A Year-End Wrap-Up of the Economy and a Peek Ahead

Remarks before the Longview Rotary Club

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The views expressed are my own and do not necessarily reflect official positions of the Federal Reserve System.

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I am delighted to be here today with a fine group of Rotarians. Before I went up to Washington to serve as the deputy U.S. trade representative, I was a member of the Downtown Dallas Rotary. I enjoyed the camaraderie and sense of purpose that the Dallas Rotary shares with Rotarians here in Longview and everywhere. The vision Paul Harris had in 1905 is one of lasting influence, and I can't think of a nicer group of solid, patriotic citizens to have lunch with on the Tuesday before Christmas.

As I left the house this morning, my wife, Nancy, said: "Now don't you go spoil those nice people from Longview's holiday by talking economics. You know, Richard, it is not for nothing that they call it 'the dismal science,' and no one wants to hear dismal stuff at this happy time of year."

Well, this bothered me driving all the way here. Then I remembered a tale one of the wittiest of the Federal Reserve's economists, David Stockton, told last week. It seems a bachelor who thought himself in tip-top physical form was called in by his doctor. "My friend," the doctor said, "I have just read your lab tests from your physical, and I have very bad news. You have a horrible disease for which there is no known medical cure. I suggest that you marry an economist and move to Arkansas."

"Geez, that's awful," the man said. "Are you telling me that settling down with an economist in Arkansas will help me live longer?"

"No," the doctor said, "but it will seem longer."

So as to not dispense too much dismal science today, I thought I would limit myself to a brief brief on the economy to leave plenty of time to answer questions.

As usual, I will speak today only for myself and the Dallas Federal Reserve, not for any other members of the Federal Open Market Committee or for the rest of the System. So what you are going to get today is just one man's opinion.

Here is the bottom line. The economy is sending mixed signals. The bad news is that the housing industry is undergoing a sharp correction that may not have run its full course and auto production is more anemic than desirable. The not-so-good news is that expansion of manufacturing activity and things made in factories has shown signs of slowing, but—and this is important—from high levels of activity. As one of my friends in manufacturing and industrial production likes to put it, "We are not stepping on the brakes, just lightening our foot from the accelerator."

The good news is that the dampening effect of the housing and auto sectors and the slowdown in manufacturing activity have been offset by continued growth in the service sector.

Now I am going to lay a little dismal science on you.

America has about 144 million workers, producing over $13 trillion in output. Our workers produce more output than the combined total of the next four largest economies, which are Japan, Germany, China and the United Kingdom. When you sit down with your family over the holidays, you can feel good about what American brawn and brains produce.

And you can be proud of being Texans. Our state alone produces more than Korea or Brazil or Mexico. Here is a fact that will startle you: We Texans produce 25 percent more output, measured in dollar terms, than all of India. That's just the production of 10 million workers in one state alone. We are blessed to live in a mighty big country with a whopping big, growing economy.

How do we do it? What are the dynamics of that mighty economic machine we know as America? How do we keep growing when we hear about the downturn in housing and the woes of our auto industry, or when the papers tell you that China and others are taking away our manufacturing business?

Well, first you have to understand that the United States is no longer just a manufacturing economy. In fact, it hasn't been a manufacturing economy for quite some time, just as we have not been an agricultural economy for an even longer period of time. This is not to say that the United States is not an agricultural or a manufacturing powerhouse. We very much are. But these sectors have less and less impact on our well-being as we continue our inexorable climb up the value-added ladder.

Agriculture employs only 1 percent of our workers and accounts for only 1 percent of our gross domestic product. Manufacturing employs 10 percent of our workers and contributes 12 percent of our output. If you add those numbers to the contribution of utilities, mining, and oil and gas and construction activity, you will account for 25 million workers and $2.7 trillion in output. In other words, the goods-producing sectors of our economy employ a sixth of our workers and produce a little less than one quarter of our output.

Keep this in mind as you read in the press or hear on the radio and television that the markets went into spasms after this or that index of manufacturing activity—the Philadelphia Fed Manufacturing Index or the Empire State Index or the Dallas Fed's newer manufacturing index—was released, or when dour economists report on declining auto production. Certainly these indicators matter and are taken seriously, particularly by the families whose incomes depend on work in those sectors of the economy.

But in trying to divine the course of the whole U.S. economy, remember that, for example, about 1.1 million people work in motor vehicle manufacturing in this country, producing eight-tenths of one percent of our GDP. The legal services industry, in contrast, employs 1.2 million people who collectively contribute 1.5 percent of our GDP. I am tempted to make a lawyer joke here—God knows there are plenty of them (both lawyers and jokes)—but it is not a laughing matter to economists. The legal services industry provides as many jobs as the auto manufacturing industry and contributes almost twice as much to our economic output.

In contemplating the course of the economy, we need to look beyond manufacturing and consider where the other five-sixths of our workers work. Where do we produce over three quarters of our $13 trillion in output?

The answer is in the service sector. We have almost 120 million people producing over $10 trillion in output working in law firms and hospitals and restaurants and offices and classrooms and laboratories and sales rooms. From the medical complexes in Houston and Dallas to the biotech labs of Boston, from the trading floors of Wall Street to the government offices in Washington, from the retail stores in Miami to the entertainment emporiums of Las Vegas, from the universities in California to the software salons of Seattle. As our society has progressed, we have moved up the value-added ladder toward what Winston Churchill once called the "superfine processes" where the greatest profit is reaped and the quality of life is best; where we work more with our brains than with our backs.

Economists will point out that this is where America enjoys its comparative advantage. We have created a system that harnesses the greatest brain power in the world and the most nimble and flexible business culture on the planet. Our comparative advantage is at the nano and bio and techno and financial end of the economic spectrum, not at the part of the spectrum where we till fields or bend metal. As we have moved up to these higher rungs on the value-added ladder and positioned ourselves to master the "superfine processes," others have taken our old place on the lower rungs of the ladder.

For example, Vietnam produces the second-largest robusta coffee crop in the world. They have a comparative advantage in that aspect of agriculture that we don't have. China churns out all kinds of manufactured goods that they can produce more cheaply than we can. We employ over 100 million people to take these foreign inputs, as well as what we make here in the good ol' U.S.A., refine them, transport them, package them and sell what we make from them in order to grow our economy. This is the service sector, and it is the service sector that drives our economy.

To be honest, one of our problems is that we do not have very good data on the service sector. We have tons of data that tell us every squiggle and wiggle of the agriculture and manufacturing sectors, but we do not have sufficient equivalent data on services. The dearth of data makes it hard to do what economists love to do: build models that accurately forecast economic growth. We still have a lot of useful indicators for identifying changes in the business cycle from back when manufacturing ruled the day, but we have yet to identify counterparts for an economy that is service-sector driven.

This is all just a long-winded way of saying that it is difficult to say with true precision just how the economy will close out this year in terms of growth and pace. My guess is that we are most likely going to finish the year at a pace that exceeds the gloomy forecasts making all the headlines lately. If you net the downdrafts from the housing and auto sectors against the tailwinds from other countries that are growing faster than the United States, then adjust for the updrafts of a dynamic service sector and thank your lucky stars for a warm start to winter and burgeoning oil and gas inventories that have softened energy prices, I wouldn't be surprised if the economy proves to have grown at better than two percent, net of inflation, in the second half of this year, then picks up pace in 2007. This is not a forecast, mind you. There are risks out there that, should they come to pass, would result in slower growth. Barring any unforeseen circumstances, however, I think this is a reasonable expectation. At least, that's how I see it from my perch at the Dallas Fed.

On the inflation front, the good news is inflationary pressures appear to have reached a stasis, despite the labor shortages in certain sectors—particularly in chemicals and petroleum industries and in functions requiring skilled and semiskilled workers. The bad news is that the stasis is at too high a level for party poopers like me who will have no choice but to advocate tightening monetary policy further if inflation does not ratchet downward.

At the Dallas Fed, we prefer to look at inflation through a prism called the Trimmed Mean PCE. I won't bore you with the details of how it works, but I'll tell you this: We had some encouraging news in September when the Trimmed Mean showed inflation had dropped down to 1.6 percent. Unfortunately, it rose back to 2.6 percent in October, close to where it had been nestling before the September drop. This uptick was partially caused by costs in that pesky service sector: medical services.

When we analyzed all the items in the personal consumption expenditure basket from medical costs to the costs of restaurant meals, we noticed that the median inflation rate was running at 4 percent and that over 30 percent of the items in the basket had prices that were increasing at a rate of over 5 percent. Now, this was for October. The November numbers come out on Friday, so we will have to wait until then to see the latest movements. While we at the Dallas Fed are hopeful that the measures taken to raise the federal funds rate from 1 percent to 5.25 percent will quell inflation and, very important, expectations about future inflation, we cannot yet say with conviction that we have turned the corner and have this problem fully contained.

Given all of this, I would have to say that the risk of unacceptably high inflation still outweighs the risk of substandard economic growth.

Nonetheless, I think we are ending the year in pretty good shape. I do not agree with pundits who argue about whether we can engineer a "soft landing." "Landing" implies stopping. I prefer to say that the Fed's job is to provide the monetary conditions necessary to pilot our economy at a comfortable cruising altitude and speed while preventing the engine from overheating with inflation. As we look to 2007, I consider this objective to be within reach. And that, good Rotarians, would be far from a dismal outcome. You needn't marry an economist and move to Arkansas. You can stay right here in Longview and thrive.