

## Speeches

### The U.S. Economy: What Happened? What Changed? Where Are We Now?

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Thanks for that introduction, Mike [Guynn], and good afternoon.

When Mike approached me last year about speaking here today, there were a lot of good reasons to say yes. At the top of the list, of course, was *Mike*. He's my number one fan *and* my number one critic. So when he said I ought to come out and speak to you, I knew right away that I would. Thanks for the invitation, Mike.

Second, I really like the name of your organization: "The Council for *Quality* Growth." That pretty well summarizes what monetary policy is after, too, but it rolls off the tongue more easily than "Federal Open Market Committee."

Finally, some months ago, when Mike offered April as a potential date, I knew that it would mark the 10th anniversary of the beginning of the expansion. I thought this would be a great opportunity to celebrate, to speculate about what the next 10 years might bring.

Well, obviously, things have changed, and in ways I didn't anticipate. The economy is barely growing at all right now. I'll talk about that this morning and also about what monetary policymakers can and cannot do about it. But I also want to hear from you.

What I'd like to do in the next few minutes is to answer the three questions I get everywhere I go these days. They are "What happened?," "What changed?," and "Where are we now?" I'll try to answer them in turn, beginning with what happened.

#### ***What happened?***

I think that to begin to understand what has happened over the last eight or nine months, it's essential to understand what happened over the eight or nine years that preceded them.

Up until about the third quarter of last year, the U.S. expansion was unlike any we'd seen in a generation. What's largely been forgotten, though, is that it had a pretty ordinary beginning. GDP growth fluctuated between 1992 and 1996: from 3.1 to 2.6 to 4 to 2.7 to 3.5 percent, respectively. That averages out to 3.2 percent — not too shabby, but also not particularly spectacular, especially for an economy just emerging from a recession.

By comparison, the four years that followed — the 1997–2000 period — seemed exceptional, or even "new." And if you only look at the statistics, I suppose they really were. GDP grew over 4 percent per year — and pretty consistently, too. Unemployment was below 5 percent, and inflation remained very low. That combination of indicators was almost unprecedented, and to that extent we really *did* have a new economy.

Because the fact is that the so-called "new economy" period of the expansion probably would not have been so spectacular without strong assistance from an equally unprecedented set of positive economic shocks that also arrived in 1997.

The first shock was the Asian financial crisis, in which the currencies and economies of more than half a dozen Southeast Asian nations collapsed in a span of about three months. The Asian crisis was, of course, an unmitigated disaster for millions of people throughout the world, but it actually had some stimulative effects on the U.S. economy.

Prices of imported goods — and especially high-tech inputs like computer memory chips — fell because the currencies in which they were denominated were now dramatically lower. Commodity prices fell, too, as global demand went into a serious slump. And the United States became the safe haven of choice as the world's investors pulled their money out of Asia in 1997 and out of other parts of the world when Russia defaulted in 1998.

Energy prices were the second positive shock. Oil prices fell to \$11 per barrel in 1997, less than half of what they are today. In part, of course, the energy shock of 1997 (and 1998) was a function of the Asian crisis: Demand for all commodities, including oil, was lower, and therefore so were prices. But the oil shock was every bit a function of *supply* as well. As oil-producing countries tried to make up in volume what they were losing on price, they drove prices lower still.

These shocks, along with the flood of foreign capital and the Fed's long-standing commitment to low inflation, combined to create a nearly perfect investment climate.

At the same time, several technology-related developments made it nearly impossible for businesses not to invest. Technology continued to get better and cheaper in the late 1990s — and not just because it was imported from Asia. Old-line companies, large and small, in almost every industry became convinced that to remain competitive they had to invest — quickly and heavily — in technology. And the looming Y2K transition served as an all-purpose justification for a once-in-a-lifetime technological splurge. Moreover, with persistently tight labor markets, companies had few other options *but* to invest in technology if they wanted to continue to grow.

On the supply side, what all this new investment accomplished was a substantial upgrade in the overall productive capacity of the U.S. economy. Beginning in 1996, labor productivity accelerated from an average of around 1.5 percent, where it had been stuck for over two decades, to a trend rate of around 3 percent. The resulting gains in aggregate supply meant that the U.S. economy could accommodate substantial gains in aggregate demand without inflationary consequences.

That was a good thing, too, because aggregate demand was also accelerating quickly. In part, this growth in demand was a result of the investment boom I just

mentioned, of businesses buying from each other. But it was also driven by a significant rise in consumer spending.

That's because the same factors that facilitated business investment also had a powerful effect on consumers. The lower price of imported goods and the lower price of energy freed up cash to spend on other things. Some of the financial resources that flooded into the United States made their way into the hands of consumers, where lower interest rates spurred housing markets and spending on durable goods. Consumers felt wealthier as homes, stocks and other assets increased in value. Also, consumers genuinely were better off, as productivity gains in the workplace translated into wage gains for households.

So the combination of low prices, rising incomes and higher individual net worth meant that consumers were spending with great enthusiasm. In addition, the rate cuts implemented by the Fed in the fall of 1998 "to counter a significant seizing-up of financial markets in the United States" caused by the Asian and Russian default-related crises also stimulated spending. The Fed maintained an accommodative monetary stance through the first half of 1999 because of ongoing concerns about the ramifications of these crises.

In short, the conditions for a boom were just about perfect from 1997 through 1999, as an economy that was already fundamentally sound was further strengthened by an unprecedented set of shocks and policy responses. With the benefit of hindsight, however, it's also clear that consumers and businesses made decisions that were premised on those extraordinary conditions being sustained. As long as they were, those decisions made sense.

#### **What changed?**

So what changed? First, the global financial environment stabilized. And then in June of 1999, the FOMC implemented the first of six rate increases in the Fed Funds target rate. The first of those rate increases was essentially a mopping up effort, as concerns about the stability of financial markets lessened.

As 1999 wore on, however, the FOMC became increasingly concerned that aggregate demand was growing far too rapidly to remain noninflationary; that even accounting for the huge gains we had witnessed in productivity growth, aggregate demand would soon exceed sustainable aggregate supply and inflationary pressures would begin to build.

Considering both developments — the reduced financial dangers and the growing inflation risks — the case for additional rate increases in 1999 and 2000 seemed fairly clear cut and should not have been surprising.

What we had not completely reckoned on, though — and what almost nobody else had, either — was high energy prices. After bottoming out at \$11 per barrel in 1998, oil prices began to increase again in 1999 and 2000 (when they actually peaked at about \$34 per barrel).

Initially, higher energy prices seemed to have almost no effect on aggregate demand. As I just noted, consumer spending and business investment continued to grow at a very rapid pace in 1999. And while we can only speculate about why, one strong possibility is that most people anticipated energy prices would soon fall again. That was absolutely the case in oil futures markets, and as I recall, it was the prevailing view among most economic and energy analysts as well. I believed it, too!

But then, of course, oil prices did *not* fall. Instead they leveled off at around \$28 per barrel — about \$6 per barrel below their peak, but still well above where futures markets anticipated they would settle.

For firms, higher energy prices raise production costs, which squeeze profits. Lower profits usually mean lower retained earnings, which can lead to less investment. Lower profits can also mean lower stock prices for publicly traded companies, which can have additional repercussions for business and consumer spending.

For consumers, higher energy prices mean less disposable income. Because in the short run it is not possible to substitute away from specific energy sources, consumers just have to spend less on other things. Usually, those things are durable goods, items that require lots of energy to manufacture and operate: cars, appliances, computers and all the other items that matter so much to the U.S. economy.

Around the third quarter of last year, the impacts of higher interest rates and higher oil prices began to bite. At the same time, some of the costs of the earlier boom environment began to make themselves apparent, as consumers started to feel overextended, and businesses struggled to digest a surfeit of investment. Consequently, the pace of investment and consumer spending growth slipped and so did economic growth. GDP fell from 4.8 percent on an annual basis in the first quarter of last year and 5.6 percent in the second quarter to 2.2 percent in the third quarter to just 1 percent in the fourth. We'll get some data in a few weeks, but my hunch is that the economy didn't grow much more than that in the first quarter of 2001.

#### **Where are we now?**

So where are we now? Well, beyond the latest numbers, a few other things seem clear. First, the economy has excess capacity in several important sectors. In a few cases, this has to do with the expectation that some "New Economy" industries were immune to fluctuations in aggregate demand. A year ago, who would've guessed that higher oil prices would make purchases of their products postponable? In other industries, though, excess capacity resulted from decisions based on expectations that aggregate demand growth would remain at high levels. These economic decisions made a lot of sense *at the time* — but adjusting to the new, lower sales and production levels will carry substantial economic costs.

The good news, however — and this is the second thing that's become clear in the last few weeks — is that the economy makes those adjustments dramatically faster than it did even a few years ago. This is in large part a result of the very same technologies that helped generate such big gains in productivity: telecommunication, data processing, computer power, the Internet and all the rest. They might not have been able to prevent a slowdown, but they should help deliver us from it much more quickly, as new inventory control systems push information on sales and inventories back through the supply chain almost instantly.

The third thing to keep in mind is that energy prices may well remain elevated in the foreseeable future. In the short run, the United States faces constraints in its domestic refining capacity, a result of earlier low oil prices that kept investment away from new refining facilities. Even when those domestic capacity constraints are resolved, however, the supply of oil remains under the control of a handful of foreign producers whose interests are not necessarily aligned with ours. The upshot is that the positive energy shock we enjoyed in 1997 and 1998 was just that — a shock, an aberration, an event that's not likely to happen again any time soon.

And that may very well prove to be the case with the entire U.S. economy, circa 1997–2000. It was, as my colleagues and I said so many times, a truly extraordinary period. But with the benefit of hindsight it also seems clear that this *extraordinary* period was made possible by some equally extraordinary developments.

Which is not so say that it was all a temporary phenomenon, or that the economy didn't improve in some fundamental ways over the last four years. I, for one, believe that it did, that underlying productivity growth is and will remain substantially higher than it was prior to 1997 and that the economy is capable of sustaining over 3 percent GDP growth without risking an outbreak of inflation. That's impressive by just about any standard — except, perhaps, the one we set over the last four years.

#### ***What about the Fed?***

So where does that leave the Fed? And what about monetary policy? I'll get to that, but let me begin by stipulating three things that monetary policy absolutely *cannot* do.

The first is turn back the clock. Just as it is extremely unlikely that a combination of positive shocks like the Asian crisis, sharply lower oil prices, the technology investment frenzy, Y2K and all the rest will happen again soon — and at the same time — so it is also very unlikely that the 1997–2000 boom will return in the near future.

The second thing monetary policy cannot do is generate economic output. Yes, good monetary policy is *essential* for growth. But it is not *sufficient*.

Finally, monetary policy is not the tail that wags the bull — or the bear, for that matter. Stock prices are ultimately determined by the fundamentals of the overall economy — and not the other way around. And while I recognize that consumer spending and business investment can be influenced by equity prices, in my view, it is not the place of monetary policymakers to target stock prices. Unless the current adjustment begins to threaten the ability of the financial system to operate (as was the case in 1987), it can be no more (or less) consequential to monetary policymakers than any other economic adjustments.

Now, I realize that all of those stipulations are fairly obvious, but I bring them up to make a larger point. At the most fundamental level, monetary policy exists to allow investors, consumers and businesses to do what they do best in order to create the maximum amount of value from society's limited resources. Usually, as over most of the last 10 years, monetary policymakers do this by pursuing price stability, low inflation. Sometimes, however, as over the last three months, our more immediate objective is to minimize the costs of economic adjustments.

Some sectors of the economy are experiencing a painful transition as boom-time industries adjust to a boom-less reality, and the Fed is playing a role in ameliorating that transition. Even so, the fundamentals are still good, with unemployment at very low levels, inflation risks subdued, and consumers and businesses making necessary adjustments. As they work through these — as we all work through them — I'm optimistic that solid and sustainable growth will return.

Thanks for the opportunity to share these thoughts.

## **CONTACTS**

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