The Economic Outlook for the Nation and the Region

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My topic this morning is "The Economic Outlook for the nation and the region." Obviously, we have a lot to talk about. These are interesting times. So, let's get started. I'll begin with the national outlook and then move to prospects for Delaware.

As you have heard many times, this economic expansion is the longest in US history. Now, as you are all aware, nothing grows for ten years without evolving and changing. Ask any parent, any business owner, any political leader - or any economist. Everything evolves, and economic expansions are no exception.

This expansion has already gone through several stages. It is currently experiencing a rather substantial slowdown in growth. The pace of growth slowed sharply in the fall of 2000, and I expect that growth will remain slow throughout the first half of 2001.While considerable uncertainty remains and there are risks along the way, I do not expect this slowdown to halt the economic expansion.

Rather, I see it as a transition to move us toward what we want to achieve - sustainable growth with essentially full employment and no increase in inflation.

To put our current situation in context, it's worth taking a few minutes to review where we have been. It's easiest to think of this ten-year period as a sequence of four distinct sub-periods or stages.

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 to help the economy build momentum. 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. Simultaneously, core inflation declined to 2 percent - essentially creating 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. Rather, the Fed eased policy in the fall of 1998 to help insulate the expansion from the international financial turmoil triggered by the problems at a then-prominent hedge fund, LTCM.

By mid-1999, the expansion moved into a third stage, going from exceptional growth to clearly unsustainable growth. 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 the first half of 2000. Then the combination of the earlier Fed tightening, a jump in international oil prices, and a revaluation in the stock market ushered in a slowdown in growth. This began the fourth, and latest, stage of this expansion. Data for the third quarter of 2000 confirmed the growth slowdown, as real GDP growth fell to just 2-1/4 percent. That was followed by fourth quarter growth of 1 percent. Expectations for the first quarter of this year are for a similarly low but positive growth figure. We will see shortly, as the preliminary number will be released soon.

This slowdown in growth has been evident in our district and throughout the economy. As I talked to people in the business and banking communities since the early fall of 2000, I could see the slowdown unfolding.

In its basic features, the economy displayed 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."

But these developments represented something more than a response to tighter monetary policy. They showed a response to some other special factors as well. Higher international oil prices, compounded by the spike in domestic natural gas prices and the unusually cold weather of the past winter, sapped away consumer dollars and raised the cost of doing business. The decline in equity prices, which began early last year and became quite substantial in the first months of 2001, eroded households' wealth and businesses' access to capital. Simultaneously, measures of consumer confidence and business sentiment fell off sharply. This combination of factors contributed to a sharp deceleration in the growth of consumer and business spending, shifting the risks to the economy away from accelerating inflation and toward excessive weakness.

That threat has prompted a substantive response from the Fed. We cut the funds rate and the discount rate twice in January by 50 basis points each time, again in March and again this past Wednesday. This total reduction of 200 basis points in less than three months is aggressive counter cyclical monetary policy. This is as it should be. Monetary policy must be flexible and responsive to rapidly unfolding economic developments.

As the FOMC indicated in its statement accompanying Wednesday's action, we are seeing positive signs in the economy. Businesses have made strides in reducing excess inventories. Consumption and housing expenditures have held up reasonably well, even though activity in these areas has recently slowed. Measured productivity may have weakened in the first quarter, but the rate of increase that developed in recent years seems largely intact.

Nonetheless, there are reasons for concern. Capital investment has continued to fall. Companies are still reporting reductions in earnings and profitability, and announcing expectations for further reductions in future earnings. The persistent erosion in current and expected profitability, in combination with rising uncertainty about the business outlook, seems poised to dampen future capital spending. These factors, together with the possible effects of recent reductions in household wealth on spending and slower growth abroad, threaten to keep the pace of economic activity unacceptably weak.

The impact of the easing steps we have already taken will ripple out into the economy in the coming months. That's one of the factors making me believe that growth is likely to increase in the second half of this year, and reach a more acceptable level next year. Fortunately, the underlying rate of inflation is not accelerating, and long-term inflation expectations appear contained. So should further unexpected weakness in spending materialize, the Fed has the latitude to again respond quickly and effectively. Just as I believe we have done in the past four months.

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

Now, let me turn from the national economy to economic developments in our own region. As you know, the Federal Reserve Bank of Philadelphia serves a District comprised of eastern Pennsylvania, southern New Jersey and the state of Delaware. As Bank president, I have the opportunity and responsibility to represent the District in the Fed's monetary policy deliberations, so I have a keen interest in economic developments here. Over the years, our Bank has developed a number of economic indicators to help us monitor the District economy. Recent readings of our indicators show how changes in the pace and pattern of national economic activity have affected our region.

At the national level, the manufacturing sector has been most severely affected by the growth slowdown. Likewise, that pattern has played itself out in our own District as well. The Bank's *Business Outlook Survey*, which measures conditions at District manufacturing firms each month, signaled a sharp decline in District manufacturing activity in January. The string of negative statistics continues to the most recent reading for the month of April, just released this past Thursday.

The encouraging news is that the magnitude of the declines has been diminishing each month. The index has moved from -37 to -7 over the last quarter, suggesting that the drop off in manufacturing activity should soon bottom out. District manufacturers seem to agree with this assessment. Their survey responses indicate they are becoming increasingly optimistic that activity will increase within the next six months.

As I mentioned just a moment ago, one of the FOMC's concerns about prospects for an uptick in the national economy is whether a better business climate will induce firms to reaccelerate investment spending. Businesses' spending, particularly for new equipment, has been a strong engine for economic growth in this expansion. But, it has faltered as growth has slowed. The results of our *Business Outlook Survey* suggest this is a legitimate concern. Survey participants indicate they do not plan to increase their capital expenditures in the near term.

Moving beyond manufacturing, our Bank has recently developed a set of coincident and leading economic indicators for the three states in the District -- Pennsylvania, New Jersey and Delaware. They are designed to gauge the overall performance of the states' economies over time. Our coincident indicator for Delaware shows that the pace of economic growth slackened here last year, as it did for the nation as a whole. As a result, Delaware's job growth slowed to its lowest pace since 1992. The state's unemployment rate rose from a low of 3.4 percent in 1999, to just over 4 percent in January 2001.

The good news is that recent readings from our leading economic indicator for Delaware consistently signal growth in the Delaware economy going forward. In fact, the most recent numbers signal continued expansion through the third quarter of 2001.

Similarly, the long-term outlook for Delaware remains very bright, and I expect Delaware will continue to be a leader in economic performance. The key to keeping pace with the national economy is to develop and maintain industries that serve the national marketplace. Delaware has done a remarkably good job in this regard. That's why the state now enjoys some significant advantages that will continue to give it an edge in tapping the future national marketplace.

For example, Delaware has positioned itself as a national leader in both corporate law and credit card banking, expanding fields that will continue to pay great dividends to Delaware residents and state coffers. In more traditional Delaware industries like chemicals and agriculture, Delaware firms have shown a creative willingness to find and exploit niches in growing markets like poultry and biological science.

Perhaps more important, Delawarians have the savvy and flexibility to continue changing with the times and pursuing new opportunities as they arise. Just look at the field of high tech electronics. This is not an industry traditionally associated with Delaware, but it seems to be growing relatively rapidly here. Recently, the American Electronics Association ranked Delaware 40^{th} of the 50 states in the proportion of the work force employed in high-tech industries. However, Delaware ranked first among the 50 states in high-tech employment growth.

Looking ahead, I believe we will see economic growth improve both in Delaware and across the nation. 2002 should be a better year, one that affords us the opportunity to move the economy toward its maximum rate of sustainable growth.

In summation, the US economy's long economic expansion continues to evolve. We are in the midst of a stage of substantially slower growth that seems likely to persist at least through mid-year. With some good fortune, this stage will evolve into a long period of sustained economic growth. Certainly, that is the Fed's goal. At the Federal Reserve Bank of Philadelphia we strongly support that goal. We know that sustainable growth will be the economic foundation for our nation's, and Delaware's, continued future success and prosperity.

I will now be glad to take any questions you may have.