2002: A Turnaround Year for the U.S. Economy

Presented by Anthony M. Santomero, President
Federal Reserve Bank of Philadelphia

Greater Philadelphia Venture Group and Association for Corporate Growth
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Good afternoon. It is a pleasure to be here. The economic outlook is an issue on everyone's mind, and I am sure that this is true for those of you in this room. I have been spending a good deal of my time speaking to people from around the Third District about where the economy is and where it is going. As I talk to people in our area, I hear a bit more optimism these days, but perhaps some lingering apprehension as well.

Such sentiments are to be expected when the economy reaches a turning point, and we seem to be at or near one now. Today, 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.

As the title of my talk indicates, I believe that 2002 will be a turnaround year for the U.S. economy. As the year progresses, we will move steadily from recession to recovery and sustained expansion.

The first phase of the recovery is underway now, and it is going extremely well. In fact, statistics released since the beginning of the year have been almost uniformly more positive than expected. As the FOMC's press release on Tuesday indicated, the near term risks to the economy are no longer tilted toward continued weakness, but appear to be more balanced. Yet, the recovery process still has a way to go, and the strength of demand growth is still somewhat uncertain.

As I have indicated for some time, I expect that this recovery will turn out to be a modestly paced one by historical standards. We are not likely to see the sharp acceleration in growth that we usually do in the first year of economic expansions. Nonetheless, early indications are that real output will grow at something close to a sustainable pace this year, and I expect the economy to be solidly on the path to sustainable growth by year-end.

Last year ended with the economy in recession, but stimulus in the pipeline

Looking back, the U.S. economy has suffered a series of significant setbacks in the past two years: a major stock market correction; the bursting of the tech bubble; the shocking attacks of September 11; and, most recently, the collapse of Enron and a crisis of confidence in corporate financial reporting. Looking beyond our shores, I could add the spike in international oil prices in 2000, followed by a global economic downturn, and the financial crisis in Argentina.

Yet, in spite of it all, the recession of 2001-02 will go down as perhaps the mildest in U.S. history, at least in output terms. Real GDP growth came to a virtual halt in the first half of last year, then turned negative in the third quarter, but turned in a surprising 1.4 percent rate of growth in the fourth quarter. This is not to minimize the loss and economic hardship that the recession caused. The national economy seemed to come to standstill in the weeks immediately after September 11, and nearly one million people lost their jobs in the fourth quarter of the year. Still, 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 this year with considerable policy stimulus at work in the economy. The federal funds rate stands at just 1 ¾ percent, stimulative by any standard and its lowest level since 1961. In addition, fiscal policy has an added significant demand impulse to the economy. This can be seen by the swing in the federal budget from a surplus of well over $200 billion in fiscal 2000 to a projected deficit of nearly $50 billion in fiscal 2002.

By late 2001, our earlier policy actions were working to temper the downturn. Though employment fell in the fourth quarter, economic activity expanded. The consumer was a key contributor to this increase in economic activity, with 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 mentioned earlier.

And the full impact of the monetary and fiscal policy stimulus has yet to be felt. Monetary policy actions have their maximum effect on economic activity nine months to a year after they are taken. So, the interest rate cuts 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 and beyond as a result of increases in defense and security expenditures, a continuation of the 10-year tax reduction plan legislated last year, and the recently passed economic stimulus package, which includes a combination of extended unemployment benefits and business investment incentives.

Now a recovery is getting underway

As we gather here at the end of the first quarter of 2002, the monetary and fiscal policy stimulus in place seems to be working - indeed, perhaps even better than we had anticipated.

Consumer spending has been relatively resilient throughout this downturn, and retail sales continued to grow in January and February. Perhaps more important, increases in spending are now generating increases in production. The Fed's industrial production index rose in January and February, the first back-to-back gains in industrial production since September 2000. The upward trend is likely to continue this month. Our Bank's Business Outlook Survey, a monthly poll of manufacturers in our District, tracks national developments pretty well. The Survey results for March, released at noon today, show manufacturing activity in our District continuing to expand and becoming more broad-based.

This pickup in industrial production is a welcome development. At the onset of the recession, when demand growth began to decelerate, businesses reacted quickly, cutting production to stave off excess inventory accumulation. In the face of soft final demand, they continued to cut inventories aggressively throughout 2001. This magnified the impact of the downturn on the manufacturing sector, and industrial production fell sharply. Now, the pickup in production is a sign that the aggressive inventory cutting is coming to an end. Going forward, increases in demand will translate into additional increases in output.

Equally encouraging are the improving conditions in the labor market thus far this year. The unemployment rate declined in January and February, and payroll employment increased in February. A brighter employment picture is probably one reason that consumer confidence rose to pre-recession levels in March.

Going forward, we need job growth and improving job prospects in order to solidify the growth in consumer spending. This is an important step in the transition to a true economic expansion. As we move out of recession, interest rate reductions and price cuts will recede as spending motivators, and they must be replaced by better income and employment prospects. This seems to be beginning to happen.

The recovery is likely to be moderately paced

With things going so well, one might be tempted to project a robust recovery for the economy in 2002. However, as I have mentioned, a more moderately paced recovery is the more likely scenario. Growth in consumer spending is likely to remain solid, but it is unlikely to surge in the months ahead. Meanwhile, business spending is likely to recover gradually, and then expand at a relatively 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. Indeed, sales of homes and automobiles have been, and remain, remarkably robust. That is one reason why the recession has been as mild as it has. But it also means that now, as the economy improves, consumers will be less motivated to go on a spending spree. So, while consumer spending may increase at a solid pace over the coming months, it is not likely to accelerate significantly. And sales of homes and autos are more likely to maintain their current pace than to increase markedly.

Solid growth in consumer spending is not enough to propel a recovery and sustain an expansion. It never is. Business investment will have to turn around and begin growing again if the economy is going to recover fully and achieve a healthy pace of growth.

Recall that it was a 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 the year 2001.

My own expectation is that a strong turnaround in business investment spending is several months away. It will occur only when the recovery gets fully underway and better corporate financials enable firms to begin investing again. Even at that, 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. Only as production picks up, and the capacity utilization rate rises, will firms have the 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. 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.

Long-term growth prospects are good

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. Recent figures on productivity growth suggest the trend rate may even be higher. So, with our labor force itself growing at about 1 percent per year, I believe that the economy surely has the capacity to grow at 3 to 4 percent per year on a sustained basis.

Thus, if the recovery unfolds as I expect, then there will be relatively little buildup of inflationary pressures in the economy over the near term. Unused capacity will come on line, and businesses will absorb the available labor force, only gradually.

Assessing the risks and making monetary policy

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. Nonetheless, shifts in economic conditions among our trade partners or developments in international financial markets could affect the path of our recovery. Likewise, international oil prices seem to be settling into a range 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.

Barring such developments, I am optimistic about the U.S. economy in 2002. We have weathered the recession, a recovery is getting underway, and I expect it to proceed steadily along its course. The recent strength in consumer and government spending should lead to growth in business expenditures and in overall production, as we move through the year. A more rapidly expanding U.S. economy will help support a stronger global economy, and that, too, will reinforce growth here.

As the economy builds forward momentum, it will be time for the Fed to shift gears, moving monetary policy from its current stance, geared to stimulating a recovery, to a more neutral stance, geared to sustaining a long-term expansion. As to the proper pace and timing of such shifts, it is still too soon to tell.

For you engaged in the most innovative and entrepreneurial segment of the financial services sector, the unfolding expansion offers an opportunity to shift gears as well. The last few years have surely been volatile ones in the venture and M&A businesses, moving from the highs to lows in short order. After the flood of venture capital available in 1999 and 2000, the sudden decline in available funds in 2001 has been something of a shock. Yet, some might not realize that 2001 ranked as the venture capital industry's third best year in terms of dollars invested at $36.5 billion.

Given that you are operating in a less frenzied marketplace, you now have the opportunity to scrutinize the fundamentals underlying new business opportunities, and demand more maturity in both the revenue streams and the management teams. This positions you well to take advantage of new investment opportunities as the recovery gives way to sustained expansion. But, it is a markedly different market today than in the hay days of high burn rates and new business models.

The region's near term outlook and long term challenges

Turning from the national economy to our own local economy, let me begin by saying that I expect the Greater Philadelphia area to be a full participant in the national recovery and expansion that I foresee this year.

This has not always been the case. In fact, 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. Fortunately, this seems to be changing. In this business cycle, Greater Philadelphia is running on an even keel with the national economy. The recession has played out differently in different parts of Delaware Valley. But, the Metropolitan Region as a whole has moved in close step with the nation. Employment fell here only when the nation's did, and our unemployment rate is currently below the national average.

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 the shifting composition of economic activity located in the Delaware Valley. Over the past 20 years we have been evolving from a manufacturing-based economy to a more service-based economy. In addition, our region's concentration is in so-called "knowledge" industries, primarily health care, education, biotech, and pharmaceuticals. 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. Knowledge workers are less susceptible to unemployment in economic downturns.

Not all of the news is good news, however. One of the reasons our region fared relatively well in this downturn is that the downturn hit the tech sector particularly hard, and the Delaware Valley has not developed a particularly large technology sector. But longer term, technology represents growth, and so our challenge is to build our strength in that sector, and participate in the new growth that it represents.

These efforts have already begun in your industry. Venture investment in the Philadelphia region has been heavily concentrated in software and biotechnology lately. Funds are flowing to ventures exploiting the wide range of new opportunities created by the integration of technology in the drug development process and continuing advances in genomics.

I believe that Greater Philadelphia will reap substantial long-term benefits from an expanding technology base, and we all must work to add to the knowledge based activities in the area. I trust that all of you share this sentiment and would welcome the opportunity to work with and support regional businesses in your venture and corporate growth endeavors.

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 as signs of renewed growth have emerged. 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.

Perhaps more significantly, this business cycle has been testament to our economy's ability to heal itself and to persevere with a resilience that is truly impressive.