

Economic Outlook for the U.S. & Berks County

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Introduction

Since early this year, an economic recovery has been under way in the United States. For much of this time, interest has centered on the speed of the recovery. Many economists --- myself included --- were expecting a modestly paced recovery, rather than the rapid acceleration of growth that has been more typical of previous post-war recoveries. Now the recovery is proving to be even more moderate than we had expected.

Meanwhile, the turmoil in financial markets this summer has heightened everyone's concerns about the recovery's future course. Professional forecasters are trimming their growth projections for the year, and people I talk to around the District are expressing more uncertainty about where the economy is headed.

I too have scaled back my expectations and share people's concerns about the risks out there. But I believe the recovery will continue to move forward. I expect the pace of economic activity to gradually accelerate through the rest of 2002, setting the stage for sustained expansion and healthy growth in 2003 and beyond.

Today, I would like to share my thoughts on how I see the economic recovery unfolding, as well as the risks we face along the way. I will also address some issues closer to home, namely the state of business activity in the Berks County area and the factors affecting this region's economy.

National Economy

The recent recession has been called a "business recession" because it was sharp cutbacks in the business sector that drove the downturn. I think there is a lot of truth to this characterization. One implication is that an important driver of the recovery will be the re-engagement of the business sector. I see this happening in three stages: first in production, then in hiring, and finally in investment spending.

Right now I would say we are mid-way through this process. At the outset of the recession, firms slashed production in the face of declining sales. Last year, businesses cleared their shelves of most of their excess inventories. Since the beginning of this year, they have been increasing production to meet customer demand. The Fed's index of manufacturing output has been increasing since January. Admittedly, last month's increase was very modest. But with inventories lean, I believe production will stay on a positive trend.

This brings us to stage two: hiring. Businesses are no longer slashing payrolls, but they have not yet begun to hire in earnest. Employment gains have been positive, but small and uneven over the past several months. We need to get to the point where firms are consistently adding over 100 thousand jobs a month in order to see real improvement in the labor market. In fact, we need more than that to reduce the unemployment rate. So far firms have been conservative and reluctant to add to their workforce, but I expect firms to add to their payrolls once they are convinced the recovery is sustainable.

The third step in the business recovery is the resumption of growth in business investment spending. Here we are at the very earliest stages. That should not be surprising. All along we had been expecting businesses would not take this step until their existing capacity was more fully utilized and their profit pictures began to improve. There is some evidence that this is happening. Capacity utilization has been rising, and profits have been improving. In the second quarter, business spending on new equipment and software showed its first increase after six consecutive quarters of sharp decline. I expect an acceleration in investment spending as we move toward the end of the year and the recovery progresses.

So at this point, we are in the midst of the "business recovery," but we still have some distance to go. The fuel that we need to carry this process forward is business confidence. For businesses to step up production, hire more workers, and invest in new plants, equipment, and software, they must be confident that the economy is coming back and the demand for their products will continue to grow. In large measure, that means they must be confident that the consumer will continue to spend.

Consumer spending has been remarkably strong throughout this cycle. Its growth slowed from the frantic pace of the late 1990s. Yet, in spite of everything -- the stock market declines in 2000 and 2001, the job losses, and even the shock of September 11 -- we never saw a negative quarter. In fact, sales of houses and cars have stayed very strong, buoyed by historically low mortgage rates and zero percent financing incentives from auto dealers.

The resilience of consumer spending made the recent recession one of the mildest on record. However, this also led us to expect that the current recovery would be a relatively mild one as well. Because consumer spending stayed so strong throughout the recession, we did not expect the usual bounce back when recovery got under way. Pent-up demand was just not there. And that is fine, so long as consumer spending continues to grow at a modest pace to support the business recovery.

But, now, some uncertainty surrounds the forecast for the consumer. We do not know whether this summer's stock market decline will induce the household sector to pull back. I do not think it will. At least as of July, the stock market retreat had not induced the consumer to leave the mall. As it is often said, "Don't underestimate the consumer's willingness to spend." I expect consumer spending to continue growing, but this is a risk factor in all our forecasts.

One reason that the stock market's decline may have only a mild effect on the consumer is that the decline in financial assets has been offset by appreciation in home equity. A second and more important reason is whatever is happening to consumers' wealth position, their real disposable income continues to grow at a healthy pace. Traditionally this has proved to be a more reliable driver of consumer spending. Low inflation, low mortgage interest rates, and lower federal tax rates have combined to give people more purchasing power.

So, I expect consumer spending to continue growing and supporting recovery on the business side. Of course, the business recovery itself will, in turn, bolster employment, disposable income, and consumer spending. Indeed, it is that interaction between consumers and businesses that turns a recovery into a healthy, self-sustaining economic expansion.

I do recognize that this summer's developments in the stock market have taken their toll on people's portfolios, businesses' capacity to raise capital, and everyone's confidence. However, it now appears stock markets are beginning to stabilize, and barring further sharp declines, I expect the recovery to continue, though perhaps at a slower pace than we were expecting only a few months ago.

Recently our attention and concern has been focused on stock prices and the corporate sector. That is understandable. But several other factors are shaping the pattern of the economic recovery too, and I think they bear watching.

One is the likely slowdown in government spending. At the federal level, the surge associated with the response to September 11 and the initial phase of the war on terrorism is dissipating. At the state and local levels, balanced budget requirements and declining tax revenues are squeezing governments on the expenditure side. Here in Pennsylvania, the Commonwealth has been forced to dip into its "rainy day" fund to help maintain its programs. So, looking ahead, the contribution of government spending to overall demand growth is more likely to shrink than to swell.

Beyond our own shores, developments in the global economy are creating some uncertainties for the U.S. outlook. On a positive note, the economic picture in Asia seems to be improving. On the downside, the pace of growth in Europe has slowed, and several Latin American economies face steep challenges. There are crosscurrents on the financial side as well. Much as in the U.S., equity markets around the world have fallen

off, diminishing people's wealth and so potentially slowing economic growth. On the other hand, the modest decline in the value of the dollar vis a vis other currencies should help buoy demand for U.S. exports.

These factors are all worth watching, but none appear to be of a magnitude to threaten the recovery. But we should all remember that there are always risks and uncertainties in the near-term outlook and every economic recovery is subject to fits and starts. This one is no exception.

Nonetheless, there is one persistent positive for the economic outlook that I want to emphasize. The relatively rapid growth in productivity that was part of the late 1990s has weathered the recession well. This is likely to remain intact as we move into the expansion.

If we look past the boom and bust in the tech sector, the fact is that the application of new computing and telecommunications technologies has already given businesses plenty of new opportunities to increase efficiency and bolster productivity. And these technologies continue to get less expensive and more powerful. As the economy recovers, prospective productivity gains will provide a strong incentive for businesses to increase their investments in new technologies.

At the aggregate level, I expect the continued diffusion of new technologies through the economy to keep labor productivity growing at an annual rate of 2 to 3 percent on a sustained basis. Demographics say the labor force will grow 1 percent per year. If we combine these two factors, the economy has the capacity to grow 3 to 4 percent per year on a sustained basis. With continued strong growth in productivity, our economy can sustain a higher rate of real growth than most of us would have thought possible a few years ago.

So my outlook for the national economy is cautiously optimistic. The recovery continues to move forward, and our long-run growth prospects are good. Still, the recovery is more modestly paced than we had hoped, and it is still subject to more risks than we would like.

In this context, I believe the Fed's current monetary policy stance is appropriately supportive of the recovery process. At some point, prudence will dictate that we begin moving monetary policy back toward a more neutral stance. But in the near term, given the uncertainties surrounding the economic outlook, the proper pace and pattern of future monetary policy actions are difficult to predict. We at the Fed will continue to watch economic developments closely and set a monetary policy that we believe will assure self-sustaining growth.

The Berks County Economy

Let me turn from the national scene to developments closer to home. As you probably know, the Federal Reserve Bank of Philadelphia serves eastern Pennsylvania, south Jersey, and the state of Delaware. Berks County lies roughly at the geographic center of our District.

One of the key activities in Reserve Banks is the monitoring of economic developments in their Districts. I can report that our District economy has moved through this cycle very much in sync with the nation. Job losses here have been proportional to job losses nationally, while unemployment rates in our region have been just below the national average. Here in Berks County, unemployment stands at 5.8 percent, compared to 5.9 percent nationally.

Unfortunately, the close parallel between the performance of the nation and the region extends to the manufacturing sector as well. While the recent recession was generally mild, it hit the manufacturing sector hard. This has been of particular concern here in Berks County where manufacturing represents such a significant share of employment and where layoffs in the sector continue.

As I mentioned a few moments ago, national manufacturing output began to recover early this year, but employment in the manufacturing sector has yet to come back. Our Bank's most recent [Business Outlook Survey](#), a survey of District manufacturers, which is a recognized indicator of national trends, tells the story. It moved into positive territory early this year and has faltered recently, suggesting that the recovery in manufacturing activity may proceed in fits and starts. The data there suggest that gains in manufacturing employment may yet be some months away.

In Berks County, the manufacturing core is strong, and longer term, I believe it will remain strong, because you are taking advantage of the new technologies that will keep you competitive. I saw that for myself a few months ago when I was in the area and I had the opportunity to visit the foundry of a precision metals firm. The company has been in business since the 1960s. From the outside, you might be led to believe it had gone unchanged for 40 years. But inside is a different story. In the back of the facility, where metals are poured, the plant manager showed me how technology has changed the production process. Everything from mixing alloy ingredients to testing the final product is managed from the keyboard of a computer. Production is more efficient and the product of a higher quality than ever before.

Like the nation, our District is evolving toward a more service-based, and hence less cyclical, economy. That trend is also playing out here in Berks County. Reading has been growing and diversifying into the financial services sector. To attract more tourists and visitors, the region is building on its reputation as a destination for outlet shopping by adding a new sports arena and renovating the Lincoln Plaza hotel and the Convention Center. And as a former finance professor, I cannot resist emphasizing the benefits of portfolio diversification. One measure of Berks County's economic diversification is that no single company here employs more than 2 percent of the area's workforce.

Having emphasized ways in which Berks County is evolving in line with national and regional economic trends, I'll also point out two uniquely positive features of the region.

The first feature is the relatively rapid growth in Berks County's population and employment. Pennsylvania is a notoriously slow growing state, but the Reading area is just the opposite. Over the past decade, Pennsylvania's population has grown just 3.4 percent. Meanwhile, Reading's population and employment have grown 11 percent.

There is no denying that population growth has brought its challenges to the region. But ultimately a growing population is a good thing for the local economy. It brings opportunity for economic growth and change.

A second factor that bodes well for your future is Reading's unique geographic position in the midst of the very populous Northeast Corridor. As modes of transportation have changed, Reading has continued to be an important node in the transportation network. Early on, Reading was at the crossroads of a canal network; then it formed the hub of the Reading Railroad; now it is at the epicenter of the highway network.

Conclusion

In closing, our District economy continues to evolve in parallel with the nation's, and Berks County is uniquely positioned to take advantage of that evolution. The prospects for the Berks County region are positive as you enhance traditional strengths and develop new capabilities. The challenge for you, as business leaders, is to confidently continue to compete, innovate, and seize good opportunities. I am sure you will.