ongoing economic expansion.

Fortunately—and not accidentally—these moves have not come as much of a surprise. The Federal Open Market Committee has worked to become more predictable and credible over the years, and at improving our communications. We recognize the importance of having public support for and understanding of our policy goals, and we see real benefits for the economy when people correctly anticipate our actions. So, I regard the fact that we have surprised virtually no one this year as a positive development.

As we point out in every press release following our FOMC meetings, the objectives of the FOMC are sustainable economic growth and price stability. In other words, we try to prevent inflation and deflation from affecting the economy's performance. Price stability in practice means a low-inflation environment that the public expects to continue into the foreseeable future.

This year, for reasons I have already explained, I began to see consistent signs that the economic expansion was self-sustaining, and that the potential for further disinflation, which I was worried about last year, seemed highly remote. And for the first time since becoming a member of the FOMC last year, I had to start thinking about the circumstances that could possibly lead to accelerating inflation. Under these conditions, I thought it was vital that the FOMC begin to remove its unusually large degree of accommodation and to gradually adjust the federal funds rate back to a more neutral level.

What do I mean by “neutral”? Well, in simple terms this means a federal funds rate that is no longer either accommodative or restraining. There is not one specific value for the federal funds rate that always equals a neutral policy stance. It's a little like aiming at a moving target, and one that can seem a bit blurry at times.

The neutral range for the federal funds rate during the next several quarters and beyond will depend on how economic conditions unfold, but our experience suggests that during extended periods of reasonably sound and sustained economic performance, the neutral federal funds rate will almost certainly be above today's level of 1.5 percent.

In fact, historical experience suggests that when our economy is operating soundly and when resources are at high levels of capacity utilization, the neutral range is likely to be 3 to 5 percent. Where does this estimate come from? Without going into the exact formula, the most important components in the equation are the rates of productivity growth and expected inflation. As either one of these factors moves up or down, so too will the neutral federal funds rate.

At the moment, evidence from futures markets indicates that financial market participants expect the federal funds rate to steadily move up into that neighborhood over the next two years. If you think about it, this interest-rate forecast can be taken as a vote of confidence in the way our economy is expected to perform.

By now, I hope that you can understand why I am convinced that the current 1.5 percent funds rate lies below neutral. In short, our economy no longer requires the substantial amount of policy accommodation that it did until relatively recently.

It's a lot like using cruise control on your car. You want to maintain a certain speed, but the amount of gas you use will depend on the terrain you cover. When people are cautious, and prefer safe, liquid assets instead of making riskier capital investments, then a lower federal funds rate is similar to the cruise control signaling the fuel pump to send more gasoline to the engine to get the car up a hill. As conditions begin to normalize and the car approaches more level terrain, that fuel pump will begin slowing down to maintain the cruise control speed. As the economy continues to expand, we can continue to withdraw our policy accommodation—so that we do not unintentionally promote an inflationary environment down the road.

## Conclusion

The FOMC's job - my job - is to ensure that our nation's monetary policy supports the economy by delivering price stability. In my opening comments, I mentioned that some people have expressed satisfaction with interest rates at their current levels and I said that I do not think interest rates can stay this low forever. I encourage you to view the FOMC's recent policy direction as good news. At this stage of the expansion, rising interest rates in fact reflect a return to a more normal economic environment. With improved conditions and greater confidence, businesses will increasingly look for investment projects that will lead to further innovation, economic growth, and job creation. As credit demands pick up, the price of credit—interest rates—will naturally increase as well. None of us has a crystal ball, though. Because I cannot know exactly how the economy will evolve, I cannot predict the extent and timing of future movements in market interest rates or the federal funds rate.

I do know that I will continue to rely on you in the banking industry for your insights and input as I continue to combine science and art in setting national monetary policy.