Boston Municipal Research Bureau Semi-Annual Meeting

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It's a pleasure to be with you here at the semi-annual meeting of the Boston Municipal Research Bureau. As a director, I am extremely proud of the way the Bureau brings an unbiased, analytical perspective to the finances and public policy choices made in Boston. The Bureau's publications are invaluable in separating the political hype from the real issues. Moreover, Sam has become a trusted colleague for a lot of us who try to help find solutions to difficult situations in the city. Clearly, the Bureau, and Sam have helped to shape Boston's current healthy status. But I'm sure he shares my own sense that more than the usual amount of uncertainty faces the economic outlook for the city, the region and the nation as we look forward. This uncertainty will be the focus of my comments today.

It goes without saying that the last half of the '90s set a standard of economic performance that is in many ways unparalleled. That period is critical to understanding where the economy is currently, and why things seem so uncertain now. I'd like to highlight the key aspects of that period for you, and then turn to the present situation in the nation and New England.

In February 2000, the U.S. economy set a record for the longest expansion ever -- that is since 1854, the earliest date for which an official business cycle date exists. The expansion began in March 1991, and continues today, as far as we can tell. As if that weren't enough, rather than gradually losing momentum through its long lifespan, as most expansions do, this one gained steam as it aged, posting a blistering 6.1 percent growth rate in its ninth year, from mid-1999 through mid-2000. At the same time, unemployment dropped to a thirty-year low of less than 4 percent, and, astonishingly, inflation, measured in many different ways, was at extremely low levels as well. This combination of growth, low unemployment, and low inflation had not been seen since the early '60s, and, frankly, some thought it wasn't possible.

What caused this good fortune? Well, many things contributed, such as extremely low oil costs, excess world capacity for much of the '97-99 period, and a growing U.S. fiscal surplus, which helped to keep interest rates low. But as we look back on the period, one aspect of the economy during that time seems most significant--rising productivity.

As you all know, the rate of productivity growth in an economy--that is, how much can be produced with given resources at a point in time--determines--at least over longer time horizons--how fast standards of living--and real incomes--will rise. It is an unequivocally good thing. If the rate of productivity growth doubles--as it did from '96-2000 versus the previous 3 decades--then standards of living can double in about half the time.

Productivity can fluctuate significantly with the business cycle, rising when demand is high, just as all of us can work harder and produce more over short periods of time, and falling when demand falls and employers find it hard to downsize to keep pace with the slowdown. This type of productivity variability is cyclical by definition and short-term. But productivity also can be affected by permanent changes in how efficiently the economy works--for example, through changes in the level and use of technology, or through a better-educated workforce. These so-called "structural" productivity changes are hard to separate from cyclical variations, but they are critical to rising economic fortunes over time.

Undoubtedly, some of the growth in productivity in the last half of the '90s was cyclical--particularly the spectacular growth rates of 1999. But some appears to have been structural as well, driven both by capital deepening and by the sheer desire of U.S. business to work harder and smarter in the face of global competition. In the five years from 1996 to

2000, the economy grew at an annual pace of 4.3 percent, and productivity averaged 2.9 percent. During the same period, investment in equipment and software grew over 24 percent annually, and investment in computers and peripheral equipment grew by more than 40 percent. Even allowing for the more rapid depreciation rate of the high-tech equipment in which firms invested during this period, that pace of investment implied that businesses added nearly 7% to the capital stock of U.S. firms in 1999 alone, the last year for which data are available. This annual rate of net capital formation was nearly double that of the period of 1990-98, and appears to have played a key role in businesses' ability to meet growing demands while keeping prices in check.

Rising productivity had other related effects as well. Consumers became increasingly optimistic about the future, spent more on big-ticket items like cars and houses and saved less. Asset markets reflected this optimism and soared, particularly in high-tech areas. And investors in other countries reacted as well, pouring money into U.S. markets, strengthening the dollar and financing the external deficit caused by exuberant U.S. consumers.

But this sort of economic bliss can last only so long. Sooner or later the stress on resources brings problems. One indication of this was the gradual decline in the unemployment rate over the period--to a point where labor market tightness became a constraint on growth. Even in the face of huge productivity increases, demand was outstripping supply.

In recognition of this, the Fed began tightening policy in the second half of 1999, hoping to bring demand and supply back into a more sustainable balance. But at the same time a number of other, arguably more potent, impediments to economic growth appeared. After a period of extremely low energy costs, prices rose significantly in 1999 and 2000--and not just oil prices, but natural gas, electricity, and gasoline. Developments in these energy markets are, of course, closely related, as natural gas is a primary fuel for electric generators, and is also used extensively in home heating. These energy price increases acted as a tax not only on consumers, but also on businesses whose rising energy costs took a chunk out of profits.

Financial markets reacted to the sense of unsustainability in the economy as well. Spreads widened in the spring of 2000 and then again in the fall, and the bloom came off the rose of the dot.com miracle. Equity price declines took almost $3 trillion out of consumers pockets--or what they may have assumed was in their pockets at the height of the market--and declining equity markets had a hand in slowing business spending as well.

Finally, it is arguable that after a four-year spending spree, consumers and businesses reached a point of satiation. Consumers owned all the cars, houses, and durable goods they could use; businesses had acquired enough capital goods, particularly in the face of slowing demand. Spending rates slowed, in some industries drastically. High-tech businesses, even those with long successful track records, reported the slowdown was unprecedently fast and hard--like running into a wall at 60 miles an hour, to quote one contact. Over the year 2000, GDP growth slipped from a strong 5+ percent pace in the first half, to a 1 percent run rate by year-end, and spending on high-tech equipment and software dropped. Likely not a recession, our Bank's forecasts tell us, but to those most seriously affected--the manufacturing sector especially--it sure feels like one.

So where are we now, and where are we going? These are not easy questions to answer. Over the longer term, I have confidence that the determination of U.S. businesses to be ever more competitive, combined with and facilitated by the use of new technology, bodes well for continued solid productivity growth. But on the way to the long term, one has to get through the short run. And right now--this quarter--there is a distinct pause in firms' willingness to spend on the capital equipment. Orders for equipment are off, industrial production has declined for a remarkable 8 months, and manufacturing capacity utilization is at its lowest point since 1983. Businesses are waiting to see clear signs that demand for their products has returned; I believe that will occur, but it's hard to see the turnaround in the data as yet.

Obviously this has affected employment decisions as well. Firms may well be both holding on to labor that only a few months ago was in extremely short supply, and avoiding making the long-term investment in a new hire as well. Indeed, many manufacturing firms, who have been hit the worst in this slowdown, have cut back on temporary hiring. In addition, the rest of the world, including our key trading partners, is slowing, in large part because U.S. demand was driving foreign growth as well as our own. While the foreign slowdown may be less than our own, foreign demand is not likely to provide a boost to U.S. output in the near term. The ace-in-the-hole so far has been the consumer. Real consumption spending has held up fairly well, growing just under 3 percent for the two most recent quarters. In large part, motor vehicle manufacturers were able to trim outsized inventories late last year because sales were so strong in the first quarter of this year. To be sure, some of the sales were supported by manufacturers' incentives in the form of rebates and low financing rates. But in times of recession, even rebates and cheap financing lose their appeal. So far, apparently, consumers have not moved into recession mode.

Consistent with this picture of consumers' relatively healthy attitudes, construction of new homes has held up quite well. Through April, new home building continued near the rates that set records in 1998 and 1999. I don't expect fantastic growth in housing construction. But again, the willingness of so many households to make this largest of investments is an encouraging sign.

If labor markets remain relatively solid, recent developments in fiscal policy may keep the consumer in a buying mood. The combination of tax rebates, and reduced tax rates, that are included in the Administration's recently approved tax plan should boost consumption, beginning in the third quarter of this year. The Treasury is scheduled to mail rebate checks, up to $300 per single filer, and up to $600 for a joint return, beginning in August. Over 90 million checks will be mailed. As you may know, normally the Treasury uses electronic means to make its payments. For a variety of reasons this can't happen for this rebate. Thus, the Treasury--and the Reserve Banks as well--will have some gearing up to do to get this job done.

What will consumers do with this relatively small windfall? Historical experience with tax rebates suggests that consumers will spend about half, and either save or pay off debt with the rest. If the split is 50/50, this would add between one-half and three-fourths percentage point to GDP growth, likely split between the latter half of the third quarter and the first half of the fourth. The tax rate reduction portion of the tax plan is, of course, more long lasting than the rebate, but will take some time to kick in. Essentially all of the effect of the rate cuts will show up in 2002, again adding one-half to three-fourths percentage point to GDP.

Going forward, the continued resilience of the consumer is key to keeping the economy growing. This is not without its risks. On the one hand, the savings rate is very low at least for consumers in the top half of the income distribution, in part because earlier in the expansion, capital gains in equity markets substituted for more conventional forms of saving. This former source of savings is not so abundant now, raising the risk of consumer retrenchment. Similarly, demand for autos and other consumer durables may not remain at its current relatively robust level, particularly in the face of job uncertainties. On the other hand, gains in house prices continue and remain a significant source of wealth for many households--in fact, a good deal more than those who experienced the surge in equity wealth in the late '90s.

I mentioned at the beginning of my remarks that this is a period of considerable uncertainty. It may be that the drop in business spending has leveled off, and that in the face of continuing consumer demand, the over-investment problem may gradually abate allowing businesses to grow into existing capacity and resume investment in new technologies. This could take time, however. The Federal Reserve has eased policy rapidly over the past five months, and overnight rates are now a full 2.5 percentage points lower than they were on January 1. Moreover, much of the impact of this easing will be felt in the latter part of this year, possibly providing a boost along with the fiscal stimulus just when other parts of the economy may be turning up. The consensus forecast continues to see a pick up in the latter part of the year and I think there is a good chance this is what will happen. But this is by no means a certain outcome, and the preponderance of current economic data suggests that in the short run, downside risks are real.

Looking beyond the current period, however, longer-run questions are key. These are questions to which I don't have answers, but they also shape my heightened sense of uncertainty. How does the central bank know how much is enough? Is the monetary stimulus already in the pipeline sufficient, or is more needed to ensure recovery? Current real overnight interest rates are below normal averages, and below many assessments of the long-run equilibrium. But are these rates low enough, given demand conditions? Finally, when the economy does turn around, will inflation be the worry? Recent increases in employer compensation coupled with slower productivity growth have produced more rapid growth in unit labor costs. Headline inflation, however, has been relatively moderate lately, absent the impact of increases in energy costs, which are expected to be transitory. But further down the road, as the economy retraces its steps back to its long-term rate of growth, this may become a concern that needs to be addressed.

The national economy has been facing uncertainty in the face of slow growth, manufacturing retrenchment, and reliance on a consumer stressed by job questions for some time. New England generally, and Massachusetts specifically, however, are only now beginning to experience these problems. This region has been healthier longer than most of the rest of the nation, in part, because it is so diversified and, in part, because it is not a primary home of industries hardest hit by the decline initially--namely automobiles and steel. However, both New England and Massachusetts have a large, high-tech manufacturing base and the longer the high-tech slump lasts, the harder the region may be hit. To date, incoming data on local jobs suggest the region is holding its own, but there are worrisome signs as well.

From April 2000 to April 2001, payroll employment in New England grew more than twice as fast as the U.S. as a whole. Massachusetts's growth was even faster, especially in construction employment. Services also grew faster in the state than in the nation, while manufacturing employment declined less rapidly.

However, various indicators suggest that the demand for workers is softening. Nationally, help wanted advertising has fallen sharply over the past year. The New England data are much more erratic; but if one smoothes through the ups and downs, they too seem to be trending down. The help wanted index measures the number of want ads in newspapers; as businesses have done more of their advertising for workers over the Internet, this index has become a less useful measure of the number of job vacancies. Accordingly, one of our economists has begun to follow data from a company, Flipdog, which compiles data on the number of online job listings, scaled by the size of the labor force. On-line advertising is apparently quite popular in New England, especially in Massachusetts. The volume of on-line advertising in Massachusetts is higher than in any other state. However, after rising rapidly over the course of 2000, on-line advertising in Massachusetts has fallen sharply since December.

More revealing, perhaps, initial unemployment claims have started to increase in New England and the unemployment rate has edged up. The unemployment rate is still extremely low - just 3.0 percent for the region in April and 3.2 percent for Massachusetts, but it is higher than a year ago both for the state and for Boston.

As you may know, Reserve Banks conduct informal surveys of businesses in their Districts in order to gather a more timely picture of the economy than is available from statistical information. The "Beigebook", as the compilation of write-ups from the 12 Reserve Banks is called, also provides businesses' interpretations of economic events. At times, the Beigebook can be quite revealing, and I think that is the case at present.

Our staff in Boston was quite surprised by the pessimistic tone of their conversations with New England businesses. The situation at the end of May, when these conversations were held, was quite different from that six weeks earlier. Business was reported to be flat to down compared to a year earlier and our contacts were nervous about the outlook. They do not know when to expect an upturn.

Among manufacturers, two-thirds of our contacts reported that business is the same as a year ago, one-third reported sizable decreases. They have instituted aggressive cost-cutting programs, involving layoffs, shortened workweeks, and plant shut downs. Personnel supply firms have been particularly hard hit, with business off on the order of 20 percent from a year ago. Demand for IT workers has fallen very sharply. One contact at a personnel supply firm said that the change had happened at "Internet speed". He claimed that companies were importing workers from India a few months ago, and are now sending the workers back. A number of software houses have also experienced a sharp slowing in demand. Both the software providers and some of the personnel supply firms identified cost-saving efforts on the part of large firms as responsible for the slowing. Big national companies that had been growing rapidly and accounting for an important share of these firms' business activity are now hunkering down. Thus, while the statistics indicate that the New England economy is currently performing better than the national economy, it is clear that the region is vulnerable to the same problems as the nation and further, that these problems continue to ripple out. As we look forward, the best bet is that the region's performance over the next year or so will closely mirror that of the nation.

Conclusion

In closing, let me say that I am guardedly optimistic that the consensus forecast is a good one. That is, starting in the second half growth will pick up in both the region and the nation. The economy has slowed from a very high pace of activity and some time is needed to absorb the excesses that period of growth engendered. Downside risks exist to be sure, but both monetary and fiscal policy makers are focused on addressing those risks, and shaping the environment for a resumption in sustainable growth.

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