The Federal Reserve Board

Remarks by Governor Susan Schmidt Bies

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Comments on the Current State of the Economy

It is a pleasure to be with you this morning at the Annual Economic Outlook Conference of Middle Tennessee State University to discuss the state of the economy. As you will hear, recent readings on the economy suggest that the pace of economic activity has picked up of late, our financial system is healthy, and inflation pressures remain subdued. Although uncertainties remain, I believe that the economic fundamentals are now in place to generate a sustainable, non-inflationary upturn. As always, the views that I will express are my own and do not necessarily reflect those of the Board of Governors or the staff of the Federal Reserve System.

I am going to describe the key factors that have dominated this recession and recovery. Then I will talk about the current state of the household and business sectors. Finally, I want to make some remarks about corporate-sponsored, defined-benefit pension plans.

The Recent Economic Cycle
Before delving into current events, I think it is helpful to review some of the key aspects of our recent economic history. After a record, ten-year economic expansion, the U.S. economy slipped into recession in March 2001. This recession was unusual in that it was led by a drop in business investment, rather than a decline in consumer spending. According to the National Bureau of Economic Research (the traditional record keeper of U.S. business cycles) the downturn lasted eight months--a bit less than the duration of the average post-war recession. But thereafter, between the trough of the recession in 2001 and the second quarter of this year, real gross domestic product grew at a rather disappointing annual rate of 2-3/4 percent, on average. Although household disposable income and spending increased appreciably over this period, capital spending continued to weaken. Indeed, in the second quarter of this year, real business fixed investment was 4 percent below its level at the trough of the recession--an unusually weak investment performance almost two years into a recovery.

Financial conditions undoubtedly played an important role in these developments. In the late 1990s, financial conditions were easy. Very narrow risk premiums in both debt and equity markets and lofty expectations about returns on the part of investors and borrowers greatly reduced the cost of external funds. A frenzy of capital-raising followed, led by telecommunication and Internet firms. Corporate debt and equity issuance soared--adding almost $2 trillion in new debt and equity to the balance sheets of nonfinancial corporations from 1998 through 2000 alone, with a good portion of the money raised by risky firms in the junk bond, venture capital, and initial public offering (IPO) markets. Firms used the proceeds not only to fund investment, but also to finance acquisitions of other companies, stock repurchases, and operating expenses.

The spectacular collapse of high-tech equity valuations in the spring of 2000, led by the same telecommunication and Internet firms, wreaked havoc with corporate credit quality in some sectors and began a prolonged retrenchment in financial markets. Subsequently, financial markets were buffeted with a barrage of terrorism, war, and corporate governance shocks that further eroded investor confidence and stoked uncertainty and pessimism. The consequent retreat from risk-taking led to a substantial markdown in asset values, with obvious negative consequences for portfolios. Between early 2000 and the end of 2002, more than $6 trillion of stock-market wealth evaporated, and more than $200 billion of corporate bonds went into default. Many of the telecommunication firms that did IPOs or issued junk bonds during the easy market conditions of the late 1990s went bankrupt. For other firms, debt burdens that had appeared manageable suddenly looked excessive. Investors and lenders rightly responded to these events by becoming more wary, and financial conditions accordingly became more restrictive.

Businesses faced a similar set of shocks: bankrupt clients, elevated uncertainty, skeptical investors, and expected rates of return that had plummeted. With limited pricing power and opportunities for sales expansion, businesses had to focus on expense management to increase their earnings. Businesses re-engineered processes. Their inventories and hiring slumped, and demand for funds fell. Although tighter financial conditions contributed, this pullback reflected mainly defensive actions by the borrowers themselves. Surveys of bank loan officers and small businesses support this view. Both groups have consistently pointed to weak business demand as the main factor behind sluggish borrowing during this recovery.

In this environment, economists pushed out the expected date of the recovery in capital spending, and concerns grew that the household sector--the mainstay of the economic recovery--might become overextended and curtail its expenditures before capital spending perked up.

But this is not evident from recent data. Business investment increased over the spring and summer, and the household sector remains in good financial health and has demonstrated a continued willingness to spend. Let me now discuss these recent economic developments in more detail.

Households

In the household sector, real personal consumption expenditures rose briskly over the summer, with strength widespread among the various types of goods and services. Supporting these gains have been large increases in real disposable incomes, higher stock prices, and favorable buying attitudes among consumers. The reductions in income tax withholding and the advance refund checks for the child tax credit mailed in late July and August likely added to the magnitude of the spending increases. Homes sales and new residential construction remained very strong during the summer, although the rise in mortgage rates could result in some cooling in the housing sector in coming months.

Although households have been borrowing rather heavily to finance the rise in spending, they also have taken steps to keep the repayment burden of that debt in check. Notably, many homeowners have taken advantage of low interest rates to refinance their mortgages, some having done so several times over the past couple of years. In more than one-third of these "refis," the borrower took cash out during the transaction, often to pay down loans with higher interest rates. The resulting drop in the average interest rate on household debt, combined with the increase in after-tax income, has helped households stay current on their loan obligations. Indeed, delinquency rates on consumer and mortgage loans held by banks have been trending lower, and most other measures of household loan performance have been stable on net this year.

Businesses

Capital spending by businesses increased at an annual rate of 7-1/4 percent in the second quarter, and orders and shipments of nondefense capital goods--a key indicator of equipment spending--rose briskly over the June-to-August period. Moreover, the tenor of anecdotes from the corporate sector seems more upbeat, as corporate managers see sales picking up and the financing environment improving.

Four important factors have contributed to this improvement in financial conditions: a widespread restructuring of corporate liabilities over the past two years, a bounceback in corporate profitability from its trough in 2001, a narrowing in market risk premiums, and low interest rates. I will discuss each factor in turn.

First, pulled by low long-term rates and pushed by nervous investors burned by a few high-profile, rapid meltdowns, firms have done a great deal to strengthen their balance sheets. Many firms have refinanced high-interest-rate debt, paring the average interest rate on nonfinancial corporate debt by almost 150 basis points since the end of 2000. At the same time, businesses have replaced short-maturity debt with longer-maturity debt, both to lock in low rates and to improve their ability to withstand a liquidity shock (since long-term debt does not need to be continually rolled over). In addition, many firms--especially in the most troubled industries--have retired debt via equity offerings and asset sales, helping to hold growth of total nonfinancial corporate debt in 2002 to its smallest gain since the early 1990s.

Second, firms have significantly tightened their belts. Over the past two years, the drive to cut costs has generated rapid productivity gains, and this greater efficiency has boosted corporate profits despite tepid revenue growth. Profits at Standard & Poor's 500 corporations grew almost 6 percent in 2002 from depressed 2001 levels and have increased another 10 percent in the first half of this year. Although this growth has been somewhat unevenly distributed across sectors, large-firm profits in the aggregate are now up smartly. Profits at smaller firms, which had fallen more precipitously, also appear to have rebounded sharply.

Third, risk premiums have fallen substantially this year as corporate governance scandals are less notable and investor sentiment has turned favorable. Stock prices reflect this brighter view. The broadest index of stock prices--the Wilshire 5000--has risen about 20 percent so far this year, while the tech-heavy Nasdaq index and the Russell 2000 small-cap index have logged even more impressive gains. Meanwhile, bond spreads have narrowed appreciably--especially for the riskiest firms--and are now back around historical averages. Declining spreads have, no doubt, been helped along by the beneficial effect of the balance sheet improvements on measures of credit quality. Indicators such as rating changes and default rates, though still elevated, have eased notably this year.

In another sign of improved sentiment, money has flowed into risky securities--for example, equity mutual funds have registered strong net inflows since March after net outflows in 2002 and early 2003, and extremely large inflows have boosted assets of high-yield bond funds nearly 15 percent over the same period. Offerings of risky securities have also reappeared since March, including a handful of IPOs and many low-tier junk-bond deals among a surge of corporate bond issues.

Improved profitability, coupled with subdued capital spending, inventory investment, and hiring, has translated into better corporate cash flow. Looking ahead, this larger income stream can help finance expansion directly out of internal funds or indirectly by supporting firms' borrowing capacity. Furthermore, over the past year or so, many firms have retained their excess cash and built up liquid assets. Thus, firms will be able to draw not only on improved cash flow but also higher liquid assets.

Fourth, and finally, the federal funds rate remains at just 1 percent. As a result, extremely low short-term borrowing costs have helped firms keep their interest expenses down. This is a direct benefit of the accommodative stance of monetary policy. For longer-term debt, the combination of low yields on benchmark Treasury securities and reduced risk spreads has kept borrowing costs attractive. The yield on Moody's Baa corporate bond index, although up a bit from this spring and summer, is otherwise at its lowest sustained level since 1968.

These four points all suggest that financial conditions are capable of supporting a sustained, healthy pickup in economic growth. By and large, firms are well positioned to fund expansion both internally and externally. And, given the successful efforts to pare costs, firms are set to benefit from a further pickup in the growth of revenue. Thus, future rates of return should be favorable. Accordingly, equity analysts are calling for S&P 500 profits to advance 5 percent more in the third quarter and by a similar amount in the fourth quarter of this year, before rising an additional 13 percent in 2004; and profits at small firms are expected to continue outpacing those at large firms.

As you know, banks are an important source of external funding for businesses. Although a small number of individual banks have been weakened by the downturn, I do not see a need to worry about banks' overall health. Banks continue to have strong financial positions and have weathered the credit deterioration in the corporate sector quite well, largely because of the improvement in their risk-management practices over the past decade. In marked contrast to the 1990-91 recession, bank profitability reached record levels in the past two years, and bank capital continues to strengthen. In addition, delinquency rates on most major loan categories have decreased noticeably since the end of 2001.

Employment, Productivity and Inflation

So far, I have talked about the upbeat part of the current economic picture. The downbeat portion is the lack of any appreciable improvement in the labor market. Although aggregate demand appears to have grown rapidly in the third quarter, nonfarm payrolls continued to fall through August and increased only a bit in September--the result of ongoing efforts by businesses to restructure their operations and boost efficiency. Based on recent economic research at the Federal Reserve and on many anecdotal reports, I suspect that a large part of these net job losses--particularly in manufacturing, airlines, and telecommunications--are permanent and will not be reversed as the economy gains steam. Instead, new jobs will need to be created in other sectors of the economy to replace them. This process will take time. But if history is a guide, in an expanding economy job creation will eventually outstrip job destruction, and lower the unemployment rate. The increase in payrolls in September was a start, and I hope will be followed by larger gains in future months. I will be watching conditions in the labor market closely because an expansion that is sustainable in the long run will require solid growth in employment.

The flip side of this so-called jobless recovery is that labor productivity has been increasing very rapidly. Output per hour in the nonfarm business sector rose almost 7 percent in the second quarter, bringing the four-quarter change to more than 4 percent. That pace is quite high by historical standards and suggests to me that the productivity gains of recent years are not cyclical developments that will disappear as labor demand strengthens but are permanent gains in efficiency. That is good news because growth in labor productivity generates growth in real wages of workers and thus raises our nation's overall standard of living.

Strong growth in productivity also has been an element in the low rates of core consumer price inflation in recent years. The personal consumption expenditure price index excluding food and energy increased only 1.3 percent over the twelve months ending in August--about 1/2 percentage point less than in the year-earlier period. In the current environment of excess capacity and intense global competition, most businesses simply do not have the ability to raise prices. As a result, I do not see a large risk of a pickup in the underlying pace of price inflation anytime soon.

Pension Obligations

Before concluding, I would like to discuss an element of corporate financial statements that has attracted a good deal of negative attention lately--namely company pension obligations. As you know, pension plans come in two varieties, with very different effects on corporate balance sheets and cash flow. Defined-contribution plans, such as the 401(k) and 403(b) plans that many of you are familiar with, are essentially employee savings accounts and generally do not have much effect on corporate reports. But traditional defined-benefit, or DB, plans can have large effects. DB plans, which are more common in older and larger firms, promise workers a stream of benefits during retirement, and companies that sponsor them are required by law to set aside sufficient funds to cover the payments they have promised to their workers. If the investment returns on the pension fund's assets are not enough to keep up with the growth in pension liabilities, firms must make additional pension contributions.

Three years of negative equity returns, combined with sharply falling interest rates, have put considerable stress on some DB plans. Because pension funds typically invest more than half their portfolios in equities, stock market losses significantly eroded pension assets; at the same time, sharply declining interest rates raised the present value of future liabilities, weakening the funding status of many DB plans.

Just among the firms in the S&P 500, the combined effect was to subtract nearly *half a trillion* dollars from pension net asset values from the end of 1999 to the end of 2002. At the end of 1999, about 20 percent of S&P 500 plans were underfunded, meaning that their assets were valued less than their liabilities. But by the end of last year, the figure was 90 percent, and DB plan assets across all S&P 500 firms were more than $200 billion shy of liabilities. The implication is clear: Many companies need to make additional contributions to their pension plans, and in some cases the contributions need to be large.

Indeed, last year S&P 500 firms contributed $46 billion to their pension plans, three times more than in either of the previous two years. Some contributions were considerable, and this trend continued in the first half of 2003: Twenty-five sponsors of the most underfunded pension plans have already made contributions this year as large as last year's.

This situation does not mean investors should panic about the financial positions of the firms sponsoring these plans. The bulk of the pension underfunding is concentrated at large firms with good access to capital markets. Among S&P 500 firms last year, about 90 percent of the underfunding occurred in firms with investment-grade debt. In the current market environment, these firms likely would have little difficulty raising funds to replenish their pensions. This suggests that pension contributions will not likely be a major cash flow impediment to corporate investment.

That is not to say, however, that many firms--indeed, whole industries--are not struggling with their pension plans. Severe cases can be found in the auto, steel, and airline industries, where long-term business structure issues make the recent business-cycle effects on pension plans more acute. These firms face a confluence of negative trends, including increasing competitive pressures, aging workforces, rapidly growing retiree populations, and a history of collective bargaining agreements that emphasized larger pension benefits over wage increases.

Automakers currently face some of the largest dollar amounts of underfunding, but as noted earlier, they generally have good access to credit markets, which has allowed them to weather these difficulties. Steel companies and airlines have had a harder time. In the past two years, a half-dozen large, established steel firms and airlines have declared bankruptcy, and their pension plans either have collapsed or remain mired in uncertainty.

Not surprisingly, required pension contributions represent a greater burden on cash flow to the surviving firms in these troubled industries. Although most DB pension contributions are made in cash, some airlines and steel companies have turned to making noncash contributions--company stock, generally--to their pension plans. While this conserves cash for other uses, it increases the risk in plan funding since the value of plan assets will be more correlated with the health of the sponsor. Thus when the company gets into financial difficulties, the ability to contribute to the pension plan will be the weakest just when the declining value of those plan assets requires larger contributions.

The recent experiences of the steel and airline industries, in particular, have led to the sudden reversal of fortune for the Pension Benefit Guaranty Corporation, or PBGC--the federally chartered company that partially insures pension benefits by assuming the assets and some of the liabilities of failed plans. Each time the PBGC takes over a bankrupt firm's plan, it assumes a new claim that comes due as the firm's workers retire. New claims have skyrocketed in the past few years--from an average of $150 million per year in the late 1990s to $3.3 *billion* in 2002. This year will be worse. Thanks to several large new bankruptcies, claims exceeded $5 billion in just the first half of fiscal year 2003.

These plan failures have had an enormous impact on the PBGC's balance sheet, which swung from a net positive position of nearly $10 billion in 2000 to a net negative position of nearly $6 billion by July of this year. Despite this negative position, the PBGC does not face an immediate liquidity crisis because of the relatively long duration of its liabilities and its steady stream of premium income from active plans. However, it faces serious challenges beyond those indicated by its current balance sheet, including substantial underfunding that exists at troubled, but still operational, DB plans. Indeed, the PBGC estimates that its annual tally of underfunding in "financially troubled" companies could exceed $80 billion this year.

So what is the prognosis for corporate pension plans in the near and long term? For the near term, I see some indications that the stresses have abated somewhat. So far this year, the financial condition of these plans have likely improved due to the rising stock market and higher contributions, although the precise extent of that improvement will not be known until year-end financial statements are released. But under a reasonable set of assumptions, perhaps $50 billion of last year's S&P 500 funding gap, or about one-quarter of the total, apparently has already been closed by improved market conditions.

And what about the longer-term prognosis for S&P 500 firms? Assuming current discount rates and normal pension asset returns, these firms would need to make about $150 billion in contributions to close the funding gap over the next three years. And once the current funding hole is filled, these firms would still need to make contributions to cover their rising liabilities. Indeed, DB plans are increasingly concentrated in mature industries with aging workforces, for which the growth rate of liabilities is relatively high (and rising), while their duration is relatively low (and falling). These longer-term challenges remain even if market conditions improve.

Conclusion

In summary, recent indicators suggest the pace of economic activity has picked up, the banking system is healthy, corporate financial conditions are strengthening, and inflationary pressures remain subdued. Although uncertainties remain, I believe the fundamentals are in place to generate sustainable economic growth.

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