The Recovery - Has It Begun?

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Good morning. It is a pleasure to be here. The economic outlook for 2002 is an issue on everyone's mind. As I talk to people in our area about the state of the economy, I hear a bit more optimism these days, but also some lingering apprehension. I think both sentiments are well founded. This morning, I will offer you my own perspective on where we are and what lies ahead for the nation and for our region. Then, I will open the floor to your questions.

Let me begin by answering today's topic question directly. Has the recovery begun? My answer is that the recovery may indeed have begun. Recent statistics on economic activity are heartening, in fact, surprisingly strong. However, the balanced growth of a true recovery requires improvement in a broad range of economic data, such as employment, manufacturing activity, and consumer and business balance sheets. The data show some evidence of this, but more will be necessary before a true recovery can be assured.

That said, the stage has been set; I expect to see solid evidence of a recovery underway over the next few months. Compared to past recoveries, this one may turn out to be somewhat milder, at least in its early stages, in light of the way the recession has evolved. Nonetheless, I expect the recovery to deliver a healthy rate of economic growth by mid-year, and into the year's end.

Perspective on Recent Experience

The economy officially slipped into recession just a year ago, in March 2001, according to the National Bureau of Economic Research, the organization that dates business cycles; though for most of us, this recession will always be associated with the events of September 11. Economic activity declined in the third quarter of 2001, after a significant slowdown in growth earlier in the year. This was a period of great uncertainty and significant employment decline; the economy lost nearly one million jobs in the fourth quarter of 2001 alone. Yet, there were also some positive developments by year-end 2001 that helped set the stage for recovery in 2002.

On the policy front, both monetary and fiscal policymakers responded quickly and significantly to help counteract the negative economic effects of September 11. The Fed cut both the federal funds and discount rates by a full percentage point in two moves immediately following the attacks. Congress and the President authorized expenditures to help with rescue and rebuilding, support affected industries, improve security, and mount a military response. This led government spending to increase at a 10 percent annual rate in the fourth quarter - its biggest quarterly gain in over 15 years.

Both the monetary and fiscal policy actions were additions to stimulative policy steps taken earlier in the year. The Fed began cutting short-term interest rates back in January 2001 when economic activity showed a sharp drop-off. Congress and the President had implemented a 10-year tax reduction program and kicked it off with cash rebates to individual taxpayers last summer.

The net result is that we entered the year 2002 with considerable policy stimulus at work in the economy. The federal funds rate stands at just 1-3/4 percent, some 475 basis points lower than one year earlier, and at its lowest level since 1961. In addition, fiscal policy remains a powerful stimulus to the economy, as represented by the swing in the federal budget from a surplus of $236 billion in fiscal 2000 to a projected deficit of $106 billion in fiscal 2002.

By late 2001, these earlier policy actions were working to temper the downturn. Though employment fell in the fourth quarter, economic activity expanded. Last week's GDP report showed that the increase in economic activity was the result of increased consumer spending, fueled in large measure by low interest rates --- including zero-percent financing on autos, which automakers were able to offer because of low interest rates overall --- and the sharp increase in government spending.

The full impact of the monetary and fiscal policy stimulus has yet to be felt. Our monetary policy actions have their maximum effect on economic activity nine months to a year after we take them. So the interest rate cuts we put in place in 2001 will help stimulate the economy well into 2002. On the fiscal policy side, additional stimulus is already programmed in for 2002, as the result of increases in defense and security expenditures and a continuation of the 10-year tax plan.

Interpreting the Present Economic Situation

As we gather here at the end of the first quarter of 2002, the good news is that the stimulus seems to be working - indeed, perhaps even better than we had anticipated. Consumer spending continues to increase. Retail sales have shown strong growth thus far in the cycle.

Just as important, spending increases are now beginning to generate increases in production. This is welcomed. Businesses cut inventories aggressively throughout 2001. As soon as demand began to soften, they cut production sharply to stave off excess inventory accumulation. As demand for their products decelerated, they continued to cut production, meeting demand with product already on the shelves and further trimming inventories. These actions amplified the impact of the downturn in demand on the manufacturing sector, and industrial production fell sharply.

Now, we are seeing the first signs that aggressive inventory cutting is coming to an end, and as demand expands, production is beginning to pick up. Our Bank's Business Outlook Survey was the first indicator to show signs of a turnaround. The survey polls manufacturers in the Third District every month -- some of you here may be participants. In January, the survey registered its first positive reading since November 2000, and it moved slightly more positive in February. Now other manufacturing surveys, including the National Institute for Supply Managers' survey, are picking up as well.

Likewise, labor market conditions are starting to firm. The first employment report for this year showed that while the economy lost jobs in January, the rate of decline continues to slow. We all await the employment report for February, which will be released this Friday, for further evidence of the slowdown in job losses. It is important that employment begin to increase and employment prospects to brighten in order to sustain the growth in consumer spending that we have been observing.

Meanwhile, sales of homes and automobiles remain remarkably robust. As you know, the market for residential real estate has proven surprisingly resilient in the face of the economic downturn thus far. And while auto sales have moderated from the record-setting pace of late last year, the financing deals that generated that sales surge seem to have robbed surprisingly few sales from this year.

Looking Ahead

With things going so well, one might be tempted to project a robust recovery for the economy in 2002. But a more moderately paced recovery is the more likely scenario. Growth in consumer spending and the sales of new homes and cars are likely to remain solid, but they are not likely to surge from their already high levels in the months ahead. And the outlook for the other important component of spending, business spending, is less optimistic. Inventories are likely to be restocked slowly, and business fixed investment is likely to recover at only a modest pace.

There are a number of factors limiting the growth in consumer spending. Perhaps the most obvious is the lack of pent-up demand. Normally, when the economy weakens, consumers, concerned about their employment prospects, postpone their purchases of big-ticket items. Then, once they see signs the economy is improving, they go out and buy the new car, the new home, or the major appliance that they wanted. In this cycle, consumers have continued to spend through the downturn, apparently postponing few purchases. As the economy improves, they will be less motivated to go on a spending spree.

In fact, when consumers consider their financial position, they may find reason to watch their spending. Consumers have accumulated considerable debt over the past several years, and the ratio of their debt service payments to their disposable income is close to a record high, in spite of lower interest rates. This is occurring at a time when the value of their stock portfolios has declined significantly and is subject to considerable uncertainty going forward. So, while consumer spending may increase at a solid pace over the coming months, it will likely not be the driver of rapidly accelerating growth.

As we move out of recession, interest rate reductions and price cuts will recede as spending motivators, but they should be replaced by better income and employment prospects. At the same time, sales of homes and autos will remain at the relatively high levels they have achieved in recent years, but their rate of growth is unlikely to accelerate markedly.

Business spending, both inventory rebuilding and capital expenditure, is more of a concern for the near-term outlook.

We should keep in mind that businesses cut inventory adjustment not only by cutting production but also by cutting prices. In fact, price declines in the fourth quarter left little room for profit and even less enthusiasm for rapid inventory rebuilding. Accordingly, I sense a rather cautious business sector, and I expect firms to replace their depleted inventories more slowly than usual. Of course, simply ending the inventory decumulation would boost near-term growth but would do nothing to sustain it over the longer term.

Then there is the prognosis for business fixed investment. One must recall that it was the collapse in business investment spending that pushed us into the current recession. The double-digit growth in investment spending that powered the expansion in the late 1990s gave way to double-digit rates of decline in 2001.

Business investment will have to turn around and begin growing again if we are to sustain the recovery and achieve a healthy pace of growth. My own expectation is that a strong turnaround in business investment spending is several months away. It will occur once the recovery gets fully underway and rising capacity utilization and better corporate financials enable firms to begin investing again. I expect the growth in investment, however, to be more moderate than it was in the late 1990s.

At that time, of course, businesses were ramping up their investments in high-tech systems. Businesses saw these developments as an opportunity to expand capacity, increase efficiency, and experiment with whole new business models. They were also preparing for Y2K. When the tech bubble burst and the economy began to soften, the shakeout began and investment spending began to plummet.

Declining capacity utilization and the slump in corporate profits reinforced the downward spiral. These factors will unwind only gradually.

Typically the industrial sector operates at something over 80 percent of capacity. Presently, it is operating at just over 70 percent. As production picks up and the capacity utilization rate rises, firms will have greater incentive to expand operations and increase capacity.

The other substantive drag on corporate investment is the slump in corporate profits and the weaknesses in their financial position. Banks are reporting increases in delinquencies and chargeoffs on their commercial and industrial loans. From the banking perspective, the problems are well contained. Banks are well capitalized and have adequate loan loss reserves. Nonetheless, increased delinquencies and chargeoffs point to underlying softness in the business sector and the caution to which I just alluded. Again, as the recovery unfolds, businesses' profitability and financial position should improve, clearing the way to increase investment spending, but, at least for now, they pose some downside risk.

Longer term, prospects for steady growth in business investment spending are good. The fundamental drivers of strong investment spending -- the competitive pressure to increase productivity and the availability of more powerful technology at lower prices -- are still at work.

Steady growth in business investment spending is important not only for its contribution to the growth in overall demand for goods and services but for its contribution to the economy's capacity to supply those goods and services. Strong investment spending boosted productivity growth in the late 1990s, and productivity growth has held up relatively well thus far in the downturn. The consensus is that continued diffusion of new technologies through the economy will keep labor productivity growing at an annual rate of 2 to 3 percent on a sustained basis. With our labor force itself growing at about 1 percent per year, the economy has the capacity to grow at 3 to 4 percent. I subscribe to that view.

Indeed, if the recovery unfolds as I expect, then the economy will be growing at a steady 3 to 4 percent rate in the second half of this year. Acceleration to growth in this range should generate enough new jobs to cap the unemployment rate at about 6 percent by the second half of this year and begin bringing it down. At the same time, the moderate pace of growth should prevent the accumulation of any inflationary pressures.

I should add that my prognosis for economic recovery in the U.S. is predicated on continued growth and stability in the global economy. The dollar has been remarkably stable, and I do not anticipate any substantive change in the market for our exports. But shifts in economic conditions among our trade partners or developments in international financial markets could affect the path of our recovery. Likewise, oil prices have settled down and the war on terrorism seems to be under control, but a dramatic change on either front would have a significant impact on the outlook.

So, Where Does This Leave Us?

Barring such developments, I am cautiously optimistic about the U.S. economy in 2002. The balanced growth of a true economic recovery should soon be underway. The recent strength in consumer and government spending should lead to growth in business expenditures and in overall production, as we move through 2002. A more rapidly expanding U.S. economy will help support a stronger global economy, and that, too, will reinforce growth here.

However, risks remain. We want to be confident that the recovery is sustainable and built on a strong foundation. To assure this, all forces necessary for a balanced recovery must align. This should occur over the next quarter or so.

As we see evidence that the recovery has taken hold and is building momentum, risks will become more balanced. Monetary policy must then shift gears, moving from its current stance, geared to stimulating a recovery, to a more neutral stance, geared to sustaining a long-term expansion.

Some Thoughts on the Region

In my remaining time with you I would like to turn the spotlight on our local economy. How will our region fare in the year ahead? Let me say that I expect Greater Philadelphia and the Main Line community to be full participants in the national recovery and expansion that I foresee this year.

This has not always been the case. As I noted at last year's Chamber meeting, the past few economic downturns have hit our region harder than the nation as a whole. We tended to slide into recession sooner, decline more sharply, and recover later than the rest of the country. The city of Philadelphia usually bore the brunt of the past slowdowns, but the entire region was also affected. At that time, I noted that I hoped, indeed expected, that this would be changing as a result of the shift in the composition of economic activity located in the Delaware Valley.

Recent evidence seems to support this assertion. Greater Philadelphia is running on an even keel with the national economy. Employment fell here only when the nation's did, and our unemployment rate is currently below the national average.

Of course, other cyclical developments in the national economy have also been reflected here in the local area. The residential real estate market has been strong, and home builders have been extremely busy. The weakness in the business sector has shown through as softening demand for office space and spotty demand for commercial and industrial space. The good news is that as the region continues to move in sync with the nation, the national recovery should also bring a turnaround in these segments of the regional economy as well.

No doubt, the closer alignment of our region's economic performance with the nation's is a result of our evolution from a manufacturing-based region to a more service-based economy. In addition, our region's concentration in knowledge industries, primarily health care, education, biotech, and pharmaceuticals, has made us less susceptible to unemployment in economic downturns. Nearly one-third of the Philadelphia metro area's workforce is now in knowledge occupations, that is, requiring formal education at the bachelor's degree level or higher.

In truth, some of our current strength comes from earlier weakness. The Delaware Valley had a smaller technology-based sector, and, on this side of the river, telecom was not a major force. So, as these industries declined, we were not disproportionately hurt. Going forward our challenge is to build up these areas, where appropriate, and be sure that we participate in the new growth that they represent.

It seems appropriate to raise this issue here on the Main Line, as this business community has been one of the most successful in our region. Thanks to the long economic expansion of the 1990s, the growing 202 Corridor and the opening of the Blue Route, the number of jobs in Montgomery and Chester counties jumped 21 and 35 percent, respectively, over the past 10 years. This growth has been in new and vibrant industries, knowledge occupations as I have called them before.

In some respects, this is just the latest demonstration of the power of a transportation network to shape a region's economy. We can go back to the 1950s with the construction of the Pennsylvania Turnpike, the Schuylkill Expressway, and Route 202. Each of these roadways brought high-tech firms, pharmaceutical companies, retailers, and financial firms to the surrounding area. I suppose there is some truth to the axiom, "If you build it, they will come." But there is more to it than that. You offer larger spaces, lower taxes, and a quality of life that appeals to both new and relocating firms, as well as their employees.

Conclusion

In closing, I see 2002 as a turnaround year for the U.S. economy and for our region. We weathered some significant difficulties in 2001, and we may yet have some anxious moments in 2002. Still the year is off to a good start. We should see consistent signs of renewed growth by mid-year and a healthy pace of growth through the second half. I am optimistic about the economy's long-run prospects. With continued strong growth in productivity, we can sustain a higher rate of real growth than most of us would have thought possible just a few years ago.

The challenge for us at the Fed is to set monetary policy conducive to achieving and sustaining economic growth at full potential. The challenge for you, as business leaders, is to continue to compete, innovate, and seize good opportunities with confidence, as I am sure you will.