The Outlook for the Economy

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When your topic is "The Outlook for the Economy," there is a lot to talk about. These are interesting times. So, let's get started. I'll begin with some comments on the national economic conditions, and then move on to how those conditions have played out here in our region. People have been talking non-stop about current conditions. I have too. I hope my comments today put recent developments, and the Fed's responses to them, into clearer focus.

As you have heard many times, the current economic expansion is the longest in U.S. history. It's now in its eleventh year. This expansion has gone through several stages, including a surprisingly strong growth spurt in the late 1990s. Now we are in the midst of a substantial growth slowdown that began in the fall of 2000. While considerable uncertainty remains and there are risks along the way, I do not expect this slowdown to halt the economic expansion. I anticipate that the pace of economic growth will begin to pick up in the second half of this year, and that next year it will approach a pace more in line with the economy's long-run capacity for growth.

Why do I think this is the most likely scenario? Primarily because the weakening economy has prompted a substantive response from the Fed. On five different occasions this year, we cut the funds rate and the discount rate, each time by 50 basis points. There were two reductions in January, then in March, April, and May. This total reduction of 250 basis points in less than five months is aggressive counter cyclical monetary policy. Just as it should be. Monetary policy must be flexible and responsive to rapidly unfolding economic developments.

Having said this, it is important for us to keep in mind that the **impact** of monetary policy is not instantaneous. It usually takes six to nine months for monetary policy actions to have a substantial impact on economic activity. This means that the effects of earlier moves should just now be beginning to affect the real economy. Over the remainder of this year and into early 2002, the impact of our recent actions should gradually ripple through the economy.

In the statement accompanying its action last Tuesday, the FOMC offered its assessment of overall economic conditions. I think three aspects of that assessment are particularly relevant to us here this morning. One concerns household spending, the second business spending, and the third, overall risks to the outlook for continued growth.

First, household spending. The FOMC noted that consumption and housing expenditures have held up reasonably well during this slowdown. The consumer has continued to spend, an important plus because consumer spending represents such a large share of total spending. That is not to say that the consumer spending is on the rise, just yet. For example, retail sales posted a strong gain in April, but this merely offset declines in February and March. And recent increases in energy costs, both for home use and retail gasoline, are of concern to those of us who see consumer spending as a central part of the economy's health. Nonetheless, consumer spending has held up relatively well. The issue now is building upward momentum.

Second, business investment spending. The FOMC has expressed concern about the continued declines in this spending category. Business spending on new plant and equipment represents a significant share of overall spending, and its importance has increased in recent years. Indeed, double-digit growth in business investment spending -- particularly spending on new computers, software and telecommunications equipment -- was the major story behind the strong growth in overall demand during the late 1990s. The sudden reversal in this trend is one of the major stories behind the current growth slowdown. Looking ahead, we need a healthy pace of growth in business investment spending to achieve a sustainable pace of growth in overall demand.

This will take time, as I am sure you in this audience can appreciate. Businesses invest in new plant and equipment basically to improve efficiency or build capacity. While the pressure to improve efficiency is relentless, the need to add capacity is not. Until businesses see convincing signs of a reacceleration in overall demand, they will not ramp up their investment spending to add capacity. Indeed, historically, when there is an acceleration in overall economic growth, it is led by consumer spending, and then later amplified by business investment.

The third part of the assessment offered by the FOMC that warrants our attention today concerns the risks to the outlook for continued growth. The FOMC continues to believe that the risk is tilted toward continued weakness in the economy. Among the effects the FOMC specifically cited as potentially weighing down the economy is what has been called a reverse wealth effect.

The rapid growth in consumption spending during the late 1990s was fueled in part by the rapid rise in the stock market. As the value of their stock portfolios rose, so did households' willingness to spend on goods and services. Now the stock market's decline has reduced the value of those portfolios. It remains to be seen how substantially that will affect households' spending habits going forward.

When we talk about potential risk factors to consumer spending, I think two others quickly come to mind: employment growth and energy prices.

When economic growth slowed down in the middle of last year, so did the growth in employment. In March of this year, we saw some decline in employment. In April, the magnitude of the job losses increased and they spread beyond the manufacturing sector -- which has been most cyclically sensitive -- into the service sector. If a pattern of job losses emerges, and it is significant enough to undermine consumers' willingness to spend, this would pose a clear risk to the economy's prospects.

I mentioned energy concerns earlier. A combination of factors including a spike in international oil prices, a dearth of domestic production capacity, and a patchwork of environmental regulations, has produced a sequence of hits to the consumers' wallets. They have translated into higher prices for home heating oil, then natural gas, and now gasoline. While the form of this "energy tax" on consumers is changing with the seasons, I think its overall impact is not. Higher energy prices, though painful and persistent, pose less of a risk to the accelerating growth scenario that I expect to play out. At current levels, the impact of energy on the economy's short-term outlook is troubling, but not critical. So, it is likely to be a persistent drag, rather than a growing constraint on the near-term outlook.

Let me sum up my perspective on the national economy. I believe the Fed has put substantial monetary stimulus into the pipeline. While there are some downside risks, economic growth should begin to increase in the second half of this year and reach a more acceptable pace next year. If this is so, how will the economy of our own region fare?

The Delaware Valley has participated fully in the national expansion, including the rapid growth of the late 1990s. Employment growth was strong, given the demographics of our region, and the unemployment rate declined steadily with the nation's to as low as 3.8 percent. Our region has also felt the impact of the national growth slowdown. Employment growth has flattened, and the unemployment rate has ticked up to 4.2 percent.

Based on the data we compile at the Philadelphia Fed, and the conversations that I have had with bankers and business people around our District, I expect that our fortunes will continue to reflect the nation's. Let me share a few perspectives on the recent performance of the regional economy.

When the economy slows down, the manufacturing sector is usually among the sectors hit first and hit hardest. This slowdown was no exception, nationally or regionally. The Philadelphia Fed conducts a monthly survey of the large manufacturing firms in our District -- eastern Pennsylvania, South Jersey and Delaware. We call it our Business Outlook Survey. We've been taking the survey for over thirty years, and it has proven to be a reliable indicator of swings in economic activity. In fact, when we release new survey results on the third Thursday of each month, we hold a press conference for reporters from the national and international news wires, so we can explain the results.

Our Business Outlook Survey showed a sharp decline in District manufacturing activity in January, and the string of negative statistics continued through the most recent reading, released last Thursday. The encouraging news is that the magnitude of the declines has diminished. The index has moved from -37 in January, to -7 in April, and -8 in May, suggesting that the drop off in manufacturing activity should soon bottom out. District manufacturers seem to agree with this assessment. The trend in the survey responses indicates firms are becoming increasingly optimistic about the outlook. This month, nearly 50 percent of the manufacturing firms surveyed expect business conditions to improve over the next six months. Only 17 percent expect deterioration.

Outside of manufacturing, some important spending components are holding up relatively well in our region. I continue to hear that construction activity and the demand for services have held their own. And District labor markets remain relatively tight. There continues to be a 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. I take this as a particularly good sign because I believe the perception that there are good job opportunities out there is crucial to sustaining consumers' willingness to spend.

I mentioned that one of the FOMC's concerns is businesses' willingness to spend, and the continuing decline in business investment spending. The results of our most recent Business Outlook Survey suggest this is a legitimate concern. We included a special question about participants' capital spending plans and how those plans have changed since January. Over one-third of the respondents said they reduced planned investment expenditures. About one-fourth said they reduced their plans significantly.

When I talk with business people, I find they are relatively conservative in their approach to spending right now. For example, I hear that companies are repairing pieces of equipment that they simply would have replaced a few months ago. Thus, in our region, as across the nation, it will take a better business climate to induce firms to reaccelerate investment spending. I will say that, in keeping with their expectations of a better business climate six months out, our BOS participants say they are planning to increase capital spending over that horizon.

What lies ahead for our region? To help get a better sense of where we are and where we are going, our Bank has recently improved its coincident and leading economic indicators for the three states in our Bank's District -- Pennsylvania, New Jersey and Delaware.

The most recent readings from our coincident indicators for the three states show that the step down to slower growth that began in the middle to late 2000 has persisted through the first quarter of 2001, with no further deterioration or appreciable improvement. Our leading indicators for the three states have been signaling that growth, albeit slow growth, will continue for at least the next several 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.

In short, the nation's long economic expansion continues to evolve, and conditions here in the Delaware Valley continue to evolve along with it. Right now, we are in a stage of substantially slower growth that is likely to persist for a while. But with some good fortune, the national economy will soon move toward a period of growth at its full potential. Certainly, that is the Fed's goal, and ours in Philadelphia, and it will continue to serve as the guiding principle for our future policy actions.