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The Economic Outlook for 2003

Remarks by

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It is a pleasure to be with you today. Each year I receive several invitations to give talks on the economic outlook for the year ahead, and this is my first such talk for 2003. I enjoy preparing these forecast talks, since I prepare them during the holiday season when I have a little more time than usual to review the latest economic data, and also to read what other economists and policymakers are saying about the outlook. So hopefully I have a little clearer handle on things than I sometimes do, and I hope these remarks will be useful to you.

Obviously the last three years haven't been particularly happy ones for the economy, neither here in the U.S. nor elsewhere in the world. After four years of sustained high growth in the late 1990's, the economy slowed sharply in the year 2000. It slowed further and entered a recession in 2001 before apparently beginning to recover in the final quarter of that year. As 2002 began, most economists expected the recovery to continue to accelerate, and to deepen. I remember summarizing that kind of concensus outlook when I made the 2002 edition of this talk a year ago. And indeed the recovery did continue, and growth did accelerate last year, but it did not appear to grow the kinds of economic roots needed to develop into a broad, sustained business expansion. In particular, a sizable portion of last year's growth reflected the aggressive new car sales incentive programs in place at various times during the year. Since these programs were scaled back late in the year, most forecasters now expect real GDP growth in the fourth quarter to come in at only about 1 percent at an annual rate when the initial GDP report for that quarter is released January 30.

More broadly, I think 2002 will be remembered as the year when the economy did begin to recover, but the recovery wasn't really firmly grounded and remained unbalanced. Consumer spending was reasonably healthy, and housing activity was exceptionally robust. But business investment remained weak overall, as did export demand. There were also substantial imbalances on a sector-by-sector basis. Many service industries did reasonably well; others –

like the airline industry – did not. And I hardly need to tell an audience in this region that many manufacturing industries lost additional momentum last year. Indeed, the manufacturing sector as a whole shed more than half a million jobs in 2002. Actually, the performance of the job market overall in 2002 was a good proxy for the performance of the economy as a whole. The job market was stronger in 2002 than in 2001, but on net about 180,000 jobs were still lost during the year – a relatively small decline in an economy with over 130 million jobs, but still a negative number. You'll remember the recovery from the 1990-91 recession was – and still is – widely referred to as "the jobless recovery," and 2002 may eventually come to be known as "jobless recovery II."

Having said all these unenthusiastic things about the economy in 2002, I think it is important to keep a few positive things about last year's performance in mind so that we don't lose perspective. When you think about it, it is really quite remarkable that the economy grew at all last year considering what it was up against: continuing threats of more terrorists attacks, extraordinary revelations of deficiencies in corporate governance, severe budgetary problems in many state governments, and, towards the end of the year, sharply rising oil prices due to the increased risk of war with Iraq. The ability of the economy to at least initiate a recovery in this hostile economic environment says a lot, all of it positive, about the underlying strength and resilience of our economy and our economic system.

I think it also reflects some notable improvements in our economic fundamentals in recent years. In particular, productivity growth has remained high. Output per hour rose at a 5½ percent annual rate over the four quarters ending in the third quarter of last year. That's a remarkable productivity advance given the sluggishness of the recovery. There's not as much talk about a "new economy" these days, but to the extent that accelerated productivity growth was a central attribute of the new economy, it is still around. Ironically, this faster productivity growth does have a downside in the very short run: with productivity growth higher, business

firms have been able to meet the current moderate growth in demand without hiring additional workers. This is one reason employment has been growing so slowly.

But the benefits of stronger productivity growth have outweighed the negatives, even in the short run. It has helped keep inflation low. Perhaps most importantly, it has allowed firms to pay higher real wages to those who do have jobs. This is one reason that real, after-tax household income rose markedly last year, which, in turn, is a key reason consumer spending held up well despite slow growth in jobs and the other headwinds buffeting the economy that I mentioned earlier. And of course the continued growth in consumer spending, along with continued strong housing activity, was one of the main supports of the recovery last year. Consumer spending also benefited from cashouts from home mortgage refinancings and other forms of increased household borrowing, but the hefty growth in disposable income was the main driver, and, again, the strong income growth resulted primarily from strong productivity growth.

The other big positive in last year's economic performance was continued low inflation. To long-time Fed people like me, who have spent most of our careers confronting inflation, it is really quite remarkable, not to mention comforting and gratifying, that there is little concern about the risk of inflation currently in financial markets or the general economy. This absence of underlying inflation expectations allowed the Fed to maintain a very stimulative monetary policy throughout 2002, punctuated by the 50 basis point reduction in the federal funds rate we executed at our FOMC meeting on November 6 in response to the so-called "soft-patch" in the recovery. Not many years ago, when the Fed's credibility for low inflation was not as well established as it is now, we could not have acted so aggressively. And of course the absence of inflation expectations has helped keep long-term interest rates low. In particular, the lowest mortgage rates in a generation have fostered the sustained strong growth in home sales and construction.

One other positive in last year's performance – not as impressive as the strong productivity growth or the low inflation I just described, but worth noting – was some limited improvement in one category of business spending, specifically, spending on new equipment and software. Equipment spending declined for six consecutive quarters through the first quarter of last year. But it turned up moderately in the second and third quarters, which is a modestly hopeful sign with respect to prospects for business spending in the year ahead.

Let me turn now to the future and comment on the outlook for 2003. Early each year various business publications put out compilations of forecasts made by professional forecasters, and econometric forecasting services publish detailed model-based projections. I've faithfully read many of them this year as I try to do every year. I won't dwell on the so-called consensus forecast that emerges from all these individual forecasts because you probably are already broadly familiar with it. Briefly, it calls for continued recovery featuring a modest acceleration of real GDP growth from about 2¾ percent in 2002, to about 3¼ percent in 2003. Many forecasters are not explicit about their assumptions regarding the potential conflict with Iraq. Those who are explicit generally expect – rightly or wrongly – a relatively brief and successful engagement sometime in the first half of the year, and I sense that those who are silent have broadly the same expectation. Partly because of the assumed timing of the conflict, most forecasters expect growth to be slightly slower in the first half of the year than in the second half: a little under 3 percent the first half, rising to a little over 3½ percent by year end. Growth at this pace would reduce the unemployment rate somewhat from its current 6 percent level – or possibly from a somewhat higher level, if the rate ticks up temporarily early in the year – to about 5¾ percent. In the absence of a sustained run-up in fuel prices, inflation is projected to remain well behaved at about 2¼ percent as measured by the CPI. This would translate to about 1½ percent on the core personal consumption expenditures (PCE) index, which is probably a better measure of underlying inflation than the CPI even though it is not as well known.

Backing off a minute from all the numbers, and using plain English, the consensus forecast calls for a second year of very moderate – some would say subpar – recovery from the 2001 recession. This is not a particularly inspiring forecast, and there are downside risks in it. If there is war with Iraq, and it turns out to be more protracted than now expected, and the crisis in Venezuela continues, oil prices likely will rise more than now expected. This would restrain growth, not only in the U.S. but in other industrial countries and many developing countries as well. A longer and stickier conflict with Iraq also could reduce consumer confidence and restrain consumer spending. And there are obviously other downside risks in the consensus projection, like another terrorist attack or even greater weakness in the global economy than we are currently experiencing. Japan is in a protracted downturn accompanied by deflation, the European economy is soft, and a number of developing economies – especially in Latin America – are very seriously challenged currently.

So again there are downside risks in the consensus outlook. My own feeling, though – and this is really the bottom line of this speech – is that the consensus is plausible, and that there is at least some chance that the economy may turn out to be stronger in 2003 than the consensus projects. The accelerated productivity growth I discussed earlier seems set to continue this year. At least there is no obvious reason to expect it not to continue. Continued strong productivity growth may retard job growth to some degree, but it will continue to underwrite healthy growth in disposable income for those who are working, and hence household spending. Beyond this, monetary policy currently remains very accommodative. The funds rate, at 1¼ percent, is at its lowest level in several decades. Since the core inflation rate is currently about 1½ percent, the real funds rate is negative, which constitutes very stimulative monetary policy by historical standards. And of course the President has recently proposed additional fiscal stimulus.

Finally, 2003 may be the year when business spending begins to strengthen. I don't want to overstate the prospects for capital outlays. Business capital spending responds above

all to evidence of rising aggregate demand, and demand growth is currently still subdued. Moreover, overall capacity utilization, especially in manufacturing, remains low. But as I said a minute ago, continued robust productivity growth will induce some businesses to buy new equipment and software in order to capture the productivity increase for their own operations so they can remain competitive and enhance profitability in an environment where pricing power is still limited. Further, both corporate profits and cash flow have been increasing, which positions businesses to finance capital expenditures internally. Again, I don't want to exaggerate the case for stronger business capital spending. There's not much evidence of a meaningful actual firming yet. But the financial and other conditions that might foster such a firming are increasingly evident. Needless to say, a material increase in capital investment would be a big plus for the economy because it would ensure the transition from a recovery to a broad, balanced business expansion.

So to repeat my bottom line: I think the recovery will continue. And while there obviously are still downside risks in the outlook, for the first time in a while, I think the chances that actual growth will exceed the consensus forecast somewhat are about equal to the chances that it will come in below it. I'm going out on a limb a little in saying this, but I think it's realistic.

Let me now make a few closing comments about monetary policy. The environment in which the Fed conducts monetary policy has changed materially recently. For most of the last 30 years we've been fighting inflation – struggling either to keep it from rising further or to reduce it. Over the last several years, however, we seem to have finally achieved price stability, the Holy Grail of monetary policy. The core PCE inflation index has been below 2 percent since the mid-1990s. Moreover, we now have credibility for price stability in the sense that both financial market participants and the general public have confidence that we will maintain this stability pretty much indefinitely. We absolutely need to do this. It would be difficult in my view to overstate the significance of this policy achievement. Credible price stability has reduced risk in the economy, which has increased the economy's potential longer-term growth. And it has

permitted the Fed to act much more aggressively recently to counter the temporary but substantial negative shocks to the economy – like the stock market decline – that might otherwise have undercut the recovery.

One other key difference in the current policy environment is that the risk to price stability is now two-sided rather than just one-sided. Obviously, we could experience renewed inflation at some point. But with inflation currently quite low, it might be easier to shift towards deflation than when inflation was high. Neither risk looms large at present, and the Fed is committed to ensuring that both risks stay well contained. I'm confident we can do it – which is something I wouldn't have said not very many years ago.

With respect to deflation, candidly, I worried about it a little in the immediate aftermath of 9/11, when both aggregate demand in the economy and employment plummeted temporarily. We eased policy promptly and materially after the attacks, which brought the funds rate down from 3½ percent at the time of the attacks to 2½ percent in early October, and then subsequently to 1¾ percent in early December. These actions helped stabilize the economy and provided a foundation for the recovery. Not surprisingly, today some people worry that with the funds rate only a point and quarter above zero – and taking account of recent experience in Japan – we could "run out of ammunition" if for some reason the economy weakened abruptly and sharply. I don't think we would run out of ammunition, since even if the nominal funds rate did approach zero, we would still be able to add substantial liquidity to the economy through open market operations. But the most effective way to deal with deflation – which can be every bit as damaging to the economy as inflation – is to act decisively to preempt it, that is, to prevent it from arising in the first place. We understand this at the Fed, and this is a principal reason I don't think deflation is a serious threat currently.

The other risk to price stability, of course, would be a reemergence of inflation, which is the more familiar concern for most of us. Again, the Fed has now achieved high credibility for low inflation, and while the recent run-up in oil prices bears watching, I don't think renewed

inflation is a clear and present danger either. Having said this, the big monetary policy lesson of the last 30 years is how difficult and costly it is to restore credibility for low inflation once it has been lost, as it was in the 1970's and early 80's. We don't want to go there again. With that in mind, a number of economists and policymakers, myself included, favor introducing explicit numerical inflation targets as a device for "hardening" our anti-inflationary credibility. Such targets have been widely and successfully used to contain inflation and inflation expectations by central banks in other leading industrial countries. While inflation targets are certainly no panacea, I think they would be a material aid to the Fed in sustaining price stability, and sustained price stability will foster a stronger recovery as effectively as anything I can think of.

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