Economic Outlook for the U.S. and Greater Philadelphia Area

Presented by Anthony M. Santomero, President
Federal Reserve Bank of Philadelphia

The Greater Philadelphia Chamber of Commerce
January 18, 2005

Introduction

It is three years since I last addressed the Greater Philadelphia Chamber of Commerce and much has changed in the interim. On January 8, 2002, just four months past September 11th, we believed the national economy was in the midst of a recession. Uncertainty abounded. I said I believed we were headed for only a modest recovery in 2002. Growth did, in fact, resume at a modest pace in 2002, but the country continued to lose jobs that year.

What a difference three years makes! Now much has improved and this morning I will be giving you a very different perspective on the 2005 economic outlook, both at the national level and for our own region. Let me begin with the national outlook and then move on to what has been happening in the Greater Philadelphia region.

The Outlook for the U.S. Economy

On the national level, I believe the U.S. economy is now embarked on a period of sustained expansion. This will carry us through 2005, and, quite likely, well beyond that. As I just mentioned, the recession of 2001 was followed by an unusually attenuated recovery. But economic performance improved noticeably after mid-2003, and 2004 was a year of solid real growth.

Looking forward, I expect real GDP to expand at a 3-1/2 to 4 percent rate through 2005. This outlook for continued real GDP growth is based upon an examination of who will be doing the spending and their most likely behavior going forward.

As always, consumers will do the bulk of the new spending. During the recession and recovery, consumer spending held up unusually well, continuously expanding throughout the cycle. Holiday sales were good, if not spectacular. Looking forward, steady job growth and rising household incomes will fuel continued growth in consumer spending. Turning to the sales of big ticket items — houses and cars — these have remained remarkably robust, and I expect sales of such items to remain at relatively high levels.

Businesses too will make a substantial contribution to new spending. As you know, swings in business investment spending have driven the pattern of this business cycle. It was the sharp decline in business investment that spawned the recession and slowed the recovery. Likewise, it was the return of growth in business investment spending that energized the recovery in 2003. Since then, bolstered by strong profits and an improving economic outlook, firms have begun investing in everything from high-tech equipment and software to warehouses and machinery. Thus, firms have been positioning themselves for greater efficiency and greater productive capacity going forward. I anticipate this robust growth in business investment spending will continue.

Add to this pattern of private sector spending, moderate growth in government spending on goods and services, and you have solid growth in what economists call domestic final sales.

Of course, as we have all become aware, how much of that domestic demand translates into domestic production depends on what happens to our international trade balance. Over the past decade, a widening trade deficit has sapped growth in demand for domestic production. A strong dollar and a relatively strong U.S. economy drove the gap.

But, over the past year, at least partially in response to the large trade deficits themselves, the dollar steadily depreciated. The declining value of the dollar, combined with reasonable growth in the economies of our
trading partners, should help stabilize our net export position in 2005. As the trade deficit stabilizes, solid growth in spending by U.S. consumers and businesses should translate directly into solid growth in GDP.

Turning to the labor market, the hallmark of this cycle has been a prolonged slump and the slow recovery of employment. Fortunately, nonfarm payrolls now seem to be growing steadily, and I expect them to continue increasing at a rate of 150,000 to 200,000 jobs per month this year. With those kinds of employment gains, the unemployment rate should continue its gradual decline.

A scenario of solid output growth, at or just slightly above the economy’s long-run potential, and steady job gains, which gradually bring the labor market into better balance, is consistent with a relatively stable price environment. Accordingly, I expect inflation, to remain well contained in 2005, both overall and by core measures which exclude food and energy prices.

Having said that, I think we all recognize that 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, potentially putting pressure on prices. We already saw some indications of a shift down toward long-run productivity growth at the end of last 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. Indeed, the recent decline in the value of the dollar may lessen the competitive pressure on domestic producers that has until now limited their pricing power.

It is incumbent upon the Fed to make every effort 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.

In fact, 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 continued output growth, steady increases in employment, and reasonably low inflation — then I expect we will continue to move the federal funds rate toward neutrality at a measured pace. But, the precise course the Fed takes very much depends on the precise course the economy takes. As I have said before, if signs of price pressure emerge on a consistent basis, we will need to consider quickening the pace at which we move toward policy neutrality.

That is my outlook for overall economic performance and monetary policy in 2005. Now, in this context, I would like to touch on two specific issues that have become increasingly relevant recently. The first issue is: “What is the likely path of job creation in this forecast, and more to the point, will the jobs created be good jobs?” The second issue — of particular relevance to this gathering — is: “How will Greater Philadelphia fare as the national expansion moves forward?”

**Job creation and job quality**

Turning to the first issue — job creation — let me start by saying that, as a general rule in macroeconomics, when output grows, employment grows too. However, as I mentioned at the outset, job gains have been slow to materialize in this cycle. Output behaved much as it had in previous cycles, but job losses persisted longer and job gains have come along more gradually. The reason for this unusual dynamic is strong productivity growth.

Businesses invested heavily in new information technologies in the late 1990s. Under pressure from intense competition and a soft economy after 2000, businesses used their new technologies intensively to cut costs and improve efficiency. So they were able to meet the demand for their product or service with fewer employees.

Looking ahead, productivity growth is likely to remain relatively strong as technology continues to become cheaper and more powerful — but it is not likely to be as strong as it has been over the past few years. That is why I expect demand growth to generate steadier employment gains going forward.
But will the jobs created in the process of this expansion be good jobs? One concern I have often heard expressed is that while the number of people employed may be growing again, the mix of jobs is becoming less favorable than usual. To put a point on it: Some say high-paying jobs are being lost and replaced with low-paying ones.

Our Research Department recently looked into this issue. Of course, as is often the case with interesting economic questions, available data make it difficult to provide a truly definitive answer. However, I do not think that available data support the declining job quality story offered by some. In fact, a strong case can be made that the composition of job growth in this cycle is consistent with previous cycles.

The complete analysis is on our Bank’s website. You have the URL in your materials. But I want to offer a few highlights from our work this morning to give you some idea of what we believe is happening in the national job market.

To address the issue of job quality we first have to measure it, and here we turn to available data from Washington. The private sector economy can be divided into nine major sectors.

Each month the Bureau of Labor Statistics produces figures on the number of people employed in each sector and their average hourly earnings. Using that data, one can compute average hourly earnings across all sectors. If you divide the sectors into two groups: those sectors paying above average hourly earnings, and those paying below average hourly earnings, you can begin to analyze the job quality question that is on everyone’s mind.

The high-paying sectors, shown in blue are: education and health services, professional and business services, manufacturing, construction, finance, and information services. The low-wage sectors, shown by the yellow bars are: trade, transportation and utilities; leisure and hospitality services; and other services. The “other services” category captures a broad array of mostly personal services, from appliance repair to nail salons. Admittedly, these categories are broad and somewhat imprecise, but they are indicative of what is going on in the labor market.

Let us now examine the employment growth in the high-paying and low-paying sectors over the past 15 years. The high-paying sector is the blue line; the low-paying sector is the yellow line. The grey area on the left represents the latter stage of the recession of 1990-91. The grey area on the right represents the recession of 2001. Two observations are readily apparent from this data:

First, notice that the pace of total job growth, that is, the growth in both low and high-paying jobs, has been slow in this cycle compared to the previous cycle. I have already mentioned that this morning; it has been the subject of considerable discussion for some time now; and it is evident here.

But, second, notice the pattern of relative job growth during the cycle. The high-paying sector gets hit harder during a recession, while the low-paying sector holds up better. In the recovery phase, the high-paying sector comes back more slowly. It was the low-paying sector that began to increase employment first. Then, as the expansion matures, job growth in the high-paying sector begins to outpace job growth in the low-paying sector. You can see this is similar to the pattern that we followed in the cycle of the early 1990s. Indeed, this pattern is common to recessions and recoveries prior to 1990 as well.

So, the good news here is that historically the composition of job growth tends to shift toward high-paying jobs as expansions mature. This pattern seems to be emerging in the current expansion as well. Consequently, I think there is good reason to expect that as this expansion continues, we will not only see sustained growth in the number of jobs, but also an increase in the proportion of high-paying jobs as well.

How will Greater Philadelphia fare as the expansion moves forward?

Now let me turn my attention to the state of the Greater Philadelphia region, and say a few words about how we in this area have been faring over this cycle and how we are likely to fare going forward.

As you have heard me say, in many ways the Philadelphia region is a microcosm of the nation. If one compares the distribution of economic activity across the major sectors, using employment in the same nine
sectors we have just discussed, this is apparent. In fact, the similarity between the nation and the region is quite striking.

However, there are three noteworthy differences. The first comes as no surprise: A significantly larger portion of total employment in the region is accounted for by education and health services — 21 percent for the region versus 15 percent for the nation. The second and third differences may be something of a revelation: We have a significantly smaller portion of total employment in manufacturing in the Greater Philadelphia region, just 10 percent for the region versus 13 percent for the nation. Of course, this was not always the case, but times have changed and so has the economic base of Greater Philadelphia. The third difference is that we have a smaller proportion of employment than the nation in the leisure and hospitality sector, under 9 percent versus over 11 percent, even though we are growing in that segment.

With this as background, how has our region fared in the most recent cycle? Given the similarities in the distribution of employment between the nation and the region, you might expect that Greater Philadelphia followed the national pattern of employment growth in this cycle. But, surprisingly, the employment cycle in Greater Philadelphia was not as drastic as in the nation this time around. Indeed, it was much less drastic than it was here in Philadelphia during the previous cycle. What happened?

Well, first we must realize that each business cycle is unique. Nonetheless it is worth pointing out that in this cycle our first two differences from the national employment pattern worked to our advantage. In this recession, the manufacturing sector was hit very hard, and many manufacturing jobs were lost. Because our region has diversified away from manufacturing somewhat, these losses effected the region relatively less severely than both the nation and our pattern in the past. Therefore, the transformation of our economic base out of a heavy dependence on manufacturing has finally paid off.

Meanwhile, despite the recession, the nation saw relatively robust job growth in the health and education sector. This sector includes colleges and universities, pharmaceuticals and bio-tech. With Philadelphia’s relative concentration in this sector, this trend helped keep total employment here from dropping significantly during this recession. So, in short, our over-representation in health and education, the so-called knowledge sectors, worked to our advantage in this cycle.

I also mentioned that the Philadelphia region’s leisure and hospitality sector is smaller than the nation’s although it’s growing. In fact, over the past three years employment in this sector has grown more than twice as fast as in the nation as a whole. This is also true for the other services sector which includes the personal services I mentioned before.

Since leisure and hospitality services and other services are low paying sectors, one might surmise that the pattern of employment in the low-paying sector overall held up relatively well here in this cycle. That actually was the case.

And, since both manufacturing and health and education services are high-paying sectors, one might surmise that the pattern of employment in the high-paying sector in Philadelphia held up well, too. That too was true until this year.

While growth in the high-wage sector has turned positive, we do not see that recent acceleration of growth that is evident nationally. This may be due to our already high base and, therefore, a limited capacity for growth. We have heard from some firms that they are starting to look elsewhere for expansion, feeling they have exhausted our labor force’s potential. But, if a shortage of available talent is constraining the growth of our high-wage sector, then that speaks to the strong need for making the region a location of choice for new potential workers. I recognize this as a key agenda item for the Chamber, and it is both a noble and important one as these data suggest.

**Conclusion**

With that, let me end. By way of summary, our nation’s economy appears to be on a path of sustained expansion. I expect 2005 to be another year of healthy growth in output, steady gains in employment, and
modest inflation. At the Federal Reserve, we are committed to pursuing monetary policy that supports sustained growth by fostering public confidence and stable prices for the long term.

I expect Greater Philadelphia to be a full partner in this national expansion. Our diversified economic base certainly works in that direction. But we cannot afford to be complacent. We are seeing, and I expect we will continue to see, the U.S. economy generating growth in high-paying jobs going forward. As continued expansion supports the growth of high-paying sectors, we must do what we can to attract more of that growth to our own region. It is in that spirit I applaud the Chamber and others in the region for their collective efforts to ensure that businesses pursuing new opportunities do indeed “Select Philadelphia.”

View the GPCC presentation (PDF, 3.7MB, 18 pages).