

Speeches

The State of the Recovery

**Remarks by Jack Guynn to the
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Thanks for that introduction, Miller. I was happy to accept Miller's invitation to speak to you this evening.

Miller has made some great contributions as a director of our Birmingham branch, so the possibility of picking up some insights from two or three dozen — or two or three hundred — other Miller Wellborns was appealing.

But I have to confess that when Miller told me I'd be speaking to the Birmingham Traffic and Transportation Association, I wondered whether my audience would be a bunch of Jefferson County road planners. When he told me what you all really do, though, it reinforced my long-held belief that the actual significance of an association is inversely related to the ambition of its name.

And that gets to the next reason I wanted to be here: This country was built up around its ports and rivers and railroads. Few sectors are more important to its history or its economy than the transportation industry. Part of my job on the Federal Open Market Committee (FOMC) is to inform our discussions of monetary policy with anecdotes and insights about what's really going on in the economy, and I can't do it with numbers alone. So I appreciate all the real-world stories many of you shared with me during the reception.

Let me begin with a quick overview of the state of the recovery. GDP growth ranged widely over 2002: 5 percent annualized in the first quarter, 1.3 percent in the second quarter, 4 percent in the third quarter, and 0.7 percent in the fourth quarter. As recoveries go, that works out to a fairly respectable average of somewhere around 2.4 percent on the year. But the big swings made the recovery seem like something else.

Compared to the last downturn, which began more than a decade ago, this recession and recovery really have been different. Manufacturing employment is way off in this recovery compared to the last one, while construction employment — because of homebuilding — is relatively stronger. And capital spending on equipment and software, which is one of the keys to renewed expansion, fell back to 1999 levels and is only recovering slowly.

Another big difference in this recovery is that there has been no consumer-spending boom. And there's been no boom, in part, because consumer spending never declined in the first place during the 2001 recession.

So a lot of the things we usually expect to see in a recovery are missing. What I want to do this evening is take a look at what's different in this recovery, as well as how we reconcile measured growth in the economy with the absence of the usual signals.

In most recoveries since World War II, growth has surged as consumers loaded up on the big-ticket, credit-sensitive goods they put off buying during the recession: things like cars, sofas and refrigerators. This consumer-spending rebound is an important signal to businesses. It tells them first to begin building inventories and then to increase spending on capital equipment and facilities, recall laid-off workers or put up help-wanted notices.

But in the downturn that began two years ago, consumer spending never declined; in fact, it actually grew — real personal consumption expenditures grew by 2.5 percent in 2001 and over 3 percent in 2002. And it grew even faster in interest-rate sensitive sectors like housing and autos. To be sure, all of this consumer spending was good for the economy: There wouldn't be any recovery to discuss if consumers had cut back on their spending. And spending probably would have been weaker if incomes had fallen as sharply as they did in the last recession. Even so, the absence of a decline in consumer spending also means there's unlikely to be a sharp rebound either.

What this means going forward is that the recovery's going to be driven by growth in business investment spending and a pickup in employment, supported by solid, but not dazzling, consumer-spending growth.

I actually do think businesses will start to increase the rate of their investment spending soon (and, anecdotally, I'm hearing that many already have). But it's possible that we won't begin to see much clear evidence of it until the second half of this year.

For one thing, as I just discussed, the absence of a consumer-spending boom means businesses don't have the unambiguous signal they usually look for to start investing again. The two-year, low-level buzz — not going away, but not getting much stronger, either — makes it difficult for businesses to pick up, or count on, a strong growth trend in the consumer sector. That makes it difficult for them to plan investment spending.

For another, industrial capacity utilization is still off: At around 75 percent, it's well below the 80 to 85 percent range we witnessed during much of the 1990s. Obviously, this decline is the legacy of the last decade's high-tech boom, when too many industries anticipated too much demand and invested too much. For the last couple of years, those industries have been in profit-restoration mode, cutting costs by laying off workers and idling plants. Before many of these industries begin to invest in new capacity again, they'll first bring some of their underutilized capacity back on line — running two shifts instead of one and so forth.

A related concern to me — and this is not strictly economic — is that the exuberance of the late 1990s, and the downturn that followed it, has made executives gun-shy about taking risks. I can't say that I blame them, of course! But it would not be good for our economy if executives become too risk-averse. They simply have to take them. And one kind of risk — an increasingly reasonable one, I think — is business investment.

I'm sure that risk aversion and investment postponements are also related to another big unknown factor — the possibility of war. That's another very large source of

uncertainty, and, for now, many businesses are simply holding off additional investment until they have a better picture of what's going to happen overseas.

So there are a lot of reasons to be concerned about business spending. But there are also, I think, some good, solid reasons to be optimistic.

First, the painful rounds of cost-cutting we've witnessed these last few years are making a difference. No, we surely haven't seen the last of them, because in a dynamic economy businesses restructure all the time, recession or recovery. But the restructurings are working. Slowly but surely, profit growth is returning. And profitability has to be present before businesses will consider expanding investment and recalling laid-off workers.

Another thing for business to be optimistic about is continuing productivity growth. Many things that happened in the 1990s later fell apart, but, happily, productivity wasn't one of them. We learned last week that productivity growth declined slightly in the fourth quarter of 2002, but the level of labor productivity was still 3.8 percent higher than a year earlier. Rising worker output pushes unit costs down, which reinforces profitability. Over time, this also allows businesses to raise workers' wages without increasing prices.

Finally, for well over a year now, monetary policy has been aggressively expansionary. This has been a boon for consumers and most apparent in the auto and home-building sectors. If we haven't yet seen an expansion in demand for credit from businesses, they have at least been able to refinance existing debt at lower rates. I do think, though, that business demand for capital will grow, especially when some of the current geopolitical uncertainty is resolved.

More than a few times, I've heard this economy referred to as a "stealth recovery." You'd have to drive up to Huntsville for a full briefing on stealth, but I do think it's fair to say — if I can borrow that aviation analogy — that right now the recovery's obscured by some of the clouds I just mentioned. The recovery is real — it's showing up on our radar; we know it's here — it's just not as obvious as it usually is.

Setting aside the towering exception of war — which, to a pilot, I suppose, is like saying "except for that mountain" — I think the recovery will be a lot more apparent to all of us in the second half of the year. Until then, though, some numbers may get a little worse before they start to show improvement.

Unemployment, for example, may still increase a bit before moving in the right direction later this year. Actually, that is typical of most recoveries. Usually, when the economy begins to emerge from a recession, people who hadn't been looking for work — and therefore hadn't been counted as unemployed — go back into the labor market. But since early in a recovery there are more new job-seekers than jobs, unemployment actually increases.

It may also be a while before manufacturing employment makes a turn for the better. Manufacturing employment continued to fall through 2002 and still has not stabilized. Even when it does, though, it's probably more likely that temporary workers will be added first on an as-needed basis and that permanent workers will only be recalled as market conditions firm up. What this means for the overall composition of labor market growth is that we'll probably see relatively more employment growth in services than in manufacturing. This was also the case in 1991 and 1992.

Also — and this is more of a reiteration than a prediction — I don't think consumer spending is likely to accelerate for a while. Just to be clear, I certainly don't expect a decline in consumer spending. But considering that we've had three straight years of stock market declines, and that many businesses are still in cost-cutting and lay-off mode, consumers are being understandably cautious. I think that adds up to only modest growth in consumer spending for the near term.

So while the economy is in recovery by a GDP measure, you could be forgiven for thinking otherwise. The big things we usually associate with a recovery — a consumer-spending boom, larger business investment spending increases — haven't materialized, largely because of the nature of the recession and the boom that preceded it.

And I think it's essential to keep that in mind when you're thinking about the economy's growth. In the late 1990s, huge segments of the U.S. economy were gearing up for much faster growth: More than a few industries thought the U.S. economy had transformed itself and that, in the future, overall demand would increase at a much faster clip than usual. We know now that demand in fact slowed below expectations, and with painful results.

The temptation, and I'm guilty of it myself sometimes, is to assume that when the adjustment ends, the economy can go right back to where it was before all the unpleasantness — to assume that implications end with the event. But that's not how the economy actually works. Imagine one of your truckers is making a cross-country haul. He's got it in tenth gear, he's making good time, he's expecting a fast trip. But then something happens that he didn't expect — road construction or bad weather or heavy traffic — and he has to hit the brakes and downshift hard.

That's what happened two years ago. Then last year the economy started to accelerate again. Even so, while that period of deceleration is behind us, its impact on the engine, on the transmission — maybe even on the distribution of the load it's hauling — continues to affect the rate it's accelerating now. Yes, it will take a while to get back up to cruising velocity, and we may never actually reach the speed we might have expected to make three or four years ago. But the fact that we're not moving as fast as we were in the late 1990s, or that we still hit the occasional pothole, does not mean that we've stalled out.

I think that's where we are with this economy. We've worked our way through some tough adjustments, and we've started along a good path to solid growth. As profits continue to improve, investment spending and hiring will pick up. The recovery then will be a lot more apparent to us all.

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