

## Speeches

### The Economy in Transition

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

Jackson Rotary Club  
Jackson, Mississippi  
July 23, 2001

Richard (Hickson), thanks for that gracious introduction. I also want to say a special thanks to Roy Ward for arranging my visit today. Richard has been a great director of the Atlanta Fed, and Roy has made a significant contribution to our economic intelligence gathering as a member of our Small Business, Agriculture and Labor Advisory Council.

It's good to be back in Jackson. I loved coming here often when I was a young officer in our New Orleans office in the 1970s. Your way of treating people made me feel more at home here than any place in our region. I've always believed that Mississippi was one of the South's best-kept secrets, but every time I return now, there's some new development that suggests that the secret's getting out.

Your state has long been known for its abundant natural resources, and most American homes have something that's been grown, loomed or manufactured here. Jackson, of course, is home to one of the world's largest telecommunications companies. And soon they'll be manufacturing pickups in Madison County. Finally—a vehicle big enough to haul around all those John Grisham books!

The substantial manufacturing base here means that Mississippi is significantly exposed to economic developments at the national level. I'd like to talk about some of those developments this afternoon. This is a particularly appropriate time to do it, too, since we're just beginning the second half of the year, a period when many analysts and policymakers expected to see healthier growth resume in the economy. Also, it's now been just over six months since the FOMC began a series of aggressive monetary policy easing moves that has so far resulted in a 275 basis point reduction in the federal funds target rate. It's a good time to take stock.

But let me begin by summarizing the three messages I hope you'll take away from my remarks today. First, the business cycle remains alive and well; the economy has always cycled between periods of faster and slower growth, and I see no evidence that this has changed. Second, the objective of monetary policy over the last six months has been to support demand as the economy adjusts to a more sustainable rate of economic growth; the adjustments are unavoidable, but monetary policy can make them a little less painful. Third, in the long run, economic growth will continue to get an important boost from the development of new technologies and the discovery of new ways to work better, faster and smarter.

I'll start with a few observations on the current economic transition.

#### ***What a difference a year makes***

Things were very different a year ago, weren't they? In the first half of 2000, the economy grew at a real annual rate of over 6 percent. In contrast, most analysts expect the first half of 2001 to post around 1 percent growth. The change has been dramatic, even if the economy is still probably expanding. Why did things change so drastically and so quickly?

To begin to answer that question, I think it's helpful to look at economic conditions over the decade leading up to the recent changes. The 1990s were characterized by tremendous technological innovation. Those innovations provided firms many new profit opportunities, including ways to produce existing goods and services more efficiently, to better manage their supply chains and also, of course, to create new products and markets. Anticipating high rates of return from technology, firms invested heavily. And those investments, in turn, stimulated an increase in labor productivity in many U.S. industries.

Broadly speaking, productivity can improve for three reasons. The first is labor quality—when employees work better, faster and smarter on the job. The second reason is what economists call “capital deepening”—giving workers more and better equipment to do their jobs with. The third reason is innovation—the arrival of some piece of equipment or software that dramatically improves the way things get done on the job.

Nationwide, we've witnessed substantial increases in the productivity of many sectors of the economy over the last decade, and much of that growth has resulted from capital deepening and innovation. But the thing that truly brings economic stability to a community is *human capital*: the skills, talents and training it takes to use technology effectively to generate productivity growth. It is difficult to keep the lead in technological innovation without a sufficiently skilled workforce. But a skilled workforce doesn't just happen. Like technology itself, it requires a substantial investment of intellectual energy, money—and time and patience.

Over the last decade, as firms invested more in new technologies, the demand for people with the skills necessary to produce and use these technologies also grew. But a chronic and acute shortage of skilled high-tech workers in the United States probably kept many firms from reaching their full potential.

#### ***The technology investment boom***

The technology investment explosion had other significant effects on the economy as well. Equity prices surged, especially in the tech sector, increasing the asset wealth of many American households. And as labor markets tightened and asset wealth grew, consumers increased spending sharply.

As if this technology-induced virtuous cycle wasn't enough, a number of other developments also compelled businesses to invest over the last decade. One critical impetus in the latter part of the '90s was the looming Y2K transition. Far more than just an extraordinary exercise in preventive maintenance, Y2K actually became for many companies an all-purpose justification for a once-in-a-lifetime technological splurge.

A second critical development in the last decade was the Asian financial crisis. Imports—especially high-tech imports—manufactured in Asia became dramatically

cheaper as the relative value of the dollar increased. Commodity prices, including oil prices, fell sharply as global demand fell. And the financial “flight to quality” out of the world’s high-risk areas and into the United States contributed to a substantial capital inflow, which led to a stronger dollar and lower long-term interest rates.

A third investment imperative was the need to crank up production capacity to accommodate booming U.S. demand. Of course, in the high-tech companies that made up the new economy, demand was thought to go in only one direction—up. But even in old-line industries such as automobiles and household appliances, demand was also surging.

It’s no coincidence that the investment explosion took place in an environment of low inflation. In part, of course, low inflation was reinforced by some of the developments I just mentioned: strong competition from overseas, low energy prices and downward pressure on production costs associated with productivity advances. But monetary policy, along with a balanced federal budget, probably also deserves some credit for the low-inflation environment that facilitated the investment explosion.

To get some idea of the magnitude of investment growth over this period, consider that investment in equipment and software increased from around 10 percent per year from 1993 to 1996, to around 13 percent in 1997 and to more than 15 percent in 1998 and 1999. These investments seemed essential if the economy was going to continue to meet current and future demand growth.

But then, of course, the tech investment boom became an economic imbalance as overall demand eased. For one thing, demand for technology dropped after Y2K finally arrived. For another, rising energy prices meant that businesses and consumers now had less to spend on other things. It’s also possible that after a decade of springing for appliances, cars and other durable goods, the American consumer was at least temporarily sated.

It’s also clear that substantial excess capacity developed in some of the newly emerging and hypercompetitive high-tech industries. Indeed, in many ways, what we witnessed over the last four years was something like a high-tech land-grab, with companies staking out vast tracts of the electronic frontier in anticipation of a sudden migration to the new economy. Think about broadband and the expansion of the fiber-optic network. Think about wireless. Indeed, think about the entire Internet “revolution.” I have no doubt about the long-term value of investments in these technologies—and that the future’s in all three. But the future’s not here just yet. And in the meantime, the real economy has billions of dollars of excess IT infrastructure in place.

And while it’s true that the economy has never had to work its way through the fallout of a significant tech investment imbalance, we have experienced investment imbalances before.

In the early 1990s, the commercial real estate market collapsed, helping to bring to an end an expansion that began around 1983. In retrospect—and the difficulty with imbalances is that we usually only recognize them “in retrospect”—developers overestimated the demand for commercial real estate, throwing up buildings and half-filled office parks across the country. Eventually, of course, the excess capacity was absorbed; eventually, the properties found tenants. But it was an adjustment that took several years and in the interim caused significant economic distress for many investors and financial institutions.

#### ***Working through imbalances***

Now, I realize that technology isn’t commercial real estate and that the full implications of a tech investment imbalance may not become apparent for quite some time. But there are some reasons to think the current adjustment won’t be as prolonged or painful as the real estate bust of a decade ago.

For one thing, better inventory management technology helps businesses adjust production to changes in demand much more quickly than before. Now, just to be clear—technology has *not* improved businesses’ ability to anticipate a downturn in demand. (There’s not much evidence that it has improved *policymakers’* forecasting ability, either, for that matter.) But when a change in demand does occur, that information flows much more quickly through the supply chain so that inventories don’t stack up to the same extent as in the past. That’s one reason I’m optimistic that inventories in most industries have more or less adjusted to lower levels of demand. A decade ago, I think it would have taken longer (and a commercial real estate adjustment longer still).

Changes in the financial system should also mitigate the impact of the current adjustment. The U.S. financial system allocates risks and procures capital more widely than at any time in the past. Think back a year ago to the NASDAQ correction, the dot-com bust and all the rest. Billions of dollars of paper wealth vanished overnight as demand for new technology failed to materialize and it became clear that not every high-tech venture was destined to be a runaway success. Yet the U.S. financial system remains sound, with sufficient financing available for those companies with the strongest business plans. Because investment losses have not been concentrated in the banking sector—because they’ve been distributed among equity markets and venture capital funds—banks have avoided the brunt of financial losses, and the entire financial sector is in much better shape than in previous downturns as a result.

Now I will concede the possibility—even the likelihood—that the deregulated nature of the U.S. financial system has altered the way monetary policy affects the economy. In the 1960s and ’70s, interest rate regulations made banks the primary channel through which monetary policy changes were transmitted to the economy. But in today’s deregulated financial environment, the effects of monetary policy actions are also transmitted well outside traditional banking channels. This development probably affects both the time it takes for monetary policy actions to work their way through the economy and the magnitude of the economic responses. Even so, I’m convinced that the deregulation of the financial system has been a favorable development for the economy.

A third reason I’m optimistic about the economic outlook is *monetary policy* itself. Now it’s true that the balance of economic risks remains weighted toward weakened economic growth: Consumer spending has moderated substantially this year and could weaken even more. And an additional deterioration in sales, profitability and cash flow would further exacerbate weakness in capital spending and employment. But the 275 basis point reduction in the federal funds target rate implemented over the last six months has been the most aggressive series of rate cuts in a decade and reflects the FOMC’s commitment to supporting demand conditions and mitigating the financial costs associated with the structural adjustments taking place. To put it another way, while the current adjustments are pretty much unavoidable, monetary policy can at least help make them a little less painful.

Having said all that, I’m confident that solid economic growth will resume in the next few quarters. Even with the current adjustments taking place, the economy is still operating at a relatively high level, and strong underlying productivity growth—the catalyst for any meaningful expansion—remains in place. And in the final analysis, that’s why I’m most optimistic about the economy’s recovery. Productivity growth is ultimately determined by technological innovation and ideas. And there is no stronger market for either than the United States.

**CONTACTS**

Jean Tate

404-498-8035