

## Prospects for the U.S. Economy for 2005

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### Introduction

It is a pleasure to be here today at the Global Economic & Investment Outlook Conference. I welcome the opportunity to share with you my views on the progress of the economic expansion in the United States.

I will begin today's remarks with an overview of the national economy — where I believe we stand at the moment and what we can expect as we move ahead. As we are all aware, risks are an inherent part of any outlook. I would be remiss if I did not mention the issues I perceive as potential obstacles to the continued U.S. expansion, so I will do this next. Finally, I will offer some observations on how monetary policy is playing out in this context as well as the current challenges faced by monetary policymakers.

### The Outlook for the Economy

As far as the current outlook for the economy, I believe we are now on course for a sustained period of expansion at a moderate pace. After the recession of 2001, the economy went through an unusually attenuated recovery, marked by periods of fits and starts. But economic performance improved noticeably after mid-2003. And, despite a significant increase in international oil prices, I expect **real GDP growth** to be in the neighborhood of 3-3/4 percent for 2004, that is, from fourth quarter to fourth quarter. Looking ahead to 2005, I expect growth in real GDP to remain in the range of 3-1/2 to 4 percent. This kind of growth, combined with a return of productivity to its long-run trend, should support solid gains in employment while keeping price pressures well contained.

As you are aware, **job gains** have been slow to materialize in this cycle. From a historical perspective, our growth in output has been on par with previous economic recoveries, but that growth has been slow to generate satisfactory employment numbers, largely because growth in productivity has been so strong. In this regard, the most recent employment report was welcome news, and hopefully, the harbinger of continued positive news on the jobs front.

Part of the strong productivity growth we have enjoyed reflects the application of new information technologies that began in earnest in the late 1990s. This is a healthy trend and I expect it to continue. But the outsized productivity growth of the last several years also reflects businesses' uncertainty about the future, and an associated unwillingness to add employees. As the expansion continues and businesses gain confidence in its sustainability, I expect nonfarm payroll employment will increase consistently by 150 to 200 thousand jobs per month. I believe this is strong enough job growth to continue the gradual decline in the unemployment rate.

As you all know, the key to generating this sustained growth in employment is generating sustained growth in the demand for goods and services. Here, we are seeing several positive trends.

First and foremost, **consumer spending** continues to expand at a healthy pace. During the recession and recovery, consumer spending held up unusually well, continuously expanding throughout the cycle. Of course, during the early stages of the cycle, the consumer was motivated primarily by accommodative fiscal and monetary policies: tax cuts and low interest rates. Now, the impetus for consumer spending growth has shifted to stronger private-sector performance in the form of greater job growth and rising household incomes. Indeed, making this transition is the essence of maintaining a self-sustaining economic expansion.

**Business investment spending** has been showing renewed strength as well. This is a far cry from the sharp decline in business investment that spawned the recession and slowed the recovery. Now, bolstered by strong profits and an improving economic outlook, firms are again investing in everything from high-tech

equipment and software to warehouses and equipment, positioning themselves for greater efficiency and greater productive capacity going forward. I anticipate that this growth in business investment spending will continue.

Strong business investment spending and continued growth in consumer spending, combined with modest expansion in government spending on goods and services, should deliver enough aggregate demand growth to support real GDP growth in the 3-1/2 to 4 percent growth range through 2005.

### Risks to the Outlook

However, let me add three important caveats to my forecast. Two refer to international developments: the future path of oil prices, and the future path of the U.S. trade deficit. The third is closer to home: the future course of the federal budget deficit.

Let me begin with **oil prices**. As I alluded at the outset, sharp increases in the international price of oil have robbed the economy of some of its momentum this year. Fortunately, oil prices have eased off their peaks in recent weeks, and futures prices indicate market participants anticipate some additional easing in 2005. This is comforting. However, one must keep in mind the fact that futures markets are often inaccurate and have not forecast oil prices particularly well in the current expansion.

That said, my own assessment is that the underlying fundamentals of long-run supply and demand will keep oil prices from declining substantially for the foreseeable future. And, given the many sources of instability in the countries that supply much of the world's oil, we must recognize the possibility of another spike in oil prices as a significant risk.

I believe my outlook for the U.S. economy in 2005 is consistent with oil prices remaining at their current levels, or easing slightly, next year. However, a significant step-up in oil prices could very well impede growth in the coming quarters. How much impact it would have is an open question.

There are reasons to believe the impact would be relatively small. These have been widely noted, and I have pointed them out before. So, I will only mention them here in passing. First, the economy weathered the recent oil price run-up relatively well. Second, in real terms the oil price increases — at least the ones we have seen thus far — are not as large as those we experienced in the 1970s. And third, the economy is far more energy efficient now than it was in the past.

On the other hand, we must recognize that higher oil prices can sometimes have psychological effects, which amplify their impact on the economy. Such considerations are relevant in the current circumstance, when an oil price spike would likely reflect geopolitical developments — actual or threatened. These concerns could have broader implications on businesses' confidence, which has been somewhat fragile recently. We all recognize that confidence in the future is so essential to investment and hiring decisions. As a result, movements in energy prices will be on my radar screen in 2005.

With that, let me now turn to the second caveat to the outlook: the future course of the **U.S. trade deficit**. Over the past decade, the trade deficit has widened considerably, persistently sapping growth from aggregate demand for U.S.-produced goods and services. This year has been no exception. Through the first three quarters, our net exports fell by \$70 billion, reducing GDP growth by roughly three-quarters of a percentage point.

In some respects, the persistent and widening trade deficit can be seen as an indication of the strength of the U.S. economy. Strong GDP growth in the U.S., relative to that of our trade partners, has contributed to our strong and growing demand for imports relative to the demand for our exports. In addition, the relatively strong demand among foreigners for dollar-denominated assets has kept the value of the dollar high, both financing the trade gap and tipping it further into deficit.

What will happen to the trade deficit over the near term? My best guess is that recent declines in the value of the dollar, combined with reasonable growth in the economies of our trading partners, will help stabilize our net export position, significantly diminishing this leakage from the growth in demand.

That said, I recognize that considerable uncertainty surrounds any forecast of our international trade balance. So developments in the trade sector will require vigilance going forward no matter what we believe the most likely path to be.

This then leaves me with only the last risk factor to deal with — the future course of the federal budget deficit. The **federal budget deficit** for the fiscal year 2004, which ended two weeks ago, is estimated to be over \$400 billion. The forecast for fiscal 2005 is little better. From a macroeconomic perspective, these numbers present us with both a short-run and long-run challenge. In the short run, these deficits must be financed. In the long run, they must be addressed.

I am confident that the short-run challenge can be met. The market for U.S. government bonds is large and deep. Indeed, the only immediate issue appears to be lifting the federal debt limit so the Treasury can issue new debt through its fiscal agent, the Federal Reserve.

The long-run issue of restoring fiscal integrity at the federal level is more challenging. Most economists would agree that any national government ought to strive for a cyclically balanced budget — a budget that goes into deficit in times of economic contraction and moves into surplus as the expansion matures. But, the Congressional Budget Office projects that budget deficits will persist over the next decade, given the taxation and spending programs currently in place.

With the elections now behind us, and economic expansion ahead of us, this is an opportune time to restore the budget to cyclical balance. It is my expectation — or at least my hope — that plans to do so are duly debated and enacted in 2005.

Until the timing and features of such plans are finalized, however, the issue of how a cyclically balanced budget will be restored introduces another element of uncertainty to the outlook. Yet, I consider this additional uncertainty a small price to pay for greater fiscal integrity and a more rapid return to a cyclically balanced budget.

## The Inflation Outlook

Let me now turn to the outlook for **inflation**. Accompanying my most likely scenario of moderate growth is a relatively benign inflation outlook, provided that inflation expectations remain well anchored. However, as the economy continues on its path of expansion, price dynamics are prone to shift.

As productivity growth returns to trend, unit labor costs will probably start to rise, putting upward pressure on prices. We have already seen some indications of a shift down toward long-run productivity growth in the second and third quarter of this year. Moreover, higher prices for oil and other commodities may exacerbate price pressures, as producers try to pass on some of their higher input costs.

It is incumbent upon the Fed to keep these price pressures well contained. As long as the public remains confident in the Fed's commitment to essential price stability — and the Fed conducts its policy in a manner consistent with that commitment — transitory adjustments in prices will not generate persistently higher inflation.

## The Path of Monetary Policy

Thus, the future of price stability rests squarely where it should — on the shoulders of the Federal Reserve. It is incumbent on us to navigate through this period with an eye toward our goal of maintaining price stability so that the expansion the economy has achieved can now be sustained.

Indeed, with the recovery having given way to expansion, the Federal Reserve has already begun to make the transition from an accommodative policy stance to a neutral one, more conducive to sustained non-inflationary economic growth.

If the economy evolves as I expect over the next year or so — with solid output growth, sufficient job growth to put us on a course toward full employment, and reasonably low and stable inflation — then I expect we will continue to move the federal funds rate toward neutrality at a pace that is likely to be measured. But the

precise course the Fed takes in moving monetary policy depends on the course the economy takes on the path to sustained expansion.

In my remarks today I have outlined several risk factors that could alter the short-term dynamics of the economy — oil prices, the trade balance, and the federal budget. I am sure we could name some other factors. The course that these factors take will figure into the precise path the Fed follows. If softness emerges and the expansion seems to be losing momentum, we would need to consider slowing the pace at which we remove our monetary accommodation. Conversely, if signs of price pressure emerge on a consistent basis, we would need to consider quickening the pace at which we move toward policy neutrality.

In any case, given the likely pace of these policy adjustments and the Fed's commitment to transparency and clear communication, I expect the financial markets will continue to take the Fed's actions in stride, adjusting asset values accordingly. In turn, these financial market adjustments will help guide the overall economy along an orderly path of sustained expansion.

## **Conclusion**

In summary, our nation's economy appears to be on a path of moderate, sustained expansion. Though issues and concerns exist, I believe the economy has the strength and flexibility to continue on this path for 2005 and beyond. At the Federal Reserve, we are committed to pursuing monetary policy that supports sustained growth by fostering public confidence and a stable price environment.

Thank you. Now, I would be happy to take your questions.