

Speeches

The Economic Outlook for 2001

**Remarks by Jack Guynn
President and Chief Executive Officer
Federal Reserve Bank of Atlanta**

**Downtown Atlanta Rotary
January 8, 2001**

Thank you, John, and thanks to the program committee for inviting me back again.

Well—2000 was quite an interesting year, wasn't it?

In January, the infamous Y2K transition, which we worried could trigger a communications and financial meltdown, turned out to be one of the greatest non-events in history (because, of course, we acted on those worries). The November election, meanwhile—which is usually remarkable only because it precedes a regular and uneventful transfer of power—turned out to be, in my view, one of the greatest sources of uncertainty since Russia defaulted on its bonds in the summer of 1998.

Also at the beginning of the year, many fledgling dot-com companies attained billion dollar market caps with a promise to “revolutionize” the world with their awesome, soon-to-be-realized “solutions.” By May, dot-com mania was losing momentum, as investors realized that the one solution many Internet companies *hadn't* provided was profitability.

On top of all this, the price of oil went from around \$24 a barrel in January to more than \$36 in September and then retreated to the mid \$20s at the end of the year—still more than \$10 higher than in 1998.

Despite all this uncertainty—and after growing more than 4 percent in 1997, 1998 and 1999—the U.S. economy actually expanded at an average of about 5 percent last year. The economy hasn't grown that fast since 1984, when we were still climbing out of the early-80s recession.

Of course, it's not the annual growth numbers for last year that are on our minds so much as it is the dramatic shift that took place during the year: from a very strong first half to a substantial moderation by year-end. If I may borrow an analogy from the Summer Olympics, I bet some of you can recall a track or swimming event when some athlete began a long race at a torrid pace but then had to adjust his or her pace over the next lap—sometimes dramatically—in order to stay in the race. It's all about pacing, and that may say something about the next leg of our economic race or, more precisely, the prospects for 2001.

And that brings us to last week's decision to cut the Fed Funds target rate and the discount rate by 50 basis points each, to 6 percent and 5 1/2 percent, respectively. Here's what we said in the announcement we made after our special Federal Open Market Committee meeting:

These actions were taken in light of further weakening of sales and production, and in the context of lower consumer confidence, tight conditions in some segments of financial markets, and high energy prices sapping household and business purchasing power.

The statement continued:

The Committee continues to believe that, against the background of its long-run goals of price stability and sustainable economic growth and of the information currently available, the risks are weighted mainly toward conditions that may generate economic weakness in the foreseeable future.

That statement was intended to be very straightforward, highlighting the various developments that have contributed to the moderation we've witnessed recently. But right after the statement was released Wednesday afternoon, I ran into a younger colleague at the Bank who said, “So what the FOMC's really trying to say, Jack, is ‘Don't bonk,’ isn't it?” Now the expression “Don't bonk” may be familiar to some of you who recall a few of the ads from the Sydney Olympics this past fall. I had no idea what the young man was talking about, though, so he patiently explained that “Don't bonk” was the slogan for a certain sports nutrition bar, and that it refers to the tendency of even the strongest, best-toned muscles to freeze up during conditions of peak performance—to simply run out of gas.

Well, I'm still trying to decide how helpful the “Don't bonk” analogy is in thinking about the intended effects of our policy action last week, but the rate cuts certainly can help the economy stay on its feet and keep running the race. And I remind you that in this race, there is no finish line.

Where we are, where we're going

There are milestones, however, and in January of 2001, the economy is about one quarter away from completing its 10th consecutive year of growth. We entered record territory with this economy some time ago, but as I've mentioned here in the past, it's not just the length of the expansion and not just the strength of GDP growth. It's also the fact that this period of extraordinary growth has been achieved with inflation below 3 percent for seven years in a row and unemployment drifting steadily down from 5 percent since 1996. Things have been good!

As I look into the new year, I think the economy's most likely path is one in which inventories and spending continue to adjust in the near term but with a return to a more moderate rate of growth—perhaps around 3 percent—over the course of the year. I think it's likely that unemployment will tick up slightly but remain quite low, and I expect inflation to remain relatively stable with relief in some of the pressures that had been building.

Now, by just about any historical standard, those results would amount to a very good year. Compared to the last four years, however, when just about everything's gone right and all the breaks have gone our way, it may sound a little disappointing. And as I'll discuss shortly, this disappointment could turn out to be a major challenge for all of us, including monetary policymakers, this year.

In the long term, though, I think the moderation of growth that we'll witness in 2001 will be a mostly healthy thing. It will help the economy avoid some serious imbalances that might otherwise have begun to accumulate, and it will help ensure that growth remains sustainable.

Now let me talk generally about where I expect that moderation to occur.

The demand side: consumer spending

On the demand side of the economy, the thing that matters most is consumer spending. Because it accounts for two-thirds of GDP, consumer spending is often and accurately described as the foundation of economic growth in the United States. Well, you don't need to be able to recite the most recent data from the University of Michigan's consumer sentiment survey or the Conference Board's confidence index to know that consumer confidence has fallen substantially over the last few months. No doubt the decline in stocks, as well as its effect on pension and personal stock portfolios, has been a factor. Also, the relative availability of credit has finally started to abate; throughout most of 2000, consumers spent in excess of their income. In addition, the recent binge in spending on big-ticket durable goods has probably left some consumers finally—or at least for the moment—sated. Whatever the reason, it means consumer spending is probably going to grow at a more moderate rate in the short term.

The good news, though, is that unemployment remains low, that nearly everyone who wants to work is working, and that wage growth remains very healthy. All of these serve as a sort of psychological and financial foundation for consumer spending, and as long as they're in good shape, consumer spending will continue to increase—although, again, at a more moderate rate. There's also some good news in what consumers are *not* spending. What I'm talking about, of course, is consumer debt, which can grow into an expansion-killing imbalance when it's exposed by a financial or other external shock as we've seen in past expansions. While the current level of consumer debt is not at a particularly alarming level compared to consumer income, it is moderately high by historical standards, and some moderation in the employment and income picture would put additional pressure on consumer debt. So the lower pace of consumption growth over the next year ought to help ensure that consumer balance sheets remain healthy.

The supply side: capital investment and labor

On the supply side of the economy, I would emphasize that part of the Fed's statement last Wednesday which said, "To date there is little evidence to suggest that longer-term advances in technology and associated gains in productivity are abating." As an engineer who's spent most of his career working with finance-related technology, I believe that the productivity gains delivered by technology since 1996 are here to stay. I know there are lots of views on this subject, but as I've said before, and this has now become clearer, productivity is not likely to continue growing at the very high rates we've witnessed over the last five years. In the coming months, I'm going to be keeping a very close eye on two things in particular that will help determine future productivity gains: capital investment and labor.

Productivity growth doesn't just happen: businesses plan for it; they *invest* in it. And that's exactly what's happened in the current expansion: the productivity explosion that began around 1996 was preceded by a capital investment explosion that began around 1992 or 1993. Investment spending over the past five years has averaged almost twelve percent annually, more than double what we saw in the 1970s and 1980s. But if productivity is going to continue to grow—or even to maintain its current high levels—capital investment is going to have to grow too.

Can it? Perhaps, but I do have some concerns. Capital investment is inextricably bound to financial markets, and I don't need to tell anyone here that there's been considerable volatility and uncertainty in financial markets recently. This uncertainty, of course, arises from questions about future economic growth prospects (notwithstanding my confidence that the economy will continue to grow at a pretty solid rate). In the short term, uncertainty can lead to higher capital acquisition costs, which result in less investment. And in the longer term, less investment may lead to slower productivity growth.

As for 2001, I think it's unlikely that businesses will increase investment spending at the rate they have in recent years, although I think they should still be able and willing to make the capital investments they need to continue to grow productivity. I think businesses have seen the light on capital investment and the pivotal role productivity has played in helping control costs.

The reason they have is labor, which is the other area I think bears watching on the production side. When we talk about productivity, there's a tendency to overlook labor. Maybe it has something to do with the way we define productivity, which is output per unit of labor. The labor component of that definition sounds almost like a multiplier, as though it's simply a matter of giving employees the best tools and letting them do their thing. But of course it's not that simple. Because employees have got to be able to take advantage of the productivity investments that their employers have made—they've got to make them *work*. It does absolutely no good for a company to invest in, say, a piece of customer service software that can do the work of 30 employees if you can't find the one highly skilled individual you need to keep it up and running.

The concern I've heard expressed over and over again in the last couple of years is that it's much more difficult to find employees who have the skills needed to make the most of productivity-enhancing technologies. In discussions I've had around our southeastern region—and this has been confirmed by recent surveys conducted by the National Federation of Independent Business—the primary concern hasn't been labor *quantity*. It's been labor *quality*.

There's a skills match problem: Employers haven't been able to find the people they need to make the most of their investments, and in many cases they've even had to import skilled employees from overseas. So when I say that a more moderate rate of growth will allow the economy to avoid potential imbalances, this is one more example of exactly what I mean: Workers who've been let go as their old companies gear down ought to be able to help their new employers gear up right away.

So the slowdown we're witnessing in spending growth ought to ensure that a more comfortable and sustainable balance is achieved between demand growth and supply growth, and that inflation remains low. This was, of course, the ultimate objective of the six rate increases implemented by the FOMC beginning in June 1999. Low inflation helped bring the expansion into its 10th year, and low inflation will help take it on through the 11th.

Inflation expectations vs. inflated expectations

But it doesn't look like inflation will be the biggest challenge facing monetary policymakers this year. Neither, for that matter, will dealing with the moderation I expect to see in overall demand and productivity growth be our only challenge. No, while we have so far been collectively victorious in keeping inflation low and *inflation expectations* under control, the great challenge this year for all of us, including policymakers, may very well be *inflated expectations*. And inflated expectations could be just as damaging as rising prices.

Two years ago, in my remarks to you, I warned of something I called the "institutionalization of unrealistic expectations." I expressed concern that after so many years of unprecedented economic performance, economic growth that's not exceptional, that's not spectacular—that's merely good—would be seen as not good enough.

Others have cautioned against the same inflated expectations. As it turned out, my concerns were a little premature: we managed to top two great years—1997 and 1998—with two more extraordinary years.

So let me again offer this reminder: slower GDP growth is not the same thing as no growth; a *slightly* higher unemployment rate is not the same thing as high unemployment; and a very modest uptick in measured inflation does not signal a return to accelerating inflation. Businesses, consumers, investors—and, yes, even policymakers—should not allow inflated expectations to distort their thinking.

The U.S. economy remains the envy of the world, and everything that brought us here remains: low inflation, low unemployment, strong income growth, innovative businesses and a sound financial system.

I look forward to another solid year from the U.S. economy, even as it makes some necessary adjustments. And I hope—for the sake of all of us—that you will too.

CONTACTS

Jean Tate

404-498-8035