Economic Outlook

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Introduction

Good evening. I am glad to be a part of the South Jersey Bankers' Association's first meeting of 2004, and I welcome the opportunity to share my views on the progress and prospects of the U.S. economy. I will begin tonight's remarks with an overview of the national economy and offer my perspectives on how the recovery is playing out. Then, I will mention some of the challenges facing policymakers in the months ahead. Finally, I will conclude with some insights on the economy here in our region.

The Progress of the Recovery

Let me begin by saying I believe that 2004 should be a good year for our economy. Despite December's disappointing payroll numbers, the recovery continues to gain traction, and we seem to be moving toward a well-balanced and self-sustaining economic expansion. I expect economic growth to continue in 2004, with GDP growing at a healthy pace and with labor market conditions improving gradually. Still, after three years of sub-par performance, the economy has considerable ground to make up, and inflationary pressures will likely remain subdued.

Most forecasters are calling for improved economic performance in 2004. They expect healthy growth in overall demand emanating from continued strength in consumer spending and a revival in business spending. I concur with that prognosis.

The reasoning is fairly straightforward. The consumer, who has been the mainstay of the economy over the past three years, will continue to spend in 2004. Despite early forecasts of gloom, the sales figures for the holiday season just completed generally met expectations - the best numbers since 1999. This suggests that the household sector is willing to continue spending. In addition, consumer spending will get another boost from the federal income tax cuts enacted last summer. The cuts were retroactive to January, so many taxpayers will receive refund checks this spring. As a result, most economists expect that we will see solid growth in consumer spending this year, with sales of homes and autos expected to remain at high levels.

Meanwhile, after a spending hiatus, the business sector began to re-engage in the second half of 2003 and is well positioned to accelerate its spending in 2004. Now, businesses are exhibiting a renewed appetite for investment, especially in equipment and software. To some extent, this spending was motivated by the depreciation of acquisitions made in anticipation of Y2K. It was also driven by the competitive pressure to contain costs and boost productivity, as well as continued declines in the price of technology. Looking ahead, I expect firms to maintain a healthy pace of spending.

Businesses will have a stronger incentive to invest in 2004. Continued growth in overall demand will create the need to add hardware and software, as well as to expand capacity more broadly. And tax cuts - this time in the form of the temporary acceleration of depreciation allowances - provide additional incentives to invest sooner rather than later.

In addition to having the motive to make these new investments, businesses also will find the means to finance them readily available. Profits have been on the rise, and with narrowing credit risk differentials, the cost of bond financing remains low. Moreover, as the equity market ends its first year of positive performance in the new millennium, funds are flowing back into the stock market. And of course, as I need not tell this audience, banks are actively seeking to make good commercial loans. As a result of all this, I expect firms to embark on healthy programs of investment spending in 2004 and, thus, make a significant contribution to overall demand growth.

You will note that I have been concentrating my comments on the expectation that our expansion will be built on growth in private domestic spending. What about the government sector? And what about international trade and its impact on the U.S. economy?

I do not think either one will substantially affect overall growth in 2004. Government spending is not projected to add a great deal to growth this year, and developments in the trade sector are not expected to subtract a great deal. The combination of the recent depreciation in the dollar and future prospects for stronger growth around the world suggests that the trade deficit will stabilize. So, our participation in the global economy will not have a significant impact on the growth rate of the U.S. economy near term.

Rather, it is private domestic demand that will drive the U.S. economy in 2004, and as I said, it is well-positioned for sound growth as we move through the year.

Demand Growth and the Employment Picture

This improved demand growth will likely translate to stronger demand for labor, addressing the remaining soft spot in this recovery. Here, there is significant room for growth.

As you all know, the economy lost 1.5 million payroll jobs during the recession of 2001. Even after the recovery began, it lost nearly 1 million more through last summer. The economy has been adding jobs each month since August, but the gains have been disappointing. Going forward, strong growth in demand will induce businesses to slowly add to their payrolls.

But to just absorb new entrants into the labor force, the economy needs to add 150,000 new jobs per month. To re-employ those who have lost their jobs and bring the economy back to full employment, we will need even more job creation. We have not seen that yet - monthly gains have averaged only about 56,000 since August. However, as demand increases, firms will begin to add permanent workers to their payrolls. Over the coming year, I expect to see job growth accelerate to 200,000 per month. This is a tall order, and I expect the labor market to reach that level only at a gradual pace.

The reason for the slow growth in employment here in the U.S. is that the labor market is feeling the impact of two fundamental trends that are reshaping our economy: technological change and the globalization of markets. New technologies are revamping production processes, increasing output per worker, and, at the same time, slowing the rate at which currently unemployed workers are being re-absorbed, relative to previous recoveries. Simultaneously, growing access to an international labor market is inducing some firms to take operations - and jobs - to other countries, particularly China and India.

From a simple accounting perspective, it was the remarkable gains in labor productivity that allowed businesses to delay hiring yet still expand their output. This was precisely how the recovery was able to proceed for so long without boosting payroll employment. However, job creation will be critical to the recovery going forward, despite the strong gains in productivity.

The process of regaining and maintaining a full employment economy will not be easy, nor will it be smooth and painless. It never is, and this time labor demand growth has been slow to materialize. It appears that changes in the way firms use technology and the increasingly global marketplace have created new trends and dynamics in the U.S. labor market that present both near- and long-term challenges.

Pervasive advances in technology have generated continual growth in productivity for more than a decade, and at surprisingly high rates. Looking forward, productivity growth is likely to remain in the 3 percent range. With the labor force growing at about 1 percent, therefore, we need sustained demand growth of at least 4 percent in order to stabilize the labor market - even more to bring down unemployment. So, sustaining demand growth is the first order of business. As I indicated a moment ago, I believe we will achieve it in 2004, and as a result, I believe that we will see continued growth in employment as the year progresses.

Then there is the impact of the constant pressures of globalization. On top of the factors responsible for the current business cycle, our economy faces the challenge of adjusting to truly global markets. This is reshaping the way our economy works and is also affecting our domestic labor market.

Improvements in information and communications technology, coupled with the decreasing cost of physical transportation, are creating a globally integrated marketplace for goods and services. This, in turn, is creating a global market for labor. The development of this more integrated global marketplace is a positive for economic performance in the long run. Greater specialization and greater exploitation of the comparative advantage of various locations affords everyone a higher standard of living.

Of course, "off-shoring," as it is now being called, has been the trend in much of the production activity associated with manufacturing for a long time. But now it seems to be intensifying, particularly with the opening of the Chinese economy. It also seems to be spreading to the service sector. Lower-skilled, call-center and other service jobs have been migrating to India and elsewhere in the Far East for several years. More recently, the process has been moving up the value chain to higher level professional service jobs, such as accountants, financial analysts, and software engineers.

But we must all remember that the numbers here are not large when compared to the size of our economy and the size of the U.S. labor force. And the U.S. remains the world's largest exporter of both goods and services, accounting for over 18 percent of the world's service exports in 2001 according to the WTO.

Traditionally, our comparative advantage is innovation: the development of new products and services and new ways to deliver them. Innovation will continue to be our source of international competitiveness, or as economists say, our comparative advantage. That is not to say it will come automatically or easily, but the U.S. economy is up to the challenge. Given the agility, adaptability, and flexibility of our nation's labor market, we are well-positioned to take full advantage of the global recovery and the increasingly interdependent nature of the global economy.

Aside from these secular factors effecting the growth in labor demand, there are some noteworthy positive signs in recent data releases. Initial claims have been falling rather consistently as of late. Temporary jobs, usually a leading indicator of permanent jobs, have been increasing for some time. But so far, significant growth in employment has not materialized as rapidly as we had expected.

Clearly, firms are still only grudgingly adding permanent employees. Part of the explanation is that businesses are cost conscious. Unlike the cost of new technology, which is falling, the cost of adding permanent employees is rising, most noticeably in the form of outsized increases in benefits costs, particularly for health insurance and pension programs. The recovery must continue to convince firms that the value of adding new employees is worth the risk. Until then, this is likely to be a persistent problem.

So, the bottom line is that healthy job growth may be slow in coming. Yet, an acceleration in employment is a crucial element to achieving a self-sustaining recovery. Job gains must replace tax cuts as the source of higher disposable income. Better job prospects must replace lower interest rates as a motivator to spend. Thus we achieve the virtuous cycle of employment leading to output demand, leading to more employment. Fortunately, as I indicated a moment ago, I believe we will see increasing growth in employment as the year progresses.

How should our nation's fiscal and monetary policies be managed under these circumstances? If the expansion unfolds as expected, then monetary policy, which has been so aggressively geared to stimulating economic recovery, can eventually begin returning to a more neutral stance. Likewise, the stage would be set for fiscal policy to pursue a more balanced posture.

Fiscal Policy Issues

On the fiscal policy side, the Bush administration came into office intending to permanently reduce tax rates as a strategy for fostering stronger economic performance over the long term. As events unfolded, the tax reductions were accelerated and enhanced in order to provide the economy with much needed stimulus in the short term. Without a doubt, this application of counter-cyclical fiscal policy was extraordinarily well-timed and effective.

The aftermath, however, is a federal budget pushed into a deep deficit for the foreseeable future. As we move forward, fiscal policymakers will need to consider strategies for returning to a cyclically balanced federal budget. At the moment, they have not announced such a plan, but fiscal integrity must return to both national and local municipal budgets as the expansion continues.

The Fed's Goals and Monetary Policy Issues

On the monetary policy side, once the current expansion gains a firmer foothold, monetary policy can move to a less stimulative, and then a neutral, stance. This will avoid momentum toward accelerating inflation or destabilizing shifts in long-term inflation expectations.

However, given the Fed's goals of price stability and full employment, no monetary policy action is likely to be necessary in the near term. Non-farm payroll employment is still nearly 2.5 million jobs below its pre-recession peak, and the labor market has yet to build positive momentum. At the same time, inflation is at a 40-year low, and there are no signs that it is accelerating appreciably.

Assuming that the recovery proceeds as most economists expect, inflation will remain relatively stable and we are likely to see little price pressure. At the same time, the labor market will need time to absorb those currently unemployed, and, accordingly, it is likely to remain relatively slack in the near term. Under these circumstances, it would be appropriate for monetary policy to maintain its current accommodative stance.

The major challenges for the Fed going forward will be gauging the economy's long-run capacity for growth and its near-term capacity to employ people. There are no hard and fast rules here. The Fed must continue to monitor and assess the economy's performance closely, examining both the rate of growth and the speed with which growth absorbs underutilized resources. We will not stay ahead of the curve simply by looking at the numbers. Reserve Bank presidents will be listening to our boards of directors and to business and banking contacts across our Districts for indications that the tone of labor markets is shifting, production bottlenecks are occurring, or pricing strategies are becoming more aggressive. We can then adjust monetary policy accordingly.

No doubt monetary policymakers will face some challenges as we move through this cycle and into sustained expansion. Given the lags at work in the economy and in the impact of monetary policy, it would not be prudent to put off taking any monetary policy action until we actually see sustained increases in inflation. Rather, we will need to begin the adjustment as we see signs that the economy is on a trajectory to achieve full employment or potential output, but before inflation actually accelerates.

Regional Economy

Let me close with some observations on how national economic developments are playing out here in the Garden State and in South Jersey specifically.

Two indexes released last week by the Philadelphia Fed herald good news for the state. Our New Jersey Economic Activity Index, which has risen consistently over the past 12 months, increased yet again, indicating the state's economy is steadily expanding. Our New Jersey Leading Economic Index also showed a positive reading, signaling that more growth lies ahead as we move through the year.

On the job front specifically, the state's economy has outpaced its neighbors and the nation during this cycle. As other states struggled with unemployment during the recovery, New Jersey added more than 40,000 new jobs to its infrastructure through November, replacing those lost in the 2001 recession. In fact, Joseph Seneca, Chairman of the New Jersey Council of Economic Advisors, recently boasted the state is not only "a regional dynamo, but also a national leader in job growth."

Especially noteworthy is the fact that this job growth is largely concentrated here in South Jersey. Indeed, southern New Jersey accounted for approximately one-half of the state's job gains. This is significant since South Jersey's labor markets are far smaller than those of central and northern New Jersey.

Specifically, South Jersey has benefited from gains in education and health, retail, business services, and increased federal government defense contracting. The hospitality and leisure sector was also given a boost with the opening of the Borgata, Atlantic City's newest hotel and casino.

South Jersey's revitalization efforts are also paying off. Consider Camden. With its prime Delaware waterfront location, the city is experiencing an economic renaissance as luxury apartments replace abandoned buildings and the ballpark and aquarium attract visitors and dollars to the area.

From a regional perspective, the Beige Book, the Federal Reserve's summary on current economic conditions around the nation, was released yesterday and reported improving business conditions for the Third District as a whole. Manufacturers report increases in orders and shipments, and retail sales posted a solid holiday season compared with a year ago. Our region's banks, as you know, reported modest lending growth, with business and real estate loans on the rise.

The manufacturing sector continues to improve in the region as well. The most recent readings from our Business Outlook Survey show that manufacturing activity in the Third District continues to increase as we enter the new year. In addition, new orders are rising and the employment situation seems to be stabilizing.

So, what lies ahead for South Jersey's economy? I expect the region to be a full participant in the nation's recovery and expansion. South Jersey's economy will improve along with the nation's in 2004, bringing more jobs and increasing economic vitality to the region. It will go on to contribute to the nation's long-run economic success, as well.

Conclusion

With this said, allow me to sum up. The economic recovery is gaining traction, and I look forward to solid expansion in 2004, with GDP growing at a healthy pace and job growth accelerating as we move through the year. Meanwhile, inflation should remain subdued.

Longer term, changes in technology and the globalization of markets will continue to present the U.S. economy with new challenges and new opportunities. By responding as we always have, with ingenuity and innovation - we will ensure continued improvement in living standards both here and around the world.

This is good news for South Jersey and all of the Third District, as the local economy has been evolving along with the national economy, and will therefore benefit from the accelerated growth.

As the expansion unfolds, monetary policy can begin returning to a more neutral stance. Likewise, the stage will be set for fiscal policy to pursue a more balanced posture. However, both these policy changes are likely to occur only slowly and in response to the acceleration of growth.

In short, the U.S. economy is on the right path - a path of sustained growth with low inflation - and that is a good place to be as we enter this new year.