Speeches

The Economic Outlook: Building Momentum on the Road to Stronger Growth

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Construction Industry Institute Annual Meeting
July 31, 2003

Thank you for making me feel welcome. It's an honor to be here before such an important group. Kenneth Eickmann asked me to talk today about the outlook for the U.S. economy as a backdrop to your focus at this year's conference on driving greater capital efficiency. This is a fitting theme given the sluggish rate of growth we're still experiencing some 20 months after what was recently declared the end of the 2001 recession. My plan today is to offer some remarks describing where I think we are and where we're going and to comment on some of the pivotal economic issues of the day. Afterwards, I'll be glad to take a few questions.

"Defining average up"

In preparing for today's remarks I looked back over some of the speeches I gave during the heady days of the late 1990s. That was actually not so long ago, but it seems like it has been eons for our economy. One of the concerns I mentioned during a speech in early 1999 — as it turns out, the heyday of the economic boom — was the "institutionalization of unrealistic expectations." At the time, the United States was coming off three straight years of extraordinary growth, quarter after quarter — plus we saw unemployment and inflation lower than we'd seen in decades. It seemed like the best of all possible worlds. My concern at the time was the widespread perception that this exceptional performance had become the norm and would continue indefinitely. Essentially, I worried we were — to borrow a phrase from the late New York Senator Daniel Patrick Moynihan — "defining average up."

As we now have learned, personal and business decisions based on such a euphoric outlook can lead to classic excesses and imbalances in a free market economy like ours. We're still coping with many of the consequences of this pervasive delusion in the form of excess capacity, and in some ways we still may be dealing with unrealistic expectations — just another kind. That's something I'll describe in more detail in a moment.

Compounding the excesses of the late l990s, the U.S. economy endured some nasty hits, starting in 2001. These include the September 11 terror attacks and accounting scandals that devastated not only Enron and a number of other major companies but also investor confidence. Stocks suffered a substantial across-the-board correction starting in the spring of 2002, and earlier this year we had the Iraq war and the associated spike in oil prices. Yet, it's easy to forget that even with all of these disruptive economic shocks, we've been reporting positive GDP growth for quite some time. Gross domestic product was up 1.4 percent in the first quarter of 2003. Over the past six quarters, not including the GDP figures for the second quarter released this morning, GDP growth has averaged about 2.6 percent. These figures tell us the economy is expanding. Although growth has not been impressive by historical standards, the recent performance could be viewed as a testament to the resilience of the U.S. economy, given all of the difficulties I've just outlined.

So where are we now? For some time, I've been saying that because the period before the recession was so different I thought we would have a different kind of recovery. And we have. Of course, I'll have to admit that what's unfolded has been even more different than I expected.

Today, we're still waiting for a decisive pick-up, and, like a lot of folks, sometimes I find myself getting impatient. But the economy is growing, and I am among those who expect momentum to build as we move through this year and into 2004. What I think we'll see in the coming months will be a slow build-up instead of a quick and dramatic "pop" back to a late 1990s pattern of growth.

I know there's quite a bit of conflicting economic data right now. But I believe businesses, individuals and policymakers are doing what's necessary to prepare for stronger growth. As an optimist I would suggest that in looking at the data and anecdotal evidence the tank is half full, but I recognize we still need to address some ongoing uncertainties.

Investment spending

Two key uncertainties come to mind that I believe will determine to a large extent the timing and the strength of the expected pick-up. These include business investment spending and job growth, and I'd like to spend a few moments on each.

Let's start with investment spending. When the history of the 2001 recession is written, almost certainly it will describe the downturn as an investment-spending bust. Beginning in the last half of 2000, businesses got a serious reality check and suddenly applied the brakes to capital spending.

In a broad sense, one might say we got ahead of ourselves in the late 1990s. Y2K, and the lure of new technology generally, resulted in tech spending that grew at a 10 to 15 percent rate quarter after quarter, and in many industries, plants were built to accommodate a growth in demand that was not sustained.

Consider capacity utilization for manufacturing. Today it's hovering around 74 percent, almost 7 percentage points below its 1972-2002 average. Industrial production has lagged dramatically for an extended period of time. Compared with the average of the past six recessions, the drop off is definitely more severe this time.

In general, business investment spending sputtered and then slowed to a crawl in 2001. This decline in investment spending combined with a steep contraction in manufacturing output caused GDP to come to a screeching halt and then lurch into reverse. During the last 13 quarters of the 1990s, GDP had been cruising along at an average of 4.5 percent, but its sudden turnaround in the first quarter of 2001 marked the beginning of the recent recession.

But it's not just factories that are coping with excess capacity. Office vacancy rates in major cities soared as tenants shed jobs. Just look at my hometown of Atlanta, where the office vacancy rate increased from about 11 percent just two years ago to 22 percent this year. Airline bookings and hotel occupancy levels also have suffered since September 11, 2001, following a sharp reduction in business and leisure travel.

While lots of corrections have been made, the recovery has been slowed by some of the economic wreckage that is still being cleared away. It has taken a while to realize just how broad-based the excesses and imbalances were.

For the past 2 1/2 years, businesses have overhauled their operations. The result has been a wave of plant closings, write-downs and write-offs, mergers and bankruptcies. On top of dealing with these excesses, companies have been adjusting to some new costs. Corporate governance has become more heavily scrutinized following the much-publicized accounting scandals. While the new checks and balances are a healthy and necessary response to corporate misdeeds, they have dragged down earnings and have created another type of caution and risk aversion for business leaders. Also, many organizations, most notably the airline industry, have spent a great deal of money to beef up security.

But even with these challenges, we're seeing progress. The whispers and comments I'm hearing from our contacts in the Southeast have become more upbeat over the last couple of months. Spending on computer and software has been growing again for the last 6 quarters. Even commercial real estate developers tell me they are starting to get their phone calls returned. Companies in many sectors have been reporting higher profits. This improvement in profits has helped push stock prices higher in recent months and in turn boosted the perception that we're moving forward. That's a necessary step, but rising profits alone are not enough; ultimately, increased demand and revenue growth is needed in order to fuel the type of expansion that sustains job creation and capital spending. Looking at the data and anecdotal evidence, my sense is that industry by industry and company by company, this appears to be happening.

The "job-loss" recovery — the other big uncertainty

The other big uncertainty is employment. We know that coming out of an economic downturn, employers typically wait to be sure the economy's gaining strength before making a commitment to significant new hiring. While the GDP data I cited earlier suggest the recovery has been underway since November 2001, sustained new hiring still has not occurred. As some people have said, if what we experienced in 1991 was the "jobless" recovery, this feels like the "job-loss" recovery.

The job market continues to be tough. The number of people working part time because they can't find full-time work is up about 40 percent since 2000. The employment slump has extended for 28 months, a lengthy time by historical standards. One in five unemployed individuals has been looking for work for more than six months. The more promising news is that in recent months, the economy has been shedding jobs at a slower rate, and other recent data show fewer initial filings for unemployment. But it's still not clear that labor markets have fully stabilized.

Since demand for goods and services in the economy has been growing slowly in recent quarters, it's understandable that businesses are reluctant to hire. Various factors have discouraged job creation. The rapidly rising cost of health care has deterred employment, and the need for many companies to now begin contributing again to pension plans also has added costs to each new hire. On top of that, we're seeing a continuing trend of some jobs moving to less expensive labor markets offshore.

Another consideration is productivity, a subject closely related to the conference theme of driving greater capital efficiency. We've seen labor productivity rise at about 2.5 percent annually since 1995, compared with about 1.5 percent between 1973 and 1995. Increased productivity has lent momentum to GDP growth. This in part reflects the heavy investment that businesses made during the late 1990s in automation, and as a result many operations have become more efficient. Companies are now able to do more work with the same number of or fewer people. While that's healthy for businesses, improved productivity also has had the side effect of reducing the need to increase payrolls during a time of slack growth. But when demand increases, and companies approach the limits of what they can accomplish without additional people, they will begin to rehire, and at this time new businesses also will form, further adding to payrolls.

For a while now, I've been saying that the unemployment rate could go a bit higher before we see sustained job growth. Segments of the job market have moved in fits and weak starts at best, and it will take a steady increase in the number of new jobs to push down the unemployment rate, now at 6.4 percent.

In June, we saw the number of people entering the labor force and actively looking for jobs surge by 600,000 people, which could be viewed as a sign of increased optimism. Also hopeful is the recent increase in temporary hiring, typically a precursor to expansion of full-time payrolls. The increased demand for temporary workers is a reflection of businesses' concerns with cost control. We'll have to wait and see if temporary employment expands further and develops into permanent job growth. At that time, we'll have a clear signal that the economy really is picking up momentum.

So what's ahead? I believe that as aggregate demand in the economy continues to expand and starts to outpace aggregate supply, we'll see some moderate job growth. As I think will be true with capital spending, sustained job growth will most likely build more slowly than we might like to see.

Growing list of signs pointing to recovery

But today, I think we're moving past many of the problems that took us into the recession. As I've mentioned, businesses have done some hard rethinking and made some painful adjustments over the last several years, a process that is continuing even as I believe many companies are beginning to prepare for fresh opportunities. The payback will take time, but I believe the economy is poised to accelerate to a more satisfying pace. Here's why:

Monetary policy has been quite accommodative, sustaining and boosting interest rate-sensitive sectors such as single-family housing and autos. With mortgage rates lower than we've seen in decades, lenders project some $3 trillion in new originations and refinancing this year. The refinancings and associated cash-outs continue to unleash substantial amounts of liquidity - and potentially consumer spending - into the economy. A recent up-tick in mortgage rates may curtail refinancing and origination volume somewhat, but mortgage rates remain very low by historical standards and home sales should remain strong.

Fiscal policy also is stimulative and fueling growth. The recent passage of the Jobs and Growth Reconciliation Act is likely to provide a near-term stimulus to GDP of as much as $60 billion for the second half of 2003. Estimates for the eventual impact of the tax cut vary widely. Some analysts, assuming that consumers will spend a significant portion of the proceeds, predict a sharp boost to the economy. Others forecast a more muted impact in which consumers spend less of the proceeds. We'll have to wait and see how consumers react to this additional disposable income to determine the eventual impact on the economy.

The end of combat operations in Iraq bolstered consumer and investor confidence. Oil prices are off their highs from earlier this year, but at about $30 a barrel presently, the economy could still benefit from a further reduction in those prices.

Financial markets also are supportive. Interest rates are low, and we're seeing narrower risk spreads between high-grade and low-grade corporate debt. Banks are flush with liquidity and ready to lend when borrowing demand picks up. And, as I mentioned earlier, the stock market is up almost 25 percent since its low point in March this year.

Putting it all together

I've talked about some of the powerful forces that I believe are falling into place and will fuel the economy. I also have suggested that capital spending and employment should slowly begin to pick up — industry by industry, company by company. My bottom line outlook is for an increase in investment spending, production and employment. Looking ahead, I see the rate of growth improving over the rest of this year and into next year.

Slow to moderate growth can be disappointing, especially after the heady experience of the late 1990s. But, again, it's about expectations. As I said earlier, I think the tank is half full, although I've come to realize that we can get a lot further if we trade in our fully loaded SUV for a more economical sedan. At times, these last several years have felt like driving slowly past a multicar wreck on the highway, with broken-down cars, glass in the road and other hazards. But I think it's important, as I reminded others and myself back in 1999 and again today, to set realistic expectations. My gut feeling is that the fundamentals have become more firmly set for the economy to move through this caution zone.

In this day and age, I've learned not to rule out anything. But as far as I can see, it looks like the road to stronger growth is opening up, and it's a matter of when, and not if, the economy will pick up momentum.

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