Rhode Island Economic Summit

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Thank you. It's great to be here in Providence and be part of this important conference. It is early in the year, a time to reflect both on the experiences of 2001, and the prospects for 2002.

The past year evokes powerful social, economic and personal memories. The tragedy of September 11 stands out as an historic watershed in terms of its enormous consequences for this country, for the lives of thousands of families who lost loved ones, and for the heroic public servants who continue to labor at ground zero. Truly it was a time when—in the words of one of my colleagues—ordinary people did extraordinary things.

Directly in the wake of that horrible day, U.S. financial markets were tested in ways never conceived, and came through, keeping market problems from adding to the concerns facing this country. Reserve Banks played a key role here, a role of which I am very proud. The Federal Reserve monitored the financial system, supplied sizeable amounts of liquidity and kept key parts of the underlying operational plumbing that keeps that liquidity flowing functional through long hours in the days after the crisis. This kept the payments system working, eased the markets' reopening, and made a difficult situation easier to deal with. Clearly, the Reserve Banks and the rest of the financial sector were prepared for contingencies—Y2K, if nothing else, had seen to that—but a lot was learned about what else needs to be done to better address contingency situations. So we have our 911 projects to complete this year, and I expect many of you do as well.

Beyond the tragedy, however, 2001 also witnessed the beginning of the first recession in about a decade. Obviously September 11 made things worse, but it is also possible that a recession might have occurred in any event given the slowdown that preceded that historic day. Since then, many aspects of the economy—the consumer, the equity markets just to name two—seem to have rebounded from the immediate shock of the tragedy. But the pace of economic activity is still very slow and uncertainties abound. Much of the incoming data now suggest that things are bottoming out and a recovery is in the works for 2002. The big question is what that recovery will look like. Will it be the rapid pickup experienced after most recessions? Or will it be something that takes place more slowly? I want to reflect a bit on the answers to those questions, assess both what's likely to happen and where the risks are. Then, I will be focusing at some length on the effect of the current slowdown on the fiscal condition of state governments, both because of its interest to many of you and because circumstances have changed here unusually fast.

Over the last several years economic forecasts have often been wrong, sometimes markedly so. In the late '90s, nearly all underestimated the economy's potential to grow and overestimated the degree to which inflation might be a problem. Then, just as many were getting the hang of predicting a high growth, low inflation economy, growth started to stall. Last year saw errors on the opposite side, at least as it regards growth, with most forecasts of GDP revised downward with every passing month.

In some ways this is no surprise. Economic forecasting is based on the idea that the future will obey the rules of the past. Thus, forecasting is particularly difficult when economic fortunes change direction, or when the rules of the present truly are different from the past. Last year saw an important economic turning point, so it's not surprising that after the longest period of economic expansion in U.S. history, a downturn was hard to predict.

But the last several years truly have been different as well. The last half of the decade and the first years of the new

millennium were unlike any in thirty years or so. During the late nineties, economic growth was fed by rising levels of productivity. This was spurred in part by large business investments in new technology, accommodative financial markets, and rising consumer and business confidence and demand that fed on itself to create even faster growth. And, in spite of periods of oil price increases, inflation never really surged.

Remember the last quarter of 1999, when the economy grew at a 8.3% pace? Even with rising productivity, mature economies with slowly growing labor forces cannot maintain that pace for long without severely straining resources. As Herb Stein said—if something can't continue, it doesn't.

Businesses saw profits eaten away by rising wages paid to ever harder to come by skilled workers, and by increases in energy costs. They began to cut back by trimming workforces and by cutting costs particularly in the area in which they had spent so much in the last half of the nineties—capital goods, especially high-technology-computers, software and anything to do with telecommunications. As businesses stopped spending in the fall of 2000, economic growth slowed suddenly as well—to remind you, in the first half of that year the economy grew by 4%; by fourth quarter it was growing at a pace less than one-half of that. And that pattern of very slow and eventually negative growth continued through 2001.

But even the slowdown has been different from the normal recession. Usually a downturn in business fixed investment follows rather than leads an economic slowdown or a recession. The usual, though simplified, recession timeline goes like this: fast-paced growth strains the economy's resources raising the potential for rapidly rising inflation. The Fed steps in to return the economy to a more sustainable level of growth and the interest sensitive sectors of the economy begin to slow. Consumer spending on houses and other big ticket items contracts and the rest of the economy follows suit. But, in this recession exactly the opposite has happened-consumer spending has maintained some strength but capital spending has been slowing or declining for over a year.

Most forecasts now see what is being termed a short, shallow recession with a resumption of growth at a very solid pace by the last half of 2002. Indeed, GDP growth for the fourth quarter of 2001 now appears to have been slightly positive, though I would caution that the first readings on GDP are often revised, and recently most revisions have been in a negative direction. Nonetheless, there are good reasons to expect the recovery is, if not upon us, certainly near.

After a year of vigorous inventory reductions in the face of weak sales, businesses are likely to ease the pace of inventory trimming, especially if demand strengthens. This could add strength to industrial production. Recent growth in productivity suggests the squeeze on corporate profits may begin to ease, providing the cash flow businesses need to increase spending. Further, businesses may be poised to resume spending on technology. Signs of this can be seen in data on chip production, new orders for durable goods and in surveys of purchasing managers. If business investment just stops falling, GDP growth would be nearly 1 percentage point higher, all other things being equal. That alone might keep the economy in positive growth territory.

But all forecasts should be taken with a large grain of salt. The best guess may be a short, shallow downturn, but there are risks, particularly as to how fast and how sharp the recovery is. I want to talk about several of these areas of risk, not to dissuade you from feeling optimistic, but to temper that optimism somewhat.

First, the U.S. slowdown does not exist in a vacuum. Most of the rest of the world has followed the U.S. into recession, with forecasts of world growth below 2% for at least the first half of 2002. Growth outside the U.S. had been driven by overheated U.S. demand in the late nineties, with exports to this country, rather than domestic demand, leading growth. With the U.S. slowing, our imports have declined affecting the growth of trading partners in the rest of the world. There are spotty signs of recovery in some countries, but, for the most part, it seems unlikely that foreign demand, independent of a resurgence in U.S. growth, will act to cushion U.S. economic activity anytime soon.

Second, while inventories were drawn down to very low levels in 2001, much of the drawdown was in consumer durable goods. A lot of this was the result of financing and other incentives related to consumer purchases of automobiles. Inventories of goods other than autos don't seem particularly low relative to sales. This calls into some question whether the inevitable inventory turnaround beyond autos will be as robust as the headline inventory reductions might suggest.

Third, and most important, one has to be skeptical about whether U.S. business investment will grow at a solid pace if anything should happen to the remarkable resilience of the US consumer. Consumption is two thirds of gross domestic product-it is very hard for the economy to grow if consumers are not willing to spend. This has never been more evident than in the past year when, despite the recession and September 11, consumers bought autos and new homes at near-record clips. Indeed, spending picked up as the year ended with fourth quarter consumption growing by over 5 percent.

But the real question is whether the consumer will stay the course long enough to revive business investment. And here one can reasonably have doubts. On the positive side, eleven cuts in short-term interest rates by the FOMC have created an environment in which it is easier for consumers to borrow and spend, putting a floor under the weak economy. Some of the effects of that ease are still in the pipeline. Moreover, the pace of job losses has begun to slow and the unemployment rate did fall a bit in January, though this is largely the result of a marked decline in the labor force. On the negative side, outstanding amounts of consumer debt are at high levels historically, interest payments as a share of disposable personal income are high and personal bankruptcies are as well. This can continue only so long before consumer finances become a drag on spending and overall financial health.

And we should remember that the spending spree of the last couple of years really can't continue-just take automobiles as an example. Consumers have been buying new cars at a record 16 million unit a year pace for some time now. One wonders how many cars U.S. consumers can own or how many driveways they have.

There are other possible clouds on the horizon as well. Equity and credit markets started the year in a state of growing optimism. Longer term interest rates remained relatively elevated after a year of declining short term rates likely reflecting, at least in part, optimism about a surging economy later this year.

Similarly, as the year began, equity markets were elevated as well, with price-earnings ratios for the S&P 500 at about double their long run average. And this after a year in which corporate profits plunged 20 percent, and corporate profit levels were down to those last seen in 1995. Over the last couple of weeks, however, credit spreads have widened, and equity markets have fallen back, reflecting the fallout from the recent revelations related to corporate accounting. To be sure, the incoming data on corporate profits is somewhat better than it had been and surprisingly strong productivity growth also bodes well. But it is also clear that corporate profit data will be viewed with increasing skepticism. Right now, anyway, equity markets may not be feeding into consumer confidence and demand in the way they seemed to be even two or three weeks ago.

So what's the answer to the question I posed earlier? Will the recovery follow post War trends and be swift and sharp—that is averaging 6 or 7% in the first few quarters? Or will it be longer and slower, growing at half that pace? All the factors I've just mentioned—a weak foreign sector, doubts about an inventory rebound, risks to the strength of consumer demand, financial market uncertainties—suggest to me that longer and slower may be the best bet. A mild recession, and perhaps a mild recovery, in some ways not a bad outcome. But for certain segments of the economy, many of these factors suggest longer lasting problems. One of those segments is state government.

The recession and September 11 have dramatically reversed state fiscal fortunes. State tax revenues grew by 6.5 percent in fiscal year 2001 and by 8 percent the previous year. This tide of revenues was strong enough to support tax cuts, accelerated spending, and substantial deepening of reserves. All that good fiscal fortune is now a distant memory. Budget makers are throwing their policies quickly into reverse, mulling tax increases, spending cuts, and withdrawals from rainy day funds. However, like the captain of an ocean liner, they're having difficulty turning things around quickly.

Growth in state tax receipts began to slow about a year ago. What began as a worrisome deceleration has turned into a steep plunge that has precipitated serious fiscal problems in almost every state. Through December 31, the midway point of the current fiscal year, nationwide state tax receipts stood 7 percent below a year ago, with revenues in all but 5 states below budgeted levels. Receipts from personal and corporate income taxes, which together account for almost half of state tax revenues, have been shrinking the most rapidly, a reflection of declining employment, the weakening stock market, falling profits, and enacted tax reductions.

The situation in New England is as serious as it is elsewhere. General revenues to date have fallen or are flat this year in every state in the region except New Hampshire. New Hampshire's relatively strong performance mostly reflects an

increase in its business profits tax rate enacted in response to by a court-ordered increase in education spending. At mid-fiscal year, Rhode Island's and Connecticut's general revenues were both off 4 percent. Through January, Massachusetts' year-to-date tax revenues were almost 10 percent lower than the level at the end of last January. Most forecasters foresee no improvement in the state revenue picture for at least several months.

Since revenue shortfalls developed rapidly, they threw 2002 budgets way out of kilter. Moreover, these shortfalls confront fiscal planners with the prospect of significantly larger imbalances in fiscal year 2003, which begins in less than 5 months. Governors and state legislators across the nation have responded to the immediate problem with every weapon in their budgetary arsenal. On the spending side they have delayed construction, imposed bans on travel and purchases of IT products, cut local aid, and postponed contributions to public employee retirement funds. Some have increased borrowing. Several, including every New England state, have recently implemented or have considered increases in cigarette taxes. (Maine doubled theirs in 2000). A few are considering delays in the implementation of previously enacted tax cuts.

Had the states not buried so many fiscal acorns, many would be facing a budgetary crisis rivaling some of the worst in post-war experience. As recently as last June, total state reserves were almost 8 percent of general fund spending. By contrast, in June of 1990, at a comparable point in the business cycle, reserves were less than half that share of spending. However, over the course of the current fiscal year, reserves are expected to shrink by over 20 percent and a comparable decline is highly likely during fiscal year 2003. Within New England, Governors Swift and Rowland, the two governors who have released their proposed FY2003 budget, are both counting on significant reserve fund withdrawals to achieve fiscal balance without major tax increases.

However, tapping reserves by itself will not solve the problem. Slowing growth in spending will be an important component of most fiscal strategies this year and next. From fiscal year 1998 through fiscal year 2001, the states increased general fund spending along with the growth in revenues or by an average of 7.2 percent per year. This fiscal year, spending is projected to grow by less than half that pace. But most reductions cannot be implemented across the board. Some rapidly growing programs are extremely difficult to reign in.

The most prominent example is Medicaid, a program accounting for one-fifth of all state spending in fiscal year 2000. During the late 1990s, when revenue growth was rapid and the cost of medical care was under control, several states extended the coverage of their Medicaid programs. During the past couple of years, however, the program's costs have increased sharply. Several factors are responsible besides expanded eligibility and outreach. Prices of prescription drugs have risen and their use has broadened. After years of low reimbursement rates, health care providers are demanding higher payments. The number of disabled Americans has increased. Cost savings from managed care have proven disappointing. As a result, state Medicaid expenses grew by 14 percent during fiscal year 2001, more than twice as much as appropriated. This fiscal year, states have appropriated an increase in Medicaid spending of almost 9 percent. Absent reductions in benefits, 9 percent might not be enough.

Local aid for elementary and secondary education, which accounted for 23 percent of state spending in 2000, will also be difficult to pare. The demand for educational services remains strong. State and local governments continue to respond to the challenges of educating the baby boomlet generation by hiring more teachers and by expanding classroom space. Similar pressures and demands have stiffened resistance to cuts in public higher education, which commands 11 percent of state spending. State budgets for the current fiscal year provide for a nationwide increase in spending on education of less than 4 percent, much less than increases of recent years. Still, several states have spared education from the latest round of budget-cutting measures.

Categories of spending other than Medicaid and education account less than half of state general fund outlays. Much of this remainder is also difficult to cut. Health care for public employees, public health and safety spending, particularly in light of September 11, corrections, public transportation, and contributions to public employee pension funds all enjoy strong support and are very difficult to cut. Whichever way they turn, fiscal policymakers are going to have to wag a big dog by a small tail.

When are state governments likely to obtain some fiscal relief? Given the forecast I spoke of earlier, budgetary pressures aren't likely to ease materially until the early part of calendar year 2003. Although most economic forecasters

believe that the economy will be growing at a respectable pace before then, growth in income tax revenues will probably lag since employers are generally reluctant to hire back workers until they're confident that the recovery has legs. Sales tax revenues might be sluggish for several more quarters, since consumption of durables is not likely to surge as much as it usually does during the early stages of a recovery. Consumers have been buying too much all along, and are too deeply into debt, to spearhead a burst of growth. Nor will spending pressures abate very much; demands for health care, school funding, and homeland security will continue to stiffen resistance to deep spending cuts in these areas. Many previously enacted tax cuts will probably be implemented, further tightening the fiscal noose around the states.

Arkansas Governor Mike Huckabee summed up the fiscal bind of the States colorfully in mid-November. The Governor warned that, unless things improved very quickly for state governments, “we're going to be.between a dog and a fire hydrant.”

In sum, it may well be that the recession of 2001 will be seen in the fullness of time as one of the shallowest on record. But how quickly the economy returns to healthy rates of growth remains a question. The rebound might be rapid, driven by inventory restocking and solid productivity growth. Or, more likely, in my view, it might be slower, in the face of waning consumer willingness to spend on autos and other durables, a weak foreign sector, and financial market uncertainties. Moreover, state spending, a source of strength through 2001, seems poised to subtract from growth as well.

The American economy has had to absorb some extraordinary shocks over the past year or more. It has done so in remarkable fashion, even in the wake of the tragedy of September 11. There is much that is good news in incoming economic data—glimmers of hope for manufacturers, strong productivity, a slowing in the pace of job losses, and growing consumer confidence. There is reason to be optimistic, but it is also wise to temper this optimism with caution.

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