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Prospects for the National Economy: A Monetary Policymaker's View

I. Good morning. I'm very pleased to be here with you today.

A. What I plan to do is focus on economic conditions in the nation,

B. and I'll try to draw out some of the implications I see for monetary policy.

II. First, where do we stand now?

A. For one thing, we got the announcement just recently that the recession has been over since November of 2001. Well, that's the good news.

1. But you could hardly call this recovery "robust."

a. Indeed, I think you could say we've been "in a lull" for quite a while now.

2. The bright spot has been consumer spending, especially when it comes to autos and housing,

3. But employment has been stagnant or worse—

a. —in popular terms, this has been *another* "jobless recovery."

4. What has been missing is solid, sustained growth in business investment.

a. Weakness in business investment led us into the recession,

b. and it's going to take strength in business investment to lead us out of this lull and into a robust expansion.

B. I must admit, we've been *expecting* to see a solid pickup in growth for quite a while.

1. The reason is that there are—and have been—some very positive fundamentals at work in the economy.

2. One is the stimulus in the pipeline both from fiscal policy and from monetary policy.

   a. On the fiscal side,

      (1) there's some extra stimulus from the pickup in defense spending to support the action in Iraq.

      (2) In addition, Congress passed stimulus packages in 2001 and 2002.

      (3) And, of course, in May the President signed a significant tax package with some immediate effects on spending.

         (a) More than $13 billion in refund checks for 2002 child tax credits have been mailed,

         (b) and withholding schedules have been modified to reflect lower tax rates.

   b. In terms of monetary stimulus, the Fed cut short-term interest rates from six and a half percent to one and three-quarters percent in 2001.

      (1) And we brought the rate down to 1 percent with additional cuts in November 2002 and last June.

      (2) So short-term rates are now at their lowest levels in more than forty years.

3. Another important fundamental is the economy's strong productivity performance.

   a. The faster productivity growth that began with the economic boom in the mid-1990s has continued—

      (1) —even through the 2001 recession and the modest recovery since then.

   b. This suggests that the process of technological innovation that drives productivity in the long run is still alive and well.

   c. And that bodes well for the future, because faster productivity growth creates business opportunities that stimulate economic

growth.

III. Looking ahead, the most likely outcome appears to be that the economy will show reasonably strong growth for the rest of this year and then pick up some more steam in 2004.

A. And recent data do contain some positive signals that support the forecast.

1. Business investment in equipment and software—and especially the information processing equipment component—has showed healthy gains,

2. and profit reports have been excellent.

3. The beleaguered manufacturing sector has registered positive growth,

4. and recent numbers for autos and retail sales have actually been stronger than expected,

a. so consumers are still spending.

IV. But I should point out that these positive signals have not been sustained long enough to be conclusive, and there are *still* some downside risks to be aware of.

A. For example, the forecast depends on continued strength in consumer spending.

1. But there are a couple of things that could cause consumers to pull back.

a. One is the sharp rise in longer-term interest rates, including mortgage rates—more than a full percentage point since late June.

(1) Of course, they're still low by historical standards.

(a) And that's certainly part of the reason we've seen a spike in home purchases—

(b) —people are rushing to buy a house to avoid the risk that rates may go up more.

(2) But later on, higher rates could slow growth in new-home construction.

(3) And the higher rates certainly already have taken a lot of the wind out of the refinancing boom, which put so much money in people's pockets.

b. Furthermore, so long as this *remains* a jobless recovery,

(1) it could weigh heavily on consumers

(2) and lead them to hold off on making purchases.

B. In terms of business investment, we saw an uptick earlier in this recovery, only to watch it fade away in subsequent quarters.

1. We could see *this* uptick fade away, too.

2. In other words, the factors that were making firms cautious before could very well still be at play.

V. What does all of this imply for inflation?

A. Because of the economy's sluggish performance, we've built up a lot of slack in labor and product markets over the past 2-1/2 years—

1. —the unemployment rate has been at or above six percent for the last four months,

a. and there's a lot of excess capacity in product markets.

2. This means that it's going to take more than a few quarters of the kind of reasonably strong growth we're forecasting for the rest of this year to work off that slack.

a. In fact—it's going to take more than a few quarters of *quite* strong growth to work it off.

3. And that means that core inflation—which already is low—may trend down even lower.

B. Let me put some numbers on this scenario.

1. The measure of consumer inflation that the Fed relies on quite a lot came in at just under one and a half percent over the past year.

a. That measure is the price index for personal consumption expenditures, excluding food and energy.

2. Now, this measure is by no means perfect.

a. In fact, there's fairly broad agreement that it probably *overstates*

inflation by about half a percentage point.

3. So, given that bias,

   a. it's likely that so-called "true" core inflation could be below one percent this year—

   b. —even with a pickup in growth.

VI. Now let me wrap this up with a few words about what I think this means for monetary policy.

A. I must admit, I find it interesting that there seems to be a "disconnect" between my own take on this and what the financial markets seem to be signaling.

1. For example, just look at what's happened in the bond market, with rates spiking sharply since late June.

   a. Putting that together with movements in the Treasury Inflation-indexed market,

      (1) it appears that most of the bond rate increase was in the "real" component,

      (2) while a smaller but significant portion reflected higher inflation expectations.

   b. This could suggest that participants expect policy to get tighter because of faster economic growth and some added inflationary pressure.

2. You also see expectations of tightening in the behavior of the fed funds futures market.

B. Now, I'm certainly a believer in markets.

1. But at this point, I see things a little differently.

C. As you know, our primary goal is price stability—

1. —that means, an environment in which people and businesses can make financial decisions without worrying about where prices are headed.

D. Typically, we're aiming at price stability

1. by working to bring the inflation rate down.

E. But conditions today aren't typical.

1. The inflation rate is very low.

a. In fact, this is the first expansion in over forty years that began with a very low inflation rate.

2. So the response of monetary policy isn't necessarily going to be typical, either.

F. What's typical when an expansion starts to take hold?

1. Most of the time, the inflation rate is higher than it is now.

2. So one of the main concerns is an upside surprise—

a. —that is, the possibility that the economy will come roaring back, possibly pushing the inflation rate even higher.

3. Since it takes time for policy to have an impact,

a. the Fed has often found it necessary to get an early start on holding the pace of expansion within sustainable limits.

b. And it does this by making sure that the funds rate rises relative to the inflation rate.

G. But in the current low-inflation environment, upside surprises are less of a concern than downside surprises that could push the inflation rate lower.

1. Why?

a. Because, as I said, we're likely to have a considerable amount of excess capacity for some time to come—

b. —even *with* the generally anticipated pickup in growth.

H. The Fed's current stance is accommodative, reflecting the moderate strength of the expansion, the high level of excess capacity, and the low level of inflation.

1. Given that, I wouldn't be surprised if it turned out to be appropriate to keep an accommodative stance for a considerable period.

VII. Now, you’re used to hearing central bankers like me cheer when we think inflation is trending lower.

A. That made sense when inflation was viewed as clearly too high.

B. But the Fed’s goal is *price stability*—

C. And I want to assure you—price stability will *remain* our goal,

1. whether the threat to the economy is *in*flation *or de*flation.

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