# Connecticut Business and Industry Association's Annual Economic Summit and Outlook

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It's a pleasure to be with you this morning. I have always enjoyed participating in this Conference with its "first of the New Year" perspectives.

In that regard, I took out the speech I gave here the last time I participated--that was in January 2000. I read the speech with a sense of wonderment--am I living in the same economy, no, on the same planet, as I was when I gave that speech three years ago? That January, one of my biggest concerns was the absence of problems. Y2K? No big deal. In fact, many were questioning whether those of us involved in planning and overseeing that technical transformation hadn't hyped the seriousness of the issue. The economy? Rates of growth, low inflation and unemployment not to mention stock market multiples all were remarkable, and with hindsight overdone, but both the markets and the Federal Reserve had begun to tighten credit conditions, so things seemed in hand there as well.

But that was then, and this is now. Y2K was a problem, but not in the sense we thought it might be. With the benefit of hindsight, what Y2K really did was to help spur technology spending in such a way as to make some in the high-tech industries and elsewhere believe that 40 percent annual real rates of growth in equipment and software were, if not absolutely normal, then certainly more like normal than the rates of growth earlier in the decade. And, as for an economy that needed restraint, in January 2000 we were only a couple of months away from the sharp recognition in the stock markets that those 40 percent rates of real growth were not only not normal, they were unwise and unsustainable.

And I would be totally remiss if I did not mention developments which, at the time, were completely off my radar screen--and most everyone else's I think. Most significantly, the possibility of something unthinkable like the tragedy of September 11, with its aftermath of heightened geopolitical tensions and risks. And, one cannot forget the impact of our more home-grown financial and governance scandals, which can be summed up simply by names such as Enron, Tyco, and World Com, companies that were virtual icons in January 2000.

Yes, that was then and this is now. Today we face an economy marked by uncertainty about matters large and small. Which reports about holiday consumer spending do we believe? When will companies resume capital spending and hiring? After an unusual three years of losses, will stock market gains help investors recoup some of their lost wealth? And what impact would a war with Iraq, if one should occur, have on our economy? I don't have many answers here, but I do want to provide some perspectives on the issues involved.

In doing so, I want to touch on three aspects of the current economic situation that I believe have some importance as we assess future prospects. First, the U.S. economy has proven remarkably resilient over the last several years, and, in my view, is likely to stay so. Second, as we consider the current slow pace of recovery from the '01 recession, some amount of patience and a bit of perspective really are virtues. And, finally, I want to share some thoughts on current price trends--inflation, disinflation, and the dreaded deflation. Let me elaborate.

We always knew the world was a dangerous place, but collectively we had little real understanding of how dangerous it could be here on our own soil until September 11, 2001. This realization influenced international politics and day-to-day security arrangements in this country and threatened the economy as well. In the aftermath of the tragedy, both

consumers and businesses have displayed remarkable willingness to continue life as normally as possible in the face of a diminished sense of domestic security. But the impact on our collective sense of risk is real.

Heightened geopolitical uncertainty has no doubt been partly responsible for an atmosphere of business caution that, in turn, has restrained hiring and investment activity. This uncertainty has been reflected in standard measures of business and consumer confidence, and in the elevated premia that financial markets initially priced into all but the very highest-grade investments. Recently, credit spreads have narrowed and confidence has improved, but uncertainty lingers.

As we look forward, a key concern is that geopolitical events, or even a heightened probability of such events, might undermine consumer and investor confidence. In this sense, FDR's assertion that "the only thing we have to fear is fear itself" may be as true today as it was then. So it is important that now, more than ever, we not lose sight of the ability of the U.S. economy to weather disruptions and disturbances.

Just within the past five years, the economy has exhibited this resilience by weathering several serious economic "storms." At the time, the fear was that each of these storms might precipitate a recession. Both the economic typhoons in emerging market economies, and the maelstrom of Long Term Capital Management in the fall of 1998 had the potential to severely weaken the U.S. economy. Despite these developments, however, the U.S. economy held up very well. A decline in exports related to these crises subtracted almost two percentage points from real GDP growth but domestic spending was unfazed by the turmoil abroad. Such spending grew strongly enough to propel GDP growth in excess of 4 percent for all of 1998 and 1999.

Since early 2000, the economy has survived a string of upheavals-the collapse of the equity market bubble; the attacks of September 11, and the recent scandals in corporate governance. These upheavals set in motion a broad retrenchment in business and consumer spending and confidence. To be sure, this pushed the economy into recession in 2001. But the depth of that recession, viewed in the context of other post-war recessions, was relatively mild. And even during the recession, consumer spending on motor vehicles, other durable goods, and housing remained remarkably well sustained.

But perhaps the best gauge of the economy's resilience and of its potential response to any future geopolitical disruptions was the reaction to the 9/11 attacks. Just before that date, the economy was tentatively regaining its footing. Immediately following the attacks, most all private forecasters foresaw a collapse in consumer confidence that would significantly curtail spending. A common forecast at that time for the last quarter of 2001 envisioned a 2 percent contraction in real spending.

However, that contraction did not happen. Consumer confidence did fall, but not nearly to the degree expected by forecasters. Retail sales were interrupted, but only temporarily. And in the last quarter of 2001, GDP grew 2.7 percent. But even that number understates the strength of the economy at year-end 2001, as growth in final sales was partly offset by a significant drop in the pace of inventory accumulation-final sales surged at better than 4 percent in the last quarter of that year.

Thus, I believe one key to assessing prospects for the U.S. economy in 2003 is never to underestimate the resilience of the U.S. economy: its dynamism; the flexibility of its labor and product markets to respond quickly to a variety of situations, and the basic optimism of its consumers and businesses. This has been bolstered, I think, by the almost uninterrupted 20-year period of growth that preceded the 2001 recession. The combination of strong growth, low unemployment, and stable prices in the latter years of that period was about as good as the U.S. economy gets. This record of success, and all that was done in both the public and private sectors to engender it, taught all of us more than a few lessons about how the economy can function. The legacy of that success is one reason I think we can continue to bet on U.S. economic resilience.

Thus, as some of the uncertainty surrounding potential geopolitical disruptions lifts, as I hope it will, I expect businesses to resume a more normal pattern of hiring and capital spending. Over time, that dynamic should allow the economy to regain strength and, in the process, provide for improvements in labor market conditions.

Let me turn now to the need for patience and perspective. As you no doubt know, the economy appears to have expanded by something less than 3 percent over the four quarters of 2002. This is a respectable rate of growth for a mature industrial country, and in fact exceeds growth over the same period for every other industrial country. The

problem is this rate of growth feels very slow to all of us who lived through the nineties. And this modest pace has gone hand-in-hand with zero net growth in employment over the same period.

Modest output growth without job creation creates an uneasy combination for the future. Certainly the so-called "soft patch" we have been going through brings with it concerns about how long and how soft that patch might be. But the business decisions that lie behind this combination bode well, not poorly, for the future, although they do present near-term challenges.

It is clear that firms have been abnormally reluctant to hire and to invest in more capital during this recovery. In part this is because of the geopolitical uncertainties I noted earlier. It also reflects the overhang of capacity that is the legacy of the spending binge of the nineties. But even more importantly, business hiring plans reflect concerns about the modest pace of demand growth during this recovery, and continuing domestic and global competitive pressures. In response to these concerns, firms have figured out how to meet slowly growing demand with a stable stock of workers. What this means is that they have found ways to become increasingly more productive, either through improvements in process, or through improved use of technology.

Firms' ability to innovate in these ways has helped them to contain costs and to move gradually toward better profitability without raising prices. That gradual re-building process has to play out and we need to be patient while it does so. In the long run, this focus on efficiency bodes well for sustained productivity growth, with all that can mean for solid progress in real incomes and firm profitability, as well as price stability. But in the short run, this intense focus on costs and its implications for employment can exert a drag on the recovery, and create its own uncertainty for consumers.

Businesses also need to cope with the overhang of excess capacity. Over-investment in capital goods, especially telecommunications, aided and abetted by the bubble atmosphere of the late '90s, spurred the capital investment collapse that led the economy into recession. The financial upheaval that followed affected the ability and the desire of firms to invest. Recent data on investment, however, are consistent with gradual improvement. Spending on equipment and software grew in the second and third quarters of last year and available data suggest that the expansion continued in the fourth quarter. Data on new orders for non-defense capital goods, while bouncy, also suggest modest growth for the future. To be sure, not all the news is good. New orders for semiconductors have fallen recently, and the commercial real estate sector remains moribund, with vacancy rates and excess capacity high, and rents falling. But overall, it looks to me as if business plans to gradually improve efficiency and address excess capacity are proceeding apace and should provide the foundation for continued growth in investment in 2003.

Consumers have their own restructuring to do as well. At the height of the boom, consumer savings rates dropped to near zero, as the wealth gain in their stock market holdings promised a bright future. Household net worth doubled in the '90s encouraging a "spend now" mentality. Now with the demise of equity markets, household net worth has declined and consumer saving rates are up. This is a positive trend, but it does suggest that consumer income growth will be a larger factor in supporting consumption than earlier.

So far in the recovery household spending has been buoyed as well by increases in net holdings of housing wealth. Of course, households borrowed extensively to increase that wealth, but even when increased mortgage obligations are taken into account, housing wealth grew significantly. And in this environment of low interest rates, mortgage refinancings and home equity loans have both moderated the debt burden of consumers and added significant amounts of cash to their pocketbooks. Clearly this process cannot continue forever, and in the second half of last year housing price increases moderated, though the pipeline for mortgage refinancing remains relatively full. Consumer income growth has been positive, however, and available data for the fourth quarter suggest that, so far, consumer spending is still hanging in there.

To be sure, there has been some doom and gloom about holiday spending, but not all the data are in yet and some of this may simply reflect unrealistic expectations. Swings in auto sales likely will make last year's Q4 consumption look slow, and whether or not consumer confidence has declined depends on which release you look at. Overall, however, I do not think the data suggest the year ended on a spending downturn.

In my view, consumption should continue to be reasonably solid. Equity markets have stabilized a bit in recent months,

and this should help to moderate the wealth effect drag on consumer confidence and spending. The level of housing wealth remains high, and with some modest increase in business hiring, incomes should continue to expand sufficiently to maintain both some spending and an increased savings rate. These fundamentals suggest a moderate expansion of consumption in 2003. Combined with increased business investment over the year, GDP is likely to be expanding by the end of the year at a rate that approaches what economists call potential--between 3 and 3.5 percent by our calculations.

Thus, it looks to me as if the recovery is well positioned to continue, moderately but steadily. We just need to have some patience. Both businesses and consumers need to restructure after the excesses of the late '90s. Geopolitical risks and other uncertainties exist but the added stimulus of the Federal Reserve's recent easing, continued fiscal stimulus, and improved capital markets are all working to support the economy. Yes, the waxing and waning of this slow recovery has produced a "soft patch." However, a bit of patience and perspective about this can only help the process of emerging from that patch.

This takes me to the final aspect of our current situation--the very low rate of inflationary growth. Some believe this could turn to negative price growth--not disinflation but deflation. The prospect for significant movements in prices, up or down, obviously brings with it concerns for policymakers, but absent the short-term effects of oil price changes, I, for one, do not believe significant movements are likely in either direction. For right now anyway, it seems to me that the fundamentals of the economy work in the direction of more rather than less stability in the inflation rate.

Why do I say that? First, I expect that growth over the next couple of years or so will be such that we will see a continued pattern of very low but positive rates of inflation. As resources are more fully used here and around the world with slowly expanding global growth, the downward pressure on price levels that comes from diminished demand should ease. Second, recent history suggests that inflation may be less responsive to resource utilization than it was a decade ago or more. Inflation rose only slowly in the high flying days of the late '90s, and it has fallen more slowly in the face of growing resource underutilization than it might have a decade ago or more. So, even in the short run while we work off excess capacity, I do not expect to see a large change in inflationary growth.

Third, some have interpreted a fall in the price of manufactured goods as evidence of incipient deflation. But deflation is a general decline in all prices, not just goods. And while many goods prices have declined, services prices have been rising by 3 percent or more for years. In fact, rising prices for things like medical services and insurance are worrisome as they could be a drag on the current rate of economic growth.

More importantly, one key reason goods prices are declining is that productivity in the goods-producing sector has risen dramatically. Rising productivity is a good thing-it raises real incomes over time, and provides goods more cheaply to all consumers. It would be a far different matter if all goods prices were falling, because overall demand fell well short of our potential to produce. It would be even worse if falling demand were accompanied by a dysfunctional financial system that acts to frustrate the growth process. Such was the problem in the thirties in this country, and is some part of the situation in Japan. This is not the case in the United States, and both the health of our banking system and the resilience of the economy I spoke of earlier suggest it will not be the case. Central bank vigilance related to price movements that can produce either inflation or deflation is always important, but I do not believe such movements are a major concern for the near term.

The fundamentals suggest the long run view of the economy remains highly positive. Productivity growth has been a pleasant surprise from the mid-1990s through today, and its growth through this recession has been outstanding. As I noted before, the recent increase is, in part, due to the short-term uncertainty of firms about future prospects, and given the likelihood of very slow Q4 GDP data for last year, our next productivity "surprise" may well be the softness in that quarter's data. However, as good annual numbers continue to pile up, estimates of long-run growth in productivity are rising. With that change comes the potential for larger increases in standards of living for all of us.

Turning to developments in the region, the New England economy has been moving more or less in parallel with the national economy during the current slowdown. In recent months, not unlike the nation, the region's recovery has paused - we seem to be "bouncing along the bottom." Some indicators continue to deteriorate and some are improving. The region's payrolls have mostly declined on a month-to-month basis this year, and none of the region's industries aside from government are showing more than marginal job gains. Manufacturing has shed jobs steadily since the

recession began, while sectors such as services, retail, finance, and construction are alternating small job additions and cutbacks on a month-to-month basis.

Despite this, the region's unemployment rate remains well below the national average, at 4.7 percent in November. Like the nation as a whole, the regional jobless rate has shown small increases and decreases month to month, but the trend still seems to be slightly upward. Residential real estate markets in New England have remained relatively strong, but commercial real estate markets in the region are flat at best, and metro-Boston's office market is quite weak and still retrenching. Incomes, especially wages and salaries, have softened markedly in the region, with negative effects on both government and household budgets.

New England's outlook remains uncertain. 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 high technology investment goods and related technology services, its prospects are contingent on improvements in business spending nationally. And the current nationwide weakness in telecom, computers, and technology services suggests New England may lag the nation's recovery, though its leadership in biotech and health care more generally is likely to act as a buffer. Surveys by the Associated Industries of Massachusetts and the University of Massachusetts leading economic index are just starting to suggest that an expansion may begin 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 recovery takes hold in the nation.

To sum up, on the national scene I believe the combination of inherent economic resiliency, patience and perspective on all our parts, and a tendency toward more rather than less stable price movements will lead to an improving economic picture for both New England and the nation in 2003. This forecast, such as it is, is not without its risks, the most important of which are geopolitical rather than economic. It also may be a bit longer before we in New England see the light at the end of the tunnel. But I believe that light is there.

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