

## The Economic Outlook for the Nation and the Region

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Good morning. It is a pleasure to be with you to talk about the economic outlook for the nation and for our own Greater Philadelphia area. We have a lot to talk about, so let me get right into it. I will begin with the national outlook, then move to prospects for the region.

As you have heard many times, the current economic expansion is the longest in US history. It began in the spring of 1991 and it is coming up on its tenth birthday in April. Now, nothing grows for ten years without evolving and changing form. Ask any parent, any business owner, any political leader - or any economist. Everything evolves -- including economic expansions.

This expansion has gone through several stages already, and it is going through yet another one now: a rather substantial slowdown in growth. The pace of growth slowed sharply this past fall, and I expect it will remain slow through the coming spring. I do not expect this slowdown to be the final stage of the expansion. I see it as a transition we must make to move to the stage that we want to achieve: one of sustainable growth with essentially full employment and no increase in underlying inflation.

I recognize there are risks along the way, and the future never turns out quite the way we expect. But I think that the economy is fundamentally sound, and sustained growth is an achievable goal.

### **The current expansion has gone through several stages, of which this slowdown in growth is the latest.**

To put our current situation in context, it is worth taking a few minutes to review where we have been.

The first stage of this expansion, from 1991 to 1995, was one of standard, maybe even sub par, recovery from the recession of 1990-91. Real GDP and employment were slow to make up the declines they incurred during the recession, and the unemployment rate peaked at over 7-1/2 percent. During this stage, the Fed eased substantially, reducing the fed funds and discount rates to historically low levels in order to help the economy build some momentum. Then, once the expansion picked up steam, the Fed quickly moved monetary policy back into neutral.

The second phase of the expansion, from 1996 through mid-1999, was one of exceptional performance. Real growth accelerated to 4 percent per year, well above its previous trend. The unemployment rate dropped below 5 percent and continued to fall steadily. At the same time, core inflation declined to 2 percent -- essential price stability. Underlying all of this was a marked acceleration in the growth of productivity, which permitted higher growth and the virtual absence of price and wage pressures.

Seeing these developments, the Fed did not raise interest rates, allowing the positive impact of a surge in productivity growth to play out, even as the economy blew past economists' conventional thresholds for sustainable output growth and unemployment. In fact, the Fed eased policy in the fall of 1998 to help insulate the expansion from the international financial turmoil triggered by the problems at LTCM.

By mid-1999, the expansion moved into a third stage: it went from exceptional growth to clearly unsustainable growth, and we saw early signs of an uptick in underlying inflation. Real output growth accelerated to a 6 percent annual rate and the unemployment rate fell to 4 percent, but the core rate of inflation began ticking up toward 2-1/2 percent. Recognizing the warning signs of higher inflation, the Fed began to progressively tighten monetary policy.

Unsustainably rapid growth persisted through first half of 2000, when the combination of the earlier Fed tightening, a jump in international oil prices, and a revaluation in the stock market ushered in the slowdown in growth -- the fourth, and latest, stage of this expansion. Data for the third quarter of 2000 confirmed the growth slowdown, as real GDP growth ratcheted down to just 2-1/4 percent. Recent data suggest lower growth for the fourth quarter.

I'll add as a personal note that I joined the Fed in July of 2000, just about when this growth slowdown began. As I talked to people in the business and banking communities in the early fall, I could see the slowdown unfolding.

In its basic features, the economy had many of the attributes of a textbook slowdown. First came the word that fewer new construction projects were coming into the pipeline. Manufacturers of big-ticket consumer goods saw softening demand for their products. Auto dealers were selling cars only by offering more and more creative financing. Then, business people said they were beginning to scale back their capital investment plans. And I heard from a number of quarters that both businesses and consumers were generally becoming more "cautious."

However, this slowdown in growth has had some special features that do not show up in textbooks, just real-life economies. The substantive decline in equity values and the continuing volatility of equity prices are weighing heavily on consumer and business attitudes and affecting their spending decisions. In addition, the impact of higher oil prices has been compounded by the spike in natural gas prices and unusually cold weather. I also sense that the slowdown itself has had a negative impact on both consumer and business sentiment. For many in this economy, a growth slowdown is a new experience. More than once, people have said to me: "When you've been driving at 60 miles an hour, 20 miles an hour feels awfully slow."

As growth has slowed, the risks to the outlook clearly have shifted from accelerating inflation to economic weakness. In early January, evidence of weaker than expected production and sales and of a marked deterioration in consumer and business confidence prompted a substantive response from the Fed. We cut the fed funds rate and the discount rate by 50 basis points each. As I said in remarks last week, I think this was the right move at the right time. Particularly in times of rapidly unfolding developments, monetary policy must be flexible and responsive.

### **The near-term outlook is for slow growth and then gradual acceleration.**

So where are we now? I believe it was a combination of tighter monetary policy, higher energy prices, and lower equity values that prompted a substantial slowdown in growth. The impacts of these developments have not completely worked their way through the economy yet, but if energy prices and equity values stay relatively constant going forward, then I believe the economy will experience positive growth this year. The first half ought to be the period of more pronounced slowdown, with an improvement beginning in the second half.

Clearly there will be areas of weakness. Manufacturing is likely to feel the slowdown in growth the most. Growth in consumer spending began to slow in 2000, and purchases of big-ticket items are likely to be soft. Growth in businesses' spending for new equipment also will slow as the imperative to expand capacity diminishes. Weak sales have already led to production cutbacks in autos and elsewhere in the manufacturing sector. Order books will continue to thin as businesses all along the production and distribution chain take care to keep inventories lean and work off any overhangs.

Several factors should keep overall spending from slowing down too much, however.

Job prospects remain strong in spite of pockets of temporary weakness. While announcements of layoffs in traditional manufacturing and in the high-tech sector will continue, overall demand for labor is still fairly robust. In addition, employers who spent so much time and energy trying to land employees over the past several years will be reluctant to lose talented people and will try to keep them on the payroll.

Consumers should also feel good about the value of their homes. Mortgage interest rates have declined since the spring of last year. That has helped keep residential real estate markets relatively busy and

property values high. At this point, home sales and residential construction seem likely to weather the growth slowdown relatively well.

And consumers' indebtedness should not drag them down. While consumers took on considerable debt over the past several years, relatively low interest rates have kept their monthly payments in a manageable range. Going forward, growth in consumer debt should show signs of slowing in light of slower holiday sales.

For businesses, while the immediate need to expand capacity may have diminished, the ongoing imperative to improve efficiency in a competitive environment should drive them to make continued investments in new information processing and telecommunications equipment.

Finally-- and fortunately-- if unexpected weakness in spending does materialize, the Fed has the latitude to respond quickly and effectively, because the underlying rate of inflation is not accelerating and long-term inflation expectations are contained.

Then, as we move through 2001 and the dynamics of the current growth slowdown work themselves through, I believe we will see economic growth accelerate. That affords us the opportunity to move the economy toward its maximum rate of sustainable growth.

### **Longer term, maximum sustainable growth is the goal.**

Sustainable growth is determined by the supply side of the economy: the growth in our labor force and the growth of the productivity of that labor force.

In recent years, excellent job prospects and rising real wages have drawn a greater share of the working age population into the labor force and induced a greater share of those in the labor force to take jobs. As a result, employment growth outstripped the trend growth rate in our working age population. The labor force participation rate seems to have peaked, and the unemployment rate is unlikely to fall further over the foreseeable future, so I expect employment growth to revert to the demographic trend growth in population, which is about 1 percent. Indeed, the increases to nonfarm payrolls in recent months are consistent with this trend.

Growth in labor productivity is harder to predict, partly because it is driven by so many different factors. It is driven by the speed with which firms develop and implement better technologies, broaden and deepen their capital stock, and improve their organizational efficiency and managerial effectiveness. It is also driven by the speed with which the public and private sectors improve the level of workers' education and training. And it depends on government's sponsorship of basic research and investments in public infrastructure.

Despite the uncertainties, I expect annual productivity growth of 2 to 3 percent for the foreseeable future. Why? Because "new economy" technologies have yet to infuse the "old economy" with the productivity gains they offer. Advances in information management have just begun to revolutionize the way businesses design, produce, and deliver their products and services.

Putting the supply side factors together, 1 percent or so growth in the labor force plus 2 to 3 percent growth in labor productivity implies a maximum sustainable growth rate of output in the range of 3 to 4 percent.

Based on the experience of the late 1990s, therefore, I believe that the economy can sustain real output growth of 3 to 4 percent per year, and an unemployment rate of 4 to 5 percent, without an acceleration in underlying inflation beyond its current level of about 2-1/2 percent. If my assessment of the economy's potential for sustainable growth is roughly right, then the current growth slowdown has taken us from too rapid a pace to too sluggish a pace. The challenge now has shifted from bringing growth down to its long-run potential to bringing growth up to long-term potential.

### **Greater Philadelphia is experiencing the impact of the growth slowdown and will benefit from a pickup to a sustainable growth rate.**

Before closing, let me turn briefly to the outlook for our own region. Greater Philadelphia's economic fortunes are, of course, tied to the nation's. The long national expansion has brought our region gains in overall

economic activity, and our unemployment rate has declined to about 4 percent, close to the national average.

The current slowdown in growth is likewise making its imprint on the region, and the pattern very much matches the nation's. For several months, we have seen signs of a slowing of activity in the region, and our Bank's [Business Outlook Survey](#) has been signaling a slowdown in regional manufacturing activity. Last week at the economic outlook breakfast organized by the Greater Philadelphia Chamber of Commerce, Sovereign Bank reported local survey results suggesting that consumers expect to make relatively fewer major purchases this year. However, I understand from talking with others that the local real estate market, both residential and nonresidential, is solid. Local bankers tell me loan demand is strong and loan quality remains good.

Over the long run, I expect Greater Philadelphia will continue to move in tandem with the national economy, if somewhat more slowly. As you might guess, different regions in the Philadelphia metropolitan area have been growing at different paces. In this expansion, the suburban areas tracked the national average for employment growth rather closely, while the city has had rather anemic growth. But relatively slow growth is a challenge to the whole metropolitan area, not just the city.

Last week, our Bank published a relatively comprehensive study of factors affecting economic growth in our region. We called it "[A Philadelphia Report Card](#)." In the study, we noted that in this current expansion, Greater Philadelphia's population has not grown at all, and its employment growth came in 42<sup>nd</sup> out of 50 among major metropolitan areas, trailing those of cities like Boston and New York.

The study offers some perspectives on ways Greater Philadelphia can improve its competitiveness and garner a bigger share of the nation's economic growth for itself. I hope you get a chance to read it. I think you'll find that our participation in the national economic expansion is an essential step, but only a first step, in bringing long-term prosperity to Greater Philadelphia, both city and suburbs.

## **Conclusion**

Let me sum up by saying that the US economy's long economic expansion continues to evolve. We are in the midst of a slow growth stage that seems likely to persist through mid-year. With reasonably good fortune, this stage will give way to sustained growth at the economy's potential. Certainly that is the Fed's goal. At the Federal Reserve Bank of Philadelphia we support that goal, knowing that its achievement provides the foundation for our region's future success and prosperity.