Mark W Olson: Recent economic experience and outlook

Remarks by Mr Mark W Olson, Member of the Board of Governors of the US Federal Reserve System, at the Fraser Institute Roundtable Luncheon, Toronto, 15 November 2004.

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Thank you for inviting me to speak to you today about my assessment of current economic conditions in the United States and what is required to maintain an economic environment conducive to growth, job creation, and price stability. I should note that my remarks today reflect my own views and do not necessarily represent those of my colleagues on the Board of Governors or in the Federal Reserve System.

Commentaries on the economy often focus too heavily on the latest weekly and daily data. To put today's economic performance in a broader context, I would like to step back briefly and touch on some recent economic history.

As you know, the latter half of the 1990s was a time of remarkable economic performance, fueled importantly by an investment boom that contributed to rapid growth in labor productivity. However, by late 2000, that boom had come to an end, and businesses abruptly curtailed capital spending - particularly for high-tech equipment. The cutback in spending occurred as expectations about the potential profitability of new investment opportunities turned down, and many companies, such as those in the telecommunications sector, found that they had invested too much in equipment and office space during the boom. With the sudden drop-off in business demand, inventories began to pile up, and producers cut production of all types of goods in early 2001. Against this backdrop, the Federal Reserve reduced the target rate for the federal funds rate sharply over the course of 2001 to contain the weakness and head off a more serious deterioration following the terrorist attacks in September.

This monetary policy stance, coupled with stimulative fiscal policy, was generally successful. In contrast to most U.S. recessions since World War II, consumer spending and residential investment were both relatively well maintained during this period. Even as firms cut employment and stock market losses eroded household wealth throughout 2001 and 2002, household spending was supported by tax cuts, low inflation, and low interest rates. Consumers took advantage of falling mortgage rates to buy new homes, to refinance their existing mortgage debt, and to tap into their increasing home equity to pay off more expensive debt or to finance spending on other things.

As a result, the recession in 2001 turned out to be quite shallow, and activity in 2002 recovered modestly even though businesses continued to cut spending on capital and reduce employment throughout 2002. Despite the reduction in business investment, significant improvements in efficiency allowed firms to meet their sales and production goals without having to add workers. These improvements seem to have been the result both of organizational changes in business operations and of innovations in the use of existing technologies, perhaps the result of firms applying more effectively the new technologies they had acquired at a rapid pace in the late 1990s.

In 2003, the recovery took hold: The pace of consumer expenditures stepped up, and housing activity boomed. These developments were supported by a pickup in personal income growth as job losses abated and hourly compensation moved up, as well as by rising stock market and housing wealth. In addition, the caution and uncertainty that had weighed on businesses began to dissipate, and investment turned up in the spring. A marked increase in capital spending in the second half of last year was spurred by significantly improving profits, low interest rates, and investment tax incentives. Nonetheless, the recovery remained "jobless" until the fall, when growth in private employment began to resume.

Output in the first quarter of this year continued to expand at the robust pace of 2003, and employment gains picked up sharply. However, economic activity hit a soft patch in the late spring: The growth of real gross domestic product slowed to an annual rate of 3-1/4 percent in the second quarter after posting a 4-1/2 percent average pace in the first quarter of this year and over the four quarters of 2003. The second-quarter slowing was particularly evident in consumption, which was nearly unchanged on average between April and June. Furthermore, job gains in the private sector, which had averaged close to 300,000 per month between March and May of this year, slowed to about 100,000 per month on average during the summer.

Economic developments this year have undoubtedly been influenced by the steep run-up in oil prices from about $30 per barrel for West Texas intermediate crude oil in December 2003 to a record level of $55 per barrel this past October. This rise in energy prices clearly has had a negative effect on the real purchasing power of households and has raised business costs. Nevertheless, the United States is probably less vulnerable to this year's oil price shock than it was to the shocks of the 1970s and early 1980s, both because energy represents a smaller share of household purchases and business input costs than in those earlier periods and because the higher oil prices reflect, in part, stronger growth in the rest of the world, which in turn provides an offset in the form of higher demand for U.S. exports.

Indeed, the most recent data suggest that the U.S. economy has regained some vigor in the second half of this year. According to the Bureau of Economic Analysis, real GDP expanded at an annual rate of 3.7 percent in the third quarter, and final sales grew at the fastest pace in a year. In particular, real consumer spending rebounded, as households responded to the aggressive incentives offered by motor vehicle companies by sharply increasing their purchases of new cars and trucks. In addition, low mortgage rates have helped sustain a high level of demand for new homes, and business investment in equipment and software posted another robust gain, led by a sharp increase in spending on non-high-tech equipment.

Available indicators for the fourth quarter seem a little more mixed, but the general consensus of economic forecasters is that real GDP will expand in the fourth quarter at a pace similar to that in the third quarter. Although real incomes continue to be squeezed by significantly higher energy prices, recent spending indicators, including last Friday's retail sales report, suggest that consumption was well maintained in October. In addition, housing construction and home sales have been maintained at a robust pace in recent months, and recent declines in mortgage rates should continue to support demand. Business demand for high-tech equipment seems to have softened a little in recent months, judging both from the data on new orders and from industry commentary. However, business investment on non-high-tech equipment should be buoyed by strong fundamentals, including low interest rates and strong corporate balance sheets, as well as by the partial-expensing provisions of the current tax code, which encourage businesses to accelerate investment spending on longer-lived equipment to take advantage of the temporary tax incentive before it expires at the end of the year. Presumably reflecting these factors, bookings for non-high-tech capital goods have been on a steep uptrend in recent months.

The latest reading on the labor market, which has been a source of uncertainty for some time, was particularly encouraging. After slowing this summer, employment on private nonfarm payrolls rose nearly 300,000 in October, about the same as the robust pace reported during the spring of this year. October's increase was boosted somewhat by a sizable increase in construction employment, which was partly related to rebuilding and cleanup activity following this summer's hurricanes. But even so, the pace of hiring picked up for a wide range of other industries as well. That said, recent surveys and the continued, low level of labor force participation suggest that households remain concerned about a lack of employment opportunities, and we will have to wait and see whether this faster pace of hiring can be sustained.

As you know, Canada is the United States' largest trading partner, and hence trade provides an important link between our economies. Indeed, U.S. exports to Canada are rising briskly so far this year, albeit still not quite as fast as the rise in U.S. imports from Canada. More generally, a surge in Canadian exports has helped fuel the recovery in Canada this year despite an appreciation of the Canadian dollar. However, unlike the United States, Canada is a net exporter of oil and other commodities and thus has also benefited, on balance, from the sustained rise in oil and other commodity prices this year. Recent Canadian data are consistent with robust domestic demand growth in the third quarter, and employment gains have recently been strong. Over time, future improvements along these lines may also support higher demand for imports, which will in part come from the United States.

Turning to the outlook for U.S. inflation, the rise in crude oil prices - coupled with rising margins for gasoline and higher prices for natural gas - contributed to a 25 percent annual rate of increase in consumer energy prices over the first half of the year. And, although energy prices turned down briefly during the summer as gasoline margins returned to more normal levels, the latest indicators are pointing to significant increases in energy prices again this quarter. As a result, headline consumer price inflation - as measured by the personal consumption expenditures (PCE) price index - rose at an annual rate of around 2-1/2 percent over the first three quarters of this year, up from 1-3/4 percent in each of the past three years.

Despite the rise in oil prices, core consumer prices have risen at a moderate pace in recent months after picking up early this year from last year's very low rate. On average, core PCE prices have increased at a 1-1/2 percent annual rate over the first three quarters of this year, up only slightly from a 1-1/4 percent increase over the four quarters of 2003. As with the real economy, the absence of a more significant effect from oil prices on core inflation reflects, in part, the smaller share of energy in firms' production processes. But in addition, the Federal Reserve's commitment to low inflation seems to have limited the pass-through of higher energy prices to wages and inflation expectations. Indeed, despite some rapid increases in benefit costs - most notably for health insurance and defined benefit pension plans - overall hourly compensation has been rising at roughly a 4 percent annual rate this year, similar to last year's pace. Similarly, surveys of inflation expectations and implied inflation compensation from Treasury indexed security yields suggest that longer-term inflation expectations have been well anchored over this period, and short-term inflation expectations have actually eased on balance since midyear despite the rise in energy prices.

Looking ahead, economic fundamentals are consistent with the U.S. economy posting solid growth over the next year. Indeed, most forecasters expect that output will continue to rise next year at a pace similar to this year's. For example, the most recent Blue Chip forecast sees output rising at a 3-1/2 percent rate in 2005, just a touch slower than their forecast for growth over the four quarters of this year. With regard to inflation, the Blue Chip participants see the rise in the consumer price index slowing from 3.2 percent this year to 2.2 percent over the four quarters of 2005.

There are a number of reasons for this reasonably favorable outlook. First, monetary policy remains accommodative, even with the rise of 100 basis points in the federal funds rate since late June. The nominal federal funds rate is currently 2 percent, a level that, using standard measures of core consumer price inflation, implies a real funds rate that is just above zero - considerably lower than the long-run average of about 2-3/4 percent. Of course, this long-run average may differ from the level of the real federal funds rate that is currently consistent with moving economic activity into line with its potential and keeping inflation low and stable. But even taking into account possible factors that would tend to push down the equilibrium rate - for example, business pessimism, energy prices, and our net export position - the real funds rate still seems low.

Second, financial conditions in general look to be supportive of continued solid economic expansion. In addition to benchmark real interest rates being low, risk spreads are quite narrow, and lenders appear very willing to provide credit to businesses and households. Moreover, many businesses, through their actions to repair their balance sheets in recent years, have built up large holdings of cash that can be tapped to finance investment outlays, and the substitution of long-term debt for short-term debt has reduced the exposure of many firms to rising interest rates.

Third, robust growth in underlying productivity should continue to support income growth and economic activity. I suspect that productivity will eventually slow from the extraordinary pace of the past few years - indeed, the recent figures offer some evidence that some of the slowing has already occurred. Nonetheless, I am optimistic that part of the step-up in productivity will be sustained and that it will be reinforced by a robust pace of capital spending. Continued solid gains in productivity will be an important plus for our economy over the longer run because faster increases in productivity lead over time to higher profits, wages, and living standards.

On the inflation front, the best news is that inflation is expected to be relatively low. With inflation expectations well anchored, the existing amount of slack and underlying strength in productivity should be offsetting pressures from indirect energy effects and other commodity price increases, which themselves should diminish as oil prices stabilize and then begin to decline.

Nevertheless, and as always seems to be the case, there are considerable uncertainties surrounding the outlook for real activity and inflation. An obvious source of risk for the U.S. expansion continues to be the behavior of energy prices. As I noted, the steep run-up in crude oil prices this year has significantly restrained real activity and pushed up overall inflation. And, the outlook for oil prices remains uncertain. Higher oil prices have damped the consumption of oil in the United States, but growing concerns about long-term supply, along with large prospective increases in demand from the rapidly growing economies of China, India, and other emerging-market economies have fueled an increase in futures prices of oil. In recent weeks, spot prices have eased back from mid-October's record levels, and market participants in oil futures markets seem to expect spot prices to ease somewhat further over the next two years. But both the global demand for oil and the availability of new supplies are notoriously difficult to predict.

Another uncertainty revolves around the effect of current tax policy on economic activity. Fiscal policy, which has been stimulative this year, is expected to shift to a fairly neutral stance in 2005, following the removal of the partial-expensing provision for various capital goods at the end of this year. Because the partial-expensing provision allows firms to subtract a large share of the cost of new capital equipment from profits right away, rather than depreciating the cost over time, it provides an incentive to firms to invest in new capital goods. However, estimates of the quantitative effect of this tax incentive on investment are highly uncertain. And anecdotal evidence that firms are responding to the partial-expensing provision is not clear-cut. As a result, the impact of its removal is equally unclear. Specifically, if partial expensing is having a very limited effect on firms' investment decisions, recent increases in business spending on equipment would be consistent with a stronger underlying pace of investment and faster GDP growth next year.

Finally, the sustainability of expansion will depend importantly on the pace of improvement in the labor market. To be sure, October's payroll employment report was a positive sign. But as we saw earlier this year, one month of data does not make a trend. Robust job gains in the coming quarters would be a convincing sign that businesses have become more confident about the future course of the expansion and would provide households with the wherewithal to maintain a healthy pace of spending growth.

Let me turn finally to a brief discussion of monetary policy. As I noted earlier, monetary policy has played an important role in providing support for the economy in recent years. But our work is not done. Now that the expansion seems to have taken hold, we face the challenge of making the transition to a policy stance more appropriate for sustained economic expansion. Our goal is to do so in a way that maximizes economic growth while sustaining the progress that we have made in achieving price stability. Keeping inflation low and stable will contribute importantly to sustaining financial conditions conducive for further gains in economic activity.

Along these lines, the FOMC has raised the target federal funds rate by 25 basis points at each of our last four meetings. As indicated in its most recent statement, the FOMC continues to support the assessment that removal of accommodation will likely proceed at a measured pace. However, the Committee will respond to changes in economic prospects as needed to maintain price stability, and it is those developments that will ultimately determine the level and term structure of interest rates.