The U.S. Economy: Getting Back on Track

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Thank you Meredith [Jarrell]. You've been a good friend for a long time, and you make me feel welcome.

I was glad to get Mike Garrigan's invitation to speak to you today. It's been too long since I was last in Columbus, and since I've always thought your city was one of the state's best-kept secrets, I was already inclined to accept the invitation. But then Mike threw in the clincher. "P.S. Mary Reed says you have to come!"

Every civic club has to have some kind of whip-cracker to keep things on track. But you need a *firecracker* to grow as big and successful as the Columbus Rotary. At the Downtown Atlanta Rotary, where I'm a member, we've heard good things about your club, so I'm really glad to have met the woman behind your success. Mary, if these folks don't treat you right, we can put you to work in Atlanta.

Let me also add that judging from what I saw around town this morning, Columbus isn't going to be a secret much longer. The River Arts Center, the Springer Opera House, the Total Systems campus, this place? If that's what you see on a quick drive through town, I can only imagine what's going on behind the scenes. It looks to me like Columbus has a very bright future.

Depending on which calendar you keep, we've either just opened the books on a brand new fiscal year? or we've got about 90 days to go 'til we can close them on the current one. Either way, it's a good time to consider what's happening with the economy, and that's what I'd like to do in the next few minutes.

I'd characterize the U.S. economy as plodding along but moving in the right direction—forward. The economy has basically emerged from recession and shifted to recovery. The scorekeepers at the National Bureau of Economic Research haven't officially declared the recovery's arrival, but the data seem to be telling us that's the case.

Gross domestic product, the broadest measure of growth in the economy, grew a strong 5 percent in the first quarter of the year, but only a little over 1 percent in the second quarter and probably somewhere around 3 percent last quarter (those numbers will be out shortly). Just about everyone in this business, including me, anticipates continuing uneven growth over the next several quarters, and I certainly don't expect a return any time soon to the long run of 4, 5 and even 6 percent growth we experienced in many quarters in the late 1990s.

Net job creation has been weak this year, averaging only around 40,000 jobs a month since May compared to about 200,000 per month during the periods of extended growth in the late 1990s. The unemployment rate may continue to bounce around over the next few quarters, but at around 6 percent, it remains much lower than it was when we emerged from the last two recessions. Still, we have a long way to go to recover all the jobs lost over the last couple of years. And while the employment situation seems to have stabilized after 12 months of job losses, it wouldn't surprise me to see some more months of slow job growth, just as we saw in the 1991 recovery.

In some parts of the country, the economy has deteriorated significantly over the last two years. Back home in Atlanta, for example, which accounts for some 55 percent of all jobs in the state, an estimated 63,000 jobs were eliminated between August 2001 and August 2002—a decline of nearly 3 percent. Those loses have been concentrated in many of the sectors that Atlanta specializes in. Construction employment is down by around 15 percent over the year, the product of a weak commercial real estate sector and less ambitious business expansion plans. (The trend this year in commercial real estate has been consolidation of office and industrial space.) Employment is down about 7 percent in the transportation services sector, which includes the critical airline industry. It's down by the same amount, too, in business services, which includes computer and data processing. And hotel employment in Atlanta has fallen nearly 9 percent on weaker business travel and convention traffic. Here in Columbus, by contrast, total employment has fallen less than 1 percent over the last 12 months. This difference is explained in part by the fact that the manufacturing sector, which took a much bigger hit very early on during the recession, has shown some tentative signs of recovery since earlier this year, and manufacturing accounts for a relatively greater share of employment here than in Atlanta.

Because consumer spending has moderated considerably over the last year, retail and wholesale trade employment has also declined. In Atlanta, for example, retail trade employment fell by 4 percent between August 2001 and August 2002, and by about 5 percent in Columbus. Falling retail and wholesale trade employment was a function of the intense competitive pressures that accumulated when consumer spending stopped growing at the remarkable pace of the late 1990s. Even so, while consumer spending never actually declined—an unusual development in any downturn—the deceleration was significant. Real consumer spending growth averaged between 4½ and 5 percent from 1998 to 2000; it's now growing at about half that rate. The latest numbers suggest that consumers are adjusting to lower expectations of real income gains, but there have been pockets of spending growth. For example, while the period of traditional back-to-school shopping for clothes and school supplies was largely disappointing this year, sales of housing-related items such as furniture and home furnishings were strong, with low interest rates helping draw consumers to the showrooms. And with automobiles selling at a rate of about 17 million a year, it's not like car shoppers have been going without.

Finally, after falling hard for several quarters in a row, it appears that business investment spending has stopped hemorrhaging; the rate of decline in investment in equipment and software seems to have leveled off in recent months. But it has to be said that a new investment boom like the one we witnessed in the late 1990s is far from imminent. Spending on traditional capital goods—everything from aircraft to office space—remains under intense pressure. Across the region, I'm hearing that the investment spending taking place these days is motivated more by a desire to cut unit costs than to grow revenues. And even this more cautious, conservative investment approach remains under the highest level of scrutiny.

The question for all of us is why things aren't improving more quickly. The answer, I think, has to do with certain characteristics of the hole we're trying to climb out of, and how we got there in the first place.

Usually, the down phase of a business cycle takes place broadly and across almost all economic sectors: Consumer spending declines, and companies stop hiring, cut jobs, and/or pare back investment plans in response. But as I said a moment ago, that is *not* what has happened over the last 18 months. In fact, consumer spending has been—and looks to remain—reasonably solid. (Thank goodness.)

The main factor in the latest business cycle was over-investment. As you've probably heard, investment spending grew nine years straight, from 1992 to 2000—an unprecedented run in the post-World War II period. In the '60s, '70s, and '80s, investment growth was tremendously volatile—up 20 percent one quarter, down 20 percent the next. But in the mid- to late 1990s, investment spending simply grew—no spikes, no troughs, just a strong, steady ascent. For example, between 1992 and 2000, real investment in equipment and software averaged more than 10 percent growth on an annualized basis. Last year, by contrast, spending on equipment and software *fell* by over 6 percent.

Because the current prospects for business investment are so heavily influenced by previous investment decisions, it's worth considering the developments that contributed to them. Why was investment spending so strong in the 1990s?

The short answer is that profit opportunities drove business investment—that the cash flow generated by new projects and products was expected to increase by more than the cost of the investment. The Internet, fiber optics, wireless and all the rest: The memory of these industries may induce an awful lot of heartburn today, but just a few short years ago, the so-called smart money was pouring into them. And, of course, there was plenty of money to go around, with very low interest rates, as capital flowed into the United States as a kind of global safe haven after the Asian and Russian financial crises.

For a while, the investment boom in the United States was self-reinforcing. As businesses cranked up production lines to satisfy expected investment demand, they hired more workers, who went out and bought more goods and services. And so on. But it all came to an end when cash flows failed to meet expectations. Demand simply never caught up with the increase in capacity produced by all that investment.

Now, it's true that cash flow projections are often the most unpredictable element in investment planning. Still, it's worth asking how so many smart people got it so spectacularly wrong. The main reason, I think, is that too many businesses made the same big bets. There were enormous profit opportunities in the Internet, fiber optics and wireless, and it actually *did* make sense to make huge investments in them—as long as not every company did it. The problem, of course, was that too many did; they didn't think they could afford *not* to invest.

It's been a while, but we've seen this before. In the 1870s, to mention one of the more famous examples, the great railroad tycoons tried to extend their empires by investing big in new mileage out west. (You may have read about this in the Wall Street Journal last week.) Those investments made sense on their own terms and they later played an essential role in the country's geographic and economic expansion. But in the end—and it took some time for the end to play out—there was only a handful of winners. We saw the same thing in commercial real estate in the 1970s and 1980s. In retrospect, a little more restraint would have been advisable in the late 1990s too. But business did what businesses do, which is to act in their own self-interest. Unfortunately, though, the assumptions that informed their self-interest were off-base. Businesses overestimated the size of the market and their share of it. All investments carry the risk of insufficient cash flow, and when revenues didn't come through as anticipated, investment plummeted.

Still, not everything about the recent boom was illusory. Productivity—output per worker per hour—improved dramatically in the late 1990s and is still growing. In fact, a kind of productivity growth is reflected in the lackluster job numbers we've been witnessing, since output is growing faster than job growth. The critical development, though, is that productivity growth reinforces business profitability and wages and will continue to have a healthy impact on the economy.

So where are we now? For the last 18 months or so, we've been working our way through the imbalances of the previous business investment cycle. A lot of capacity built up in the boom years won't be used at all—or at least not for a very long time—and so is being written off. Redundant plants are closing, and companies are merging or going out of business. Put another way, capital assets are being reallocated among the owners of the capital. These adjustments are an essential function of our financial system. And while it's an awful, uncomfortable, painful adjustment process in the short run, it's also the only way to shore up the foundation for healthy long-term economic growth.

We're working our way through some other excesses too. Specifically, I mean the ethical lapses that took root in too many corporate boardrooms. As we now know all too well, in some cases when there was no way businesses could meet outsized investor expectations, executives either fabricated their results or otherwise devised new ways to mislead stakeholders. Some of these cases will end in jail terms, but the net effect, I hope, will be a return of confidence. In the interim, however, ethical uncertainty remains another deterrent to investment.

So firms have been working to restore conditions that will be more conducive to business investment—on the balance sheet and in the boardroom. When businesses do start to invest again, as they eventually will have to, the economy will move forward at a faster pace.

At this point, you may be wondering why the expansion hinges in large measure on the return of business investment. After all, business investment accounts for only around 12 percent of GDP. Why does future growth depend on business investment? The answer is that business investment in productive capacity and new technology generates productivity, which improves cash flow and profitability, which supports wage growth, which, in turn, supports consumer spending growth.

Since January 2001 the Fed has been trying to help facilitate the transition from recession to recovery by aggressively cutting the fed funds target rate to the current level of 1¾ percent. This has lowered the short-term cost of capital and, I think, helped stanch the hemorrhaging in the investment sector. Remember, though, that monetary policy affects only the price and the aggregate amount of credit in the economy: *Allocation* of that credit—for better or for worse—is carried out by financial markets. And it's my strong belief that markets—imperfect though they may be—make better decisions about resource allocation than individuals or policymakers.

I mention this by way of pointing out the risks to the U.S. economy. And yes, one of them—a small one, in my view—is that financial resources are being misallocated and that the business sector isn't getting what it needs. Having gone all the way *in* during the late '90s, investors are now nearly all the way *out*, and just as some bad ideas got funding then, some good ideas are almost surely going without now. (This presents some great opportunities for ambitious entrepreneurs and venture capitalists, but it also underscores how difficult things are in some industries.)

Another risk is the employment situation. As I mentioned briefly a minute ago, my own view is that unemployment has probably settled out and is not likely to rise much more. But, again, any significant job creation will depend on the prospects for firms returning to stable profitability. If the profit outlook doesn't improve, though, and if firms have to make significant job cuts because of some additional shock, then consumer spending would take a hit and so would business investment.

One final risk is the uncertainty associated with developments in the Middle East, Latin America and Asia. Any one of these hot spots has the potential to deliver a large negative shock to the U.S. economy; the uncertainty and anxiety caused by geopolitical developments in these regions is having an effect on financial markets and the economy even now.

Even with the current accommodative stance of monetary policy, the other thing we need right now is patience—the patience to allow the U.S. economy to work, to get itself back on track. Obviously, though, we've also got to keep an eye on the risks in the economy.

I realize that if you're unemployed, or trying to meet a payroll, or putting together a budget for next year, it's frustrating to hear the word "patience." But the investment imbalances took a long time to develop, and it's taking us a long time to work through them. By next year, I think it's pretty likely that the balance sheet adjustments we're witnessing will have put many firms in a better position to finance capital investment. But profitability remains the determining factor. Also, the fact that businesses made some bad investments doesn't mean they're going to quit investing; investment may never be risk-free, but it's usually not without a return, either. Moreover, technology changes so rapidly that as a practical matter businesses need to keep investing—and the longer they've put it off, the more substantial their investments will have to be. In addition, businesses will need to invest in inventories just to meet demand that occurs over the regular course of the recovery. These are all developments we'll be watching.

Once we get past the month-to-month volatility accompanying the current transition and there's more clarity about the risks we're facing, I think the most likely path over the next year or so will be one of moderate growth. I realize this may not sound so great compared to the outsized gains we witnessed in the late 1990s, but it ought to be a good bit more sustainable.

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