The Economic Outlook
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To those of you who have not been to Philadelphia before, welcome. I hope you will take this opportunity to spend some time exploring all that our city has to offer. As bankers, you should know that you are at the center of the nation’s financial history. The First and Second Banks of the United States -- our nation’s first two attempts at central banking -- are just blocks from the Federal Reserve Bank of Philadelphia on Independence Mall. Both of those first two banks only survived for twenty years, while the Fed has been serving as the nation’s central bank for nearly 90 years. Focusing on the mission and responding to new challenges are keys to our continued success. This is certainly the case in our current economic situation.

Today I want to talk with you about the national economy and its prospects for improved performance over the next year or so -- prospects which I believe are quite good. That said, I also want to discuss some of the risks we face along the way, and the issues involved in short term monetary policy actions. This is a subject which essentially casts monetary policy makers in the role of risk managers, a role you can surely appreciate.

Let me begin by putting the current economic situation in context, and then lay out its prospects for improved performance over the near term.

As you have heard many times, the current economic expansion is the longest in US history. It is now in its eleventh year. Not surprisingly for an expansion of this length, it has gone through several stages. It began with a standard, perhaps even subpar, recovery from the 1990-91 recession. Then came the surprisingly strong growth spurt of the late 1990s. But by mid-1999, growth had accelerated from an extraordinary pace to an unsustainable one. So, as a result, the Fed tightened monetary policy. That action, combined with several other factors -- primarily higher energy prices and lower equity values -- caused a sharp deceleration beginning in mid-2000 in the growth of overall demand. Frankly, it was a sharper deceleration than we anticipated. It was also sharper than businesses anticipated and inventories of goods quickly accumulated. This led manufacturing firms to cut production, so output and employment growth fell sharply as well.

When this became evident, the Fed moved quickly to front load substantial monetary stimulus into the economy. Five times between early January and the middle of May, we cut the funds rate and the discount rate - each time by 50 basis points - for a cumulative reduction of 250 basis points in less than five months.

There are risks that still face the economy, as I will indicate in a few minutes. But, there appears to be a growing consensus that this aggressive countercyclical policy action by the Fed, in combination with several other developments, will cause economic growth to reaccelerate in the near term. I share that view and have stated this position several times in the recent past. I expect the pace of economic growth to begin picking 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.

I will quickly add that the incoming data have yet to offer a strong signal that this turnaround is underway. Indeed, the signals continue to be mixed at best, and they are likely to continue to be mixed for some months. Nonetheless, I believe the economy is poised for a reacceleration of growth. Let me explain why.

First, however aggressive our monetary policy actions may be, we know that their impact on the economy 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. We would expect the full impact of all our recent actions to ripple through the economy over the remainder of this year and into 2002.
Second, before output and employment growth can return to a healthy pace, the economy must complete the process of adjusting to the sudden growth slowdown and build some upward momentum. The overhang of excess inventories must be worked off, and growth in overall demand must be restored to a pace consistent with the economy’s productive capacity. We are still in the midst of that process, but it is progressing reasonably well, and I think there are good reasons to expect that it will continue to do so.

Businesses continue to trim their inventories, though the pace has not been uniform across all sectors. Auto manufacturers moved quickly to cut production, and inventories of autos and light trucks seem to have declined to satisfactory levels. Computer companies and producers of high-tech products were slower to act, and they apparently still have a way to go to eliminate the overhang. Overall, while firms have trimmed inventories, relatively weak sales have kept inventory-sales ratios relatively high. Of course, the best way to bring those ratios back into line is through faster growth in sales.

That is why stronger growth in household spending is the crucial next step in the transition from unacceptably slow growth to sustainable long term growth. Consumer spending represents over 70 percent of overall demand. When economic growth accelerates, it is the consumer who leads the way. As has been noted by Chairman Greenspan and the other members of the Federal Open Market Committee (FOMC), consumption and housing expenditures actually have held up reasonably well during this slowdown. That is not to say that households’ spending is on the rise just yet. Data on retail sales and housing market activity continue to fluctuate month to month. But looking past these fluctuations, households continue to spend at a relatively high level. The real issue now is building upward momentum.

Of course, the Fed’s recent monetary policy actions should help build that momentum by reducing short-term interest rates and increasing the availability of credit. Now, with the passage of the Federal tax reduction package, fiscal policy will add to that momentum by putting more money directly into consumers’ pockets, particularly over these next few critical quarters. Tax rebate checks will be mailed to households this summer. Furthermore, employees will see smaller tax withholdings from their take-home pay next month. And because the tax cuts are locked into place for ten years, consumers are likely to go out and spend a larger portion of these early installments. This may be the first time in recent memory that fiscal policy has been enacted at a time when counter cyclical policy is most appropriate.

The combined impact of current monetary and fiscal policies on the consumer is well timed in another sense as well. It will help offset the two known drags on the economy. The first is the so-called reverse wealth effect that has been of concern both inside and outside the Fed. As the value of households’ stock portfolios rose in the late 1990s, so did their willingness to spend on goods and services. Then, when the value of those stock portfolios fell, households pulled back on their spending. Now, as people consider that the revaluation of their stocks is more likely permanent than transitory, they are likely to modify their spending habits accordingly. I would add that the combined policy actions will also help overcome the second negative force, namely the effect of high energy costs on consumer spending—including the latest manifestation, the high price of gasoline at the pump.

Stronger growth in household spending is essential in order to achieve a sustainable pace of growth in overall demand. But that is not the whole story. We also need healthy growth in business investment spending. 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. At present, business investment continues to decline, and the FOMC has expressed concern about this spending category.

Restoring healthy growth to business investment spending will take some time. 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. But, I think once we get some upward momentum in household spending, its impact will be amplified by increases
in business investment spending. Then we will be on course to achieve overall growth consistent with the
economy's long-run potential.

While I believe a reacceleration of economic growth is the most likely scenario for the coming year, I want to
acknowledge that there are risks to that outlook. Stock prices may not remain stable. New disruptions in the
energy market could occur. And, though I have not discussed the details here, the outlook for our trading
partners, and hence our export markets, is uncertain.

However, I believe that now the most significant risk factor is the timing of the impact of the policy actions
already taken. Monetary and fiscal stimulus could come too late to offset weakness in the labor market. The
dynamic of that weakness could set in motion a more negative economic scenario than the one that I have
just outlined.

When economic growth slowed down in the middle of last year, so did growth in employment. Payroll
employment actually fell in April and May of this year. The labor market is likely to continue softening until
leaner inventories and sustained growth in customer demand induce businesses to step up the pace of
production. If, in the meantime, households' concerns about job security and employment prospects become
severe enough and pervasive enough to undermine their willingness to spend, this would pose a clear risk to
the economy's prospects for a reacceleration of growth.

In essence, I think there is something of a foot race going on. Will the stimulative monetary and fiscal policy
actions we have undertaken provide enough upward momentum in time to offset the potentially cumulating
downward momentum of a weakening labor market? I believe the answer is yes. But there remains the risk
that they will not.

That risk raises an important question for monetary policy makers. Suppose we see signs that we are losing
the race, or other signs that deeper deficiencies are materializing on the demand side. In that case, of

earlier in the year, when economic growth was slipping precipitously and the prospects of an actual decline
were mounting, it was clear that we needed a more stimulative monetary policy to boost economic activity
and avoid recession.

Of course, we were not sure what condition the economy would be in by the time our policy actions took
hold. One never is. But at that point, there was little risk that we would be too stimulative. After all, there was
considerable risk that the economy would be growing at an unacceptably slow pace, or even in decline, later
in the year. On the other hand, there was only negligible risk that the economy would be growing at an
unsustainably rapid pace later in the year.

As we gather here today, gradual acceleration to a more acceptable pace of economic growth seems likely.
Therefore, it is not clear how much more of an adjustment to monetary policy is necessary.

Given the lags in the impact of monetary policy, any stimulus that we add to the economy now will take hold
very late this year or early next year. Remember the expected six to twelve month lag to which I referred
earlier. We do not know for sure what the economic conditions will be by then, but I think there is some risk
that the arrival of such stimulus could be ill timed. Prospects are shrinking that it would be necessary in
order to resuscitate an economy in decline, or even to boost growth from an unacceptably slow pace.
However, prospects are rising that it would wind up boosting economic growth to an unsustainably rapid
pace.

The recent steepening of the yield curve indicates that financial market participants already foresee more
rapid economic growth, and perhaps some pickup in inflation, over the longer term. Indeed, the fact that long
rates rose the last several times we lowered the funds rate suggests that financial markets see these most
recent actions as contributing to a more rapid pace of economic growth, and perhaps additional price
pressures, ahead.
Even while I believe that inflation is currently well contained, and reported inflation is likely to decline in the near term, a central banker must always be cautious not to overdo in either direction. It would be unfortunate if next spring we were to again find ourselves in the situation where economic growth has accelerated to an unsustainable pace.

Summing up, the Fed’s goal is to foster the highest rate of growth that the economy can achieve on a sustained basis. In recent months, we have responded to sudden weakness in demand by front loading substantial monetary stimulus into the economy. I believe the economy now is positioned for a reacceleration of growth later this year, and achievement of more acceptable growth next year.

But the mission is not yet accomplished, and there are clearly substantial risks along the way. Steady progress toward sustainable growth is far from assured, and the short run path of the economy, judged either by GDP growth or unemployment, is a challenging one. There are still considerable near-term downside risks. Yet, we cannot ignore the longer-term risks of pushing growth to an unsustainable rate, with its associated price pressure. As you can appreciate, the ongoing challenge to monetary policy makers is to be prudent risk managers, assessing the risks that new circumstances present and responding in proper measure. That is exactly what we at the central bank intend to do.