

The Reluctant Recession: Why Was the Recession So Mild?

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

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While considering our conference theme, "Economic Policy in Uncertain Times," it occurred to me that extracting lessons from past recessions is a difficult business. Nonetheless, it is necessary to learn from history as we move our economy forward. I would like to thank the Levy Institute for inviting me to reflect upon our recent experience at this important annual conference on financial policy issues.

This recession is worthy of particular attention as it was quite unique in both its extent and magnitude. It was also unusual because of the number of negative shocks that hit our economy over such a short period of time: a stock market correction, the bursting of the tech bubble, the September 11 attacks, as well as the collapse of Enron and the ensuing debate over corporate governance. This list includes only the domestic disturbances; beyond our shores, we witnessed a global economic downturn, financial crisis in Argentina, erratic oil prices, and increasing unrest in the Middle East.

Despite it all, the recession of 2001-02 has been one of the mildest on record - relatively tame and not particularly deep. Incoming statistics have been remarkably strong. In fact, now that a recovery is well underway, the question on the minds of many economists has been, "Why was the recession so mild?"

I believe the answer lies in the powerful combination of four factors that came together to combat the recession:

- The exceptionally timely and stimulative policy mix,
- The increased responsiveness and capacity of the financial markets,
- The increased flexibility and productivity of businesses, and
- The greater confidence of the consumer in our economic future.

Together, these factors accounted for the benign nature of the recession, and our economy's recent extraordinary resilience.

Today, I would like to elaborate on the role each of these factors played in moderating this recession, and how they might impact our economy going forward.

First, let me explain why most forecasters would define our recent economic performance as "a mild recession." Looking back over 2001, GDP was flat in the first half of last year, fell in the third quarter, and then grew - surprisingly - in the fourth quarter. When GDP figures for the first quarter of 2002 are released, they too are expected to indicate positive growth. At least in terms of GDP, the recession seemed quick to relent. This is in spite of the fact the economy came to a standstill in the weeks following September 11.

However, by other measures, the recession was very real. Nearly one million people lost their jobs in the fourth quarter. Capacity utilization fell by more than ten full percentage points, and few would object to the characterization we had a serious manufacturing recession.

Still, during this time of loss and hardship, positive developments were already at work, setting a course for recovery.

A Stimulative Policy Mix

Starting in January 2001, the Fed began a series of aggressive **monetary policy** easings. As you know, the Fed reduced interest rates by 475 basis points in 11 different actions in 2001.

One question that has been raised recently is whether these policy actions were more aggressive than usual. I believe they were not. In studying the historical record of policy actions relative to both inflation and the pace of economic growth at the time of action, we acted in a rather typical manner during this business cycle. Though the Fed's swift response to the temporary financial market paralysis following 9/11 is somewhat difficult to quantify relative to previous actions, I would assert that nothing fundamental has changed in the Fed's approach to monetary policy during the past year.

Nonetheless, as a result of these prompt actions, the federal funds rate dropped to a 40-year low, providing a much-needed boost to the economy, and keeping economic activity from declining significantly further. The auto market is a clear indication of the effectiveness of that monetary policy. Low rates made it feasible for auto manufacturers to offer zero percent financing, eliciting a strong response from consumers and buoying the sector.

Meanwhile, **fiscal policy** added extra stimulus through both an acceleration in government spending and tax cuts. The former represents the most rapid increase in federal government spending in over four decades. The latter was helped by fiscal stabilizers - such as the automatic reduction in tax revenues for those who suffer profit declines or job loss. Both provided another means to bolster the weakened economy. To be sure, the swing in the federal budget from a ten-digit surplus to virtually nothing indicates the robustness of the government's policy response.

This response came in several stages. Last summer, Congress and the President kicked-off a 10-year tax reduction program with cash rebates to individual taxpayers. Then, after September 11, federal spending accelerated as the result of expenditures to help with rescue and rebuilding, support affected industries, improve security and mount a military response. Most recently, Congress has enacted an extension in unemployment benefits as well as tax incentives for the business fixed investment.

For the most part, though not deliberately intended to be, these measures were perfectly timed as countercyclical policy actions. The crisis and defense expenditures addressed the immediate needs of the nation in the post 9/11 environment. The tax reduction package was on the President's agenda when the economy was still flourishing. Nonetheless, it was the net effect of these fiscal actions that helped to stave off a protracted recession.

Responsive Financial Markets

Beyond stimulative fiscal and monetary policies, this time around, the financial sector was also quite effective in insulating the economy from the effects of recession.

In general, banks entered the recession with strong balance sheets and well-positioned capital, and will emerge from it in good financial health. During the expansion of the 1990s, banks remembered the lessons learned from their past experiences. Speculative commercial real estate received only limited bank financing. In addition, banks were cautious in transactions with both the booming tech and telecom sectors. As a consequence, losses and delinquencies associated with the recession did not impede banks' capacity to lend during the early stages of the recovery.

More than this, the financial sector shielded the economy from the financial implications of this recession through the strategic distribution of risk. Diversification policies were rigorously enforced, and concentration limits proved to be valuable in the subsequent market decline. As a result, much of the tech boom was financed by venture capital and IPOs, with risk distributed away from depository institutions to those most willing and able to endure high risk/high potential return venture financing.

In the credit market, though banks grew cautious, their lending activity continued. Meanwhile, increasingly efficient and sophisticated financial markets provided a ready alternative supply of credit throughout the downturn. Where appropriate, this helped sustain spending, as in the case of housing and consumer durables.

Financial markets also moderated the downturn in another way - through their price response to expectations of policy actions and subsequent economic activity. As a result, **market** interest rates cushioned the economic effects of the downturn.

As we all know, the Fed directly influences just one market interest rate -- the overnight rate on Fed funds. Therefore, for the Fed's policy actions to affect economic activity, they must ripple out into other short-term interest rates. How, and to what extent, this occurs is a matter of expectations.

When the Federal Reserve changes its Fed funds target, financial markets make an assessment on how persistent that change will be, what it signals about the future path of Fed funds rate targets, and the economy's reaction to the policy. This alteration in market expectations drives changes in other short-term rates and ripples out to the long-end of the term structure. Thus, a single Fed action affects the entire pattern of interest rates.

In this business cycle, fixed income markets responded to, and even anticipated, the softening economy and the Fed's countercyclical moves. Short-term interest rates moved with monetary policy actions, as well as with the anticipated effects of those actions. Long-term rates moved as a direct result of the effects of the predicted policy response. So did foreign exchange rates.

The Fed's increased transparency was one reason that the effects of policy actions have rippled so effectively through the economy this time around. The more clearly the markets can foresee the Fed's future course of action and its results, the more accurately markets can respond, and the more effective monetary policy will be.

We recognize that financial markets must have clear and accurate expectations about the future direction of monetary policy for short-term interest rates to transmit our policy actions to the economy. In this dimension, the effectiveness of Federal Reserve policy has been enhanced by our policy procedures aimed at enhancing clarity and transparency of the Fed's policy stance. Long-term interest rates can now better anticipate both economic developments and monetary policy actions. By falling relatively early in the cycle, long-term rates helped sustain the strength of the housing market and generate consumer spending.

A Cautious, Yet Flexible, Business Sector

Government policy and financial sector developments worked unequivocally to moderate the recession. Developments in the non-financial business sector present a more complicated picture.

This recession has been labeled a "business recession" because it was the collapse in business investment spending that pushed us into the early stage of this downturn. The bursting of the tech bubble caused a shakeout among companies with recently ramped up high-tech systems. The over-capacity in telecommunications caused a precipitous downturn in the performance of former high flyers. When the economy decelerated, general business investment spending plummeted. So the boom-bust pattern in the business sector's investment spending was the major catalyst for this recession.

Faced with softening demand, businesses quickly mounted an aggressive response. In some ways, far from curbing the downturn, their response worsened it. They slashed inventories, driving down production and employment. Thus, the impact of the recession on the manufacturing sector was amplified, and industrial production fell sharply. However, while the businesses' actions hastened the onset of the recession, their prompt action may also have avoided a deeper and more prolonged one.

The response of the business sector to slower demand and excess inventories did help to moderate this downturn in another way as well. It prompted businesses to cut prices, offer discounts, and generally do what it took to move merchandise. These actions were crucial in securing the robust state of consumer spending throughout this recession.

Interestingly, businesses' quick and aggressive responses to this recession were made possible by the investments in new technology that they made during the long expansion. These same technologies also allowed firms to continue to improve their productivity throughout the downturn, which is quite unusual by

historical standards. In short, high-tech investments have allowed companies to expand capacity, increase efficiency, and, essentially, create a new business model of recessionary dynamics.

The demonstrated flexibility and ongoing productivity gains offered by new technologies will give businesses a strong incentive to continue investing in them once the economy more fully recovers. Strong productivity gains may also offset a short-term profit squeeze, even while the aggressive inventory adjustment of 2001 sets the stage for a pickup in production by mid year.

Consequently, while business spending patterns may have aggravated the downturn in early 2001, they are also likely to help speed and strengthen the recovery in 2002. The recent pick up in production may well signal that inventory decumulation is essentially over. From here on, increases in demand will translate into additional increases in output.

A Confident Consumer Sector

Perhaps more than anything else the shallowness of the current recession has been a direct result of continued consumer spending, and consumer decisions are strongly impacted by their view of the future. Expectations about Federal Reserve actions figure strongly into the public's perception and consumer spending behavior. In short, maintaining public confidence in both the stability of prices and economic growth helped the economy to rebound, as consumer spending varied little in spite of substantial economic forces buffeting their fortunes.

Although businesses remained cautious throughout the recession, consumers exhibited a staunch willingness to spend their way through it. Consumers maintained confidence in our economy and stabilization policy's capacity to minimize the magnitude and duration of the recession. Their confidence worked to transform their perspective into a reality.

In fact, the responsiveness of consumers to recent price and interest rate cuts -- again, perhaps best exemplified by the housing and auto markets -- was indicative of this confidence. Price and interest rate cuts can only stimulate spending when consumers are convinced they will soon be reversed.

Now, as the recession gives way to recovery, consumers' incentive to increase spending will no longer come from reduced interest rates and price discounts but from rising incomes and improving job opportunities.

It is for this reason that a moderate recovery is being forecast, as consumers emerge from the mild recession with little pent up demand and a fair amount of debt. Since consumers never recessed, they have little incentive to step up and buy goods, especially at the beginning of the recovery. Longer term, consumers' willingness to spend will reflect their confidence in a rising standard of living, as a result of ongoing strong productivity growth.

Implications for the Future

As I indicated at the onset, extracting lessons from recessions can be a difficult business, but one that we must pursue. The lessons learned will impact our economic future. Most significantly, the lessons might answer the question on everyone's mind, "What will the next recession look like?"

To gain insight to bring to the future, we should look to the moderating factors we discussed here today: the stimulative policy mix, the responsive financial markets, the flexible business sector and the confident consumer sector. Were these factors one-time events? Or were they sustained changes to the economy?

Let's dissect each in turn.

On the monetary policy front, the Federal Reserve responded to this recession with a policy program that I would consider somewhat typical, given the sharp slowdown in economic growth and the lack of inflationary pressure. On the fiscal policy side, the usual countercyclical force of the automatic stabilizers was bolstered by a series of deliberate taxation and spending actions. These measures were enacted to address national needs and priorities beyond those of the current business cycle. They should not be considered harbingers of a new more pro-active countercyclical fiscal policy.

So going forward, I think we should continue to see monetary policy as the predominant discretionary stabilization tool. If future recessions are milder, I think it will be the result of permanent changes in the private sector economy, rather than any change in the conduct of public policy.

By contrast, the financial sector was more effective than usual in insulating the economy from the shocks that generated the recent recession. This is likely to be a permanent feature of our modern economy. Lessons learned and risk management systems implemented within the financial sector are likely to remain relevant in the years ahead. In short, the financial sector may well have improved as a result of past experiences. This experience, in particular, has shown the beneficial effects of efforts made and systems installed.

Finally, there are lessons to be learned from the dynamics of the real economy. The business sector responded more rapidly, cutting both production and prices in light of the decline in final sales. However, as I indicated, this was a double-edged sword, and is likely to remain so going forward. Last, but by no means least, consumer confidence in the economy's capacity to recover provided the incentive to spend throughout the downturn and expedited the recovery.

Technological progress has given the economy the capacity for stronger, steadier economic growth, presumably with the support of good stabilization policy. Right now, the public seems to be confident that this capacity will be realized. Again, that public confidence helps make it so.

The challenge for the Fed is to provide a policy that is demonstrably supportive of --- rather than disruptive to --- the market economy's adjustment processes.

As you all know, this involves appropriate policy in times of weakening and strengthening demand. This means that as the economy gains momentum, it will be time for the Fed to shift gears, moving monetary policy from its current stance, geared toward stimulating a recovery, to a more neutral stance, geared toward sustaining a long-term expansion. This will provide us, and the private sector, with the next challenge toward long run sustainable growth. As to when the challenge will come --- in anticipation of your likely first question ---it is still too soon to tell.