Economic Outlook

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Introduction

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. When we last convened, we discussed the evolution of the longest economic expansion in U.S. history. Now one year later, I return to talk about recovery from a recession. Times have indeed changed.

Today, I would like to share my thoughts on the impact of recent events on the national economy, and how this affects our national prospects for future economic growth. I will also talk about developments in and around the Greater Philadelphia area, and what is needed to spark a regional resurgence.

The national economy is in the midst of recession

Late last summer, the economy was struggling to revive growth from the precipitous slowdown that began in the fourth quarter of 2000. Then came September 11. Already low growth rates turned negative and the nation finally fell prey to recession. Some months later, recession was officially declared by the NBER, the authority on such measurements. While the formal start of our 10th post-war recession was dated March 2001, it will forever be associated with the September 11th attacks. The post-9/11 economic impact became readily apparent in real GDP figures: real GDP growth for the third quarter of 2001 is now estimated at -1.3% and fourth quarter growth is forecasted to be negative as well. This --- the first recession since 1990-91 --- officially brings to a close the longest period of post-war economic expansion in American history.

The consensus view is that recovery will begin in the first half of 2002

Economic recovery is widely anticipated to begin in the first or second quarter of 2002 according to the median forecast from our *Survey of Professional Forecasters.* Given that past recessions have averaged about 11 months in duration, this makes sense from a cyclical perspective. I concur that recovery is pending. However, based on my own analysis of recovery criteria and the risks we face, I believe recovery will occur around mid-2002 - a few months later than the median forecast predicts. In fact, most professional economists are moving toward this view given the obstacles that have turned up along the road to recovery.

Reason for confidence: Substantial monetary and fiscal stimulus are in the pipeline

Nonetheless, we can all be confident recovery is on the way. One reason for such confidence is our country has the biggest stimulus and lowest interest rates we have had for a very long time.

Fiscal policy, as captured by the projected federal budget, has changed dramatically in this cycle. The stimulus associated with greater government spending and lower taxes should have a significant positive impact on the economy. The government's package is expected to equal over $200b, or roughly 2% of GDP. Government action has resulted in a rapid response package covering clean-up, airline bailouts, security and selected tax cuts. Beyond this, the economic stimulus discussions currently underway may offer an additional boost to beaten-down sectors of the economy - such as tech - and encourage these sectors to increase investment spending.

On the monetary policy front, as a direct result of aggressive Federal Reserve action, interest rates are at levels not seen for over forty years. Since January 2001, short-term interest rates dropped 475 basis points. It has only been one year since the first rate cut, and it is important to remember these rate cuts continue to work their way though the economy. Our aggressive easing policy should have begun to work by the fall, and I am on record indicating that the stage was being set for a second half recovery in 2001. However, this action was suspended due to the attacks. The economy is valiantly trying to find its footing. In the meantime, our rapid-fire rate cuts have gone a long way toward strengthening consumer spending, which should keep the current downturn mild and brief.

As a result of these fiscal and monetary activities, the economic landscape is beginning to resemble pre-attack days in one important way: It is beginning to give mixed economic signals. This is a good sign, and an indication that the economy may be preparing to resume growth.

The pattern of recovery will be typical, but its pace will be a slower than usual

For this recovery to proceed as planned, certain conditions must be met: decumulation of excess inventories, retention of consumer confidence, increased business investment spending and a stable world economy. These criteria involve risks that may complicate recovery.

First, the build up of excessive **inventories** at many levels of the distribution chain has been a key part of both the manufacturing recession and tech contraction. Now, businesses' liquidation of excess inventories -- a crucial first step to recovery -- is well along. In fact, businesses' inventory reduction totaled a record $61.9 billion in the third quarter of 2001. We do not yet feel the effects on new orders, but this decumulation is paving the way for increased production and a revival of the hard hit manufacturing sector.

What are the roadblocks to recovery? First, the decumulation of inventories, with the exception of autos, may take longer than planned. Anxiously awaited fourth quarter retail sales will likely be lower than hoped, still reflecting the shock of 9/11. And, although we have seen substantial inventory adjustment throughout 2001, due to the slowdown in sales the inventory-to-sales ratio may not have declined as much as necessary. Second, inventory restocking is predicated on expected sales growth, and I sense a rather cautious business sector. Therefore, I believe firms may replace their depleted inventories more slowly than usual. Then there are vehicle sales. In the auto sector, most expect the high year-end sales figures were the result of pulling sales forward from 2002. It is unlikely inventory restocking here will occur anytime soon.

But, **consumer spending** should remain strong into the spring. The consumer has proven surprisingly resilient throughout the current slowdown. Retail sales, while down since 9/11, have been better than expected. The durability of the housing market is further testament to consumers' unwillingness to cower from a weak economy. Current weakness is viewed as transient, which bodes well for recovery. Looking ahead, low interest rates, low energy prices and the recovery in the stock market since 9/11 should all work to bolster, or at least sustain, consumer spending.

The roadblock can be stated simply: Consumers must be employed to spend. Softness in the labor markets could put pressure on consumer spending and affect confidence going forward. If sharp job losses persist, consumers may retrench, making the recovery slow and potentially more painful. That said, we should remember that unemployment is a lagging indicator. It is likely that unemployment numbers will still be on the rise as the economy begins its rebound. But as long as consumers keep the faith, the recession could be mild and short-lived.

However, for the economy to move from recovery to sustained expansion, we will need healthy growth not only in consumer spending, but in business investment spending as well. Indeed, the sharp decline in **business investment spending** was the number one contributor to this recession. Historically, when overall economic growth accelerates, it is usually led by consumer spending, and then amplified by business investment. So, I do not anticipate a recovery in business investment spending until the second half of 2002, but it must at least stabilize and not be a drag on economic growth.

A potential roadblock here is overcapacity in the technology sector. The sudden collapse in business investment spending was, in large measure, the bust following the late 1990s boom in the tech and telecom sectors. These sectors are still plagued by overcapacity. For example, analysts estimate capital spending in the telecom industry will fall $58 billion in 2002 from its peak of $98 billion in 2000. However, a bottom to this process appears in sight.

Finally, the rest of the world

It is important to remember that the U.S. economy does not operate in a vacuum. As we entered the new millennium facing economic decline, some of our European trading partners argued that the U.S. growth slowdown had little impact on their short-term performance. Our friends to the south and east knew better, however, and anticipated the contagious decline in world economic activity. Now, with our fates closely aligned, or at least clearly recognized, we are well aware that the prognosis for growth in the U.S. is related to recovery elsewhere. At this moment, with one or two exceptions, the world economy seems well poised for growth in the coming year. Foreign economies, as far as Asia and near as Central America, will add to the recovery picture for the U.S. economy in 2002.

But risks, or roadblocks as I have been calling them, are present here as well. Japan must act upon restructuring plans to end its current recession, and Argentina must contain its instability. Finally, but most importantly, it is imperative that growth accelerates in the Eurozone. Anything less will slow U.S. recovery.

Recovery by mid-year is very likely, but not yet certain

In short, a number of sectors will need to transition before we can be confident of an acceptable level of economic activity. In the near term, we will be watching indicators like holiday retail sales, employment, consumer confidence, new orders in the manufacturing sector, foreign growth estimates and business inventory levels to see that recovery is on track.

Future Fed actions will be based upon careful analysis of incoming information, new developments, and the realization that monetary policy continues to have long and variable lags. During transition periods such as this it is important to recall this last adage. Actions taken today will alter economic performance in the second half of 2002 at the earliest, so caution must be the watchword in the months ahead.

As with any forecast, uncertainty remains. Of course, a key uncertainty here is progress in the war on terrorism --- a risk on which it is impossible to put a probability. The world has changed, and although consumers and businesses have adapted surprising well to the new realities, there is still much left to discover. Unforeseen developments in the war on terrorism could delay a recovery, just as the speed of the war has buoyed the world economy and hastened the recovery. Given the uncertainty, we must remain flexible and open as to what is required going forward.

The regional economy

In my remaining time with you I would like to turn attention to our own backyard. How will our region fare in the year ahead? Let me say that I expect Greater Philadelphia to be a full participant in the national recovery and expansion I foresee this year.

The past few economic downturns have hit our region harder than the nation as whole. We tended to slide into recession sooner, decline more sharply, and recover later than the rest of the country. Now that seems to be changing. Thus far in this downturn, we are running on an even keel with the national economy. Employment decline in our region was simultaneous with the national decline. This closer alignment of Greater Philadelphia's economic performance with the nation's is a result of our region's evolution from a manufacturing based to a more service based economy. This bodes well in a new economy that favors the service sector.

At your place is a copy of a new regional economic report produced by the Philadelphia Fed's Research Department. The report is entitled "The Industrial Evolution: Two Decades of Change in the Philadelphia Metro Area's Economy." It explains the evolution of Philadelphia's economic character, and details our region's progress compared to the nation and other large metro areas.

Please read it. There is good news inside. You will find that Greater Philadelphia compares favorably with the nation and many other large metropolitan areas in some important economic measures. Our region's concentration in knowledge industries, primarily health care, education, biotech and pharmaceuticals, has made us less susceptible to unemployment in economic downturns. This partially explains the fact that the unemployment rate of the Philadelphia Metro area, currently at 4.4%, is well below the national rate of 5.8%.

Nearly one-third of Philadelphia's workforce is now in knowledge occupations, that is, requiring formal education at the Bachelor's degree level or higher. Due to the higher earnings of these knowledge workers, our 1999 per capita income in the Philadelphia metro area was 14% above the U.S. average.

Philadelphia's strength as a tourist destination, also, acts as a catalyst to bolster the region's economic prospects. Our economy has already gained strength from a large number of construction projects, including two new sports stadiums and the renowned new Kimmel Center for the Performing Arts. In addition, an aggressive new advertising campaign to promote tourism has been launched.

As our region's economy continues this evolution, I think this bodes well for the future of Greater Philadelphia in the years ahead. We will continue to benefit from growth in the service industries, including education, pharmaceuticals and tourism and move more in sync with the national economy. Therefore, the national economic recovery I expect by mid-year, should also bring a turnaround in the region.

Admittedly, the job growth in the early stages of the recovery will probably not be strong enough to keep both the national and regional unemployment rates from rising into the second half of 2002. But by year-end, activity growth should be healthy enough to start bringing down unemployment rates.

Conclusion

To summarize, I see 2002 as a turnaround year. Thanks to the progress we have made in recent years, the Greater Philadelphia region will recover along with the nation. We should see clear signs of renewed growth by mid-year, and a healthy pace of sustained growth by year-end. Our challenge is to manage the current period of economic weakness with an eye to the future. There is no question that business owners and employees will still face some anxious months, particularly early in this New Year. But ultimately economic conditions over the next couple of years will be determined by fundamentals, and those fundamentals are positive: tame inflation, low interest rates, and robust productivity growth. Through it all, we have learned that our economy, like our nation, is enormously resilient.