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A Perspective on the Current Economic Scene

**Cathy E. Minehan, President
Federal Reserve Bank of Boston**

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It is a distinct pleasure to be here with you to ring in the New Year. In my view, the beginning of a new year, and for those date purists among us, the beginning of a new century and a new millennium, is a good time to take stock of the present economic situation. It's also a good time to develop some perspective as well, and I'll try to take the longer view as I discuss the extraordinary economy we have seen in the past decade. I want to use that as a backdrop to answering two questions: what happened in 2000? and what may lie ahead in 2001?

It goes without saying that the period since the end of the last recession - 9+ years - has been extraordinary. It is the longest period of economic expansion in U.S. history. Moreover, if one sets aside the relatively brief recession of the early '90s - and I know that's hard to do here in New England - the economy has been expanding for over 18 years. And even more surprising is the fact that in the later years of the expansion - from 1996 on - good things got even better. Overall U.S. GDP growth, which averaged 3.2 percent from '92-'95, averaged 4.4 percent in the

latter years of the decade. Unemployment hit a 30-year low of 3.9 percent, and the rate of inflation declined for a good part of the time.

What is sometimes overlooked about this long period of economic growth is the strength of U.S. final domestic demand - the total of goods and services bought by Americans either from domestic sources or imported from abroad. This total grew at an annual rate of about 5.8 percent in the late '90s - a very strong pace for an advanced, developed economy like that of the United States. One striking indicator of this strength was reflected in auto sales in the beginning of 2000. Most new cars are purchased to replace old ones. Actual additions to the pool are relatively small. However, at the level of sales experienced in the beginning of 2000 -- just over 18 million units on an annual basis -- the rate of growth of the nation's stock of autos more than tripled its usual pace.

The experience of the past several years was virtually without precedent in the post-War period. Therefore, it was, and is, difficult to grasp how this combination of rising GDP growth

rates, increasing job growth and decreasing inflation happened. As an example, most econometric models continually under-predicted growth and over-predicted wage and price pressures especially at the beginning of the period. Gradually as time passed, however, some of the factors underlying this very beneficial economic trend became more apparent.

First and foremost is the rise in productivity in all sectors of the economy. Whether the result of technological change; capital deepening; a more flexible workforce; the sheer determination to work harder and smarter in the face of intense global competition; or some combination of all of these things, the productivity of the U.S. economy grew over the latter part of the '90s at a pace more than double that of earlier years. Moreover, it actually accelerated toward the end of the nineties. By second quarter 2000, productivity was growing at a rate of 5.3 percent as compared with 2.1 percent for its 1995 to 1998 average.

Some portion of this very rapid productivity growth was simply a reflection of the growing economy of the period – strong demand can prompt more efficient use of resources over a short

period of time much like all of us cope with peak activity.

However, it became clear that a portion of the productivity growth the economy was experiencing reflected true structural change, primarily related to advances in the use of technology induced, in part, by domestic and foreign competitive pressures. Estimates vary as to how much of the productivity surge is cyclical versus structural, but if only a third of the recent gains are long term, U.S. standards of living could double in about half the time they could have in the '70s or '80s. Productivity growth began to evidence itself everywhere, from rising corporate profits, to rapid technological change in almost every aspect of business and personal life. Reflecting this, consumers and businesses began to believe that the future held great potential, spurring increases in spending and leaps in confidence.

Another factor underlying the strong economic performance of the late 1990s was an increase in the efficiency of the labor market. Although we have been through several business cycles since the late 1960s, we had not approached the unemployment rates we have seen over the previous three years. In the past,

the labor market would have been strained at unemployment rates significantly above the ones we have experienced since 1997. In fact, only 5 years ago, the debate was over whether such strains occurred at unemployment rates 2 full percentage points above the level in 2000. It is clear that the labor market can now accommodate lower unemployment than it could over the previous 30 years. As a result, the potential for the economy to grow is greater than was anticipated even 5 years ago.

At the same time, for most of the period, the rest of the world was experiencing relatively slower rates of growth. In particular, during 1997 and 1998 the developing world experienced economic crisis. These crises were tragic for the countries involved, but the related excess capacity in the rest of the world absorbed excess U.S. demand and reduced price pressures. Moreover, relatively stronger U.S. growth strengthened the dollar, moderating price growth and further encouraging productivity as well.

These three factors - rising U.S. productivity, more efficient labor, and increased market globalization - produced a remarkable

situation. Employment and real compensation grew and U.S. workers and families became ever more confident about their futures and willing to spend that extra dollar on housing, cars and other consumer products. Consumer debts rose, and the savings rate plunged, but in the context of a booming economy with rising equity and real estate wealth, these seemed small negatives. Credit markets became more accommodative, and financial asset markets boomed as businesses invested ever greater amounts on new technology and enhanced their bottom line results.

Reflecting the very strong growth in U.S. domestic demand, the nation's trade deficit ballooned. By last year, the deficit amounted to over 4 percent of GDP, or about \$400 billion on an annual basis. But even this figure -- as large as it is -- raised more eyebrows than problems in 2000. Because of the attractiveness of U.S. investment markets financing the huge deficit proved less than difficult, at least to date. In short, the U.S. experienced a long-sought-after "virtuous" cycle of economic growth feeding on itself.

So what happened in 2000? As they say, trees don't grow to the sky and as 1999 progressed into 2000, it became apparent that various contributors to the virtuous cycle could be undergoing change. For one thing, price pressures began to emerge as a source of concern. Global growth rates surged – reaching almost 5 percent -- and oil prices moved dramatically upward. Constraints on labor resources became more apparent, and the forecast, if not the reality, of accelerating inflation began to color economic prospects in the eyes of many observers. Thus, in the fall of 1999, the Federal Reserve started to tighten policy to ensure that growth could continue at a more sustainable level.

Asset and lending markets also began to signal the need to return to a more balanced pace of economic expansion. Beginning in the spring of 2000, declining corporate profit growth and rising concern about future profits began to be reflected in declining financial asset values. These values continued to fall through the end of the year, with particularly large declines in the area of the newest, most unproven technology companies – the

dot.coms. By year end, blue chip stocks – that is the Dow Jones industrial average – were off only a modest 6 percent from their 2000 highs; in contrast the NASDAQ fell over 50 percent from its peak.

Did this decline in the market for high tech stocks reflect deep underlying concerns about the future of technology? Or did it largely encompass a return to more or less reasonable valuations after a period of cyclical excess? Assessing the reasons for financial asset market movements is never simple; but one must realize that the future annual growth in after-tax profits implied by peak NASDAQ valuations was well into double digits. By the end of December, these after-tax profit expectations were much closer to the long-run average for the NASDAQ market. Thus, there is some evidence that this market change does not reflect deep concerns about the benefit of new technologies in general, but a revision, albeit sharp in particular cases, in short-term profit expectations.

Credit markets, which had never returned to the headiness of the 1997 global pre-crisis period, also became more

discriminating in early 2000. Yield spreads, particularly for lower-rated securities, widened considerably in the spring and again in the fall. Lending standards at major commercial banks tightened as well. I should add here that given building economic uncertainties, neither wider spreads nor tighter standards were necessarily bad. In this way, over the course of the year, credit markets tended to restrict funding, especially to less than investment grade customers.

These changes in financial markets began to pick up in intensity in the early summer. They helped start a slowdown in growth from the high-flying levels of 1999 and early 2000. At the same time, the continued increase in oil and gas prices was a further cause of retrenchment. Rising energy prices acted as a tax on both consumers and businesses, reducing the purchasing power of each. Moreover, after years of spending on big ticket items, consumers likely were a bit satiated as well.

The evidence of this deceleration in spending was first seen in auto and truck sales, which actually declined in the second quarter from their historic first quarter levels. However, even if

autos are excluded, the consumption of durable goods slowed significantly from its torrid pace of 1999 during 2000. By the end of the year, consumer confidence also began to falter, and this, along with sharper falloffs in auto and retail sales more generally, implied much slower consumption growth in the fourth quarter.

By the second half of 2000 evidence also emerged indicating that business-fixed investment slowed from its rather torrid pace of the last several years. Interestingly, this slowdown was centered largely in the non-computer part of equipment investment, though it did include a sharp deceleration in spending on communications and software. Real computer investment taken alone, however, grew at an annualized pace of 40 percent in the third quarter, slower than the pace of the second quarter, but clearly within the very strong growth pattern of the last several years.

The deceleration in consumption and investment clearly signaled a significant economic shift as 2000 progressed to its end, and this was most clearly seen in the manufacturing sector.

Initial estimates of GDP for the third quarter were revised downward to a final of 2.2 percent (versus 5.7 percent in the second quarter). Expectations for the fourth quarter are that growth will continue in that range, or perhaps be a bit lower. We were not alone, as economic growth in the rest of the world began to falter a bit as well, likely reflecting the U.S. situation. Reflecting all these factors, domestic labor market constraints began to ease, as employment growth slowed significantly from its rapid pace of the previous several years and initial claims for unemployment rose again from extremely low levels in 1999.

This process of slowing in 2000 from the record growth seen in the late 1990s reveals, I think, a fairly important point. Perceptions of the overall economic scene changed rapidly over the year, and at least part of this change arose from the fact that the economy in late 1999 was simply running at an unsustainable pace. The transition to a slower, more sustainable growth pattern is a difficult process and some of the negative tone of recent readings is a reflection of that difficulty.

And, not all of the news is bad. Looking forward, there are several sources of strength that should help the economy navigate through this year. Many of the positive forces that have propelled this extraordinary expansion remain. For one, while consumption has cooled, it remains relatively good. Ongoing solid growth in real wages and employment should continue to boost income growth, and thus consumption. Consumer sentiment, though weakening at the end of last year and into January remains relatively good. Moreover, the most recent evidence of retail sales in January shows a bit of a bounceback.

Housing demand should also remain reasonable. Although residential construction has backed off a bit from its pace in the beginning of the year, the recent data show it still has plenty of life. Even with a falloff in permits in December that appears to have been weather related, both starts and permits in the fourth quarter were up from their third quarter levels. Existing home sales rebounded in November, and the level of sales of new homes over the first 2 months of the fourth quarter was higher than the monthly average in the third quarter. One reason for this

continued strength in residential construction is the decline in mortgage rates since last May—they have fallen about 100 basis points since then, helped, in part, by the recent policy action. Perhaps more importantly, the health of the housing market is one indicator that consumers remain reasonably confident about the future.

While the slowing in consumption and investment into 2001 has hit the manufacturing sector hard, service output remains solid. In addition, while the most current earnings reports and forecasts for major computer firms suggest that business investment in technology in general is decelerating from its incredible pace of the previous few years. But, for the year as a whole, growth was likely positive. To the extent that this capital deepening, and the use of new technologies to enhance business processes has worked to spur productivity growth to date—and I believe it is clear that it has—this bodes well for continued productivity growth. Moreover, the sheer determination of U.S. business to work harder and smarter in the face of domestic and global competition seems, if anything, stronger. Thus, I believe

there is little evidence that the structural productivity change suggested by growth rates over the past few years has declined.

Although employment growth has slowed, the labor market remains tight. The unemployment rate stayed put at 4.0 percent in December, and while employment is an indicator of past not future strength, most expect the labor market to remain solid in the near future. This might suggest to some a potential for price pressures, but so far inflation has crept up only slightly in the last part of 2000, with much of that increase due to the rise in energy prices.

Last, but certainly not least, the action taken by the FOMC on January 3 to reduce target interest rates by 50 basis points is a source of strength going forward as well. The Committee took that action in light of all the signs of weaker growth that I have mentioned, and in light of the fact that inflation remains well contained. We also reaffirmed that "there is little evidence to suggest that longer-term advances in technology and associated gains in productivity are abating."

In sum, 2000 was a year of very rapid economic change. Corporate profits decelerated significantly from the spring onward, financial markets cooled, credit conditions tightened, consumer spending and confidence and business investment waned, U.S. manufacturing – especially the auto sector – experienced considerable slowing, external growth diminished, and the overall pace of the domestic economy slowed to a fraction of its late '99-early 2000 level. But to put this in perspective, some of this slowing needed to take place to sustain growth and some sources of strength remain.

What lies ahead for 2001? First, given the slowing pace of the last half of 2000, annual growth rates clearly will decelerate. Given the strength of the early part of 2000, GDP likely grew by about 5 percent or so for the year as a whole. The most likely outcome for 2001 in my view is half of that pace -- in the range of 2-3 percent. The beginning of the year is likely to see an even slower pace than that, with a pick-up in the second half. As I make this forecast, however, I remain conscious of an increase in downside risks. Just as we must view the last year with some

perspective on the slowdown, so also do we policymakers need to be vigilant looking forward.

Thank you.