Speeches

The Economic Outlook for 2002

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John [Wieland], thank you for that introduction. Some of you may know that John was recently re-appointed by Chairman Greenspan to serve a fourth year as chairman of the Atlanta Fed's Board of Directors, and I can't think of anyone I'd rather have in the job. John and Suzanne Boas, another Rotarian who serves on our board, have been terrific directors. John and Suzanne, thanks again for the time you devote to working with us at Federal Reserve Bank of Atlanta.

I also want to begin by thanking all of *you*. The Federal Reserve is known for its independence within government, but we're also very much a *public* institution, and that means we've got to be accountable to the people we serve. I probably spend close to half my time out in the region explaining what we're thinking and doing, and why, but I'm never held more firmly accountable than during my Monday luncheons with all of you. I've heard a lot more gripes and groans this past year, but I sincerely appreciate your real-world insights, your constructive criticism and advice, and your support.

Most of you who've heard my previous Rotary talks know that they usually begin with a brief review of the preceding year. As much as I'd like to skip that this year, there's no way around looking back for a moment, mainly because I think the adjustments that took place in 2001 are going to continue for a while before concluding later this year. So I'd like to begin today with some brief observations about the year we've just lived through.

When it comes to history, we Americans are celebrated for our short-term memory. Yes, history is important, and, yes, we usually learn what we need to learn from it. Mostly, though, history is a blur that leads to the future. But some years are different: 1917, 1929 and 1941, for instance. They're years of *clarity*. 2001 was one of those years, too.

Now just so you don't get the wrong idea, clarity does not mean that my colleagues and I have had some sort of extraordinary insight about the economy or that this year we know exactly what's going to happen. Actually, I have something very different in mind. By clarity, I mean a demonstration of what's truly great and important about this country; I mean a resetting of the national perspective.

I don't think I need to say too much about the demonstration of American greatness we witnessed last year. Our country's response to the attacks of September 11—the countless acts of heroism and sacrifice—stands alone as testimony to the real source of American might. But if 2001 is remembered as the year in which scores of ordinary Americans did extraordinary things, it will also be recalled as the year in which the longest economic expansion in postwar history met a humbling end.

Which brings me to the economic outlook I presented to you this time last year. I didn't exactly get it right. I told you last January that I thought economic growth would begin to moderate a bit, brought down by lower growth in investment spending. Well—it was some kind of moderation, wasn't it?

As we now know, the economy actually *contracted* last year. According to the scorekeepers at the National Bureau of Economic Research, the recession officially began in March (which was also, just for the record, about a month short of the 10th anniversary of the start of the previous expansion). The final numbers aren't in for 2001, but I expect GDP will have shown essentially no growth in the year.

The downturn we witnessed last year made itself apparent in a number of ways. For one thing, stock market indexes continued a decline that began in 2000. Labor markets contracted, led by a decline in manufacturing activity that began in mid-2000. In total, nearly 1½ million jobs have been eliminated in the U.S. economy since March of 2001, and the unemployment rate increased to 5.8 percent in December, the highest rate in more than six years.

How did it come to this? And why did things deteriorate so much more than I thought they would? The answer has a lot to do with how the economy was able to post such outsized gains in the first place.

From 1997 to 2000, the U.S. economy grew more than 4 percent a year, with very little inflation and with unemployment at or near a record low. My colleagues and I just about ran out of superlatives to describe it. The economy was "amazing," "extraordinary," "remarkable," "outstanding," "exceptional," and on and on. Along with everybody else, we knew we were witnessing something special.

It's now clear that the most critical factor in the late 1990s boom was *business investment*. Businesses decide to invest by forecasting costs and revenues over the life of an investment; expected profits, of course, are the determining factor. So the investment boom of the late 1990s was driven in large part by the expectation that an investment's future cost savings and contribution to revenue growth would be substantial and relatively quick in arriving. In industry after industry and business after business, the expected returns from investment looked extraordinarily promising, and massive investment spending followed.

To be sure, strong business investment spending growth was not exactly unique to the late 1990s. But what was unique—unprecedented, even—was that investment growth was sustained at such a high level for so long. And while I suspect economists will be studying and analyzing the 1990s businesses investment boom for some time to come, some of the contributing factors already seem clear enough.

There was the approaching Y2K deadline, for example, and the once-in-a-lifetime incentive it presented to upgrade nearly everything, all at once. There was the ongoing realization of efficiencies from personal computers and data processing, and the anticipation that more investment would deliver even more efficiencies. There was the broadband boom, the "if you build it, they will come" field of telecommunications dreams. Most importantly, there was every expectation of great returns in the form of future *profits* from these investments, with old-economy firms anticipating higher demand for their products in the foreseeable future, and new-economy firms convinced that demand would never slow down for theirs. And there was plenty of financing for all of these investments. In the aftermath of the Asian crisis, capital poured into U.S. bond and equity markets from abroad, with the full expectations of continued high returns on these investments.

From 1997 to early 2000, all of these developments were largely self-reinforcing. Massive sums were invested in productivity-enhancing capital equipment, and especially in information technology. Suppliers had to increase hiring to meet the orders, and the companies doing the investing had to hire the right people in order to use the new technology. Stock investors, drawn to bigger profit opportunities, piled into the market and pushed up stock values. More valuable stock portfolios, combined with rising real incomes, encouraged consumer spending, which reinforced the need to invest, and so on. In this respect, the business investment boom was a truly virtuous circle.

Unfortunately, though, in many cases the profitability of the investment spending was too slow in coming. Profit *expectations* never developed into actual profits. And when revenues persistently fall short of expenditures, businesses have to cut costs. The sharp decline in business fixed investment spending in 2001 from the hectic pace of the late 1990s is a reflection of that reality.

When I spoke to you last year, my concern was how much business investment would grow in 2001. After four years of sustained double-digit growth, I thought a deceleration—to something in the midsingle digits, maybe—would be the most likely path. In fact, though, business investment not only decelerated last year, but it actually declined. After stalling in the first quarter, total real business investment spending contracted at a double-digit pace in the second quarter and almost as much in the third quarter. It appears that investment spending declined again in the fourth quarter, although by less than in the prior two quarters.

What we witnessed over the past 18 months—and it's now clear that the adjustment process actually began in the second half of 2000—were businesses trying to return to profitability by closing the gap between costs and revenues. And since in the short run businesses have the most control over the *cost side* of their balance sheet, that's where most of the adjustments began. Manufacturing facilities were closed, inventories were liquidated, payrolls were trimmed, competitors merged or went out of business, and, of course, capacity-expanding investment spending was put on hold. On the revenue side, the main problem has been that demand fell short of what was expected when investment decisions to expand capacity were made in the 1990s. In response to weakening demand, many businesses have actively tried to stimulate sales through various incentives—from 0 percent auto financing to $75 round-trip airline fares.

Most of the final demand for goods and services in the U.S. economy is comprised of consumer spending, and consumers, too, have had to make balance sheet adjustments. As financial markets rapidly and dramatically re-valued assets, consumers had to reassess how wealthy they were—or expected to be over the course of their lives. And as they witnessed friends and neighbors losing jobs—or read accounts of layoffs in the news—consumers also had to reassess the certainty of their own employment. As with firms, consumers responded to the revised outlook by quickly cutting back on costs wherever they could, and we saw quite a slowdown in consumer spending in 2001.

As for 2002, the biggest uncertainty is not whether there will be a recovery, but when it will arrive and how large it will be. The answers to these two questions are hardly crystal clear at this time, but I see a number of factors that I think will combine to provide considerable support for a significant economic recovery in 2002. I see no reason to disagree with most forecasters who predict that the adjustment process will begin to wrap up by midyear and the conditions for profitability—and therefore for growth—will have been re-established.

For one thing, lower energy prices—mostly reflecting lower global demand—have been a bonus to U.S. consumers and businesses: Cheaper gas frees up money to spend elsewhere. Some estimates suggest that lower energy prices will lop tens of billions of dollars from household energy bills this winter. Last summer's tax cuts have also put a comparable amount of money into the pockets of consumers in 2001, and changes in the tax laws will have positive impacts in 2002 as well. For its part, the Fed cut the fed funds interest rate target 11 times last year, from 6 ½ percent to 1 ¾ percent. Lower interest rates have already allowed consumers and businesses to reduce their debt service burdens, thereby supporting the ongoing adjustment process. On the production side, inventories in most industries have been worked down to low levels, and production will soon have to be increased to accommodate even a continuation of current demand conditions. Finally, because it hasn't always been the case in past recessions, it's worth mentioning that the U.S. financial system remains in very good shape. As a regulator and a central banker, it's reassuring to me to know that when businesses are ready to begin investing again, our financial system will be prepared.

With all of that said, however, I think it is important to recognize that cost-cutting measures by businesses are likely to continue in the near term. In fact, we know from past experience that the unemployment rate usually continues to increase for a few months even after growth returns, so things on the labor front could actually get a bit worse even after the economy starts to grow again.

An open question for 2002 is how the attacks of September 11 are going to affect profitability. The terrorist attacks did not cause the economic downturn—although they surely made it worse—but we're still faced with the ongoing economic impacts of these attacks that persist on the cost and revenue sides of numerous businesses. Heightened security efforts, ongoing process redundancies, and perhaps higher inventories all add to the costs of doing business. Some of these shifts may be temporary. I doubt, for example, that the switch we've witnessed in some industries from "just-in-time" inventories to what our friends at UPS call "just-in-case" inventories will be permanent.

As for spending and revenues, some consumer purchases—notably travel and tourism activity—are suffering from a perception of increased risk; the fear effect amplified a modest decline in spending that was already underway in these industries before September 11. My own bet, though, is that the fear effect will begin to dissipate soon because of the resilience of Americans.

On balance, I'm reasonably confident that nearly all of the adjustments we've been witnessing since the fourth quarter of 2000 will be substantially completed by midyear and that the conditions for healthy growth will have been reestablished. While that probably means we'll see negative GDP numbers for another quarter or two, I think growth for the last two quarters of the year will be around 3 percent at an annualized rate—not the heady 4 to 5 percent growth some commentators had predicted was here to stay, but certainly a respectable level. Like GDP, unemployment will probably continue to get worse before improving in the second half the year. Inflation, though, should remain in check in 2002 with continued rising service costs offset to some extent by stable goods prices. Needless to say the continued presence of low inflation is very good news for the U.S. economy.

I have to concede that as forecasts go, a lot more is up in the air than I would otherwise prefer. (Occupational hazard, I guess.) Still, though, the adjustments we witnessed in 2001 make me optimistic about the prospects for the coming year.

More than anything else, my current optimism springs from the basic wisdom, strength and ingenuity of the American people and our economic system. As so many have observed, our collective response to September 11 has been extraordinary. What's so remarkable to me, however, is that the extraordinary is actually everyday, commonplace, normal—ordinary. Once again, our economic system has demonstrated its absolutely unique ability to adjust quickly. As employers and consumers, business executives and individuals are making the sometimes painful adjustments that will put us back on a path of growth and renewed prosperity. No one anywhere in the world deals with these kinds of challenges better. I believe this new year, 2002, will feel a great deal better.

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