Roger W Ferguson, Jr: Developments in the U.S. Economy - Review and Outlook

Speech by Mr Roger W Ferguson, Jr, Vice-Chairman of the Board of Governors of the US Federal Reserve System, before the Economic Club of Colorado, Denver, 16 January 2002.

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I am pleased to address the Economic Club of Colorado today. As always, the views I will be expressing are my own and are not necessarily shared by other members of the Board of Governors or of the Federal Open Market Committee.

Review of 2001

A confluence of factors shaped economic developments last year, and I would first like to review these factors, to provide a backdrop for assessing our economic prospects in the coming year.

A year ago, signs of the recession that eventually unfolded were just beginning to materialize. After several years of booming growth, economic indicators started sending mixed signals. Although consumer sentiment had dropped around the end of 2000, consumers were still spending at a healthy clip. While consumption growth had decelerated somewhat over the previous year, the modest slowing was consistent with the deceleration of aggregate demand necessary to better align supply and demand.

Businesses, however, appeared to be struggling. As data for the end of 2000 became available, it became clear that businesses--amid disappointing sales and earnings--had abruptly curtailed the record-setting expansion of investment spending. Of course, some reduction of investment usually accompanies the recognition of a downshift in the economy, as firms bring their capital stocks in line with a revised outlook. But the severity of the adjustment last year appeared to reflect more than the usual reaction. Businesses seemed to be reassessing the profitability of additional fixed capital in a more fundamental way. New capital, especially capital that embodies new technologies, continues to promise efficiency gains, but expectations seemed to have gotten ahead of even the more favorable reality, resulting in an unsustainable buildup of capital and run-up of equity market values. Capital expenditures on high-tech equipment were especially hard hit. Moreover, the sudden drop-off in business demand, coupled with some slowing in the consumer sector, apparently caught producers off guard. And despite rapid cuts in production, inventories piled up on shelves and at warehouses. Early last year, manufacturers took steps to address the unwanted buildup and began liquidating inventories in earnest by slashing production of all types of goods.

Against this backdrop, the Federal Open Market Committee reduced the target for the federal funds rate sharply last January to contain the weakness and head off a more serious slackening. This was to be just the first installment of a series of policy easings to counter the weakness in the economy that emerged over the first half of last year.

In the business sector, a serious retrenchment in spending and production was under way. In addition to the initial causes of the pullback, the abruptness of the slowing seemed to jar business confidence, leading firms to postpone spending while they reassessed their situations. In this way, the investment downturn became self-reinforcing. At the same time, financial developments, including a stronger dollar, sharply lower equity prices, and tighter lending standards at banks and in security markets, tended to offset some of the influence of the lower federal funds rate. By midyear, investment--and high-tech investment in particular--was posting some of the largest decreases in decades. The weaker job market and lower stock prices also began to weigh on consumers, though to a much lesser extent. With overall sales sagging, inventories remained excessive in many sectors.

As the weakness in the economy intensified, policymakers responded. In June, President Bush signed the Economic Growth and Tax Relief Reconciliation Act of 2001 into law. The first installment of the reduction in personal income tax rates went into effect in July. In addition, the act provided tax rebates of $300 to $600 per household that were paid directly to taxpayers.

As for monetary policy, between March and June, the FOMC voted to ease monetary policy four more times, bringing the cumulative reduction in the federal funds rate to 275 basis points in the first six months of the year--the most rapid reduction in the funds rate since the early 1980s. Despite both fiscal and monetary efforts to bolster sagging aggregate activity, by late summer, only a few hard signs had surfaced that recovery was at hand.

The terrorist attacks on September 11--whose worst effects were felt by those people and their families directly touched by the tragedies--were a blow to our already weakened economy. In the weeks immediately following those events, most forecasters expected the damage to the economy to be extensive. The initial effects on the airlines and the travel industry were severe. Also, a rapid deterioration of business and consumer confidence seemed highly probable. In addition to immediate crisis-related injections of liquidity, the Federal Reserve moved to address the perceived shock to the macroeconomy by lowering the federal funds rate 50 basis points on September 17 and an additional 75 basis points by the end of the year.

Over the past few months, we have all been watching closely to see how aggregate activity would unfold in the aftermath of the terrorist attacks. No doubt a great deal of pain has been inflicted on the economy. But, given the magnitude of the shock, the economy has proved more resilient than initially anticipated. While several industries have been hit very hard, the worst-case scenarios spun in late September have not materialized. In particular, households' views of the economy have remained relatively stable, all things considered. In fact, in one of the most recent readings, consumer confidence was not much lower than it had been in August. While spending has surely been buttressed by some temporary factors such as aggressive discounting on motor vehicles and other retail goods, the effect of terrorism on consumer spending has not been as severe as most had feared in late September.

To be sure, 2001 was a rough year for the economy--one of the roughest we have faced in a long time. The weak economic outcome despite sizable reductions in the federal funds rate has led some to question the effectiveness of monetary policy. But I believe that monetary policy substantially cushioned the negative forces weighing on the economy. Residential construction has been visibly buoyed by policy easing. Housing activity remained at a high level all year, as lower mortgage rates apparently offset the restraint from declines in employment, smaller gains in income, and lower levels of wealth. Also, although delinquency rates have risen, few restrictions have emerged on the availability of credit to consumers. Indeed, low interest rates have made it attractive to refinance mortgages to reduce mortgage payments, extract some home equity buildup, and pay down more expensive forms of consumer credit. Even businesses, which have been feeling the pinch of lower corporate profits, have benefited from lower interest rates; aggregate interest expense has remained fairly low relative to cash flow, and businesses have moved aggressively to bolster their financial stability by locking in more-assured, longer-term sources of funds. Automakers in particular have been able to offer inexpensive financing to customers because their own funding costs have fallen.

In many ways, the mechanism that propagated the weakness last year was quite traditional: A negative demand shock led to an unwanted accumulation of inventories and to an adjustment of production. That, in turn, idled workers and fed back into even weaker demand. But even before the shock of the terrorist attacks, two aspects of last year's slowdown were atypical. First, the main source of the negative hit to demand was a large shock to capital expenditures. In the past fifty years, investment spending has nearly always begun its decline one to four quarters after the peak of the economic cycle, not before it. What started out as a very gradual cooling of an overheated economy became much more serious because of the severe shakeout that hit the high-tech sector. Second, consumer spending on goods and services--which represents about two-thirds of the gross domestic product--held up remarkably well last year. In the past, consumption spending has almost always declined as a recession started. But last year, despite a sharp drop in consumer confidence and a decline in wealth from lower equity values, households kept buying.

At this point, it is still too early to classify this recession as mild or severe. In general, economic fluctuations in the past fifteen to twenty years have been tamer than their counterparts in earlier eras. Economists have conjectured that this is caused by improved technologies that allow businesses to monitor their demand more closely and manage their inventories better. Recent developments ought to give us more evidence on this subject. One thing is certain: Because of the unusual, investment-led nature of this recession, we cannot put too much weight on the shape and profile of past recoveries in trying to predict this one.

Current Situation and Near-Term Outlook

This year, forecasters are predicting an imminent recovery, with first-half growth of more than 1-1/2 percent at an annual rate and second-half growth of almost 4 percent. Financial markets--which have rallied in recent weeks--appear to have priced-in an outlook at least this optimistic. It is too early to know whether either of these forecasts--either the explicit one of economists or the implicit one of financial markets--will come true. Incoming data have shifted from distinctly negative to more mixed of late. Some data provide support for an optimistic view: Declines in payroll employment slowed in December, and initial claims for unemployment insurance remain well below their November peak. In addition, according to recent sentiment surveys, consumers have become more upbeat recently, and consumer spending has continued to advance. Even orders for capital goods have exhibited some encouraging signs over the past couple of months. Other data indicate some downside risks to the outlook. In the past few months, despite some abatement, payrolls continued to decline and the unemployment rate jumped to 5.8 percent, putting a dent in labor income. Moreover, some of the resilience in household spending last quarter was likely due to temporary factors: the zero percent financing available from automakers, the steep discounts at retailers, and warm weather. Additionally, corporate profits remain quite soft.

Economists have always had difficulty identifying turning points, so I will not try to predict this one. However, I do think stimulative policies in conjunction with the normal equilibrating dynamics of the economy are likely to promote a rebound before too long. The contours of the upturn are uncertain. However, the turnaround is likely to be characterized by some of the same features as the recession that preceded it. In particular, it is likely to be uneven across industries, with some sectors booming ahead and others continuing to lag. It also seems likely that inventories will represent an important component in the bounceback. As inventory stocks approach desired levels, the mere slowing in the pace of liquidation will provide a boost to GDP growth. And when firms are confident that demand is going to pick up, the accompanying inventory re-stocking needed to meet that demand will lead to further production gains, which will provide a real jump-start to the recovery. An important question is when businesses will determine that they have pared their capital expenditures sufficiently. While the recent data hint that one important investment category, computer equipment, may have bottomed out, an overall recovery will likely be associated with a broader-based rebound.

The Longer-Run Outlook

One of the main forces that will lead to the recovery from this temporary slowdown is the confidence of businesses and households that, in the long run, the outlook for the U.S. economy is still bright. Despite our current problems, the fundamentals of this economy are strong. Our workforce is well educated and adaptable. In addition, our banking system is healthy and our capital markets, which are flexible and multifaceted, are well equipped to handle shocks.

Perhaps the most notable feature of our economy in recent years, however, has been the acceleration we have experienced in productivity. In the second half of the 1990s, output per hour in the nonfarm business sector increased at an annual rate of almost 3 percent per year, well above the pace earlier in the decade. These efficiency gains allowed real GDP to rise 4 percent a year, on average, over the period. With these rapid increases in productivity, business costs were well contained and the rate of price inflation was stable, despite a fall in the unemployment rate to below 4 percent.

Of course, over the past year, productivity growth has slowed, increasing 1-1/4 percent at an annual rate over the first three quarters of 2001. This, in itself, is remarkable, given the historical tendency of productivity growth to turn negative when the economy enters recession. I believe that the reason for the good performance at this stage of the cycle is that the improvements in productivity growth that we have witnessed since the mid-1990s have been largely structural and will persist for a time.

The fundamental factor leading me to be cautiously optimistic that much of the improvement is likely to be sustained is my outlook for the state of technological advancement in the United States. As Fed economists Dan Sichel and Steve Oliner have shown, one major source of the gains in output per hour were the high and rising levels of business investment, which raised the amount of capital per worker, thereby boosting productivity. Booming investment in the 1990s owed importantly to steep declines in prices of high-tech equipment, which largely reflected rapid technical progress. About half a percentage point of the increase in productivity growth in the 1995-99 period can be attributed to this so-called capital deepening. I believe that technological progress will continue to drive down information technology costs in the coming years. Moreover, businesses have reaffirmed their intentions to improve productivity by substituting cost-saving high-tech capital for labor.

While there are certainly risks to the view that improvements in productivity growth will persist, I do not believe the terrorism of last fall is going to permanently harm increases in output per hour (and thus the health of the economy). Most assuredly, in the aftermath of these attacks, many businesses have been forced to redirect resources from efficiency-enhancing investment to meet greater demands for security. Businesses may also have been compelled to increase redundancy to cope with the greater potential for supply disruption. However, these effects will be mainly a one-time hit to the level of productivity. They are not likely to change the trend growth rate of output per hour. Moreover, their effects will be ameliorated as businesses use new technologies and find creative ways to hold down the cost of enhancing security and providing for contingencies.

Conclusion

Obviously, 2001 was a challenging year. But the American people once again proved to be up to the challenge. The relative strength of the various forces that will shape 2002 are yet to be determined. At the Federal Reserve, we stand ready to do what is necessary to maintain financial stability, as we did on September 11, and to maintain a monetary policy stance that will foster price stability and promote maximum sustainable growth in output.