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**“The Economic Outlook: Issues and Uncertainties”**

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Thank you for inviting me to speak on this distinguished panel. I can assure you that, with regard to real estate markets and prospects, the information will flow will be from you to me. However, perhaps I can shed some light for you on the current thinking at the Boston Fed on the evolution of the national economy, and the role that monetary policy has played in that evolution. In my comments, I want to address three questions. Where is the economy right now? What's different about this period? And, finally, where are the risks?

First, where are we now? Clearly, the economy is in the midst of a drop-off in economic growth that is steeper than most analysts would have expected even as recently as six months ago. This slowdown in the U.S. economy increasingly seems to be taking on those characteristics of depth, duration and diffusion that are used to classify periods as recessionary. Third-quarter GDP numbers showed a small decline in GDP, the first drop in eight years and the largest since the 1990-91

recession. The Blue Chip consensus forecast has GDP falling by about 2 percent for the current quarter. While this outcome is far from certain, I see little reason to question the broad thrust of that forecast. The slowdown has been proceeding for some time; industrial production alone has fallen for twelve straight months, the longest string in post-war history. Finally, and most importantly, over a million jobs have been shed in the last nine months or so by businesses across a broad swath of industries, first in manufacturing and then expanding to services as well. So whether or not this period is ever seen as a recession, the economic hardship has been significant.

Similar to that old saying about unhappy families each being unhappy in its own way, periods of relatively unhappy economic prospects have their unique aspects as well. This one is no different. As compared with other slowdowns in post-war history, this one is a bit different, and I want to talk a bit about those differences. For one thing, a marked decline in capital

investment has *led* us into the downturn. It is far more common for investment spending to follow the rest of the economy into a slump. The investment downturn began in response to Y2K and “dot-com”-fueled over-investment in 1999 and early 2000. Since then, declining corporate profits, spreading economic weakness and general uncertainty have led most firms to put investment plans on hold. Many businesses have discovered the ability to “manage obsolescence,” extending the normal cycle of computer turnover, for example. The result has been double-digit declines in equipment and software investment over most of the past year. Moreover, orders and shipments data suggest this weakness will continue in the near term.

The obvious question is how long will this continue? One take on this is that the depth of the decline, and the related sharp drop-off in inventory spending might be precursors to growth once demand recovers. In fact, the potential for

inventory spending to support growth is one reason why most forecasts see an upturn in mid-2002 or so.

A second key difference has been the relative resilience of the household sector. You can find evidence of this resilience in a number of areas: personal consumption expenditures, especially durable goods, have continued to grow, even through the most recent month's data. Housing starts and building permits have remained at elevated levels, rather than declining at the 20-plus percent rates that are typical during the early phase of a contraction. Auto sales broke records in October albeit because of large incentives and 0% interest financing. Some say this simply brings future spending forward to the present, leaving the future weaker, and there clearly is some logic to that. But the desire to spend a hefty sum at all seems to me to be a sign that the consumer has not yet thrown in the towel.

Consistent with this, at least in my view, is the fact that some measures of consumer sentiment have remained at their

pre-September 11 levels. Moreover, while some of the resilience in housing can be attributed to aggressive monetary easing earlier this year, the willingness of so many households to continue making this largest of investments is yet another testament to the underlying vigor of their confidence.

To be sure, one can see the clouds surrounding the silver linings in these indicators. Consumer spending, while still growing, is growing at an ever slower pace—just barely above 1 percent in the most recent quarter. And the hoped for stimulus from the tax rebates (or more properly, advance tax credits), distributed from July through September, has so far not materialized. In fact, saving from July through September increased by *more* than the amount of the rebates.

Housing sales, though buoyed by the Fed's aggressive cuts, have been roughly flat over the past year, not growing. In addition, the house price increases that added importantly to homeowner wealth over the past decade appear to be fading. This form of wealth creation, born of vibrant real estate, has

been a key mainstay of ebullient, broad-based consumer confidence and strong consumption during the late nineties. Leveling off of growth here could be a warning light for the near future.

A third difference this time around has been the near absence of inflation concerns. Directly preceding most post-war downturns, some would even say causing such slowdowns, monetary policy tightened to address the rising inflation that typically followed periods of expansion. This time around, aside from volatile oil prices, inflation has not been a significant issue, though clearly it is always a concern. That has led to both more restrained tightening from mid-'99 on after the domestic effects of the 1998 world financial crises subsided, and to the current ability to ease policy more aggressively in response to economic weakness.

Another major difference between this downturn and its recent predecessors is that the longer-term underpinnings in the economy appear to be considerably stronger now than they

were in the 1970s and 80s. In particular, I believe the long-run prospects are good for the continuation of the stronger average productivity growth that we saw over the last half of the decade of the nineties. To be sure, some cyclical downturn will be seen in productivity in the near-term. Moreover, the necessary resources that now need to be devoted to increased security may, for a time, slow measured productivity growth. But I believe the impact of this will be temporary, and that the desire of U.S. businesses, so evident in the late '90s, to work smarter and harder and to be ever more competitive will reassert itself.

In part, productivity growth will be fueled by continuing investments in new technologies--after all, businesses spent over \$400 billion on high-tech equipment and software in 2001 even in the face of a sharp slowdown in such investment. But it is also fueled by the ongoing improvements in organization and business processes that were so important to low-inflation growth in the 1990s. Future productivity gains help anchor the

inevitable recovery, and provide the foundation for continuing price stability.

Finally, both monetary and fiscal policy are available tools to address this downturn. In response to the evolving sense of weakness, both before and after September 11, the Federal Reserve eased policy aggressively, including at its most recent meeting on November 6. Overnight rates are now a full 4.5 percentage points lower than they were on January 1. Arguably, this is the most aggressive period of easing in the past 60 years--in contrast it took years, not months, for policy to ease by the same amount in the early '90s. Clearly, this ability to move aggressively when needed is a benefit of the low rates of inflation of the past several years.

By this Bank's estimates, these policy easings have already had sizable effects: they have spurred the recent wave of mortgage refinancings, the strength of housing demand, and even 0-percent financing in this low rate environment is considerably easier on the bottom line for auto companies. But

a good deal of the impact of the easing is still to be felt, and it is my expectation that the ongoing effects of lower rates will provide a needed boost during this period of economic downturn.

Fiscal policy is also poised to provide additional stimulus, and this response certainly is aided by the elimination of fiscal deficits in the late nineties. Although there remains considerable uncertainty about the precise contours of the likely fiscal package, some combination of tax rebates to households, tax incentives for capital spending, and perhaps extended unemployment insurance benefits would not be unexpected.

So, to go back to my three issues. Where are we now? With a major downturn in capital equipment continuing, and a flattening out of consumer spending, rising unemployment, and no help on the external side--a fact I'll get to later--most forecasters see a contraction already underway. Certainly there are some positives in the mix--consumers may have more

staying power, productivity provides some hope, inflation is tamer, and the monetary policy response has been aggressive, but they don't change much about the central tendency of things. The Blue Chip consensus forecast expects the downturn to be modest and relatively short, with the 2 percent decline in GDP this quarter that I mentioned earlier, followed by a gradual recovery in 2002. This Bank's forecast tracks this consensus pretty well. But for every forecast, there are a set of risks. Now I want to turn to my last question, where are those risks?

In my view the outlook is clouded by more than the usual degree of uncertainty, and much of this uncertainty lies on the downside, as reflected in the FOMC's recent press statements. The steadfastness of the consumer rests on a somewhat shaky foundation. Consumer debt burdens, even adjusted for the lower cost of finance, are quite high; the asset-side offsets to these liabilities—stock market and housing capital gains—are both moderating, at least relative to their '90s ebullience. In

addition, rising unemployment could be shaking consumers' faith in the future. This uncertainty, in turn, could tend to temper willingness in the near-term to make further purchases of big-ticket items such as cars, home electronics, and furniture. Because consumer spending has provided the counter-balance to investment weakness over the past year, the risks to the household sector will need to be monitored closely over the coming months, especially in the wake of the relatively poor employment data of late.

On the business side, the foundation is showing cracks as well. Nonfinancial business debt has risen sharply over the past four years as cash flows have slumped. With declining equity markets and widening spreads in bond markets, financing for all but the highest investment grade companies has become more expensive to finance in the market and, some say, harder to find from banks. About one-third of all corporate debt has been downgraded in each of the past two years and defaults on such debt have risen as well. Corporate

profit growth has been declining, and profits are back to their 1998 levels. Thus, the potential for feedback from poor business prospects, business investment, and equity valuations to household wealth and spending adds another risk to the mix.

Finally, we cannot expect the rest of the world to give us a boost out of our slump. While many analysts were relatively upbeat about foreign prospects earlier this year, that tone has changed more recently. The current OECD outlook is for global growth at a level below 2 percent. That would put growth on a global basis slower than it has been at any time since the early 80s. Moreover, uncertainty about the ways in which the increased inter-connectedness of the world's economies will affect the dynamics of global weakness further clouds the horizon.

When the economy does turn around, will we return to the halcyon days of the late 1990s? I think that depends on whose version of the 1990s story you read. In my version, something real happened to productivity growth—it went from

growth of just over 1 percent to something above 2 percent. That is not as exuberant as the most optimistic assessment of what happened, but it's still a remarkable boost in the economy's long-run potential to produce. It suggests we can grow at 3 percent or a bit above without straining capacity and running into imbalances. After this current period of weakness, I think it's reasonable to expect that growth will return to that higher level of potential. If most forecasters are correct, that should happen by the end of 2002. But in some ways, that is the easier prediction--the harder one is to divine the shape of the next two or three quarters. Policy response has been aggressive, and that in itself calls for some degree of vigilance going forward in my view, but the evolving dynamics of this downturn need a clear focus as well.

Before going on to the rest of the panel, let me say a few words about what we at the Bank are seeing for the macro-prospects for the region. I think you'll all recall New England seemed to have a teflon-coating during the beginning of this

slowdown. Clearly, that is not the case now. The rate of job loss and the increase in unemployment are now roughly paralleling developments in the nation, although unemployment rates remain well below national levels. Actually we'll see more about that tomorrow. Initial unemployment claims have increased steeply in New England, as they have nationwide. Specifically for high tech, data from Monster.com indicate that there are three times more job seekers posting their resumes than there are job openings; at the beginning of the year, these numbers were in balance.

I don't need to tell this group that commercial vacancy rates in the region, which had been considerably lower than the national average, have now caught up with the nation's elevated rates. While this sector is in no worse shape here than the rest of the nation, the recent rate of deterioration in the region's commercial real estate occupancy has been greater than the national average.

Looking forward, both New England and Massachusetts have a large, high-tech manufacturing base and related information technology services industries, so the longer the slump in business investment lasts, the harder the region is likely to be hit. In that regard, our Beige Book contacts continue to push out the date at which they expect to see conditions pick up again. While the New England economy is vulnerable to the same problems as the nation, these problems have shifted in the past few quarters into areas, notably high tech business investment, in which New England has above-average vulnerability. As a result, the New England economy could turn around somewhat later than the nation's.

But for a variety of reasons, the region is much better poised to weather this downturn than it was in the late 1980s. During that period, the region's problems—a dramatic adjustment in real estate prices and its effect on household balance sheets; the effect of the real estate collapse on bank portfolios that were lopsidedly concentrated in real estate; and

**an ongoing adjustment on the part of defense contractors to reduced federal spending—were considerably more deep-seated, requiring difficult structural adjustments. My expectation is that the region, like the nation, will gradually work its way out of recession over the next year or so.**

**Thank you. I look forward to the perspectives from the other members of the panel.**