Speeches

Current Economic Conditions

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Good afternoon. I appreciate the opportunity to chat with you today. I was asked to talk about how the Federal Reserve System works and also to comment on current economic trends. I'll focus my prepared remarks on current trends and leave questions about how the system works to the question-and-answer session afterward.

In reviewing current economic conditions, I'll make a few observations about 2000 and, in particular, what the last quarter suggested for this year, and then I'll turn to the more immediate present.

During 2000 we saw a huge swing in economic performance. Going into 2000, the economy was growing smartly, and everyone was surprised by the fact that this extremely rapid growth not only continued but also actually accelerated during the first half of 2000. Real GDP growth exceeded that of 1999, averaging nearly 6 percent during the first half of the year. During that time, policy discussions focused on the concern that the rapid pace of economic growth could not be sustained and that an outbreak of inflation was a risk. It was in the context of accelerating growth that the Fed continued the series of rate increases begun the previous year.

However, during the latter half of the year things changed dramatically. We saw an equally surprising and fairly significant loss of momentum in the economy—to about a 2 percent pace—with essentially none of the advance warning signals of a slowdown usually seen. The flow of shorter-term data in December and early January began to suggest weaknesses in several areas. Consumer confidence had weakened more than had been expected—as had manufacturing production and retail sales. Moreover, there were indications that credit conditions were tightening more than was needed in some segments of the financial markets.

All of this was occurring at a time when inflation pressures seemed to be abating. Together, these developments suggested to the Federal Open Market Committee (FOMC) that real interest rates were higher than necessary, and that some adjustment was called for if the expansion were to be continued.

The Committee's prompt response shows its flexible and eclectic approach to policy, as was seen in 1994–95 and again in 1998 during the Asian crisis. The FOMC has been willing to make decisive policy changes to keep the expansion on track.

Let me make a few observations about expansions in general. First, real growth over these past 10 years has been anything but regular or smooth. In this respect, the pattern of growth we observed in 2000 was not all that atypical from what we had seen earlier. We've had seven other quarters since the expansion began in 1991 of growth below the 2.2 percent now recorded for the third quarter of 2000 and three periods with growth below the fourth quarter's revised 1.1 percent. One of these quarters even recorded negative growth. In 21 of these quarters, growth was below the 3.5 percent average for the expansion.

Second, of the eight expansions we have had since World War II, none have ended due to natural causes. They have ended either as the result of a drying up of government war spending, from external shocks or from policy mistakes. The FOMC wants to avoid making policy errors—while at the same time trying to work its way through the consequences of external shocks.

Third, it is clear that we have certainly had our share of shocks to contend with during this expansion. In 1996–97, for example, we had the Asian crisis. Ironically, the Asian crisis proved to have many numerous positive effects on the U.S. economy, which I will have to admit we didn't fully appreciate at the time. For example, the worldwide declines in commodity and energy prices put downward pressure on measured inflation. The crisis also resulted in a flight to quality, bringing with it a large inflow of capital, lowering the cost of capital, and enabling us to finance a growing trade deficit with an appreciating dollar. These developments helped keep our economy growing with low inflation.

We also clearly had our share of real and potential shocks during 2000 to contend with from a policy perspective. First there was the Y2K threat in January, which we feared might trigger a communications and financial meltdown, and which was behind the buildup of liquidity observed in financial markets at the turn of the year. Fortunately, this turned out to be one of the greatest non-events in history, largely, I believe, because businesses and people heard the message and fixed potential problems so that they didn't occur.

Also in January many fledgling dot-com companies attained billion-dollar market caps, but by May the party was over as investors realized that it's hard to justify using invested capital to cover operating expenses forever. At some point earnings must appear. Significant retrenchment is now in progress in the technology sector.

We also had a roller coaster year as far as energy prices were concerned. The price of oil went from around $24 a barrel in January to more than $36 in September. The price then retreated to the mid-$20s again by the end of the year and has now jumped back up to the $30 range as OPEC has successfully designed strategies to keep revenues up. The run-up in energy prices has plainly diverted spending from other goods and services, is affecting production costs, and is clearly influencing the path of consumer confidence and spending on other durables and nondurables, at least on the margin.

The November election turned out to be a major source of financial uncertainty and contributed to the December decline in the stock market, although the run of reduced earnings reports clearly also was a dominant factor in the market's pullback.

By the fourth quarter, it had become more and more apparent that we might be entering a classic inventory-adjustment period. Business inventories accelerated in October and November of last year and inventory sales ratios bumped up, indicating that inventories would detract from growth in the fourth quarter, which they did. It was clear that consumers had been outspending their incomes for some time, and consumer spending dropped as consumer sentiment took a hit in the fourth

quarter.

Finally, corporate investment—which had been a major driver in the economy—actually became negative as firms struggled to cut costs in order to meet earnings forecasts.

All of these developments contributed to the malaise and, coupled with the evidence of two quarters of slower growth, have raised concerns about whether the expansion is in jeopardy.

The flow of recent data, however, gives us hope that the adjustments we are experiencing will be temporary, and we expect the data will give rise to a classic v-shaped pickup as the economy goes forward. The downward revisions in estimated real GDP growth in the fourth quarter actually suggest a less pessimistic outlook for current quarter real GDP.

Specifically, the December business inventories data, and inventory-to-sales ratios in particular, imply that more of an inventory adjustment took place in the fourth quarter than assumed by the Bureau of Economic Analysis when it put forward its first estimate of GDP. Business inventories posted their smallest gains in nearly two years in December, and the inventory-to-sales ratio was flat.

The inventory-to-sales ratio for durable goods decelerated noticeably in December after sizeable increases in previous months, reducing concerns that undesired inventories continued to build up at the end of the fourth quarter. The smaller inventory build-up in the fourth quarter creates a larger drag on fourth quarter real GDP growth; however, it also lessens the amount of inventory correction needed in the current quarter, assuming sales do not decline significantly.

A larger fourth quarter adjustment in inventories also increases the probability of a quicker upturn in industrial production as businesses respond to dwindling supplies of goods for sale. However, industrial production fell for the fourth consecutive month in January, suggesting that inventories may still be higher than desired. Looking more deeply at the data shows that the drop in production was largely centered in autos, and more specifically in domestic versus foreign auto production. For this reason, production declines in autos were felt more strongly in the Midwest than in the South. Excluding autos, manufacturing output was actually up 0.3 percent in January, and this has been followed by recent increases in both the National Association of Purchasing Managers (NAPM) and Chicago Association of Purchasing Manufacturers.

It is probably too soon to suggest that the decline in manufacturing production may be bottoming out. Data today suggested that new orders for manufactured goods fell in January; however, orders for nondefense capital goods, excluding volatile aircraft and parts segments, were up smartly in January. The NAPM data also suggest rising orders and manufacturing output outside of the motor vehicle industry, which in turn also suggests that once automotive inventories are reduced to comfortable levels, measures of overall industrial production will likely pick up.

Fortunately, inventory adjustment for autos actually seems well underway. It has been widely reported that light vehicle sales rebounded sharply in January to 17 million units, boosted in part by reintroduction of incentive programs by GM and Daimler-Chrysler. Additionally, recently reported production schedules have been revised upward.

Another important key to a rebound in production will be determined by the pace of consumer spending. Retail sales gained a higher-than-anticipated 0.7 percent in January, continuing the trend of December, and implying a stimulus to current quarter consumer spending growth. But much of the gain was due to deep discounting, and overall consumption expenditures were up a more modest .2 percent.

At the present time, it is unclear whether the strength in retail sales reflects improved consumer attitudes. The recent sharp downturn in the University of Michigan Index of Consumer Sentiment suggests otherwise, but these data are reported with a bit of a lag.

It is clear that consumer attitudes have done little to weaken the housing sector. The drop in mortgage rates in November and December of last year helped support the demand for housing. Housing starts and permits soared in January, improving the outlook for current quarter growth in residential fixed investment.

The strength in housing should also contribute to continued strength in consumer durables. When consumers buy houses, they also buy major durables. Housing activity is still at high levels despite the recent drop in existing home sales. New home sales, however, remained brisk, which is where more of the durable expenditures lie. Moreover, the recent upsurge in mortgage refinancing and reports from lenders that consumers are also taking additional equity out of their homes as part of that refinancing suggest that consumer spending for autos and retail goods will be maintained.

A second and closely related factor supporting consumer demand is the situation in labor markets. We've learned that when people are working they will spend. We've recently experienced increasing reports of layoffs and cutbacks. Layoff events have clearly accelerated in December and January, but there have been many other periods during the latter half of the expansion when layoff events have been significant. Additionally, while initial claims due to layoffs have increased, they still account for slightly less than 25 percent of the monthly claims for unemployment benefits. About half of the mass layoffs were in manufacturing, which accounts for only 15 percent of the economy. And the bulk of these took place in the auto industry. Finally, we note that in looking at the underlying components and reasons for the layoffs, completion of seasonal work accounted for half the events and half of all separations. Layoffs due to internal corporate restructuring accounted for 14 percent of the layoff events, and permanent closures of work sites accounted for another 12 percent of the events.

The third factor important to growth in 2001 will be investment spending. Business investment has remained very strong over the expansion as businesses have added plants and equipment, especially computers. Part of this investment, I firmly believe, was a logical response to the tightness and quality problems we have experienced in labor markets during the past three years. If businesses can't bid up wages and pass those increased costs on to their customers—as has been the very strong message we have received from our business contacts—then the alternative is to substitute capital for labor. That is, give each worker more physical capital to work with so as to improve worker productivity. This so-called capital deepening has been a major source of the economy's ability to grow rapidly without engendering increased inflationary pressures. In the fourth quarter of 2000, however, business investment actually became negative as firms struggled to meet earnings forecasts.

I remain optimistic, however, that the current investment pause is only a temporary adjustment and that there is no evidence that our ability to remain on a higher growth path due to increased productivity has fundamentally changed. Indeed, while there has been a fallout in the dot-com area, reports are that old-economy firms are just now beginning to adopt new technologies in their own production and distribution processes.

The fourth factor will be the conditions in credit markets and credit availability. I've already commented on this from the consumer perspective, but it is also clear that conditions have gotten more stringent in the corporate markets as well. Clearly, the less creditworthy borrowers are being rationed. Banks and other lenders are behaving prudently and credit markets are working. While one side of me welcomes such behavior, there is another side of me that worries that lenders will overreact and inadvertently cause a credit crunch. There is clearly no danger of this happening yet, but it is a source of concern.

While reports on real economic weakness have gained the majority of attention lately, two key inflation measures garnered some commentary as well in the last week. You will recall that both the Producer Price Index and Consumer Price Index (CPI) accelerated in January—up to a 4.8 percent and 3.7 percent annual rate, respectively.

I would be remiss as an economist working in the central bank if I didn't say a few words about this. I believe that we can never and should never let down the guard against deteriorating inflationary conditions or increased inflation expectations. We learned the hard way during the 1970s and early 1980s that the costs to the economy of doing so are just too high. However, January's acceleration in overall producer and consumer prices does not necessarily signal an alarming inflationary trend for two important reasons: First, these figures represent one month of data only and clearly have some unusual seasonal components affecting them. Second, these price pickups were clearly driven by rising energy prices and were widely anticipated. In the face of dampened aggregate demand and the widely reported inability of companies to pass on higher costs, it is not likely that these increases will persist, all other things being equal.

Furthermore, core producer prices at the intermediate and crude goods levels continue their downward trajectories on a year-ago basis. In addition, year-over-year growth rates of core consumer prices have held relatively steady. For the CPI we are looking at a core rate of 2.6 percent. These are signs that underlying inflationary pressures outside of food and energy remain reasonably subdued.

Given the recent data we have seen, I don't think that inflation will be the biggest challenge facing monetary policymakers this year. Instead, the challenge will continue to be the downside risks to real growth.

Having said that, we are looking forward to another respectable but slower year from the U.S. economy with growth only slightly below trend and with continued low inflation and unemployment. Overall, the current quarter outlook for real growth is less pessimistic than it was even two weeks ago, and the data enhance the chance that the widely forecast pickup in growth in the later half of the year will be realized. Let's hope I am right. I'm reminded of the saying that those of us who make our living with a crystal ball also have to learn to eat broken glass.

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