

The Greater Newburyport Chamber of Commerce and The Newburyport Rotary Club Economic Forum Luncheon

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Good afternoon. It's a pleasure to be here today. I want to thank you for the invitation - and especially thank Dave Outhouse from First and Ocean National Bank. It was an invitation that was impossible to refuse - Dave's one of my directors. We at the Bank really appreciate his contributions to our discussions about economic conditions, and his perspectives on management issues.

The last time I spoke here in this lovely city was a few years ago at the beginning of what was a remarkable period in U.S. economic history. For a good long while there, things only seemed to go one way - and that was up. Whether one looked at GDP growth, employment, the stock market or that key ingredient for long-term growth - productivity - the story was the same. All these were growing at rates not seen since the sixties even after what was arguably twenty years of expansion. Yes, there was a recession in 1990-91, but it was relatively short and mild most everywhere except here in New England.

That is not to say that there were no problems in the late '90s. The rest of the world suffered several crises--witness Mexico, Southeast Asia, Russia, the malaise in Japan, and, closer to home, the demise of Long Term Capital. And we know now that the first signs of some of our current geopolitical threats were becoming evident. But the U.S. economy seemed Teflon-coated through it all and just kept steaming along.

But that was then, and this is now. To many of you here in the metropolitan Boston area, with its concentration of telecommunications and high-tech industries, the Teflon probably seems pretty thin, or maybe perhaps worn through in places. But it hasn't disappeared. Despite a number of significant and unprecedented shocks over the last couple of years, the economy has shown what has to be seen as remarkable resiliency. Today, I want to reflect a bit on the nature of the economic shocks we've experienced, the resiliency that has characterized this current period of slow recovery, and the prospects facing us, uncertain though they may be.

To understand the central shock that rocked the economy, we have to go back to the exuberance of the 1990s. During that period, the stock market rose to highs never before seen, and probably never before imagined. This both reflected and helped to spur an investment boom whose duration and intensity had not been witnessed since the sixties. In retrospect, it is easy to say that there were clear indicators that this exuberance was excessive. The NASDAQ quintupled in 4 years. Price-earnings ratios reached all time highs and were more than double any value seen since World War II. But, as it is with all bubbles, there were many ways to justify why the normal relationship between equity prices and their fundamentals had changed. The most commonly accepted view was that technological change and the resulting increase in productivity growth had radically transformed the economy. And the productivity increases, even with data revisions after the fact, were sizeable and important. Equity prices attest to how many investors and fund managers signed on to this explanation.

And, they weren't the only ones. Many businesses invested based on the assumption of a "transformed" economy. In fact, the growth in investment was almost as impressive as the increase in equity prices. From 1995-99, real investment in computers and software grew at a compound annual rate of 45 percent. Spending on telecommunications gear also expanded rapidly over this period. But beyond these numbers, it was the duration of this investment boom that was so

remarkable, essentially lasting most of the period from 1993-2000. It is not unusual once recoveries take hold to get spurts of investment of similar magnitude, but it is rare to get spurts of investment that last so many years.

At the time, both equity prices and this level of investment may have seemed reasonable, but they proved to be too optimistic. I think an example from the times would be illustrative. The perceived demand for new technology and additional band width seemed to be limitless. It has been reported recently that the U.S. Commerce Department issued a press release in April, 1998, saying that a study of usage on the Internet showed that the Net was doubling every 100 days. But this finding was based on data from the early, initial burst of excitement about the Net. Investment based on that trend continuing was way too optimistic. Since then, usage has doubled about every year, not every 100 days. With compounding, this suggests that data used by an entire industry to aid in forecasting Internet demand was off by a factor of about 6. So it's no wonder that prospective demand seemed unquenchable and over-investment occurred.

Adding to this mix was the significant investment in computing equipment to upgrade systems prior to the century date change. This torrent of investment eventually produced excess capacity in many industries, particularly telecommunications. By the beginning of 2000 it became obvious that much of this investment was at best premature. Almost simultaneously, the NASDAQ, and all but the Blue Chip stocks, began a serious slide. The economy proved to be more "new and improved" than "radically transformed." Wider spreads in interest rates reflecting a new sense of risk made financing investment more difficult for all but the most investment worthy. As a result, business investment in total hit the wall - falling from a growth rate of about 12 percent in the first half of 2000 to zero percent in the second half of that year.

This decline in investment was not the only blow the economy endured toward the end of 2000. Although real estate prices kept increasing, the fall in equity values led to a decline in the consumer's net worth. Households reacted to this and to the problems in manufacturing brought about by the investment slowdown. They cut back and consumption growth fell from 5 percent in 1999, to less than 3 percent in the second half of 2000 - respectable for sure, but more consistent with a modestly improved economy, than a radically transformed one. Weakness abroad led to an actual decline in exports. By the first quarter of 2001, all these factors were sufficient to push the economy into a mild recession.

Normally, the bad news would stop there. Monetary policy would ease, firms and households would start spending again, and the economy would spring back to its feet. And, in fact, monetary policy did ease, and consumers did their part by continuing to spend through the summer. But, this time just as the recovery appeared to be taking off, the country and the economy were confronted with the terrorist attacks of September 11. The resulting increase in risks, both geopolitical and personal, appeared at first to weaken the confidence of the consumer, thus stalling the locomotive that had been pulling the economy out of recession. In September of last year, survey measures of consumer confidence fell significantly, and travel plans as well as many purchases were postponed.

And still, there was one more shock left, and we are still experiencing its repercussions now. By late last year a series of scandals hit Wall Street. Whether the scandal involved large distortions of a company's earnings, such as Enron and Worldcom, or the misuse of company assets, such as Tyco, the reliability of reported corporate earnings and the trustworthiness of corporate leaders came under suspicion. These scandals further eroded confidence in an already wobbly stock market, and equity prices began another tumble in 2002. So far this year, the S&P has declined 25 percent and the Dow has fallen almost 20 percent. From their peaks in 2000, the Dow is down over 30 percent and the S&P down over 40 percent. In the post-war era, only the bear market that followed the first oil shock in 1974 was worse. This most recent shock, combined with the aftermath of 9/11, the continuing excess capacity especially in telecommunications, and dicey prospects for corporate profits, threatens the continued recovery. That's about where we stand right now.

Yet even with these continuing problems, the economy has been expanding since the fourth quarter of last year. As we look back, a natural question is "how." How has the economy remained so resilient in the face of these blows? The answer, so far, lies with the continued optimism of the U.S. consumer. Fiscal policy has helped here, as has a major adjustment in inventories, but so far the U.S. consumer has saved the day.

The consumer fended off the blow from 9/11. The attack on September 11 may have reduced measures of consumer

confidence and badly affected the airlines, but it did not appear to affect the consumer's fundamental confidence in the future. Consumption exploded in the fourth quarter of last year as consumers purchased autos and trucks in record numbers. Consumers also continued to invest heavily in new homes. The low prices consumers were facing for both autos, in the form of sales incentives, and houses, in the form of low mortgage rates, explain some of this resilience. But the willingness of consumers to commit to these long-term obligations also reflected the confidence consumers continued to have in the economy.

Consumption has continued on a more subdued but solid pace through this year as well. After expanding at a 6 percent rate in the fourth quarter, consumption grew 2-1/2 percent in the first half of this year. Help to consumers came in the form of tax cuts and rebates - allowing consumers to pay for even more purchases of cars and houses. Interest rates fell to their lowest levels since Eisenhower's day spurring consumers to buy even more new homes and new autos. Other factors also played a role in the recovery in 2002. An increase in federal government spending on defense and security was needed in the wake of 9/11. In fact, federal spending has grown at a rate of about 9 percent for the past three quarters. But it was the stabilization in inventory investment after the sell-offs in 2001 that helped the economy most of all, adding about 2 percentage points to GDP growth so far this year. Though tepid, the recovery does continue.

Looking forward, the economy remains a fragile balancing act between resolute consumers and skeptical businesses. So far, the consumer's optimism has more than offset business pessimism. But how long can the consumer hold out? The risks here seem firmly on the down side. At some point, the ongoing decline in household wealth could begin to take its toll on consumer spending. So far jobs in the private sector have not grown much at all in this recovery and real wage growth has slowed. This can't help either. Sooner or later, businesses will have to become the key driver to the expansion, by increasing both hiring and investment in capital equipment. If business confidence does not increase soon, the current balance between consumption and investment may not last, making even the recent tepid economic performance difficult to match.

Recent data seem to suggest that concerns about the consumer may be justified. Spending on autos in July and August was sufficient to guarantee that consumption will be robust in the third quarter--in fact it's likely that GDP growth will be better than 3 percent as a result. However, this recent burst in auto purchases may simply be moving purchases that were planned for the fourth quarter forward. On that basis alone, most forecasts see consumption weakening in the fourth quarter. Spending on goods other than autos has also begun to show some signs of deterioration though housing continues to be a very bright spot. Measures of consumer confidence continue to slide - the latest reading for October fell to levels below even those seen in the immediate aftermath of 9/11. The consumer, if not the economy, may be starting to wobble.

Will businesses be the cavalry rescuing the economy in the nick of time? As I noted before, private firms have yet to begin hiring, which suggests their level of confidence is still low. It is true that second quarter investment in equipment and software turned positive for the first time in 2 years, and new orders for capital equipment have shown improvement of late. But industrial production fell in August and September, making July the last month to see an increase in factory output. Even the recent increases in productivity may reflect business' lack of confidence - productivity growth right now seems to come from concentrated efforts to economize on labor costs, rather than from new investments to meet new demands. Investment is beginning to recuperate, but it may not be the rock on which to build the economy in the near term.

The economy cannot expect a lot of help from other sectors either. Real estate investment remains at high levels, but it may be showing signs of stagnation. Government spending remains strong at the Federal level, but weakness in spending at the state and local level may offset that strength. The rest of the world is expected to provide little help. Even without further blows the economy remains fragile.

And, it is certainly possible that the economy could confront another shock. Geopolitical events facing us, or even the uncertainty surrounding potential events prior to their resolution, could affect business and consumer confidence in a way that would disturb the current delicate balance. Although the probability that such an event will occur is very difficult to quantify, the risks are real.

All that said, the economy has proven to be remarkably resilient over the past 2 years and is widely expected to remain

so over the coming period. The continued, and somewhat surprising, strength of productivity growth suggests that the returns to investment, and future income to everyone, may be better than we anticipate, providing a long-term anchor for investment and consumption. Although the expansion may be tepid by historical standards, a key reason for its mildness may be the relative mildness of the recession. The quick reaction of monetary policy to the initial signs of weakness played a key role here. However, the mildness of the recovery and the potential for bumps in the road means the economy will remain a bit fragile in the near term.

That fragility explains the continued accommodative stance of monetary policy--short-term rates are at historical lows--and the current Federal Open Market Committee statement placing the risks to the economy on the side of weak economic growth. Sooner or later as the recovery proceeds, interest rates will need to move to a more neutral posture that is consistent with healthy growth. But for now, given the prospects for low inflationary growth and the clear uncertainties in the forecast, in my view there is a need to focus on supporting the fragile recovery.

How does this play out for the region? While the New England economy has been moving more or less in parallel with the national economy during the current slowdown, in recent months the region's recovery has paused. Some economic indicators have softened, others appear to be "bouncing along the bottom" and a few are improving. The region's payroll employment has mostly declined on a month-to-month basis this year, with a total of 123,000 jobs lost (through August) since the pre-recession job peak in January 2001. While manufacturing continues to shed jobs as it has since the recession began, sectors such as services; retail; finance, including insurance and real estate, and construction are alternating small job additions and cutbacks on a month-to-month basis. The region's unemployment rate, at 4.6 percent in August, remains well below the national average, but it has continued to rise in the last few months as the U.S. jobless rate has stabilized.

As in the nation, residential real estate markets in New England have remained relatively strong. By contrast, commercial real estate, especially the Boston-area office market, weakened markedly and is still retrenching. Consumer confidence and help-wanted advertising have returned to or stayed at the lows to which they fell in the fall of 2001, and initial unemployment claims in the region remain elevated.

New England's outlook remains highly uncertain and forward-looking indicators have failed to improve. The region's recovery depends to a large degree on the timing and pace of the national recovery. But because of the region's concentration in technology and capital goods industries, the ongoing nationwide weakness in telecom, computers, and technology services suggests New England may lag the nation's recovery. There are some bright spots--biotech, for one, and the expanding defense industry. But surveys by Associated Industries of Massachusetts and the U Mass leading economic index both suggest that expansion is unlikely in the next six months. Nonetheless, unlike the structural adjustments the region experienced in the 1989-91 period, the current regional slowdown is aligned with the nation's cyclical downturn, and can be counted on to reverse as the national recovery takes hold.

To sum up, the national economy, and regional conditions, have weathered a number of blows over the last several years, and have proven remarkably resilient. It is not clear when we will return to a solid pace of growth and major uncertainties and real risks remain. But long-term prospects remain solid, and monetary policy is supportive. Our economy may have shed quite a bit of Teflon, but it's still likely to cook along.

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