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The Economic Outlook for 2004

Remarks by

J. Alfred Broaddus, Jr.  
President  
Federal Reserve Bank of Richmond

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It's a pleasure to be back with you once again. I don't know exactly how many years you've honored me by inviting me back, but it's an appreciable number, and I always enjoy being with you. I guess I should say most of the time. Some of you probably recall my appearance here a year ago. That wasn't much fun for either me or you, because I had the flu or a reasonable facsimile thereof. I was taking a bunch of medicines, which made me sleepy and even a little more confused than I usually am. So I was concerned that I might forget what I was supposed to be talking about and start talking about something like college basketball. And you had to listen to a lot of coughing and congestion. You were very patient, which I greatly appreciated, and I'll try to do better this year. Learning from last year, this year I planned ahead and did the flu early.

In any case, I am pretty confident that you will enjoy my talk this year more than the one I gave last year for more fundamental reasons than my better health and voice. Last year the economy was recovering from the 2001 recession, but so slowly most people couldn't feel it. This year we clearly still have a way to go before the recovery will be complete, and there are still risks in the outlook. But by and large, the picture is considerably brighter today than it was a year ago. While current economic prospects are not risk free – they never are – I don't think many would deny that compared to the outlook at this time a year ago, things look pretty good, as I'll indicate in more detail in a minute.

The format I've used in the past has seemed to work pretty well, so I'll use it once again if that's okay: a quick look backward, a look into the future, and a few closing remarks about Fed monetary policy.

Following my usual practice, the first thing I did in preparing for this talk was to go back and look at the outlook I presented for 2003 at this event last year. There is always the remote possibility that somebody here this morning might remember what I said last year and confront

me with it. When I reviewed the forecast I presented last year, however, it actually looked pretty good. (Incidentally, I take no credit for that. What I summarized last year was the so-called "Blue Chip" consensus forecast of about 50 private forecasters, which I will do again this year. I'm a policymaker, and therefore, like you, a consumer rather than a producer of forecasts. And the Blue Chip consensus has as good a record as any other composite forecast I'm aware of.)

Let me briefly recall where we were a year ago. As I said a minute ago, the economy had been recovering from the 2001 recession, but ever so slowly. Real GDP grew only 2½ percent in 2002. Employment actually declined by close to a half-million jobs that year. A not insignificant part of that decline was in the manufacturing sector right here in the Fifth Federal Reserve District, especially the southern half of the District from Southside Virginia down through South Carolina. Moreover, growth in the economy nationally was actually slowing as the year ended, partly because business investment in new plant and equipment was very sluggish, as many businesses were feeling the fallout from Enron, WorldCom and the rest of the corporate governance scandal, and the continued decline in the stock market. Whatever economic forecasters may have thought, there wasn't much optimism about the outlook among ordinary American business people and households this time last year; indeed, there were plenty of people who were convinced that the economy was about to drop back into recession. More generally, most Americans were highly uncertain about prospects for the economy, especially with the prospect of war in Iraq increasing.

Against this background, the consensus forecast I delivered last year sounded pretty optimistic. As I went through it here I remember some of you looking at me as though maybe I wasn't playing with a full deck. The forecast called for continued slow growth in the first half of 2003, due mainly to the Iraq-related uncertainty I just noted. It called for growth to accelerate, however, in the second half on the assumption that some kind of resolution of the situation in Iraq would be forthcoming. Beyond Iraq, the idea was that continued fiscal stimulus from the tax cuts enacted in 2001 and prospective further tax cuts in 2003, along with continued highly

stimulative monetary policy from the Fed, and the historically low interest rates implied by this policy, would sustain the extraordinary strength in housing and the impressive firmness in consumer spending that had persisted through the first year of the recovery despite weakness elsewhere in the economy. Then, as the uncertainty regarding Iraq diminished, the fallout from the corporate governance problems receded, and excess capacity gradually diminished, businesses would shed at least some of their caution and commit to new investment in equipment and software as the year progressed. (The implicit assumption, obviously, was that whatever operation was undertaken in Iraq would succeed.) The forecast did not call for anything approaching boom conditions, or even the relatively rapid growth rates that typically characterize the early stages of business recoveries and expansions, just a moderate acceleration from a 2 to 2½ percent growth pace in the first half of the year to a 3½ to 4 percent pace in the second half.

Well, with 2003 now history, we know that, while the economy hasn't followed this script precisely – it never does – it has followed its broad profile remarkably closely. GDP grew at only a 2 percent rate in the first quarter in the run-up to the action in Iraq, and even after the successful completion of the initial stage of the operation, most people did not expect much improvement in the second quarter. As it turned out, growth accelerated moderately to a 3 percent rate in the quarter, an earlier acceleration than anticipated. Housing and consumer spending remained firm in the quarter. And after declining early in the year, business spending on equipment and software turned up, reinforced by a healthy, productivity-driven increase in business profits and favorable financial conditions in the business sector. Then, in the third quarter, of course, growth accelerated sharply further to an 8¼ percent pace according to the latest estimate. Powered by further tax cuts, which went into effect at mid-year, consumer spending grew at an exceptionally strong 6.9 percent rate in the quarter – outlays of cars and other durable goods were especially robust. And most importantly, business spending on equipment and software accelerated to almost a 17½ percent annual rate, which was

encouraging evidence of increased business confidence in the expansion's staying power. Finally – last but not least – despite outsized increases in productivity in the second and third quarters, employment finally began to increase in the third quarter after many consecutive months of job losses. Non-farm payroll employment rose by 277 thousand jobs between July and the end of November. That's not strong job growth by any means, but at least the recovery was no longer "jobless."

Before I turn to 2004 and the outlook, let me make just a few remarks about some of the latest monthly economic reports. We won't get the initial report on GDP growth in the final, fourth quarter of 2003 until later this month. But the recent monthly data, which includes a fair amount of information for the month of December as well as October and November, are giving us a reasonably clear picture of what that report may look like when it is released. Some of the data are a little disappointing – in one case more than a little disappointing. Consumer confidence declined marginally in December from November according to the Conference Board index. Elsewhere, both new and existing home sales declined in November for the second consecutive month. And perhaps most importantly, new factory orders for non-defense capital goods excluding aircraft, which are a key leading indicator of business spending on new equipment and software, declined fairly sharply in November. But these orders are volatile month-to-month, and they had increased at a healthy pace in September and October. And while home sales have declined, they have declined only modestly from very high levels.

The one definitely disappointing recent report was the job market report for December released last Friday. As you probably saw, the unemployment rate dropped a couple of ticks, from 5.9 percent to 5.7 percent. But that decline was apparently due mainly to workers leaving the labor force because they haven't been able to find jobs and are discouraged. In other words, the decline in unemployment was more a statistical quirk that reflected the way the rate is calculated than a meaningful improvement in labor market conditions. Moreover, total nonfarm payroll employment rose by only 1,000 jobs in the month – far fewer than expected

given the apparent acceleration in economic activity recently. Also, average hours worked per week were down. It appears from this report that, at least in December, many companies were still able to meet increased demand for their products by increasing productivity rather than by recalling laid-off workers and hiring new workers. So the December job report – which many had expected to increase optimism about the outlook – was a bit of a bummer.

Beyond this, though, much of the latest data has been encouraging. We have only incomplete information at this point on consumer spending in the December holiday period. But both total consumer outlays for goods and services and household disposable income held up better than anticipated in October and November. They had been expected to decelerate more than they did after their outsized increases in the third quarter. Further, there is now clear evidence of improvement in the manufacturing sector of the economy. The Fed's index of factory output rose at a solid pace in each of the three months through November, and it has not declined since last May. Moreover, the Institute for Supply Management's index of manufacturing activity – a reasonably reliable indicator of factory sector conditions – has risen sharply of late, and hit its highest level in 20 years in December. This is not to deny that there is still substantial weakness in some manufacturing industries. As the textile and furniture workers in this region who are still laid off will quickly tell you, they are still in a recession. But nationally, the manufacturing sector as a whole, including high-tech as well as low-tech industries, is doing better. Finally, not all recent information on labor market conditions has been disappointing. Initial claims for unemployment insurance have been declining steadily for several months, and employment of temporary workers – regarded by many as a precursor of trends in permanent employment – has risen.

Okay. Now what? Where do we go from here, in 2004? To cut to the chase, the latest Blue Chip consensus forecast for 2004 calls for GDP growth to continue at about a 4 percent rate this year. Consumer spending and housing activity are expected to moderate considerably from their surges last fall. But they're expected to be well maintained by five things: (1) steady

growth in disposable household income; (2) the positive effect of the stock market rebound on household wealth and confidence; (3) the lingering impact of last summer's tax cuts, especially in the form of sizeable tax refunds in the first half of the year; (4) continued low interest rates – including mortgage rates and other long-term interest rates; and (5) continued attractive new car sales incentive programs. Perhaps most importantly, however, business spending on equipment and software, which, as I reported earlier, finally showed improvement in the middle of last year, is expected to continue to improve in 2004, particularly investments in computing and other high-tech equipment. Business confidence in the durability of the expansion has increased noticeably of late. I hear this message clearly in the comments I get personally from many of my business contacts, and of course it appears that the negative drag of the fallout from the corporate governance scandals of last year seems now to have waned. Moreover, financial conditions are very conducive currently to increased investment. Profits and cash flow are rising for many corporations and other businesses, enabling internal financing of many outlays, and external financing is readily available for worthy projects. Further, longer-term interest rates – again – are still quite low, and risk spreads on lower-rated credits have been narrowing for some time.

These, then, are the broad contours of the consensus outlook for 2004 nationally. But as we all know, in the economy as in life generally, things don't always turn out the way one might expect. And that's certainly true of economic forecasts. There are always upside and downside risks of error in any forecast, and that's the case here.

On the one hand, growth could be less robust than in the forecast. The key point here, of course, is the continuing softness in the job market, underlined by the disappointing December jobs reports I summarized a minute ago. To be sure, as I said earlier, labor market conditions have improved since the middle of last year. But the growth in jobs over this period has been below the trend growth in the labor force, and hence below the rate of increase necessary to bring unemployment down materially and keep it down over time. Labor

productivity has been growing extraordinarily strongly recently. Strong productivity growth is highly desirable for the long term. But in the near term, continued robust productivity growth could retard job growth, and sluggish job growth – in turn – could put a damper on the expansion. Weak job growth has a particularly negative effect on consumer spending, since it erodes the confidence of many households in their future financial security. Indeed, the subpar job growth through November may be one reason for the drop in consumer confidence last month I noted earlier. So the economy could conceivably grow less strongly this year than the consensus projection, as a result, ironically, of the negative near-term impact of high productivity growth on jobs and the negative impact of sluggish job growth, in turn, on the aggregate demand for goods and services.

On the other hand, the economy could grow more rapidly than the consensus forecast is projecting. Interest rates are still very low, and the latest round of fiscal stimulus could have larger lingering effects than expected. Moreover, the apparent upturn in expectations and confidence on the part of business decision-makers could easily lead to stronger than anticipated business investment. In addition to the increased outlays on equipment and software I've already discussed, inventories are very low in many industries, even taking account of the long-term reduction in inventory-sales ratios brought about by just-in-time inventory management practices. Consequently, increased production to rebuild inventories is another potential development that could produce stronger GDP growth this year than the consensus projects.

I recognize that there's a lot of "on the one hand this" and "on the other hand that" in what I just said. But that's the way it is with economics and economic forecasting. The other day I got on the elevator at our Bank to go from my office to the cafeteria several floors below. I pushed the button and the elevator promptly started descending. It stopped, though, on the floor where our economic research unit is housed, and about six of our economists got on. The

doors closed, but this time nothing happened. The elevator just sat there. I concluded that, with so many economists on board, it was confused.

Bottom line: I think the consensus forecast – again about a 4 percent increase in GDP this year – is plausible. For what it's worth, I personally think we'll get a stronger outcome, where my instinct is based in part on what my business contacts have been telling me, but also on the increasing evidence of growing momentum in the economy in much of the recent economic data.

Let me turn now to a few closing comments about Fed monetary policy. If we want to help ensure that the actual behavior of the economy in 2004 is reasonably close to the relatively favorable consensus forecast I just went over, we have to get monetary policy right. And in this regard, it is important to keep in mind that, despite the popular tendency to think that the Fed can fine tune a lot of things in the economy, in reality the main thing we can do reliably and consistently with monetary policy is to control the general level of prices in the economy, or, stated equivalently, stabilize the purchasing power of our money.

With this in mind, to put things in perspective, we spent close to two decades struggling to reduce inflation from the double-digit levels it reached in the late '70s and early '80s. Those of you who've attended these meetings for awhile will recall that I spent a lot of time in the past preaching to you about the crucial need for the Fed to reduce inflation and restore its credibility as an inflation fighter, and by the mid-1990's, we had succeeded in bringing the inflation rate down to the 2 percent range. This was a major achievement for monetary policy. By reducing risk in the economy and fostering a marked decline in long-term interest rates, it almost certainly contributed materially to the economy's strong performance in the second half of that decade. As the economy softened, however, in the second half of 2000 and through the 2001 recession, inflation decelerated further to the 1½ to 2 percent range as measured by the core personal consumption expenditures index, and most recently has declined to about 1 percent. Indeed, the core personal consumption expenditures index – thought by many to be

the most reliable inflation gauge currently – has increased just 0.8 percent over the last 12 months. That's the lowest U.S. inflation rate in over 40 years. Moreover, since there's about a half percentage point upward bias in this index, the "true," underlying rate is probably somewhat below 0.5 percent at an annual rate.

Now, despite this quite striking additional recent disinflation, not many people who monitor the economy closely are currently very worried about further disinflation. On the contrary, with real economic activity now turning up strongly, the more prevalent concern seems to be that inflation may return fairly soon, and that the Fed will have to react to this – or maybe even act early to pre-empt it – by raising interest rates: more specifically, by raising the so-called federal funds rate, the short-term interest rate we control in conducting routine daily monetary policy operations. Actually, these days, we don't have to guess what financial market professionals think the Fed will do with policy. One can observe these policy expectations directly by following the growing market in fed funds futures contracts. If you've been doing this recently, you know that, a few weeks ago, when the acceleration in the economy first became apparent, these markets were pricing in a Fed policy tightening as early as a few weeks from right now. Currently, the market appears to expect the initial tightening to occur later, in the second half of the year.

Let me emphasize that, even though I'm a participant in the Fed's FOMC policy meetings, I really have no better idea what we ultimately will do with policy this year than others. I will say – and here I'm speaking strictly for myself – that I do not expect a material increase in inflation this year, despite the current acceleration in demand and overall economic activity. Obviously I can't rule out the possibility of an upturn in inflation. If the economy accelerates further and moves back into the kind of boom conditions it manifested in the late '90s – much stronger growth than in the consensus projection, and sharply rising stock and other asset prices – inflation could reverse course and begin to creep up this year. Again, I can't rule this out; but I believe the probability of this scenario is low. I think it's much more likely that inflation

will remain low this year. The unemployment rate is still relatively high, so there's still appreciable slack in labor markets. There's also substantial excess capacity in a number of industries, and with productivity growing rapidly, unit labor costs have been declining most recently. Unit labor costs account for about two-thirds of total production costs and are therefore a more important determinant of short- and intermediate-term inflation trends than commodity prices and other things often described as precursors of inflation. So again, I think inflation will stay under wraps this year. I'll let you draw your own conclusions about what that may imply for our policy settings.

Let me end with a brief remark about the longer-term outlook for the U.S. economy, out beyond the end of this year. This seems appropriate since today's breakfast may be the last opportunity I'll have to deliver this annual peering into the future. In a word, I'm optimistic about this economy's long-term prospects. To be sure, there are risks in the long-term outlook. The growing budget and current account deficits – obviously – are two of these risks, and there are others, like the continued threat of terrorist attacks and growing income disparities among our citizens. But I believe that recent U.S. economic history demonstrates vividly that the U.S. economy can perform remarkably well, even in the face of extraordinary adversity, if it has a solid monetary foundation. The Fed has now achieved its long-sought goal of price stability. The challenge going forward is to maintain it – resisting both renewed inflation and excessive disinflation or deflation. We need to do this, but not just to be able to brag that we're sustaining price stability. Price stability is not an end in itself. Rather, we need to do it because price stability, by reducing the uncertainties and risks that households and businesses would otherwise face in making individual business and financial decisions, fosters more economically efficient decisions, greater saving and investment and stronger economic growth. I don't know who my successor at the Bank will be, but you can be sure that if, after I retire, I sense that price stability is slipping away, I'll be on the phone to that person very quickly.

Many thanks for giving me the pleasure and privilege of speaking to you all these years.

I will truly miss being with you.

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