Roger W Ferguson, Jr: Recent experience and economic outlook

Speech by Mr Roger W Ferguson, Jr, Vice-Chairman of the Board of Governors of the Federal Reserve System, at the 2003 Global Economic and Investment Outlook Conference, Carnegie Mellon University, Pittsburgh, Pennsylvania, 12 November 2002.* * *

I appreciate the opportunity to share my thoughts with you on the U.S. economy. Of course, the views I express are my own and not necessarily those of other members of the Board of Governors or the Federal Open Market Committee. As you all know, the Federal Open Market Committee lowered the federal funds rate target last week in response to an apparent softening in near-term economic prospects. I'll come back to that decision and share some of my thoughts about the effectiveness of expansionary monetary policy in stimulating aggregate demand. But before doing so, I think it is useful to set the stage by talking about some notable aspects of the economic recovery currently under way and some possible reasons why the economy has taken this particular course.

Like its predecessor in 1990-91, the most recent recession was relatively mild; and the current recovery, compared with previous recoveries, has similarly been restrained. The NBER has not officially declared a business cycle trough. But using the fourth quarter of last year as a benchmark, the peak-to-trough decline in the level of real gross domestic product was just 0.6 percent, matched in its shallowness in the post-World War II period only by the 1970 recession. And according to the Commerce Department's latest estimate, through the first three quarters of this year the economy has grown a little more than 3 percent at an annual rate, compared with an average increase in GDP of about 5-1/2 percent during the first four quarters following previous business-cycle troughs. Only in 1991-92 was the increase in GDP slower than in the current recovery.

As is typical, the expansion this year was aided by a waning of an earlier sharp runoff of business inventories. But some other features of the current recovery seem at odds with historical experience. For example, despite the relatively modest pace of output growth, productivity gains have been atypically large this year. In the long run, strong growth of productivity is unambiguously positive, as it implies that the prospects for increases in the general standard of living remain favorable. But the recent performance also is likely a sign that businesses are being unusually cautious in their hiring. Indeed, the labor market has not yet materially improved in the current expansion. The level of private payroll employment in October is still only marginally above the April low. And the unemployment rate has come down only slightly from its 6 percent peak earlier this year.

Another symptom of business caution is the sluggish rise in business investment compared with previous recoveries. In contrast, the household sector has been a source of strength this year. Housing starts and sales have been at their highest levels in years. Motor vehicle sales have been running well above normal levels for much of the year. And consumer spending apart from motor vehicles rose at a relatively robust pace over the first half of the year.

What accounts for the unusual nature of this recovery? I think that there are several factors at work. First, the downturn in 2001 itself exhibited some unusual features that have contributed to the patterns of economic growth this year. As I just noted, the recession was relatively mild. As a result, some of the elements of spending that normally rebound sharply from very depressed levels fell less this time and thus had less room in which to recover. This pattern is most evident in the housing sector, where home sales--and new construction--remained at elevated levels through the recession and beyond. But a lack of pent-up demand coming out of the recession was also noticeable in other areas of household spending, especially consumer durables other than motor vehicles.

In addition, the 2001 downturn was led by a collapse in business spending, especially for equipment and software. 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. In the most recent cycle, however, the main source of the economic shock to demand was a large drop in capital expenditures.

In retrospect, this downturn in investment seems to have been caused by an overbuilding of capital stocks in the late 1990s, especially in high-tech equipment. The boom in high-tech spending appears to have been sparked by the confluence of three key trends: the rapid growth in computing power generated by dramatic advances in semiconductor technology; the advent of new networking technologies that permitted computers to communicate more easily with each other in private networks

and through the public Internet; and the development of software programs that facilitated these interactions and greatly expanded the use of personal computers. During this period of rapid change, the rate of return to investing in these new technologies and applications looked to be very high. These perceived high rates of return encouraged new firms, supported by investors eager for windfall financial gains, to enter these markets, and induced a record-setting expansion of capital spending. As it turned out, however, some of these investments were overly optimistic and capital markets were not sufficiently discriminating. The expected returns to the new equipment did not materialize, and many of the new high-tech start-ups went bankrupt. As a result, the economy was left with a bulge in corporate defaults for investors to absorb, and an overhang of high-tech capital, which has subsequently exerted a substantial drag on business spending and economic activity.

The shakeout in the high-tech sector also contributed to a sharp decline in the stock market, and the resulting negative wealth effect has restrained consumer outlays. Nevertheless, household spending, aided by solid income gains that were fueled by continued productivity growth and income tax cuts, held up quite well during the economic downturn. That strength has continued into this year, supported by low interest rates and substantial motor vehicle incentives. But, as I noted above, the absence of pent-up demand among consumers has limited the extent to which the household sector has contributed to growth this year. And the recent data on consumer spending have had a weaker tone of late as households continue to adjust to the hit taken by their balance sheets.

In addition, foreign economic growth has remained relatively anemic. Real GDP gains this year are running at annual rates of only 1 percent to 1-1/2 percent in the euro area and Japan, and output is falling in parts of South America. This weakness in foreign activity has restrained the demand for our exports, with adverse consequences for U.S. manufacturers.

Another factor that seems to be limiting the economic recovery is the substantial uncertainty confronting decisionmakers. In particular, a series of unusual shocks has significantly buffeted the economy over the past year or so. Chief among these were the terrorist attacks of September 11. The worst effects were obviously felt by the people directly touched by the tragedies. But the attacks also dealt a blow to our already weakened economy. Several industries were seriously affected--the air travel and airplane manufacturing industries being the clearest examples--and activity in these industries is still well below its levels just before the attacks. The economy has proved to be more resilient than many initially anticipated, but the threat of additional attacks has undoubtedly affected some business decisions.

This year, concerns about the adequacy of corporate governance have greatly increased. These concerns likely contributed to the pullback in the stock market this summer. Moreover, lenders have responded to the sequence of accounting irregularities, and even sound businesses have been affected by the additional caution and suspicions arising in the wake of the disclosures by Enron, Worldcom, and the like. In particular, these announcements probably heightened investors' perceptions of risk and thus likely contributed to the widening in risk spreads in recent months.

More recently, geopolitical risks also seem to be weighing on businesses and households. The possibility of additional terrorist attacks has been present for some time. But added to this concern are now the prospects for armed conflict. Predicting the consequences of such an event with any precision is, of course, impossible, and this additional uncertainty has undoubtedly increased caution among businesses and perhaps even households.

Indeed, as I noted at the outset, indicators of production and spending have recently become more downbeat. Industrial production fell in both August and September, in part--but not solely--because of a dropback in motor vehicle production from the high rates earlier in the summer. Payroll employment has turned down again after rising this summer. And layoffs and initial claims for unemployment insurance continue to run at elevated levels. On the household spending side, motor vehicle sales dropped off sharply in September and October after a phenomenal pace this summer; personal consumption expenditures excluding motor vehicles were little changed in both August and September; and consumer confidence has deteriorated of late. Similarly, business spending has shown little vigor in recent months, at least judging by the latest data on new orders and shipments of nondefense capital goods.

Taking account of these latest signals, the climate of heightened uncertainty, and the very favorable prospects for inflation, the FOMC last week cut the target for the funds rate by 50 basis points. This additional easing of policy is aimed at helping the economy work through the current soft spot, and the FOMC indicated that it better balances the risks to the outlook.

Not everyone will agree with this view. In particular, the fact that the economy has grown at only a moderate pace this year despite sizable reductions in interest rates over the past year and a half has led some observers to argue that monetary policy has lost its punch. In my opinion, that argument is wrong. Academics and policymakers always thought that monetary policy operates with long and variable lags and that both the level of rates and the time required for policy to have the desired equilibrating effect depend greatly on the force of the macroeconomic instability that must be confronted. To judge the effectiveness of monetary policy, one must consider what the economy would have looked like in the absence of easing. In this light, given the severity of the shocks that have hit the economy, a better interpretation may well be that recent events validate once again the potency of monetary policy.

In my judgment, monetary policy has, in fact, countered some of the negative forces weighing on the economy. Residential investment has no doubt been buoyed by policy easing, as lower mortgage rates offset the restraint from declines in employment, smaller gains in income, and lower levels of wealth. Lower interest rates have also made it attractive to refinance mortgages to reduce monthly payments, extract some buildup of home equity, and use the proceeds to pay down more-expensive forms of consumer credit, finance additional purchases, or pay for home renovations.

Businesses, which have been feeling the pinch of lower corporate profits, have benefited from lower interest rates as well. For example, the low rates have facilitated the financing incentives used by automakers to stimulate motor vehicle sales this year. And businesses more generally have taken advantage of lower long-term rates by issuing bonds and paying down commercial paper and bank loans.

Even so, the current environment of low inflation and concerns about the recovery have raised questions about whether the Federal Reserve will eventually run out of room to lower interest rates by enough to stimulate the economy. However, I do not think that macroeconomic outcomes will be sufficiently adverse to place us in imminent danger of hitting the so-called zero bound on nominal interest rates. Even more remote is the possibility that monetary policy will be unable to prevent deflation.

To be sure, many firms, especially in the goods-producing sector, are experiencing declining prices. Goods prices have been declining this year, reflecting, in part, productivity improvements. Distinct from changes in relative prices, a general deflation would be disturbing both because it would be widely unexpected and because it would undermine the ability of monetary policy to operate through traditional channels.

I believe the risks of a general deflation are remote, as I will explain shortly. On that score, measures of overall price inflation are still running in the range of about 1-1/2 percent at an annual rate for the GDP and core PCE price indexes to a bit more than 2 percent for the core consumer price index. However, I also believe that complacency in this regard is inappropriate. The economics literature advises preemptive and aggressive action to minimize the risks of deflation. In the unlikely event that our nation should face such a challenge, I believe that the Federal Reserve would demonstrate a commitment to such timely and decisive action.

For several reasons, I think that the probability that the United States will end up in a position of general deflation is extremely low. For one thing, we’ve clearly learned the lessons of history, both the distant past of the United States and the more recent experience of other nations. Monetary and fiscal policies in the United States were quick to react to the mounting evidence that the decline in business spending that began in late 2000 was likely to be prolonged and severe. In January 2001, the Federal Reserve began to cut rates and by the end of last year had reduced the funds rate target more than 400 basis points, to its lowest level in forty years. Similarly, fiscal policy provided stimulus to the household sector at a time when household wealth was deteriorating.

In addition, the balance sheets of our financial firms appear to be in relatively good shape. Banks are well capitalized and don’t have the severe nonperforming loan problems that have been plaguing Japan. Of course, banks are being careful lenders, and the supply of credit does appear to have tightened more recently, especially for less creditworthy borrowers. But the primary reason for weak net business borrowing this year seems to be a lack of demand, and in general, credit appears to be available to higher quality borrowers in both the business and the household sectors.

The underlying structure of the U.S. economy also seems fundamentally sound, reducing the risks going forward. After the substantial reductions of the past year and a half, inventories in most areas appear to be at comfortable levels. There are no doubt places where capital goods imbalances are still

quite large--communications equipment and aircraft being two notable examples. But in other sectors, companies have remained profitable, and in the aggregate, the underlying picture of corporate profits and capital spending is not so bleak as the experiences of some industries might suggest. Indeed, as measured in the national income and product accounts, economic profits in the third quarter were well above year-earlier levels. And real investment in equipment and software, while not rising at the torrid pace of 2000, appears to have bottomed out and may be increasing.

Moreover, the longer-term prospects for economic growth in the United States continue to look favorable. A key question in assessing those longer-run prospects is whether productivity growth in the years ahead will more closely resemble the substantial gains evident since 1995 or whether it will revert to the weaker performance of the period from 1973 to 1995. The most recent record of productivity growth reinforces the view that future growth will follow the higher trend of the past half-decade. Productivity is a cyclical variable that typically falls in recessions. However, during the most recent downturn, productivity never declined and instead continued to grow at a fairly strong pace. Moreover, after September 11, many economists feared that productivity growth would suffer a severe setback as businesses diverted resources to improving security and developing contingencies in the event of another terrorist attack. Instead, according to Labor Department data released last week, output per hour in the nonfarm business sector has risen 5.3 percent over the past four quarters, its best performance since 1983.

How should we interpret this truly extraordinary performance? Cyclical forces probably played some role. And, as I noted, increased caution has probably pushed many companies to find ways to get more productivity from their workers. But these efficiency gains were likely facilitated by the capital investments of recent years. Adjusting to new technologies takes time, and it is plausible that such an adjustment process has continued to boost productivity this year. While cyclical forces and lags in the assimilation of new technologies have been important, their influence is likely to be transitory. More fundamentally, I believe that the trend in productivity has ratcheted up, and this development has been the driving force behind the recent extraordinary productivity growth.

Thus, it seems to me that with last week's easing in monetary policy, the pieces are in place to engender a gradual strengthening in economic activity in coming quarters. With the real federal funds rate now below zero, monetary policy is providing considerable support to the interest-sensitive sectors of the economy. Similarly, fiscal policy remains conducive to growth. The uncertain mood among businesspeople--and more recently households--may continue to damp spending for a while longer. But with inventories now seemingly in better alignment with sales and with much of the restructuring associated with the high-tech overhang now behind us, some important sources of economic weakness over the past two years should begin to disappear. As a result, with underlying productivity gains likely to remain strong, business profits and household income should resume their uptrend, setting the stage for a renewed pickup in private spending growth.

Of course, with inflation quite low and with significant excess capacity remaining in labor and product markets, we will need to remain watchful for any additional signs of economic weakness. Households surely won't be able to maintain spending growth indefinitely without renewed gains in employment, and a pickup in job creation will require that businesses become more sanguine about their future profit opportunities. At the Federal Reserve, we will continue to weigh incoming data and changing forecasts. But I expect that the economy will pull out of this period of weakness and that the natural resilience of the economy and the stimulative effects of monetary and fiscal policy will show through more clearly over the coming year.