The Expansion in Perspective

Additional Information

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Introduction

I will share with you my perspective on the current economic expansion and the Federal Reserve's policy response. First, I will describe some features of a typical expansion and explain how conditions today compare with the typical expansion. Then, I will discuss how the differences we are seeing in this expansion indicate that the economy is undergoing a transformation. Finally, I will explain how the Federal Reserve's monetary policy is responding to this changing environment.

I. Is our current expansion typical?

Let me begin with a brief discussion of where our economy stands today as we complete the third year of an economic expansion that began in November 2001.

To develop a benchmark for what we might expect in an expansion, economists often take the average of past expansions. They examine measures of economic performance - such as gross domestic product, household spending, business investment, employment, and productivity - to describe the state of our economy. Together, the averages of these indicators in past expansions become known as the typical expansion.

So how are we doing compared with the **typical** expansion? Not too badly, in my estimation, but it really depends on where we focus our attention.

GDP growth

We can start with the most basic of economic statistics: output, or GDP - gross domestic product. GDP growth was on the low end of typical during the first two years of the expansion. But during the most recent four quarters, GDP growth has picked up and is now running at a more solid pace, between 3½ and 4 percent. GDP pertains to the entire economy, but we know that not all sectors perform equally.

Households

First, let's look at the household sector. Households never actually cut their spending in the recession, as we might have expected them to do, and their spending has remained strong throughout most of the expansion. People bought about 1 million new homes and 17 million new automobiles and light trucks in each of the past three years.

Capital spending

So, household spending has been solid, but how do things look for capital spending by businesses? For the first two years of this expansion, business investment was well below what has been typical. Over the past year, though, this picture has improved dramatically, with spending on capital equipment and software up nearly 14 percent.

I suspect that business spending during the first two years of the expansion was held down because a lot of companies had made major capital outlays just a few years before. During the "tech boom" of the 1990s, businesses increased their investment in equipment and software by about 60 percent. That large investment may have restrained business spending on new purchases early in the expansion. But from what I have been hearing lately from my business contacts, we seem to have turned the corner. Indeed, just last month, orders at the International Manufacturing Technology Show came in very strong, and one machine tool manufacturer I spoke with recently told me that both his and his competitors' orders were going "gangbusters."

Weak labor markets and higher productivity growth

But there are a couple of important features of our current economy that are truly outside the boundaries of typical behavior in an expansion - labor markets and productivity. Clearly, one of the most surprising, and most talked about, aspects of this expansion has been the weak employment growth. No previous expansion in the last half-century has had such limited employment growth for such an extended period of time. The economy has added just over 600,000 jobs nationwide during the past three years. Even the expansion of the early 1990s, which was declared a "jobless recovery" at the time, had added about 3.7 million jobs at this stage.

And while employment numbers have been making only slight gains, productivity growth has been strong. Workers are producing more per hour that they work. Labor productivity estimates show that typical workers now create 11 percent more output than they did at the end of 2001. This productivity performance is reminiscent of the late 1990s.

What can we make of all this? Well, the performance of GDP, household spending, and business investment suggests that economic growth is sustainable. But even so, employment and productivity deserve a closer look.

II. Employment and productivity during economic transformation

All of us would like to know what is behind these two curious features of our economic environment - weak employment growth and strong productivity growth. Unfortunately, I must tell you that no one fully understands why these trends have persisted in the current expansion. I often hear stories that businesses may be more reluctant to take on new workers because of the uncertainties they face and, in lieu of hiring more employees, they have tried to pull more output from their existing resources. If this story turns out to be valid, then as the uncertainties lift, we should see the pace of employment growth pick up. But this explanation may be incomplete - there may be additional forces to consider.

Let's look at the recent acceleration in productivity growth from a longer-term perspective. Why has productivity growth been so strong in the current expansion? It might have originated in the previous expansion, when new capital and technology were being put in place at an unprecedented pace. Information technology and telecommunications investments, in particular, enabled businesses to expand their output through organizational restructuring and reengineering.

Of course, the IT revolution is only the latest in a long line of innovations that have reshaped our economy. With each cycle of recession and expansion, the economy transforms itself, and often in subtle ways that only become evident over time. This is a process economists call "creative destruction," where new technologies make the earlier economic order obsolete.

Clearly, a new machine or a new organizational technology can result in job losses in the short term. And we all know how painful and disruptive this process can be. But, just as clearly, we know that these changes make employees more productive, and that makes them more valuable. In the long term, then, these changes create more job opportunities for people, not fewer opportunities. We are understandably eager to get past the short-run obstacles we face and enjoy those long-run gains. But in the meantime, there is likely to be a mismatch between the skills and locations of the workers being displaced and the skills and locations of the advantageous opportunities that are opening up.

Jerry Jordan, my predecessor as president of the Federal Reserve Bank of Cleveland, has a favorite story that I think is appropriate to repeat here. It's about a businessperson and a government official who come upon a group of workers using shovels to build an earthen dam. The businessperson comments that with a bulldozer, the dam could be built in a matter of hours, rather than months. "But think of all the jobs that would cost!" says the government official. "Well," replies the businessperson, "if it's jobs you want to create, then take away their shovels and give them spoons!" How easy it is for us to think of capital and technology as the enemy of jobs, rather than as the creator of prosperity.

So where do all those workers and their shovels go? Well, they won't be making earthen dams anymore. They will create the new goods and services that prosperity brings, and they will produce those things that were previously unattainable.

We might ask what happened to all the jobs that were displaced when the railroads were built in the nineteenth century. Or what became of all those jobs lost when electricity transformed the nature of work for every business and household in the twentieth century. The nation was rebuilt, reorganized, and reeducated to provide for our future and to prepare us for the next economic revolution that would emerge.

We are no longer a nation of farmers, although we grow ample amounts of food. We are no longer just automakers and steel producers, although these too we can produce in abundance. We are now pioneers in medicine and health care. We are providers of financial, accounting, and legal services around the world. We envision and produce the communications technologies that are connecting every corner of the globe. We do these, and so many other things, that would amaze and astonish the generations that came before us.

Right here in the Fourth Federal Reserve District, we have a ringside seat in this transformation. In the 1950s, about a third of all employees in the District worked in manufacturing industries. Today, fewer than 15 percent work in manufacturing, and relatively few of these employees actually work on the plant floor. And this trend shows no signs of slowing down. Eric Fisher, one of our research associates at the Federal Reserve Bank of Cleveland, has studied why manufacturing's share of employment has fallen over the past few decades. He concludes that most of the decline results from the forces of technological change, not from tax policies or globalization.

As businesses acquire more sophisticated technologies, they redesign their operations and, in all likelihood, eliminate jobs. But although employment in some industries may shrink, overall employment and capital spending tend to rise at the same time. As our employees become more productive, they become more valuable and, inevitably, the demand for their skills grows. This is the nature of all economic progress.

The U.S. experience in manufacturing also mirrors developments in nearly every advanced economy. Manufactured goods remain an important source of economic activity around the world, but the growth in jobs nearly everywhere is coming from the service sector.

The challenge we face is to address the short-run dislocations without adversely affecting our longer-term prosperity. For our region, that means we need to deal with the issues that arise from an increasingly global marketplace while fostering an environment that favors new business formation. And we need to prepare our children for an economy that will change quickly and in ways we cannot even imagine.

I honestly do not know how much of our current, slower-than-expected job performance is transitory - tied to businesses' reluctance to hire, or lagging confidence, or any number of roadblocks that will quickly be removed with an improved economy - and how much is a longer-term consequence of economic transformation.

Tomorrow we will receive the preliminary employment report for September. And as the employment data arrive over the next several months, we may very well see the job numbers snap back if confidence in our economy is restored, economies around the world strengthen, and energy prices stabilize. Indeed, this is exactly what many believed was unfolding earlier this spring. But it may turn out that the process of job expansion will take more time to gain momentum. Nevertheless, the economy appears to be growing at a sustainable pace. In addition, core inflation measures and inflation expectations remain low.

III. Monetary policy's response to a changing environment

Now let me turn to the Federal Reserve's monetary policy and how we are responding to this changing environment. The policymaking body of the Federal Reserve System is the Federal Open Market Committee, or FOMC. The FOMC's goals are price stability and sustainable economic growth. The FOMC seeks to achieve these goals by influencing interest rates and the money supply. These underlying goals have been the same for many decades, but the FOMC's job is to custom-design its policies - to select different settings for the federal funds rate target - in response to changing economic and financial conditions.

During the 1950s and 1960s, when inflation and inflation expectations were low, the federal funds rate was also low at the beginning of expansions. As the expansions lengthened, the FOMC generally moved the federal funds rate up to prevent inflation from accelerating. During the expansions of the 1970s and 1980s, however, inflation and inflation expectations began at higher levels, and the FOMC sometimes found it necessary to increase the federal funds rate relatively early on in the expansions in order to fight inflation.

In our current expansion, which began in November 2001, inflation and inflation expectations have been at low levels. The FOMC held the federal funds rate steady at 1.75 percent for the first year of the expansion, and instead of increasing the rate, as many people would expect during a period of expansion, the FOMC reduced its target for the federal funds rate to 1.25 percent in November 2002, and then lowered it again, to 1 percent, in June 2003.

Why did the FOMC take this unusual course? The first rate cut came when the Committee concluded that the expansion was being hampered by greater uncertainty. The second rate cut came when the FOMC saw that the economy had yet to exhibit sustainable growth, and that inflation might fall further from its already low level. In other words, the FOMC was taking steps to head off further disinflation.

With the economy expanding at a sub-par rate, and little immediate prospects for dramatic improvement, the FOMC announced in August 2003 that our federal funds rate target was likely to remain low for a considerable period of time.

Economic conditions brightened considerably during the first half of this year, based on both incoming data and anecdotal information. With inflation-adjusted GDP growing at an annual rate of nearly 4 percent in the first half, and with low and stable inflation, the expansion now seems to be on a self-sustaining track.

As the economic expansion has gained strength, the FOMC has been gradually reducing the amount of policy accommodation we have been providing. We increased our funds rate target by a quarter percentage point in June, August, and September, bringing the target back up to the same level we had established at the start of the expansion back in 2001.

Future policy moves by the FOMC will depend on how economic conditions unfold as the expansion progresses. The FOMC will continue to design its policy based on its long-term goals.

IV. Conclusion

I am proud to help direct national monetary policy as a member of the FOMC. Our job is to ensure that our policy actions support the economy by delivering price stability - keeping inflation low and stable - so that the economy can achieve maximum long-term sustainable growth.

I have shared my views on the economic expansion and the Federal Reserve's policy response. You can look at the current economic landscape in a couple of different ways. In one sense, we are well on our way to getting back to typical economic performance in terms of conventional features of the business cycle. But in another - more profound - sense, the economic environment is forever evolving and changing, transforming itself over time.

As business leaders, you know as well as I do that we are dealing with both cyclical and structural changes in our economy. You deal with these changes every day as you make the tough decisions on capital investments, payrolls, and organizational structures that are shaping our regional and national economies. I will continue to rely on your insights and input.

As always, the views expressed in this speech are those of the speaker and do not reflect official positions of the Federal Reserve System.