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Remarks on the Economy and Monetary Policy

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It is a pleasure to be back with you once again. I'm truly honored that you invite me back so frequently, although I'm reminded of something that Jack Benny said once when he received an award of some sort. (I assume there are at least a few people in this audience old enough to remember who Jack Benny was.) When he received the award, Benny said he didn't deserve the honor, but then he had arthritis, and he didn't deserve that either.

I know you didn't invite me back to hear a bunch of bad jokes, so let me share a few thoughts about the economy and the economic outlook. I will follow my usual format that you are well accustomed to. I'll start with a little background information on the economy and try to specify as precisely as I can where the economy stands right now. Here I will repeat a few things I said in a series of talks I gave about a month ago, since the background obviously has not changed much since then, but I will also update this part with a few observations about developments over the last several weeks. Then I'll speculate a little about the outlook, and finally wind up with a few remarks about Fed policy.

By way of background, the recovery from the recession in 2001 appeared to start late that year, and it has continued, as best we can tell, since then. But it has been a very different kind of recovery from most other recent recovery periods. First and foremost, it has been an exceptionally tepid recovery. Real GDP grew only 2.9 percent last year, fourth quarter to fourth quarter, and it grew at only about a 2 percent annual rate in the first quarter of this year. This is very modest growth for the early stages of a recovery – so modest, in fact, that some economists question whether there has really been a recovery in a meaningful sense of that term.

This recovery has also been very uneven across both time and sectors of the economy. Growth accelerated temporarily in a couple of quarters last year due primarily to the periodic

introductions of highly attractive new car sales incentive programs, but quickly dropped back again when these programs were withdrawn or downgraded. This recovery also has been more than normally uneven across sectors of the economy. Housing activity has been very strong, and consumer spending has held up pretty well, as has federal government spending due especially to increased defense and homeland security outlays. But business investment has been soft. Moreover, state and local government spending has been restrained by declining revenues and budget constraints, and, in the international arena, a rising current account deficit has been a continuing drag on U.S. growth.

So there have been some differences between this recovery and other recoveries. In one respect, however, this recovery has paralleled the early stages of the last recovery in 1991, ‘92, and the first half of ‘93. Job growth was very sluggish in that period. You may recall that the early ‘90s recovery was called the "jobless recovery," and job growth has been very weak so far in this recovery. Indeed, as measured by non-farm payroll employment – the usual benchmark – there hasn't been any job growth at all. Employment has declined by about a half million jobs since the end of 2001, when the recovery is supposed to have begun. Of particular interest to our Federal Reserve District, manufacturing employment has declined by 811 thousand jobs nationally since the end of 2001. Manufacturing is still an important and highly visible part of our regional economic base. Ironically, one of the main positives in the current economic environment – strong productivity growth – now appears to be at least partly responsible for the labor market's present softness, and I will come back to this point a little later. The unemployment rate has remained steady in the neighborhood of 6 percent through most of this recovery, but that rate, of course, does not take into account the large number of discouraged workers who have dropped out of the labor market recently.

Focusing in a little more closely on developments over the last several weeks, it has been a really mixed picture. As I am sure you know, many people were hoping that the extraordinarily quick and successful conclusion of the war in Iraq, and the removal of the

immediate risk of a major disruption of oil supplies, might give the recovery a boost. And it may have. Some of the economic reports released in recent weeks have been quite positive. The Conference Board's consumer confidence index jumped up sharply in April and increased a little further in May. The confidence index published by the University of Michigan also rose strongly in April and May. The recent rally in the stock market suggests rising confidence among investors. And the latest data released indicate that total personal consumer spending – including spending on services as well as spending on goods – was stronger in the March-April time frame than thought earlier. Elsewhere, though, overall industrial production declined markedly in April for the second consecutive month, and manufacturing production was down for the third straight month. Payroll employment also dropped for the third consecutive month in April, albeit more modestly than in the two preceding months. Again, a mixed picture. The data supporting some of these reports was gathered either during or only very shortly after the end of the war – too soon to gauge its impact on the economy. But one would have to acknowledge that there is no hard evidence yet of the postwar boost that many people were looking for.

Let me shift focus now explicitly to the future. You have heard me speculate on the economic outlook many times before. Yet you're still here. This ranks right up there with the regularity of the Old Faithful geyser as an amazing but not well understood phenomenon. In any case, let me share a few thoughts on the outlook for whatever they may be worth. As usual, I'll use the latest Blue Chip consensus forecast as a benchmark. As you probably know, the consensus calls for 2 percent GDP growth at an annual rate in the current quarter, followed by a moderate acceleration to a 3½ percent rate or possibly a little higher from the middle of this year through the end of 2004. Since the growth of potential output in the economy appears to be about 3½ percent at present, actual growth at this rate would keep the current gap between potential and actual GDP approximately constant, and hence keep the unemployment rate from rising significantly further from its current level a little north of 6 percent.

Personally I think this is a plausible forecast and the most likely outcome, although I certainly recognize that the range of plausible possible outcomes is unusually wide at present. But I think the consensus view is plausible, and I even think a somewhat stronger performance is not out of the question.

There are several reasons to expect at least a moderate acceleration in economic activity going forward. First, while we don't have much evidence of a post-war boost yet, not much time has passed, and we may eventually get one. The high uncertainty about oil price prospects in the run-up to the war has been greatly reduced, and both actual and futures prices for oil have declined. Consumer confidence has risen, as have stock prices, which may reflect the reduced uncertainty now that the war is over.

Second, and more fundamentally, I believe that solid monetary and fiscal policy foundations have been laid for stronger growth. On the monetary side, the Fed's longer-term success in reducing inflation and inflation expectations, the resulting decline in mortgage rates and other long-term interest rates, and our short-term policy easings over the last 2½ years have helped produce a financial environment that should sustain spending in the housing sector where it is already strong, and encourage increased spending by both consumers and business firms. On the fiscal side, without getting into the politics of it, the tax cut – especially the acceleration of the reductions in marginal income tax rates – should reinforce the monetary stimulus in the period ahead.

Looking at expenditure categories, with respect to consumers, the extraordinary recent mortgage refinancing activity has allowed many households to substitute low-rate, tax-advantaged home equity debt for ordinary consumer installment debt and credit card debt, which has reduced the debt service burden for many households and increased their capacity to take on additional debt to support spending. Weak job growth obviously raises questions about the near-term prospects for consumer spending and I'll come back to that, but financial conditions at the household level are currently quite conducive to increased spending, and the

tax cut and any further reductions in fuel prices will help. Again, the most recent data on overall consumer spending are moderately encouraging.

The story is similar with respect to business spending. The outlook for business investment – especially for new equipment and software – is a key to overall prospects for the recovery going forward. A sharp deceleration in business spending in the second half of 2000 led the economy into recession, and the recovery won't grow real legs until business investment revives. Here, too, financial conditions are favorable. Many business firms have already strengthened their balance sheets by refunding short debt in bond markets. Low long-term rates generally and narrowing risk spreads in corporate bond markets, along with the recent rise in stock prices, have reduced the cost of capital for a wide range of smaller- and mid-sized firms. Moreover, rising productivity, strenuous cost containment, and more recently the weaker dollar have increased profits and cash flow substantially since the middle of last year, which has generated more internal funds for investment. And the tax cuts for dividends and capital gains, along with more liberal depreciation allowances, in the recently enacted tax bill should add additional stimulus as time passes. So business firms, by and large, are well positioned to increase equipment and software investment, and order backlogs for new equipment have been rising most recently.

The points I have just made, then, constitute the case for the moderate acceleration of aggregate demand and GDP growth projected by the consensus forecast. Again, I think this is a plausible forecast and the most likely outcome, and, with a little luck, we might just get somewhat stronger growth than the consensus. That would be very nice if it happened. It would provide greater assurance that actual GDP growth will exceed the growth of potential GDP, which, in turn, would provide greater assurance that job growth will revive. And stronger job growth, in my view, is another key to the near-term outlook.

Having said these things on the positive side of the ledger, let me quickly acknowledge that the relatively favorable outcome in the consensus forecast is by no means a sure thing.

There are still significant downside risks in the outlook. Perhaps most importantly, labor markets are still very soft across the country and across the economy. As I noted earlier, non-farm payroll employment declined for three consecutive months through April. The manufacturing sector has lost jobs for 33 consecutive months, including 203 thousand jobs since the beginning of the year. We will get the May job report on Friday morning. Hopefully it will show some firming. Judging from the numbers we have in hand today, however, the job market remains weak. Ironically, as I also noted earlier, this reflects one of the principal longer-term strengths in the U.S. economy, rapidly rising productivity, and the extent to which the growth of potential GDP, bolstered by this strong productivity growth, currently exceeds the growth of demand for goods and services. While the apparently continued strong productivity growth holds great promise for the longer-term future, especially as the baby boomers begin to retire, it raises practical questions in the here and now since many firms can meet the moderate current increases in demand for their products without hiring new workers, and in some cases while laying workers off. The risk, of course, is that sluggish job growth or – worse – continued job losses in the near term could undercut the apparent recent revival of consumer confidence, since confidence depends in no small measure on people's perceptions about their job prospects, whether they are currently employed or not. Reduced confidence, in turn, could undercut the moderate strength of consumer spending, which would undercut any significant increase in business investment beyond ordinary replacement spending.

To sum up on the outlook, in all candor, this is one of the more difficult situations to evaluate we've seen in recent years. We in the Fed will need to monitor emerging developments especially carefully going forward, and I can assure you that we will.

Let me close with just a few broader remarks about monetary policy. Driving up today, I was trying to remember how many years you folks have been kind enough to invite me to speak to you. I don't know for certain, but it has been a lot. In many of these years, I made you sit through a sort of mini-sermon on the evils of inflation and why you needed to support the Fed in

driving it out of our financial system. You won't get one of these sermons this evening. The inflation rate as measured by the personal consumption expenditures index less food and energy – so called "core" inflation, and arguably the best measure of underlying inflation – has been below 2 percent for almost 6 years. And over the last 6 months, inflation by this measure has declined to below 1 percent at an annual rate, the lowest rate since 1963. Moreover, since there is about a half percentage point upward bias in this measure, true inflation currently is quite close to zero. It seems abundantly clear at this point that we have achieved the price level stability we have sought so many years. Back on April 30, for the first time I'm aware of, Chairman Greenspan more or less declared victory in the long war against inflation when he referred to the possibility of a further decline in inflation as "unwelcome." This is as close to high drama as we get in conducting monetary policy, and it was a moment of considerable satisfaction to old inflation hawks like me.

Now that we have price stability, we at the Fed have a new task: to sustain it. I never thought much about sustaining price stability back in the bad old high inflation days. I just wanted to get to price stability. And I am glad, to put it mildly, that we finally have it, since price stability is a necessary condition for maximum growth in output and jobs over the long haul. But now that we have it, I am naturally more focused on, and conscious of, the challenges involved in holding on to it than I was several years ago when high inflation was the problem. The key difference – an obvious difference, but the key one – between fighting an entrenched inflation and sustaining price stability is that, with price stability, the risk is two-sided. When inflation was high, all the risk was on the upside, that is, on the possibility that the inflation rate might rise even further. Any decline in inflation was all to the good. Now, with the very low inflation that characterizes an era of price stability, we have to guard against both a reacceleration of inflation <u>and</u> an excessive further decline in inflation that conceivably could lead at some point to <u>de</u>flation, which is no better than excessive <u>in</u>flation.

Several days ago, a Wall Street Journal editorial chided the Fed a little for talking a fair amount recently about deflation and possibly frightening some Americans into thinking we are about to sink into a deflation. With this in mind, let me repeat what many in the Fed have said recently: We don't see – we truly do not see – a clear and present danger of deflation. At the same time, though, I think it is appropriate and important to assure the public – which after all has not experienced deflation for over a generation – that we at the Fed are aware of the downside as well as the upside risks associated with price stability, that we have studied these risks, and we know how to approach them in the unlikely event we need to. With our recent public statements regarding the undesirability of further disinflation, we have acted to put a floor under inflation expectations, just as in the past we worked to place a ceiling over these expectations when we were fighting to bring inflation down. And I am confident that we could put effective strategies in place if necessary to prevent further significant disinflation or deflation from developing. Because of this – and because we haven't forgotten how to contain inflation – I am confident we can sustain the price stability we fought so long and hard to achieve, and this bodes well indeed for the longer-term outlook for the U.S. economy.

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