

## Speeches

### The U.S. Economy: Where Are We Now?

**Remarks by Jack Guynn at  
Bridgewater College  
Bridgewater, Virginia  
March 24, 2003**

Thanks for the nice introduction, and good morning to everyone. I'm glad to be home again, with the people who know me best. And it's always great to be back in the valley.

I should tell you that before I accepted President Stone's invitation to come to Bridgewater, I checked to be sure it was okay with Al Broadus, president of your Federal Reserve Bank of Richmond and one of my favorite colleagues. President Broadus wanted me to tell you that he was just delighted I was coming home to help keep the folks in his region informed about what's going on in the economy. He also wanted you to know that he was reserving the right to come here some time later to set you straight if he disagreed with something I might say today. All of which is to say that I speak only for myself this morning, and not for Al or any of my other Fed colleagues.

I'd like to talk today about what I'm seeing in the economy, where I think we are and what I think about what might lie ahead.

Gross domestic product (GDP), the broadest measure of economic activity, has been growing for five quarters in a row now, since late 2001. This kind of growth is usually evidence of an economic recovery, but the official scorekeepers at the National Bureau of Economic Research (NBER) haven't officially declared that a recovery has arrived. The incoming data on things like employment and production have been something less than positive, and the NBER will want some clarification that all those factors are pointing in the right direction before declaring that the economy has officially turned up. But you probably don't need to look at statistical releases to know that the economy hasn't completely turned the corner just yet. Because if you're like most folks I talk to these days, you're thinking, "It sure doesn't feel like the kind of recovery we've experienced in the past."

I have to admit that the course the economy has taken the last year has been a little surprising to me. Like many economic forecasters and many other policymakers, I had expected the recovery to become a lot more evident around the second half of last year. And if you only look at GDP, I suppose you could argue I was right.

Now, it's true enough economic data can be particularly volatile—or "noisy," as economists say—in economic turning points like the one we're in now. But even allowing for the greater statistical noise, the economy appears to be gaining traction more slowly than I had hoped for or expected. Nevertheless, I still believe that the economy is expanding modestly, and I still expect to see an uptick in the rate of growth later this year and as we move into next year.

But before I make the case for optimism over the medium and long term, I want to address, right up front, developments that have been holding back a more vigorous recovery in the short term.

The biggest impediment to a fuller recovery at the moment is broad and pervasive uncertainty. Of course, there's always some uncertainty in this business, but under more normal circumstances we can evaluate and assign probabilities to the various risks we can identify. But the risks we're facing now are unusually large and difficult to quantify: uncertainty associated with the war in Iraq, uncertainty about terrorism, uncertainty about oil prices.

If you've been following the Federal Open Market Committee's statements since last fall, then you know we have been referring generically to all of these risks with the phrase "geopolitical uncertainty," which is just vague enough to sound a little mysterious. So I think it's worth considering for a moment the very real impact that geopolitical uncertainty is having on decision makers right now, and how the resolution of some of these tensions ought to help the economy pick up some momentum.

As you probably know, the big story in the recession we've just been through was the collapse of business investment spending. First it was the bursting of the high-tech investment bubble. The mop-up job that followed strained balance sheets to the breaking point in several industries and—as I'll discuss further in a moment—will likely continue to be a drag in those sectors even after geopolitical uncertainties begin to dissipate.

Last year, though, the business investment story took a new turn. In the third and fourth quarters we actually began to see some modest growth in spending on equipment and software, and although it was not yet a strong rebound, I also started to hear stories from businesses suggesting that orders in some industries were picking up. Arguably, with GDP growing, and with some early signs of renewed investment spending, it appeared the recovery was beginning to gain some momentum. But when investment and employment barely budged in recent months, geopolitical uncertainty—a new kind of uncertainty for this recession—became the primary suspect.

It's useful, I think, to think about the business and individual reaction to geopolitical uncertainty as a way of avoiding or preparing for the bad things that could result from war or a terrorist attack or an oil supply disruption. Down in Georgia they call it "hunkering down," but I've started describing it as "pre-shock mitigation." "Economic shock" is a term economists use, and it's just what it sounds like: an unforeseen development that quickly and dramatically changes relative prices or the expectations of market participants. Shocks can be positive, as with the oil surplus in the late 1990s. But the most memorable shocks in our recent economic history have been negative—OPEC's oil production cuts in the 1970s and the 1990 invasion of Kuwait by Iraq, to cite two notorious examples.

When a shock hits, drastically different circumstances can force consumers and businesses to make equally drastic decisions in response. The run-up in oil prices and the related increases in gasoline, heating oil and natural gas prices leave consumers with less money available to spend on other goods and services. With consumer spending lower, inventories can stack up in warehouses. Orders to manufacturers can fall, and employers find they can get by with less labor. It's a bad situation all around.

Now, if you're running a business, the economy's emerging from a recession and you think something like this is in your future, what would you do? You'd cut your

inventories to the lowest possible level. You'd push your order fulfillment times out as far as you could to allow for the possibility of cancellations. You certainly wouldn't spend money to build a new or expanded facility. And you wouldn't even think about adding anybody to the payroll, unless you absolutely had to. These are all perfectly reasonable, rational decisions.

And they are, in fact, the kinds of decisions businesses are making across the country today, and that they may continue to make—until the risk of staying on the sidelines, hunkering down and preparing for the worst, begins to exceed the risk of taking action. The bad news is that as long as the strong possibility of such a large, negative shock looms, these pre-shock mitigation measures may continue, and the prospects for the economy will probably be left more or less to the bloodied but unbowed U.S. consumer.

The good news, though, is that once we get beyond some of the current geopolitical uncertainties, the fundamentals of the economy seem to be poised for a pretty solid recovery. To make that case, though, and to elaborate on some of the risks that may be with us for a while, I think it's worth considering how this recession and recovery are different from previous economic cycles.

To begin with, manufacturing employment is way off in this recovery compared to the last one while construction employment—because of the strength in home building—is relatively stronger. In the last recovery, service employment broadly was an important source of job growth while the strongest job gains in the current recovery have been concentrated in government and health care. And the last recovery began with a big boost in business investment relative to the period that preceded it: Capital investment spending grew nearly twice as fast in 1993 as it did in 1991. By comparison, capital spending on equipment and software in the current recovery is still more than 10 percent less than the peak level it reached in the third quarter of 2000.

The big difference in this recovery, though, 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.

In the early stages of 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, then to increase spending on capital equipment and facilities and then to recall laid-off workers or begin hiring again.

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, back in 1990 and 1991.

What this means going forward is that an acceleration in growth will have to be sparked by business investment spending, along with continuing gains in consumer spending and a pickup in employment. But again, a rebound in consumption like we've witnessed in previous recoveries is unlikely because of the absence of a decline in consumer spending earlier in this cycle. And in most recoveries, employment gains are preceded by increases in business investment.

So how likely is it that business investment will pick up? Well, once we get beyond this period of geopolitical uncertainty—of pre-shock mitigation—I think a pretty strong case can be made that capital investment will return to respectable rates of growth. But even when geopolitical tensions do recede, businesses will still face some challenges in the short-term.

For one thing, 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, many businesses still have more productive capacity than they need to meet demand. What economists call "industrial capacity utilization" is still pretty far off: At around 75 percent, it's well below the 80 to 85 percent range we witnessed during much of the 1990s. Much of 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. But then consumer-spending growth leveled off at about half the 1997–99 rate, and businesses were left with too much inventory and too much capacity. 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 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 businesses become too risk-averse. They simply have to take them. And one kind of risk—a critically important one—is business investment.

So there are a lot of reasons to be concerned about when business spending will pick up. 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 know that productivity grew only slightly in the fourth quarter of 2002, but the level of labor productivity was still nearly 4 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.

Productivity growth also helps explain some of the broader trends we're observing in the economy (again allowing for the noise that accompanies some of the narrower measurements). As I noted earlier, gross domestic product—the value of our national output—has been increasing for the last five quarters. At the same time, employment has been essentially flat while investment in the stuff workers use to produce output has been weak. What this means is that employees are producing more output per hour all by themselves. That is the very definition of productivity growth. Still, it's worth noting that there is a limit to how much more employees can produce with their wits and hustle alone. And as that point approaches, companies will become much more inclined to invest.

Also, much of the high-tech investment that took place in the late 1990s was in fairly short-lived equipment. As that equipment is fully depreciated and becomes outdated by newer, faster and more productive technologies, companies will begin to make some upgrades. And we should also begin to see some rebuilding of inventories, even if final demand grows at relatively modest rates. Both of these developments will have a positive impact on business investment.

Finally, for well over a year now, monetary policy has been aggressively expansionary. Low interest rates cannot make lingering economic imbalances disappear, but they have been a boon for consumers and have been most apparent in the auto and home-building sectors. And while we haven't yet seen an expansion in demand for credit from businesses, they have at least been able to shore up their balance sheets by refinancing existing debt at lower rates. Again, I think this is a positive development for business investment. Like all the others, though, I don't think we're likely to see all businesses take advantage of the opportunity to invest—even at these historically low interest rates—until some of the uncertainty associated with war, terrorism and oil prices begins to clear up.

For economists, policymakers and businesses, one of the greatest challenges of a recession is trying to distinguish between the regular adjustments that take place over the course of a business cycle—the liquidations and layoffs that allow supply and demand to get back into balance—and any permanent changes in preferences. The distinction usually becomes clear enough after the cycle has ended—we know now, for example, that the big drop in air traffic in the last recession was only temporary, but we won't know for a while whether the current decline will be. In the meantime, though, the absence of clarity is one more level of uncertainty for policymakers and businesses.

Once we move beyond the uncertainty of war, I think the economy is poised for a pretty solid recovery. Again, uncertainties associated with the 1990s tech bubble and the continued restructuring of a handful of industries will remain in the economy for some time. But I do not believe those remaining imbalances will be a substantial impediment to economic growth in the medium or long term. This time next year, I think the recovery will be a good deal more emphatic. It should be a lot more obvious to everyone that it's here.

Thank you very much.

## CONTACTS

Jean Tate  
404-498-8035