

Speeches

The Economic Outlook for 2003

**Remarks by Jack Guynn
President and Chief Executive Officer
Federal Reserve Bank of Atlanta
Rotary Club of Atlanta
January 6, 2003**

Thanks, Suzanne (Boas). Some of you may know that John Wieland ended his term as chairman of our Atlanta Fed board of directors at the end of this past year. There are many, many things I'll miss about John, but I definitely won't miss his unusual and totally unpredictable introductions. If you think the economy's full of uncertainty, you ought to ask John for an introduction.

So, Suzanne, thank you for a mostly straightforward introduction and, more importantly, for your service on our Fed board of directors. Suzanne's work with the Consumer Credit Counseling Service has given her a perspective on the consumer that's been extraordinarily helpful to us at the Fed these last several years.

I also want to thank all of you again for the support and insights you've offered over this last very challenging year. I know the more jaded among you think I start these talks with a ritual thanks by way of imploring my toughest critics to cut me some slack. And maybe you're a little bit right. But part of my job is to bring to our FOMC discussions anecdotes and insights about what's really going on in the economy, and I can't do it with numbers alone. Your stories — even your gripes and complaints — really are helpful. So, thanks again.

I'd like to begin with a quick review of 2002. Fourth quarter GDP numbers won't be in for a couple of weeks, but it looks like the economy grew in each quarter of last year. By this measure, then — and compared to 2001, when GDP actually contracted in three quarters — the economy was in recovery. But it didn't feel much like a recovery, did it? At least that's what I heard from business leaders all over the region last year. A typical comment went something like this: "Things may not look too bad from 30,000 feet, but they're a little different on the ground."

In fact, this *has* been a very different kind of recovery. And the critical difference, so far, has been the absence of a decline in consumer spending during the recession followed by a consumer-spending boom.

In most recoveries since World War II, production has surged as consumers came back into the marketplace and bought big-ticket, credit-sensitive goods they deferred during the downturn: things like cars, sofas and refrigerators. The rebound in consumer spending is usually an important signal to businesses. It tells them first to begin building inventories and then, if consumer demand keeps growing, to increase spending on capital equipment and facilities, recall laid-off workers or put up help-wanted notices.

But consumer spending not only did not decline during the recent downturn, it actually grew about 2 percent over the last two years. And in interest-rate sensitive sectors like homebuilding and automobiles, consumer spending grew much faster; in fact, I've heard it argued that there actually was a sales *boom* in those industries the last couple of years. Now to be sure, as an economic policymaker, I'm glad consumers stayed the course during the recession: There might well not have been any recovery to discuss in 2002 if consumers had zipped up their wallets. For most businesses, though, this two-year, low-level buzz — not going away but not getting much stronger, either — has made it very difficult to pick up, or count on, a strong growth trend in the consumer sector.

For that matter, the other signals we look for in a recovery weren't particularly resounding this past year, either. Manufacturing activity picked up steam in the first half of the year, then slowed again later in the year. Investment in equipment and software showed some signs of life in the fall but stayed mostly flat over the year while office and industrial vacancy rates increased. Layoff and bankruptcy announcements dominated the business pages last year, and recovery continued to elude some service industries entirely — especially parts of the airline, telecom and retail sectors.

In short, as recoveries go, 2002 was something less than awe-inspiring.

But then the downturn that preceded it was far from ordinary too. The recession that began in March 2001 was caused by a business investment bust that followed a multiyear boom. By now, it's a too-familiar lament. With the benefit of hindsight, we know that in the late 1990s too many businesses, especially those in high-tech industries, anticipated too much demand — and often invested too much. Then when demand came up short, many firms found themselves with too much inventory, too much capacity and too many employees. Even before the last recession began two years ago, businesses started curtailing investment and restructuring balance sheets and business models in an effort to shore up profitability. And since in the short run businesses have less control over revenues than costs, that's where their efforts have been concentrated.

As we're all well aware, the layoffs and plant closings and balance sheet adjustments continued unabated last year. And that probably accounts for some of the anxiety and uneasiness about the recovery. Of course, it's difficult to discuss the restructuring that took place last year without sounding callous toward the investors, companies and employees who bore the brunt of the adjustments. But my view is that many of these painful developments in 2002 were part of a process that will make the economy much healthier — leaner, stronger and more agile — this year.

As for what 2003 looks like to me, I expect that if consumer spending and housing hold up and business profitability continues to firm, there is every reason to believe that GDP will grow around 3 percent — slightly better than last year. One important distinction, though, is that growth ought to be more broad-based in 2003 and less concentrated in particular sectors like housing and autos. Inflation, too, should remain in the same range as last year, at about 2 percent as measured by the consumer price index (CPI); I don't think inflation will be a source of uncertainty for businesses and consumers in 2003.

This year, I think we'll finally begin to see results from the rounds of layoffs and investment deferrals we've witnessed the last few years. This year, instead of the resounding starting boom we usually expect from the consumer sector, businesses should see continued improvement in profit growth — smaller than the late 1990s boom years, perhaps, but no less real. When that happens — and when firms see that profits are sustained — I think businesses will start shifting their priorities away

from short-term cost reductions and toward a longer-term focus on product innovation and new sources of revenue. This shift should show up in greater investment spending and growing employment.

All of which is to say that while the economy should get better as we move through this year, we'll have to look beyond the numbers to see the strongest evidence of improvement.

The jobless rate, for example, may well get a little worse before moving in the right direction later this year. This is a typical pattern in most recoveries: As the economy picks up steam, people who had not been looking for work and therefore hadn't been counted as unemployed begin to search for jobs. But because there are more new job-seekers than new jobs early on in the recovery, the unemployment rate actually increases. That's exactly what happened when the last recovery began a dozen years ago.

I think there's a small silver lining for the economy in the consumer sector too. It's true, of course, that after three straight down-years for the stock market, consumers haven't exactly been feeling any wealthier, and that businesses have been reluctant to start hiring again. It's also true that the economic uncertainties associated with the possibility of war could weigh on even the most enthusiastic shopper. So, yes, after 11 straight years of increases, a consumer-spending boom is very unlikely this year. But I think that's a healthy thing, because it suggests consumers are being smart: It would be foolish to go on spending like it's 1999 when the economy's not growing at a 1999 pace. Also, the fact that consumers have continued to spend demonstrates that they're not panicking, and their willingness to take on a little more debt suggests that they're reasonably optimistic about future income prospects.

Moderate growth in consumer spending, if that's what we get, has important implications for businesses too. It means they're not likely to launch a big run-up in inventories or capital investment right away, until profits firm up a bit more. Also, inventory-to-sales ratios have been trending down for several years now as technology has allowed more businesses to adopt just-in-time inventory practices. And, of course, the excess capacity that continues to plague some industries — and that I think many of us considerably underestimated when the recession began — may continue to discourage business investment in those sectors.

Productivity growth also has implications for business investment. Beginning in the mid-1990s and continuing throughout the recession, productivity has continued to show impressive growth. While over the longer run these impressive productivity gains are an unquestionable positive for the economy and will result in higher real incomes, they may also act as a slight damper on employment growth in the short run. Since businesses can already produce more goods with the same number of workers, they may not need to start hiring right away.

So I think it will be important to look a little deeper than the usual indicators this year. What we'll see, I believe, is an economy that is well along in a difficult restructuring process and that is reestablishing a strong foundation for solid future growth.

And that, I think, is a remarkable tribute to the resilience of the U.S. economy.

Think back a year ago, to January 2002. This time last year, the memory of September 11 was still four months raw. The airlines had taken a big hit but were basically still on their feet. Enron's collapse was nearly complete but seemed to be an isolated incident. And for the second January in a row, the major stock indexes kicked off the New Year lower than they had been the previous year.

Then things got worse. As the noose tightened on Al Qaeda, U.S. and Western interests were attacked in Indonesia, Yemen, Kenya, the Gulf and elsewhere. Enron turned out to be the first member in a new wing of the corporate hall of shame that also welcomed Dynegy, WorldCom, Adelphia and Global Crossing. US Airways and United Airlines declared bankruptcy, and the aviation industry continued to struggle with the effects of a seismic shift in transportation demand. And after swinging wildly all year long, the major stock market indexes finished the year well below where they started, extending stocks' losing streak to three straight years for the first time since 1941.

You've heard me speak in the past about the role that positive shocks had on the short-term performance of the U.S. economy: the surge in demand brought about by Y2K, the financial flight-to-quality to the United States that resulted from the Asian and Russian crises, and various disinflationary energy gluts, among others. Last year, though, nearly all the breaks went against us. Many of the things that could not have gotten worse did get worse (though obviously not as bad as they might have). But despite all of that, the economy still managed to grow.

A few observations. What happened with the U.S. economy last year could only have happened in an economy willing to tolerate the economic and financial risks that result from innovation and technological change. Not many other economies, if any, could have managed the transitions of the last few years so quickly and have returned to growth in the process. So the U.S. economy's performance last year ought to be a source of pride. That's not to say, however, that it ought to be a source of satisfaction. For the sake of all those folks caught up in the economy's transition, we ought to hope for better — and, again, I do think things will continue to improve as we move through 2003.

Above all, though, we shouldn't be disappointed. Most people probably think of recessions and recoveries as distinct, discrete events, so there's an understandable tendency to associate bankruptcies, layoffs and all the rest with recession and to assume that they end when the downturn ends. But in a dynamic economy, "creative destruction" — the phrase economist Joseph Schumpeter used to describe the process of innovation that he called "the essential fact about capitalism" — takes place all the time, without regard to business cycle dating or terms like recession and recovery. The restructuring we've witnessed these last few years — before, during and after the recession — is an unavoidable aspect of the process of creative destruction. Of course, no thoughtful, compassionate person would deny that restructuring is a painful and unpleasant process. But we also shouldn't be pessimistic: The United States remains the world's strongest economy in 2003 precisely because it's able to restructure so thoroughly and so quickly. Since expectations have a role in the performance of the economy, I think we ought to keep in mind that our ability to restructure is a comparative advantage and not a liability.

The U.S. financial system offers some comparative advantages too, and I think it's worth recalling some differences in that sector since the last recession a dozen years ago. In 1990-91, there was a perceived credit crunch associated with the weakened balance sheet condition of the banking system. So far, the banking sector has weathered the economic downturn and appears in much better shape than it was in the early 1990s. This improvement is in no small part attributable to changes in bank regulatory and capital adequacy policies, which resulted in healthier bank balance sheets this time around. And the financial losses that have taken place in the adjustment process have been more widely spread among an array of capital providers.

Of course, the Fed has had a role in the restructuring process too. The 11 rate cuts we implemented in 2001 were punctuated with a single 50 basis point reduction

last year, which brought the fed funds target rate to 1¼ percent, the lowest it's been in over 40 years. The low interest rate environment has helped consumers maintain their spending throughout the downturn and the recovery. It has also helped businesses work through the adjustment process I've just discussed.

As recoveries go, this one is shaping up to be one-of-a-kind. But then it followed a unique downturn too, a recession that was initiated by a collapse in business investment but then substantially tempered by continued moderate growth in consumer spending. The absence of a starting boom in consumer spending and housing has made it difficult for businesses to figure out what the long-term growth trend for the economy will be. Contributing to this uncertainty, of course, is the ongoing possibility of war. The outlook I have just described, for moderate economic growth over the period immediately ahead, reflects these factors and my belief that businesses and consumers will need a little more time to adjust to them.

I understand that all of this is disappointing to those who are still longing for a return of the late 1990s. But it should not obscure the fact that the U.S. economy made very solid progress over the last year, and under some extraordinarily difficult circumstances.

The moderate growth I expect in 2003, with improving balance across sectors and an eventual pickup in investment spending and employment, would be good news by almost any standard — except, perhaps, the extraordinary period of the late 1990s that immediately preceded the recession. What we've experienced the last year or so remains a remarkable tribute to the resilience and innovation of the U.S. economy. With a little bit of patience, I think things will feel better over the course of the year.

[Press Release](#)

CONTACTS

Jean Tate
404-498-8035

RELATED LINKS

- [Play \(MP3\)](#)