Economic Outlook for the U.S. & Delaware

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Early in 2001, the economy slipped into recession. Since early 2002, it has been on a recovery track. But movement has been too slow. In fact, over the last several weeks, the economy appeared to have lost momentum. In response to that softness, the Federal Open Market Committee reduced short-term interest rates by 50 basis points last Wednesday. I believe with that action the economy will continue on the path to recovery and sustained expansion in 2003.

Today, I would like to discuss the Fed's recent policy actions - the steps we have taken and what they mean going forward. I will follow with the context of these actions, including the reasons I see recovery and sustained expansion as the most likely scenario. Finally, I will examine how all this is playing out in our region and specifically here in Delaware.

Policy Outlook

When the Federal Open Market Committee met last week, we faced the following scenario: Economic policy, both monetary and fiscal policy, was already quite expansionary. The FOMC had slashed short-term rates 11 times in 2001. On the fiscal side, the $236 billion surplus of fiscal year 2000 had given way to a $159 billion deficit for 2002. Nonetheless, incoming data indicated that the economy was losing momentum. As a result, we felt it needed additional stimulus. Therefore, we unanimously chose to again cut rates, to hit a new 40-year low of 1.25 percent. This additional monetary easing should prove helpful in reinvigorating the economy as it works its way through this current soft spot.

What is holding the recovery back? The simple answer is uncertainty. Businesses are uncertain about the future course of demand growth. Consumers are uncertain about job prospects and the future of their retirement nest egg. And everyone is uncertain about the international situation and the threat of war.

Uncertainty breeds caution and conservatism. It induces people to pull back, to delay, and to defer. And it has been a heavy burden on this recovery. It has inhibited spending and hiring in the business sector and diminished consumer confidence. Consequently, it is contributing to subpar growth and a lack of traction in the recovery.

The U.S. economy is fundamentally sound and its long-run growth prospects have rarely, if ever, been better. Ultimately, today's uncertainties will be resolved and the anxieties will diminish. Meanwhile, I believe our most recent policy action will help to spur confidence and stimulate spending. In conjunction with our previous actions, it helps create an environment more conducive to growth and more sympathetic to the forces that foster growth, higher spending and improved job prospects.

Currently, the economy is in a soft spot. But monetary policy is positioned to generate momentum for growth beyond the current quarter. With our most recent action, I believe we have rebalanced the risks to the economy so that they are no longer primarily to the downside.

Accordingly, I am guardedly optimistic and agree with the majority of financial economists that the recovery, while slow, will continue to build its forward momentum. Let me talk about the dynamics of the recovery as I see it.

National Economic Outlook

The recent recession was business driven. And for the economy to return to healthy growth, we need a business-driven recovery. But, for this to happen, consumer spending must continue to grow.

Throughout most of this recovery, consumer spending has exceeded income. Tax cuts, price cuts, and interest rate cuts induced consumers to do their part to buoy the economy. Then, over the course of the summer and early fall, a number of factors made them more conservative. The sources of uncertainty are fairly apparent: stock market volatility, a weak job market, layoffs, accumulating debt, and of course, terrorist threats, sniper attacks, and the threat of war with Iraq.

As a result, going forward, I believe that consumer spending is likely to grow in line with the growth in household income - not appreciably faster, but not appreciably slower either. Not faster, because there is little pent-up demand in the consumer sector. Also, households have already garnered most of the gains from the refinancing of their mortgages, and, for some, debt burdens are now a constraint.

But not appreciably slower either, because the stock market has taken a more positive tone recently, the labor market has stabilized somewhat, and the geopolitical situation seems to be coming under better control. Having consumer spending grow in line with household income means solid, if unspectacular, growth.

I said a moment ago that a healthy expansion requires growth in business investment spending. And as consumers persevere to support expansion, businesses too will come around. It will not happen overnight, but we are already seeing early signs of a reengagement of business spending on equipment and software. In addition, there is also some evidence of job growth.

Admittedly, firms are still facing excess capacity, lower than desired profits, and uncertain demand. As a result, while we have seen some increases in business investment spending on replacement equipment, there has been little in the way of net additions to capital stock. And realistically, business spending on new construction is likely to remain slow, given the current level of excess capacity in commercial real estate.

Nonetheless, as firms gradually bring their existing capacity on line, as profits grow, and as uncertainties about future demand growth slowly dissipate, I expect growth in investment spending to pick up over the course of 2003. At the same time, as the economy moves into the expansion phase, I expect investment spending on equipment and software to continue growing at a healthy pace. These investments embody new technologies, and businesses will want to capture the productivity gains that they offer.

The recovery is being aided by stimulative fiscal policy as well. I have already talked about the swing in the federal surplus. Tax cuts enacted last year have helped mitigate the recession and continue to support the recovery. Looking forward, the investment tax credit will give businesses an added incentive to increase their investment spending. Meanwhile, the next phase of the multi-year tax rate reduction program will bolster households' disposable income.

In short, the powerful combination of expansive monetary and fiscal policies has helped sustain the recovery thus far, and their stimulative impact will stretch well beyond 2002.

Another important driver - perhaps the most important driver - for the economy right now is the strong growth in labor productivity. Productivity growth accelerated significantly in the U.S. during the boom years of the late 1990s. It has remained robust - surprisingly and uncharacteristically robust - through the recession and thus far in the recovery. In the near term, strong gains in labor productivity continue to boost workers' real earnings and support consumer spending. Looking ahead, the opportunity for continued productivity gains will help rekindle business investment spending. We need both to sustain and to accelerate this recovery. Taking a broader perspective, these strong productivity gains increase the economy's capacity for rapid growth and generate higher standards of living in the future.

As we all know, technological progress in computing and telecommunications has been driving this strong productivity growth. Like the transportation and communications innovations of the late 1800s, these types of innovations generate booms and busts in the early going, but ultimately they pave the way to steady progress and stronger economic growth. Moreover, the U.S., perhaps uniquely, has the economic, financial, and political resilience to fulfill the potential offered by these innovations.

That is why, despite their uncertainties about what will happen in the near term, people have confidence in our economy's long-term potential. Indeed, this confidence itself bolsters growth and ensures our ability to reach that potential. As the expansion hits its stride in 2003, we can expect the economy to grow at an annual rate of 3 to 4 percent and to sustain that rate as productivity gains continue to boost the economy's growth potential.

The Region and the Delaware State Economic Outlook

How have national economic developments been playing out in our region? The answer has been clear: Our performance has been essentially on par with the nation's. And, fortunately, as the nation moves on to better economic times, this is likely to continue.

A bit of background: As the president of a Federal Reserve Bank, it is my privilege to sit on the Federal Open Market Committee and participate in monetary policy decisions. All 12 of the Federal Reserve Bank presidents attend FOMC meetings in Washington, along with the seven Governors of the Federal Reserve System, including, of course, the Chairman, Alan Greenspan.

When the FOMC meets, each Reserve Bank president talks about the current economic conditions in his or her District. This is valuable input to the decision-making process, and we all take it seriously. Statistics have their place, but to really understand what is going on in the economy, you have to stay in touch with the people who live and work in it. So I spend a lot of time talking to business people, bankers, and community leaders around our District - a District that encompasses most of Pennsylvania, South Jersey, and the state of Delaware.

In that regard, I want to take this opportunity to thank some people who have been particularly helpful to me in getting a clearer picture of economic developments here in Delaware. Coleman Townsend of Townsends Incorporated is currently on our Bank's board of directors; Howard Cosgrove of Conectiv and Bob Burris of Burris Logistics are former members of our Board. And I want to mention several members of our Bank's Business Advisory Council, particularly David Freschman of the Delaware Innovation Fund, and Dennis Klima of Bayhealth. Each of them has his finger on the pulse of different parts of the economic activity in Delaware, and I appreciate their willingness to share their perspectives with me.

With the aid of business leaders like these, representing different parts of the Third District, I have come to see that our region is a microcosm of the national economy. The pattern of economic activity here seems to track the nation's.

This has not always been the case. The past few economic downturns have hit us 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. But over the past several decades our District has changed. It has been moving from one centered on old line manufacturing into greater concentration in services and high technology - so-called knowledge industries.

So, in this business cycle, we are on an even keel with the national economy. Activity fell here simultaneously with the nation, as did employment. In fact, our unemployment rate rose even less than the average for the nation this time around - with Delaware's rate lower than its neighbors in Pennsylvania and New Jersey.

This is partially due to the fact that Delaware also has some unique advantages. For example, Delaware is viewed as business friendly. As a result, approximately 60 percent of Fortune 500 companies and half of the companies listed on the NYSE are incorporated right here.

In addition, its economy has been fluid and adaptive. As you know, Delaware's economy was built on its reputation for manufacturing and science. Companies like DuPont and Hercules were instrumental in building the state's economic foundation. Eventually, though, Delaware moved from manufacturing toward the service sector. Industries such as financial services and law were attracted and have thrived in this new service-oriented environment. The state's leadership in credit card industry is well known. Its Chancery Court sets precedents that affect the national scene.

Now the Delaware economy is moving to the next level, experiencing a "third wave" of its development. High tech science, both creation and production, will provide the jobs of the future. Delaware is part of this future.

Many factors bode well for this third wave. Its high productivity and strong investment in technology bode well for Delaware. It also has the largest per capita concentration of science and engineering Ph.D.s and the highest patent rate per capita in the U.S.

And the strength of the past is still with us as well. Manufacturing is still a major employer representing 14 percent of jobs. Twenty-one percent of those are in chemical companies, compared with 0.8 percent nationally. This unusual distribution explains Delaware's high wages in the manufacturing sector. Delaware's chemical background is currently playing out in biotechnology, as the traditional chemical industry is evolving from producing basic chemicals to more specialized products, including pharmaceuticals.

This positive picture of Delaware's economic future has shown through in its changing demographics. The state's population increased more than 5 percent in the 1990s because of net domestic migration. Delaware is the only state in our District in which more people moved in from other states than moved out, and it bucks the trend of migration from the northeastern sections of our country to the South and West.

Going forward, high rates of growth are expected in the high tech sector, growing and building on the technical roots of the past. Growth in the tech arena tends to be among smaller, innovative firms. This environment fosters the entrepreneurship that creates high-quality jobs. This economic evolution bodes well for Delaware and is especially advantageous for the small business sector.

Delaware has a wealth of resources to help small and emerging businesses. I can cite the Delaware Economic Development Office, the Small Business Development Center Network at the University of Delaware, the Delaware Small Business Administration, Digital Delaware, and, of course, the Delaware State Chamber Small Business Alliance. These are just a few of the many local organizations that are helping small businesses generate big ideas.

You, as Delawareans, have the unique opportunity to be part of this new wave of development as the state transforms itself into a technology hub, still strong in its traditional sectors, but with an eye to the future.

Conclusion

With this let me conclude. As I indicated earlier, I believe that the U.S. economy's future prospects are good. We are currently in the midst of a moderately paced economic recovery that will put us on the path to sustained expansion in 2003. There is some softness at present, but recent monetary policy action should prove to be effective in returning the economic recovery to a more acceptable pace.

As we look forward, consumer spending should continue to grow in line with household income. Business spending should continue to accelerate as sustained demand growth supports expansion of capacity and as the prospects of productivity gains encourage acquisition of new technologies. These trends, supported by a stimulative policy mix, should bring renewed strength to employment and economic growth.

Locally, with a highly skilled workforce, and strong investment in technology, Delaware, including its small-business sector, is well positioned for this future growth. The traditions of the past and the skills for the future bode well for growth in the Diamond State. With the national recovery currently under way and a future based on industries that are well known to this region, the future looks quite bright.