## Mark W Olson: Economic outlook

Remarks by Mr Mark W Olson, Member of the Board of Governors of the US Federal Reserve System, at the annual meeting of the Charlotte Regional Partnership, Charlotte, North Carolina, 15 June 2004.

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I am very pleased to have the opportunity to share with you my thoughts about what is required to maintain an economic environment that businesses like yours will find conducive to investment and job creation. I should note that these views are my own; I do not speak for my colleagues on the Federal Open Market Committee.

Over the second half of last year, the U.S. economy gathered strength, and its performance so far this year suggests that it has made the transition to a sustained, broad-based expansion. Household spending and new homebuilding have continued to move up, and businesses now appear to have shed a good deal of the uncertainty and caution that for some time weighed on their decisions to upgrade their capital and to hire workers. Real business spending on new equipment and software in the first quarter of this year was 12-1/2 percent above its level a year earlier, and more-recent data indicate that manufacturers are continuing to book new orders for capital goods at a solid pace. The upturn in hiring has been particularly encouraging; between January and May, private nonfarm establishments added almost 1.2 million jobs. We have not seen a string of monthly increases like that in more than four years.

To be sure, monetary and fiscal policies played key roles in the strengthening in aggregate demand over the past year. Accommodative monetary policy raised the prices of household assets and lowered the costs of financing new homes and durable goods while reductions in personal taxes boosted disposable income. Businesses, too, benefited from the more-accommodative financial environment. Low interest rates have not only reduced short-term borrowing costs but they have combined with more narrow risk spreads to keep longer-term corporate borrowing costs attractive. The extended period of low interest rates has allowed firms to refinance high-cost debt and to substitute long-term debt for short-maturity debt to improve their balance sheet liquidity. On the fiscal front, firms have been able to take advantage of the temporary partial-expensing tax provision. At the same time, the impressive efforts that businesses have been making to control costs and to increase productivity have paid off in a strong rebound in profitability and cash flow. The combination of balance sheet restructuring and strong profitability has allowed corporate America to achieve the highest level of liquidity in more than a decade.

As I noted a moment ago, I find the recent recovery in hiring to be a particularly welcome indication that businesses have become confident about the durability of the expansion. Last year, as economic activity began to pick up, the recovery remained even more “jobless” than the recovery of the early 1990s. A good deal of monetary and fiscal stimulus was in place, which we expected over time to show through to a pickup in real economic activity. But firms were unusually reluctant to make commitments to take on new workers in an atmosphere clouded by risks and uncertainties associated with the war in Iraq and with the fallout from lapses in corporate governance. My sense, from both my informal contacts in the business and banking communities and the available surveys of business attitudes, is that confidence has recovered noticeably this year.

Other explanations for the sluggish recovery in employment during 2002 and 2003 focused on developments that may have more lasting effects on the labor market. First, the recovery seemed to be marked to an unusual degree by an ability of businesses to achieve labor-saving efficiency gains. Recall that we began to detect an improvement in productivity in the second half of the 1990s. The rate of increase in output per hour in the nonfarm business sector moved up from just 1-1/2 percent per year between 1973 and 1995 to 2-1/2 percent per year between 1996 and 2000. That acceleration appears to have been largely the result of brisk business investment. Since then, even with the slump in capital spending from 2001 to early 2003, productivity has risen at a stunning annual rate of 4 percent. One of the striking features of the recent acceleration is that the gains in efficiency seem to be the result of organizational changes and innovations in the use of existing resources -perhaps in part the result of learning better how to apply the new technologies that they acquired at a rapid pace in the late 1990s.

During the early part of the expansion, when aggregate demand remained weak, the especially rapid gains in efficiency allowed businesses to meet their sales and production goals without having to add workers. But as the pace of the expansion has stepped up over the past several quarters, we have begun to see both sustained advances in output per hour and gains in jobs. I suspect that productivity will eventually slow from the extraordinary pace of the past couple of years - indeed, the recent figures offer some evidence that some slowing has already occurred. Nonetheless, I am optimistic that part of the step-up in productivity growth will be sustained and that it will be reinforced by the renewed upturn in 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 standards of living.

The jobless recovery also led economists to debate the extent to which the lack of hiring overall and the continued decline in manufacturing jobs specifically represented structural changes, that is, changes that were not likely to be reversed as the recovery strengthened. Specifically, a great deal of attention focused on the loss of international competitiveness, foreign outsourcing, and the relocation of jobs to overseas subsidiaries. Although these changes are, indeed, a natural consequence of globalization, we have considerable evidence that they are only a small part of the larger story. The ongoing turnover in jobs in our dynamic economy is considerable. The estimates that our staff assembled for a speech earlier this year at Duke University by my Federal Reserve Board colleague Ben Bernanke indicated that, over the past decade, gross private-sector job losses in the U.S. economy have likely amounted to 15 million per year, not including seasonal and short-term layoffs.[1] Estimates of jobs lost to imports account for only slightly more than 2 percent of the total. More important, of course, is that the job creation side of the churning process has been even larger - roughly 17 million jobs per year. Given the total number of private-sector jobs of 108 million, an average year of job gains and losses represents about 30 percent of the total.

Certainly, the Charlotte region is very familiar with this dynamic process of job creation and destruction. In 1990, the Charlotte-Gastonia-Rock Hill metropolitan area was relatively dependent on the fortunes of its manufacturing sector. The area had almost 150,000 manufacturing jobs, which represented almost one-fourth of the area's employment; by contrast, jobs in professional and business services accounted for just 10 percent of the area's employment, or roughly 60,000 jobs. Ten years later, the picture was dramatically different: Largely because of cutbacks at textile mills, the Charlotte metropolitan area had lost almost 20,000 factory jobs. But, at the same time, employment in professional and business services had more than doubled to roughly equal the number of manufacturing jobs that existed here in 2000. Employment in education, health, and leisure had also expanded rapidly. Certainly, the broader distribution of employment in recent years has helped the area weather the recession generally and, more specifically, the continued loss of textile jobs to import competition.

You have also witnessed first-hand that globalization works two ways. As you know from your experience in attracting foreign-owned companies to this region, U.S. workers also benefit from a good deal of "insourcing." Nationwide, the employment of U.S. workers by affiliates of foreign firms was more than 5.5 million during the 2000-2002 period - up 1.7 million from ten years earlier. Although globalization clearly has resulted in very real hardships for workers in certain industries, it remains more generally an essential component of economic growth by encouraging innovation and promoting efficiency and higher standards of living. Placing restrictions on international trade would, over the long run, be counterproductive; consumers would likely end up paying higher prices for consumer goods, and businesses might lose the opportunities to be more productive that arise in an environment of open trade. The appropriate policy approaches are those that promote maximum job creation while easing the transition for workers caught up in the painful but inevitable shifts in the mix of job opportunities.

An important feature of the ongoing structural change in our economy is the increasing demand for skilled workers, which has arisen both from shifts in the industrial composition of jobs and from the upgrading of skills required within specific industries. Ensuring that the supply of workers with the necessary skills matches the demand is a critical element in adjusting effectively to ongoing structural change. As recently as 1980, many young persons depended on a high school education to launch a career; only half of all high school graduates enrolled in college. Today, the expectations of our high

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1 Governor Ben S. Bernanke, "Trade and Jobs",Distinguished Speaker Series, Fuqua School of Business, Duke University, Durham, N.C., March 30, 2004.

school students have changed dramatically as the rising demand for skilled workers has resulted in a sharp increase in the premium paid in the labor market for a college education. In recent years, roughly 60 percent of high school graduates have enrolled in college. And surveys of high school sophomores indicate that many of them believe that simply earning a bachelor's degree is not enough. In addition to the 40 percent of tenth graders in 2002 who expected that they would complete a bachelor's degree as their highest degree, another 40 percent expected to finish a graduate or professional degree.[2] This appetite for education is good news because the knowledge and skill of a country's workforce is an important factor in economic growth.

Because the demand for skills and the churning of jobs is a never-ending process, workers have also come to realize that their education is not complete once they have a formal degree. In 2002-2003, 40 percent of adults participated in work-related training to retool, upgrade, or acquire skills.[3] Many benefited from programs conducted on-site by their employers, but courses at colleges and technical schools were also an important source of training. I am sure that you all realize that your area's universities, colleges, community colleges, and technical schools are a valuable asset in developing and maintaining a flexible and ever more productive workforce. I urge you also to engage in a civic dialogue with educators at all levels - including those at the elementary and secondary levels - about the importance not only of developing skills but also of adopting the view that education is a life-long process with important economic payoffs.

As I indicated 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 way that maximizes economic growth while sustaining the significant progress that we have made in achieving price stability. I only have to compare my experience as a banker in the 1970s and early 1980s with the environment today to see the value of price stability. In that earlier period, my colleagues and I doubted that we would ever see single-digit mortgage rates again. And, many of us despaired as we listened to borrowers who were convinced that it was wise to "buy now" before prices inevitably rose further. Certainly, today's environment of low inflation and stable inflation expectations allows for much more rational business decisions concerning capital investment than we experienced in that earlier period.

Although inflation has picked up so far this year, it remains moderate. In this morning's report, the core CPI was up 1.7 percent from a year earlier; in December, the year-over-year change was 1.1 percent. Keeping inflation low and stable will contribute importantly to sustaining financial conditions conducive for further gains in business investment.

Over the short run, low inflation and well-anchored inflation expectations are critical to maintaining economic stability and, over the long run, price stability promotes growth and efficiency. As Chairman Greenspan indicated last week, economic developments will determine the level and term structure of interest rates. Of course, we cannot predict exactly how economic events will unfold over the coming year. But, at this point, I still concur with the Federal Open Market Committee's characterization that monetary policy accommodation will become increasingly less necessary over time and can be removed at a pace that is likely to be measured.

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2 National Center for Education Statistics, The Condition of Education 2004, "Student Attitudes and Aspirations: Postsecondary Expectations of 10th-Graders," U.S. Department of Education, June 2004.

3 National Center for Education Statistics, The Condition of Education 2004, "Adult Learning: Adult Participation in Work-Related Learning," U.S. Department of Education, June 2004.