Speeches

Thoughts on the Economy

Remarks by Jack Guynn
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Paula [Lovell], thanks for the nice introduction. You make me feel welcome. And let me also say thanks to Chris Ferrell for helping to arrange my visit today.

I'd like to thank you, too, the members of the Nashville Rotary Club, for helping me do my job. Meetings like this serve two very important purposes for the Federal Reserve: First, they help policymakers remain accountable to the public we serve by allowing us to explain what we're thinking and doing, and why. Second, they keep us in touch with business and community leaders like you, who often detect economic developments that won't begin to show up in the data for quite a few weeks.

Needless to say, in my six years as president of the Atlanta Fed, I've put together some travel tips for the District's six states that would probably be useless to anyone but another Federal Reserve Bank president. But I can say this without hesitation: Tennessee *always* sounds good to me.

And now's an especially good time to be in Nashville. In the last five and a half months, millions of Americans have started asking again what they can do for their country, for their community; in the capital of the Volunteer state, though, it's an ethic you never forgot.

Nashville's a good place to observe the economy, too. Most everybody knows about Music Row and all of its related industries: law, accounting, cosmetic surgery, sequin mining. (There's got to be an economic indicator in there somewhere.) But I know Nashville also to be the capital of an economically diverse state, with world-class manufacturing, health care and education — a microcosm of the U.S. economy. So as some of the latest data releases indicate that the worst may be past, I think this is a good opportunity to talk about what's next for the U.S. economy.

Different downturn, different recovery

Simply stated, my argument today is this: The current downturn has been different than previous downturns: 1990–91, 1980–82, etc. The recovery's likely to be different, too. The layoffs and costcutting we've witnessed during this recession were basically triggered by the scramble among businesses to regain profits. What this means for the economy is that the timing and strength of the recovery will largely be determined by a return to business profitability. When the pressure to cut costs begins to abate — when businesses start rebuilding inventories and they hire more than they fire — then the path will be clear for future economic growth.

To make my case for a profit-driven recovery, though, I need to begin with a brief review of the current business/economic cycle. As just about everyone who reads the business pages knows, the United States had a great investment boom from 1996 to 2000. There was the Y2K buildup, the push to improve productivity through PC and data efficiencies, the broadband rush and — with persistently low unemployment — the need to substitute capital for labor. And there was plenty of money to fund all these investments.

The investment boom produced a lot of things. I happen to think it's the main reason the economy grew at a rate of over 4 percent a year from 1997 to 2000. One thing the investment boom apparently did not produce, though — and this is critical — was the sustainable cash flows and cost savings required to generate profits. And that, of course, is the main reason businesses invest in the first place.

What we've witnessed over the last year or so — what's still going on now — is business taking the difficult but essential steps to reestablish profitability. On the cost side, manufacturing facilities have been shuttered, inventories slashed, payrolls trimmed, competitors merged or liquidated, and capacity-expanding investment put on hold. On the revenue side, businesses have rolled out lots of promotions and incentives to get demand moving again, from zero percent auto financing to $75 round-trip airline tickets. Of course, these revenue incentives can have a major impact on the cost side, too.

The latest indications are that the adjustment process seems to be working. Profitability in the aggregate is still declining, but now at a much lower rate. More importantly, though — and on the positive side — inventories are considerably lower, some firms are reporting better than expected financial results and the economy as measured by gross domestic product actually grew in the fourth quarter of 2001.

Now, it's true that in past recessions businesses have also had to make some difficult adjustments to return to profitability. This time, profitability will be important in determining the timing and strength of the recovery, too.

Why consumer spending has held up

But there are some other critical differences between the current and previous recessions. For one thing, consumer spending has continued to grow throughout the current downturn. After increasing at an average annual rate of just over 4.5 percent from 1997 to 2000, personal consumption expenditures (PCE) — the broadest measure of consumer spending — grew 3 percent last year. By comparison, in 1991, the year the last recession ended, consumer spending actually contracted 0.2 percent. In the slowdown a decade before that, consumer spending contracted 0.3 percent in 1980 and then grew a scant 1 percent in 1981 and 1982.

Why has consumer spending been strong during this recession? That question could have serious implications for the strength of the recovery and the long-term prospects for the economy, so it's worth considering some of the answers in a little more detail.

I think a number of factors have contributed to the strength of consumer spending during the current recession. First, worker incomes have continued to increase. It's true that individual employees may feel less secure in their jobs, but in the aggregate — where we measure spending most broadly — total income has been resilient despite net employment losses. Second, and similarly, the tax cut that took effect in 2001 added about $35 billion in additional personal disposable income. Third, a significant decline in energy costs added to disposable income an amount comparable to last year's tax cut.

And housing, too

Consumer spending has also received a lift from developments in the housing sector. According to data from the Office of Federal Housing Enterprise Oversight, from 1998 through the third quarter of 2001, prices of repeat sales or refinancings of existing homes increased nearly 7 percent at an average annual rate. By comparison, the inflation rate as measured by the Consumer Price Index was about 2.5 percent a year over the same period. And home ownership rates hover near all time high levels — 68 percent in the fourth quarter of 2001. Appreciating home values combined with low interest rates to facilitate a huge wave of mortgage refinancing. In 2001, cash was taken out of housing equity in one half of mortgage refinancings. These cash-out refinancings made an estimated $80 billion available to homeowners — more than twice the estimated amount introduced by last year's tax cut.

In addition to releasing a wave of cash-out refinancings that buttressed consumer spending on goods and services, lower interest rates also helped maintain the strength in housing demand. Existing home sales in the fourth quarter of 2001 stood at an annual rate of 5.2 million, near an all time high. New home sales were near a 900,000 rate in the fourth quarter. And the strong level of housing starts reported last week continued to surprise most observers.

As with consumer spending, the strength we've witnessed in housing contrasts with history. Contraction in the housing market used to be an early sign of recession. During the multiyear slump of the early 1980s, residential investment spending fell more than 21 percent in 1980 and more than 18 percent in 1982. Beginning in 1988, residential investment contracted for four years in a row, falling 0.5 percent, then 4.1 percent in 1989, then 8.6 and nearly 13 percent in the recession years of 1990 and 1991. In 2000 and 2001, by contrast, residential investment grew nearly 0.8 and 1.4 percent, respectively.

It's important to try to understand why the performance of housing has been so different, so strong in this recession. Clearly, low interest rates have been an enormous factor. But low interest rates are also very closely related to low inflation and the expectation of low inflation that resulted from sound fiscal and monetary policies over the last decade. In addition, strong appreciation in the value of housing has contributed to the nearly unanimous expectation that housing is a good, solid investment. And the broad array of mortgage products — more choices than anywhere else in the world — has helped the United States achieve a very high rate of home ownership.

What's next?

As for where all this takes us, I think the economy's going to return to sustained positive growth by the third quarter of the year. The recovery, though, is likely to be more moderate than we're accustomed to seeing. That's because consumer spending and housing are not likely to provide the usual kick we've seen coming out of previous recessions and because there's still considerable uncertainty surrounding investment spending.

Remember, this is a different kind of recession. Consumer spending never really declined (or at least it hasn't so far). It also doesn't seem likely that an additional $80 billion of home equity will find its way into consumers' wallets through mortgage refinancing this year.

The story's the same with housing. The housing sector contributes to economic growth even beyond its percentage of the national accounts because it's so closely related to other kinds of spending: dishwashers, carpets, furniture, etc. Since housing hasn't declined — indeed, since it has actually hovered at near record levels for so long — it doesn't seem realistic to expect that housing will lend the kind of momentum that it has in past recoveries. Actually, I'll be pleased if housing activity remains around its current high levels.

Profitability, then business investment

I'm fairly confident that consumer spending will continue to grow at a moderate rate and that housing will fluctuate around its current levels for the rest of the year. But I'm a lot less confident about the timing and trajectory of business investment spending in the near term. I can say, though, that a return to profitability by business probably does not mean that investment will to return to levels of 1996–2000. I think we may yet come to see that era as an anomaly. Y2K, the race for productivity gains and the "new new thing," along with the capital flight to the United States that came with the Asian financial crisis, combined to create an investment climate that we may never see again. However, a return to profitability will allow businesses to invest when the best opportunities arise.

As for near-term investment, there's still a great deal of excess capacity out there right now, and there may a be very long wait for profits in some of the most over-built industries. However, I do expect that the moderating rate of decline in investment spending will exert less drag on the economy and that development in itself will help GDP growth. Also, I still have great faith in the promise of technology, and, anecdotally, I'm hearing more stories suggesting that businesses are anxious to get back to spending on certain kinds of equipment, especially information technology and related software. Nevertheless, the path and timing of this return to capital spending — even on equipment — are very unclear at this point.

Still another important difference in this downturn — and therefore also in the coming recovery — has been inventories. Businesses have been running down inventories over the last year or so, whereas in previous downturns accumulating inventories ultimately forced firms to liquidate at huge losses. This time, however, inventory adjustments were much more rapid, and now the contraction in inventories seems to be leveling off. To be sure, this period of inventory liquidation isn't over yet for all firms, but the important thing is that inventories have not placed businesses in as sharp a profit bind as in the past. Actually, if consumption growth remains at current, moderate levels, businesses will soon need to begin to produce more just to meet demand.

Different expectations for a different recovery

Over the course of the current downturn, inventory adjustments have been more rapid and substantial than in previous recessions — businesses have been more proactive and less reactive. At the same time, consumer spending and housing have remained stable and have helped support overall economic activity. If you think you detect a theme here, you're right: Just as we're living through a different kind of contraction — I think we're going to get a different kind of recovery, too.

We probably ought to reset our expectations accordingly.

I'm concerned that there may be a temptation to compare the recovery (when we conclude that it has arrived) to 1996 through 2000 and wonder what's wrong with the economy. "Why isn't GDP growing at 4 percent?" There may also be the temptation to compare the recovery to previous, sharper rebounding recoveries and wonder — again — what's wrong with the economy. "Why aren't we growing any faster?"

What we need in the coming months is a longer-term perspective. The economy is working its way through a serious economic imbalance in the corporate sector. It's worth recalling that when we've done this in the past, things have been much worse. The current contraction, though, has been less acute than previous recessions.

So we probably ought to look on the bright side. A different recovery is indicative of a different kind of economy — of an improved economy. The flexibility of our financial system has helped to sustain residential real estate in the face of a serious economic adjustment in the corporate sector. And low and stable inflation has enabled monetary policy to respond aggressively over the last 12 months.

It’s far too soon to conclude that the long-term future is one of relatively mild recoveries in return for relatively mild recessions. In the short term, though, I do think it’s likely that that the approaching recovery will be a good deal more moderate than previous recoveries. But the developments that have helped deliver us through the downturn — the faster inventory adjustments, the stronger and less volatile consumer and housing sectors — will help ensure a future of more solid (if also more moderate) growth.

As you might say here in Tennessee, that sounds pretty good to me.

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