Speeches

The Fog Is Lifting - and the Economic Outlook Appears Brighter

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What I'd like to talk about today is the outlook for the U.S. economy, along with my own insight and thoughts on some of the key economic issues of the day. This is an opportune time to be talking about the economy because what's been a murky picture for the past two years now seems to be clearing up, and I anticipate more solid and broad- based growth ahead.

The economic picture now is sharper, and in many ways brighter, than it was as recently as this summer. I gave a speech in late July emphasizing what I saw as a slow buildup in momentum in the economy. But, given the way businesses and financial markets have performed since then, I'm even more comfortable now about the outlook for stronger growth. That said, it's important to keep in mind that there are still some weak spots and vulnerabilities in the economy, and I'll talk more about those in a moment.

Signs of expansion

What I want to convey to you now is the increasingly broad-based momentum of our economy. It's my sense that the expansion is becoming less academic and more tangible although folks who are looking for jobs are still waiting to feel the improvement. Here are a few of the indications boosting my confidence about how things are unfolding.

We've seen seven straight quarters of expanding GDP. The latest estimate of second quarter GDP growth was 3.1 percent, up from 1.4 recorded in the first quarter. And we've averaged an annual rate of growth of about 2.5 percent since the 2001 recession was declared ended.
More recent data suggest that the pace has picked up in the third quarter despite the drag of a late summer surge in oil prices — a sign that the economy has become more resilient.
Financial market conditions remain quite favorable, and the steady rise in corporate profits has supported the beginnings of a pick-up in capital spending.
The strong corporate performance has reinforced the stock market's continued recovery. In addition, yield spreads on high-yield bonds have narrowed, an indication that there's a perception of less risk.
Net job destruction is becoming concentrated in fewer and fewer sectors — now, primarily manufacturing. Importantly, hiring in the service sector is beginning to pick up.
Monetary and fiscal policies remain geared to stimulate growth.

Week after week, new reports about improved orders, profits and business efficiency are starting to make an impression. My sense is that perceptions are changing; many businesses are starting to invest in new equipment, a growing number are beginning to embark on expansion plans, and in some cases hiring new people. These developments are important because sensible risk taking is vital to lift our economy into a period of more rapid and more satisfying growth.

In describing the secret to getting rich on Wall Street, it was Warren Buffett who said, "You try to be greedy when others are fearful, and you try to be fearful when others are greedy." Of course you don't need to be greedy to be successful, but companies are not in business to sit still. They need to take advantage of opportunities at the right time and place.

Firms that have been hunkered down are starting to move on some new initiatives, but in a measured and deliberate way. Businesses have been burned in the past by false signs of resurging demand. It's only when companies are convinced that increasing demand is real and that the turnaround has staying power that they will begin to expand capacity. Based on the economic data and the reports I'm hearing from my grass roots contacts, the perception of an endless economic funk is finally starting to dissipate.

For some perspective, let's take a step back and look at how our economy began to falter at the turn of the decade. The recession began in early 2001, following a period of very strong expansion in the late 1990s that is now easy to identify as having been excessive. But, at the time, that aggressive behavior seemed rational in light of extremely high expectations of demand. When businesses realized demand was much weaker than anticipated, they cut back sharply on investment spending and hiring. Then terrorists hit on Sept. 11, 2001, and inflicted further damage to important sectors of our economy, adding to a general feeling of caution and uncertainty.

The nation pulled together and bounced back quickly, and economists this summer marked the official end of the recession at November 2001. But the past two years haven't looked or felt like a recovery for a lot of Americans, especially the more than two million workers who lost their jobs since the recession began.

Jobs: The missing piece of the puzzle

The "job loss" recovery we've been in has been painful and frustrating for many, and the most recent data and anecdotal reports suggest it's likely not over yet. In August, payroll employment fell by 93,000 at about the same time we heard about an upward revision for GDP for the second quarter and a host of other favorable economic data. This disconnect can be confusing, but it's not entirely surprising. Economists keep reminding us that job growth typically lags in a recovery although such reassurances begin to wear thin with the passage of time.

An important factor at work with the job market is productivity. Because of some ingenious innovations in recent years, businesses have improved efficiency and now are able to make and to do more with less. Improved productivity has a bearing on employment, and, without getting into the details, it's safe to say that we're seeing a trend of higher output per worker. A firm that employed 110 workers a few years ago might now be able to produce the same or more with 100 people on the payroll. Faster Internet connections and communications devices such as cell phones and Blackberries are just a few of the advancements that are making the workplace more productive. As demand sagged and companies felt enormous pressure to try to protect profits through cost cutting, real or potential productivity improvements rose to, and still are at, the top of mind for most managers.

While companies are getting more from their workers these days, it's important for businesses to keep in mind a basic concept of human nature: people have their limits. Just as the number of hours in a day is fixed, there's a limit to what firms can accomplish solely through improved productivity, especially during a time of rapid growth. As growth increases, so will the pressure for firms to expand their payrolls.

It may take a while, but I believe the job market will improve in the months ahead. Already, we're seeing job losses limited to fewer and fewer industries. Hiring is up in business services, leisure and hospitality, health care and government. The defense industry is expanding, and residential construction remains a mainstay of the economy. At this time, I believe it's a matter of when and how strong job growth will return.

Before they begin to hire in significant numbers, businesses are telling me they want to see three to six months of solid growth. That seems like a sensible threshold. I'm finally hearing at least some first reports from around the Southeast of businesses talking with developers about future projects as well as renewed interest in financing new equipment or projects, particularly those that improve efficiency.

The least responsive sector to this point has been manufacturing. Here, we're seeing structural changes that pose a great deal of difficulty for workers, particularly those with limited skills. During past expansions, firms moved to rehire laid-off workers as demand began to come back. But in this economy, manufacturers are continuing to downsize because many industries are undergoing permanent rather than cyclical changes. In order to offset this painful adjustment, it's important that our nation's public policies support worker retraining and make it easier for people to move on to new careers and possibly new markets where they can find better opportunities.

The Bush administration recently created a position to address the decline in manufacturing, and we hear a lot in the news about how jobs are moving offshore. But the trend of jobs migrating to low wage markets overseas has occurred for decades as we've expanded a global network of free trade. This period of anemic economic demand and job growth happens to magnify structural challenges confronting the manufacturing sector. Although the adjustment has been hard, I believe that free trade promotes growth broadly and is something we should not back away from — but that's a speech for another day.

Other issues intertwined with the economy

Although we've become more efficient, in other ways the cost of doing business continues to increase. Health insurance costs have risen far more rapidly than the rate of inflation. With the assets of pension plans having been eroded, pension funding has become more and more of a burden to some companies as well as state and local governments. And these developments are providing many companies with additional reasons to delay adding to payrolls. New rules related to corporate governance imposed by Congress in the wake of accounting scandals are part of a much-needed effort to improve accountability in the boardrooms. But businesses are still adjusting to the new rules and adding up the costs.

The fear of additional negative shocks to the economy also has left many business decision makers worried and cautious. The August power outage in the Northeast was a limited shock, but it could be viewed as a wake-up call to fix long-running problems with our infrastructure. Other concerns I hear mentioned frequently include the recent rash of computer viruses, along with the continuing threat of terrorism. All these concerns are outside the scope of monetary policy. They are not things, by definition, that policymakers or even individual businesses can foresee or necessarily prevent. But efforts to mitigate such problems do add costs and cautions. And over time, they are intertwined with the more fundamental economic picture.

Another uncertainty on many minds is fiscal policy. Stimulus from tax cuts appears to be helping support growth in the near term. But I share others' view that it's important to strike the right long-run balance between revenues and spending, and doing so will require addressing some tough issues that loom on the economic horizon such as health care and social security.

Despite these challenges, and there will always be risks and challenges, I believe the overall risks to the economy are receding. The housing sector has made a significant contribution to growth over the last two years as other sectors struggled to regain their footing. Indications are that the housing market will remain strong, along with consumer spending. My sense is that the mortgage refinancing frenzy early this summer was an unusual phenomenon, as rates fell to levels that were fundamentally unsustainable. As rates have increased somewhat since then, the refinancing market has slowed significantly. But people are still building and buying homes at an aggressive clip. And as we move forward, I believe a strong housing sector will be driven increasingly by job growth as well as other demographic factors.

Businesses smell demand

What's lagged in the past few years has been business spending. This is a critical area of the economy that I believe is already showing signs of improvement. Companies have spent the better part of the past three years working off vast amounts of excess capacity, idling plants, shelving outdated equipment and laying off workers. While this shift has caused a lot of pain, companies have survived for the most part despite some high-profile failures.

Businesses have put behind them much of the hard work of restructuring and cleaning up balance sheets. Industry by industry, demand appears to be picking up and, even in the weaker areas, stabilizing.

It's fascinating to watch businesses respond to this whiff of resurgent demand growth. Instead of taking a chance on expanding payrolls, many are again beginning to buy new equipment, which is less risky and less expensive right now than hiring personnel because borrowing costs are low. Also, after years of deferring their investments, companies are finding their old computers and software tools surpassed by newer offerings. I'm encouraged by a healthy pickup over the past few months in manufacturers' shipments for durable goods.

Along with the lean staffing, many companies right now are also operating with lean inventories. This is a smart move for the present because it keeps costs low while

positioning firms to “call an audible” to meet a limited demand increase. In this environment, firms have plenty of excess capacity, so it’s not hard to boost production by hiring temporary workers or maybe bringing back people who had been laid off.

Although sophisticated supply chain and inventory management systems should allow many firms to operate with leaner inventories than in the past, it seems likely we’ll get a little extra “kick” over several quarters from some inventory rebuilding as demand improves. As the economic expansion becomes more obvious, I think it will occur to many business leaders that extreme caution in hiring and investment spending could cause them to lose out to the competition on potentially lucrative new opportunities. As growth occurs, standing pat — the smart play a year ago — at some point becomes a costly business strategy.

Another sign that businesses smell demand is America’s renewed fascination with technology. I’ve always thought of technology and its application as a U.S. competitive advantage. Dating back to the days of Benjamin Franklin, we’ve always been a nation of innovators. We’re an innately curious people with an economy open to individuality, experimentation and exploitation of technology, compared with other economic and political systems that make it more difficult to innovate and put new technology to work.

Not long ago, our nation’s ardor for technology cooled after much of the “digital revolution” hype fizzled. Businesses slashed technology spending starting in 2000, and the dot-com bubble burst. But now there appears to be less skepticism about technology. Investments into early-phase start-ups increased more than 40 percent in the second quarter this year, and the tech-heavy NASDAQ is up nearly 50 percent since March.

Why is this resurgence happening? Technology investors apparently are more confident about the prospects for returns. Indeed, it’s easy to get inspired by some amazing breakthroughs in wireless networking and alternative energy, among other advances. The perception of technology has changed, once again, to the point where businesses see real value in these products in terms of better productivity and, ultimately, profits.

The economy in recent years has taken so many twists and turns that I think it calls for a little humility on the part of policymakers. Despite aggressive efforts to stimulate the economy, some of the familiar remedies have not had the full anticipated effect. I’ve been saying for a while that this recovery would be different from the others in the history books, and the way it has unfolded continues to surprise me in some important respects.

By many measures, we made our way through this latest recession relatively quickly. And although all sectors have not bounced back as fast or as strongly as we might have liked, the fundamental pieces of a more balanced expansion seem to be falling into place. I think it’s now possible to make out the shapes and forms of emerging developments that indicate with a fair degree of certainty that faster growth in the months ahead looks likely. Particularly encouraging to me are the anecdotes and stories I’m hearing from the business community, which is typically the last to acknowledge growth and recovery. As I’ve shared with you earlier, the whispers and comments from our contacts are clearly tilting more and more to the positive.

If we’ve learned anything from the boom and bust of the 1990s, I think it is that it’s a good idea to temper expectations. We’ve worked hard to get to the point where a lot of positive forces are at work, so let’s not get impatient.

Over the summer, I summarized my outlook for the coming months by describing what I expected to be a slow buildup instead of a quick and dramatic “pop” back to a late-1990s pattern of growth. Generally, I think that picture still holds true. But the emerging outlook seems to be even a bit more encouraging than I had thought earlier in the year. I’ll know we are where we want to be when growth is reflected not just in some statistics but is felt broadly by the people that drive this nation’s economy.

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