Economic Outlook

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Jewish Heritage Programs
August 31, 2005

Introduction

Good afternoon, everyone. I am pleased to take part in the Jewish Business Network Lunch Series, and to share with you my views on the progress of the economic expansion in our nation, as well as what has been happening in our local economy. Along the way, I will include some observations on monetary policy — both how it has been playing out in this cycle as well as its likely future path.

In truth, this talk would have been easier to give last week, and it is likely to be easier next week. The impact of the devastation in the Gulf of Mexico and the events in New Orleans makes forecasting national economic activity particularly challenging. It also saddens us all as fellow Americans. Of course, it is never easy to forecast the direction and speed of an economy that encompasses nearly 300 million people, but Mother Nature has made this task more difficult today. That said, allow me to forge ahead, with the realization that the events unfolding in Louisiana and Mississippi add more than the usual amount of uncertainty to our economic environment.

The Outlook for the U.S. Economy

Let me begin with the bottom line of my view on the national outlook. I believe the U.S. economy remains on a path of sustained expansion, and I expect **real GDP** to grow at a rate of 3-1/2 to 4 percent in 2005. From a policymaker's perspective, that would be a good outcome and a good place for the economy to be.

Most economists would put the economy's long-run potential growth rate at slightly less than 3-1/2 percent. With the kind of growth I am projecting — moderately above the economy's long-run potential — we will continue to add new jobs at a healthy pace, without creating undue inflationary pressures. This, in turn, positions us to settle into a prolonged period of sustained expansion.

Nonetheless, the economy faces a number of challenges going forward. Three of these challenges have garnered particular attention in the financial media recently. The first of these is the uncertainty about the future course of the housing market. The second is ongoing escalation in the international price of oil, which has moved to record levels, having reached $70 a barrel just this week. And the third is the uncertain impact of the disruption and dislocation associated with the effects of hurricane Katrina on the infrastructure of both the US petrochemical industry and on both our import and export sector. It is my view that, at the end of the day, these developments may slow the rate at which the economy will grow for a time, but the expansion is strong enough to withstand them. Let me explain why.

As you know, even prior to recent events in the Gulf of Mexico oil prices have been ascending precipitously, climbing from $34 to $70 a barrel over the past two years. Part of the increase has been the result of speculation and concerns over temporary supply disruptions. However, much of this rise was attributable to the increase in the international demand for oil associated with the global economic expansion. To that extent, oil prices are expected to remain elevated for some time.

I think we have all been taken aback by the high cost of filling up our gas tanks this summer. But, thus far, the U.S. economy has proven relatively resilient to the rising oil prices, surprising some who recall the oil price shocks of the 1970s and the severe impact they had on us. But, since that time, our economy has become more fuel-efficient, and as our output shifts from goods to services, it has become less energy-intensive. These trends render the economy better equipped to handle rising oil prices. Thus, while oil price increases have robbed the U.S. economy of some momentum, growth has remained quite healthy.

Recent events will test that resilience. The aftermath of Hurricane Katrina has accentuated the concerns already in the market place and caused a further escalation in oil prices today. There is little doubt that the weather damage to our oil industry could be substantial and dislocations are likely in the short run. In addition, the New Orleans port, and its related infrastructure are both an important part of our international trading network. Disruption here, if even for a short time, is likely to have an effect both locally and nationally, at least for a time. Nonetheless the U.S. economy has proved to be surprisingly capable of absorbing such shocks, and after a short period the effects of Katrina are likely to slow but not stall the forward progress of the national economy. Of course, we must all wait to see the damage that Mother Nature has caused, but for the moment I am hopeful that the damage done to the national economy will be neither substantial nor very long lived.

With that, let me turn to the other area of concern, the ongoing escalation of residential housing prices. Housing price increases have garnered much attention recently and some have suggested that they may present a potential roadblock to future growth. There is some reason to be concerned here too. Traditionally, housing is viewed as a type of durable good rather than a purely financial investment. But when markets turn speculative, activity in the sector can impose broader risks on our economy. Nonetheless, there is little doubt that the underlying fundamentals have favored a robust housing market. Now, most economists expect housing prices to begin to stabilize as long-term interest rates adjust upward. As this occurs, the speculation present in some markets will eventually dissipate and price increases should slow.

That said, if one takes a somewhat longer view of the U.S. economy's track record, it has performed surprisingly well over the past several years, especially when one considers the whole sequence of unexpected events, economic imbalances, and geopolitical tensions that have arisen since the new millennium began. It is a real tribute to the inherent strength and flexibility of our economic system.

So, in spite of the current challenges, I retain the view held by most economic forecasters before this week's events, and anticipate a continued economic expansion. Now, let me provide you with a bit more detail on how I reached this prognosis.

As usual, **consumers** will do the bulk of the new spending that generates this growth. They always do and always will. With the expansion well underway, solid job growth and rising household incomes are supporting steady growth in overall consumer spending now, and will continue to do so into the future. This ought to be true even with the regional disruption associated with this season's hurricanes and even as energy prices rise and the accumulation of home equity begins to moderate. These factors will, no doubt, slow growth somewhat, but with the job market improving and the momentum of the expansion at our backs, moderate growth in consumer spending is the most likely outcome.

At the same time, I expect **businesses** to continue contributing significantly to the overall increase in spending. With the expansion firmly in place, businesses are investing again in high-tech hardware and software, and in warehouses and machinery as well. In this way, firms are positioning themselves for greater efficiency and greater productive capacity. Admittedly, investment is likely to be uneven across sectors. Manufacturing has had a less positive experience in this cycle, due primarily to increased global competition and pressures from the dollar. Nonetheless, going forward I anticipate that growth in business investment spending overall will continue to play a major role in aggregate economic growth.

Next, add to this pattern of private-sector spending the growth in government spending on goods and services. At this point, there is little evidence of an appetite for either a dramatic increase or a sharp decline in spending at the state or federal level. So at least for the near term, moderate growth in **government spending** appears to be a reasonable estimate.

Adding up all of these components of demand suggests a scenario of solid sustainable 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**.

For the past decade, a widening **trade deficit** has been siphoning off some of the growth in demand for domestic production in the U.S., and funneling it into our trade partners — Europe, Japan, and most notably, China. For some time, economists were predicting that the trade deficit would begin to narrow. The argument was that as foreign suppliers accumulated more dollars, their willingness to hold still more would diminish, causing the dollar to depreciate, and thus making U.S.-produced goods and services more competitive. Furthermore, global economic growth was expected to pick up, generating greater international demand for U.S. produced output.

But things have not gone as expected. The value of the dollar declined somewhat last year, but has appreciated thus far this year. It seems that foreigners, including both private investors and central banks, have been more willing to hold dollars than we anticipated. Meanwhile, global economic growth has been more sluggish than expected, and our appetite for imports has been stronger than expected. Then, there is the rapid and unanticipated increase in the international price of oil. Rising oil prices increase the cost of our imports, and hence, the size of our trade deficit, still further. The bottom line is that the U.S. trade deficit will probably continue to widen over the near term, and somewhat diminish growth of U.S. output.

So where does this all leave us? The impact of the risks I spotlighted earlier — namely, oil, the recent disruption associated with Hurricane Katrina, and housing — are complex and difficult to predict, and likely to cause some drag on aggregate demand. Nonetheless, taken together the factors enumerated above suggest that GDP growth will be in the 3-1/2 to 4 percent range I stated at the start of this talk. Yet, as always, some uncertainty does exist.

Let me next turn to the labor market. **Nonfarm payrolls** have been growing for some time now. As those of you with children entering the labor force know, hiring is up and recruiters have returned to campus. In fact, over the past 12 months, non-farm payroll gains have averaged 185,000 per month, somewhat above the figure that many economists believe is necessary to keep pace with growth in the labor force. As a result, the unemployment rate has slowly drifted down, and now stands at 5 percent, which is relatively low by historical standards.

I expect employment growth to continue in the range of 150,000 to 200,000 jobs per month this year, and obviously, this would be a welcome pattern in an economy that had struggled to add jobs in this cycle.

But, with the unemployment rate at 5 percent, we must also begin to ask how much slack remains in the labor market.

By at least one measure, there may not be much. Every quarter, the Philadelphia Fed conducts its *Survey of Professional Forecasters*, in which we ask prominent economists about their prognosis for the U.S. economy in coming quarters. Once a year, we ask the survey participants for their estimate of the economy's “natural rate” of unemployment, that is, the unemployment rate the economy can sustain without causing inflation to accelerate. In our most recent survey, released this month, the median of the estimates of the natural rate of unemployment was 5 percent. This suggests to me that we may begin seeing some tightness in the labor markets soon, and some upward pressure on wages and prices.

In this context, let me say a few words about inflation. Thus far over this cycle, inflation has been well-behaved, and inflation expectations have remained well-anchored. I fully expect that this will continue to be the case.

In the near term, overall inflation will be affected by the substantial increase in energy prices. This summer we have been paying significantly higher prices to gas up our cars and trucks. This fall and winter we will be paying more to heat our homes and offices. As these effects ripple through the economy, overall inflation will track a bit higher. But this should be a transitory phenomenon.

That does not mean we can afford to be complacent about inflation. As the expansion matures, the price dynamics at work in the economy will shift. As labor markets firm and labor productivity growth returns to trend, we are beginning to see unit labor costs increase. In addition, as demand grows, competitive pressures on domestic producers may diminish, allowing them to exert more pricing power. It is incumbent upon the Federal Reserve to take the steps necessary to keep those pressures under control, and preserve a stable price environment, so that the expansion can continue. To keep these incipient price pressures well-contained, the Fed will have to continue shifting monetary policy from its current somewhat accommodative stance to a more neutral one.

Monetary Policy

So, I share the general view that inflation and inflation expectations will remain low. This is because I believe the Fed will continue to pursue a monetary policy supportive of that goal. If the economy evolves as I expect, then my sense is that the policy path upon which we embarked just over a year ago — a movement toward neutrality at a measured pace — will continue to be appropriate.

If the economy evolves as I expect, it is likely that we can continue to move the federal funds rate toward neutrality at what we have described as a measured pace, steadily converging to a level of interest rates that supports the current expansion into 2006 and beyond.

Of course, events do not always unfold as we expect, and, as I alluded at the outset, the economy still faces a long litany of challenges in this particular cycle. Under such circumstances, policy flexibility and public credibility are the keys to the Fed's success. So the Fed's best strategy is to keep careful watch on economic developments, approach each policy decision with an open mind, and communicate the rationale for its decisions as clearly as possible.

The Outlook for the Greater Philadelphia Region

With that, let me turn to our regional economy. The obvious first question is how has the Delaware Valley been doing in this most recent cycle? As I have often said in the past, the Philadelphia region is, in many ways, a microcosm of the nation.

While other parts of the country have concentrations in one or two sectors, or remain tied to one or two industries, the evolution that has taken place in our region has diversified our economy in a most attractive way. As a result, the expansion that is taking place nationally is playing out here as well. Output is up and employment is rising, and local real estate markets are strong.

In the labor market, unemployment rates in New Jersey and Delaware are well below the national average, and have been for some time, while Pennsylvania is about on par with the nation.

Our region continues to show broad-based strength in the housing market. Price appreciation has been quite impressive, with five-year gains of 46 percent for Pennsylvania, 59 percent for Delaware, and 76 percent for New Jersey, as compared to an average of 50 percent for the nation.

While we have become largely a microcosm of the nation, we also have some distinct characteristics that have influenced the business environment of the region and reflect upon its future. When one compares the Delaware Valley, or the three states in our District, to the national economy, three distinct and noteworthy differences surface.

First, a larger portion of our total employment is accounted for by education, health services, and pharmaceuticals — the so-called “eds and meds” concentration referenced in the local press.

Second, because of the restructuring that occurred in the region over the second half of the last century, the region now counts on traditional manufacturing for a smaller portion of its total employment.

And third, employment in the leisure and hospitality sector has been growing strongly. As I think we all realize, our region has been doing a better job of capitalizing on its unique history and location to foster growth by making improvements that add to the quality of life here for both visitors and long-term residents. Construction of the National Constitution Center, the Kimmel Center, and the two new sports stadiums were highlights in this development.

These unique characteristics of our region helped improve our economic performance in the most recent business cycle, and will help us take full advantage of the national expansion that lies ahead.

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 cycles. It turns out that the differences in our economic makeup worked in our favor.

As you know, the manufacturing sector was hit quite hard in the last recession. Because our region has somewhat diversified away from manufacturing, these losses affected the region less severely. At the same time, this cycle saw robust job growth in the health and education sectors. Philadelphia 's relatively high concentration in “eds and meds” helped keep total employment from dropping significantly. Indeed, research and development in the pharmaceutical industry has been particularly strong. In addition, our region's leisure and hospitality sector started this cycle smaller than the national average, although its growth here is accelerating. Over the past three years, our region's employment in this sector has grown more than twice as fast as in the nation as a whole.

As I mentioned a moment ago, there may be relatively little slack remaining in the national labor market. That may be true in our region as well. I 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 growth, then that speaks to the strong need for making the region a location of choice for new potential workers. Cultivating a viable workforce, with the skills to meet the growing needs of our local economy, will ensure the future success of the Greater Philadelphia region.

Conclusion

With that, let me close. To summarize, I believe the U.S. economy is on course to a sustained period of economic expansion. In coming quarters, solid output growth, at or just slightly above the economy's long-run potential, should generate steady employment gains with only modest inflation. Nonetheless, we must be ever-mindful of uncertainties inherent in the outlook. Rising energy prices, the infrastructure disruption recently experienced in the Gulf of Mexico, and price adjustments in the housing market could affect the pace of growth. Given this scenario, we at the Federal Reserve will do our part to help sustain that growth by pursuing a monetary policy that preserves price stability for the long term.

Locally, we seem to have fared both better than usual and better than average. Indeed, the relatively mild impact of the recent recession speaks well of our region and its potential going forward. We are both well diversified as a region, and possess pockets of strong growth with our high-quality industry concentration. We do however face a challenge in this regard. Ultimately, the growth of our economy is limited by the growth of its population, both in size and in skills. And so I encourage you all to be ambassadors for the region — to attract and keep the best and the brightest in the Delaware Valley.

I have enjoyed spending time with you today and will be happy to take your questions.