The Economy and Monetary Policy

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Delivered to the Philadelphia Financial Analysts
Philadelphia, PA
April 26, 2001

My topic this afternoon is a rather broad subject "The Economy and Monetary Policy." I'll begin with national economic conditions, and move on to the challenges for monetary policy. Obviously, we have a lot to talk about, as these are interesting times. So, let's get started.

As you have heard many times, this economic expansion is the longest in US history. It's currently in its eleventh year. Now, as you are all aware, nothing grows for more than 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's currently experiencing a rather substantial slowdown in growth. The pace slowed sharply in the fall of 2000, and I expect that growth will remain unacceptably 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 low inflation.

To put our current situation in context, let's take a few minutes to review where we've been. It's easiest to think of the entire 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 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, by adjusting the fed funds rate upward from 3 percent to 6 percent by 1995.

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. Instead it allowed 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 U.S. from the international financial turmoil triggered by the Russian debt default. That episode had repercussions in many of the world's financial markets and adversely impacted financial institutions abroad as well as those in the U.S.

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 and several other factors 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. This was followed by fourth quarter growth of 1 percent. Expectations for the first quarter of 2001 are for a similarly low but positive growth figure. In fact, the preliminary number will be released tomorrow.

This slowdown in growth has been evident in our district and throughout the economy. Since the early fall of 2000, as I talked to people in the business and banking communities, I could see some evidence of a slowing in growth. At first it appeared to be a small deviation from the long- term trend that had developed. Seeing one quarter of slower growth did not seem unusual given the variability of quarterly growth rates during this expansion. But, it quickly turned into something more substantive as evidence of the slowdown began to accumulate.

In its basic features, the economy displayed many of the attributes of a textbook slowdown. First came 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, this growth slowdown was the result of more than tighter monetary policy. It was a response to some special factors as well. While the effects of tighter monetary policy were working their way through the economy, other factors were also causing downward pressure on demand. 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 last year and became quite substantial in the first months of 2001, eroded households' wealth and businesses' access to capital. Then, seeing these factors dampening demand and squeezing profits, businesses deferred discretionary spending and put off adding additional capacity. This combination of factors contributed to a sharp deceleration in the growth of consumer and business spending. This in turn caused measures of consumer confidence and business sentiment to fall off sharply. Risks to the economy shifted away from accelerating inflation and toward excessive weakness.

Anecdotal evidence supported this view of the slowing economy. In the auto sector, one businessperson put it rather succinctly, "people just stopped buying cars." Then came reports of weak Christmas holiday sales. As signs of a slowdown in demand growth were accumulating, manufacturers, who are increasingly sensitive to any shift in spending, were quick to cut production. We heard from several circles that the tight labor market was starting to slacken. The cutbacks in production carried through the first quarter with manufacturers of big-ticket items and capital goods continuing to feel the pressure.

The weakening economy prompted a substantive response from the Fed. We cut the funds rate and the discount rate twice in January, each time by 50 basis points, then again in March and again on April 18. This total reduction of 200 basis points in less than four 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.

In the coming months, the impact of the easing steps we have already taken will slowly ripple out into the economy. Whether additional steps will be required is an open question. Fortunately, the underlying rate of inflation is not accelerating, and long-term inflation expectations appear contained. 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.

As the FOMC indicated in its statement accompanying its action on April 18, we are already seeing some positive signs in the economy. Businesses have made strides in reducing excess inventories. On the demand side, consumption and housing expenditures have held up reasonably well, even though activity in these areas has recently slowed. And on the supply side, measured productivity growth may have weakened in the first quarter, but the higher trend observed 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 certain to dampen future capital spending. These factors, together with the possible effects on spending of recent reductions in household wealth and slower growth abroad, threaten to keep the pace of economic activity unacceptably weak.

Data we compile here in the Third District support the FOMC's assessment of the current state of the economy. So, let me underscore the most important features that I can corroborate.

First, the process of adjusting to the unexpectedly sharp slowdown in the demand for goods does seem to be proceeding in the Philadelphia District, but the adjustment process seems to be quite slow. At the national level, the manufacturing sector has been most severely affected by the growth slowdown. 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 through the most recent reading for April.

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.

Second, on the demand side, important spending components do seem to have held up relatively well throughout the growth slowdown. All along, we have continued to get reports from our District contacts that construction activity and the demand for services have held their own. As a result, District labor market conditions outside the manufacturing sector have consistently been described as relatively tight. We continue to hear there is strong demand for skilled workers and professional people in the legal, financial services, and health care industries. Employers are looking for personnel in a broad array of fields from secretaries to nurses to accountants.

Third, our Bank has recently revised and expanded 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 and their-near term growth prospects. The coincident indicators for all three states clearly show a step down to slower growth in the middle of 2000. That pattern has persisted, with no further deterioration, through the most recent readings for March 2001, released yesterday. The leading indicators for the three states continue to signal growth, albeit slow growth, for at least a few more months. I see this pattern as consistent with the slowdown bottoming out, laying a foundation for a pickup in the pace of activity later in the year.

Fourth, data from our district reinforces the aggregate concern over business capital investment. 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' investment expenditures, particularly for new equipment, have been a strong engine for economic growth in this expansion. But, it has faltered as growth has slowed. The responses from our *Business Outlook Survey* participants indicate there is reason for concern. Asked about future spending plans, respondents indicated that they did not plan to increase capital expenditures in the near term. Anecdotally, businesses seem to be relatively conservative in their approach to spending right now. For example, we hear that companies are repairing pieces of equipment that they simply would have replaced a few months ago.

So where does this leave us? As I have indicated in the past, I believe that for the foreseeable future, the US economy can sustain long-term real GDP growth of 3 to 4 percent without accelerating inflationary pressures. If my assessment of the economy's potential for sustainable growth is correct, the current slowdown has taken us from too rapid a pace to one that's much too sluggish. The challenge has now shifted from what the Fed's concern was a year ago. Then, the Fed was focussed on bringing growth down to its long-run potential; now our focus is on bringing growth up to its long-term potential.

Monetary policy has attempted to alter the future growth of aggregate demand through its actions of the past four months. As I've indicated, I believe the impact of the easing of monetary policy will ripple through the economy in the coming months and should go a long way toward restoring growth to its full potential. That's one of the factors that leads me to believe growth is likely to increase in the second half of this year, and reach a more acceptable level next year.

But, a key determinant of our future success is confidence. We shouldn't lose sight of just how important confidence is to people's decision-making, be it a business investment decision or a consumer purchase. In each case, confidence in the future strength of the economy affects the willingness to spend, and, therefore, the future path of the economy. We have seen that confidence can change quickly, and can dramatically alter aggregate demand.

After the Christmas holidays, people saw real "gloom and doom" out there. But by the end of the first quarter, overall moods seemed to have improved. Still, as Tuesday's numbers indicated, we have a way to go before confidence is restored to a level consistent with the economy's potential for growth.

This means that the risks to the economy are still on the side of weakness, so the Fed must remain vigilant and be prepared to act if necessary.

In conclusion, the US economy's long economic expansion continues to evolve. We are in a stage of substantially slower growth that is likely to persist at least through mid-year. But with some good fortune, this stage will evolve into a long period of economic growth at the maximum sustainable rate. Certainly, that is the Fed's goal, and will continue to serve as the guiding principle for our future policy actions.