

## The Economy in Transition

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

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### Introduction

Welcome to Philadelphia. This is a good time to be here in the birthplace of our nation's freedom. Events unfolding half way around the world remind us of how precious freedom is to people everywhere. And how difficult freedom is to create and preserve.

I hope that during your stay you will have a chance to visit Independence Mall, just a few blocks east of here. The Liberty Bell and Independence Hall are there, reminding us of our history and the cost of freedom. They are well worth seeing; impressive symbols of the successful "Great Experiment" we call the United States. The Federal Reserve Bank of Philadelphia is on the Mall as well.

Of course, my purpose in being here today is not primarily to give you a geography lesson, though I hope I am a goodwill ambassador for the city. Rather it is to speak about current economic conditions. As the war in Iraq winds down and the process of nation building begins in that far off land, our attention naturally shifts toward the economy here at home.

Let me begin by looking back. A year ago, the U.S. economy seemed to be on its way to slow but steady progress toward sustained growth. Then, around mid-summer, the recovery began losing momentum. By year-end, it hit what was termed a "soft spot." The Fed reacted by cutting the key fed funds rate to 1-1/4 percent -- its lowest level in more than 40 years.

Nonetheless, with uncertainties and anxieties about the Iraq situation rising --- and taking international oil prices up along with them --- economic performance did not improve. Indeed, the war has cast a long shadow over our economy. There was uncertainty surrounding when the war would begin; there was uncertainty about how it would progress; and now there is uncertainty about how long its effects on our economy will last.

It is true that the relatively swift resolution of the hostilities in Iraq has helped reduce the pall over the global business environment. The regime of Saddam Hussein was deposed quickly and the Iraqi oil fields were not destroyed, both of which help minimize the economic impact of the war.

Markets have responded favorably to these developments. Oil prices are back down below \$30 a barrel. Stock prices and the dollar have moved up a bit; risk spreads on market interest rates have come down.

Still, it is far too soon to declare that the global situation has now been stabilized and the U.S. economy is back on track.

First of all, beyond the immediate, but waning, hostilities in Iraq, other difficulties may lay ahead. I need not catalogue the long list of political challenges we face around the world. I think the best we can say now is that we have reason to be more confident they will be managed successfully.

Second, even if our anxieties about global developments have been eased, this does not mean the economy will suddenly bounce back. There is no way to tell how much of our current slow path of recovery is attributable to circumstances surrounding the war and how much should be assigned to weak dynamics, such as persistent unemployment and slow capital spending. As I mentioned, this economic recovery has been losing momentum since last summer. Not all of this can be laid at the feet of the Iraq situation. Other events and imbalances were and still are at work.

But all things considered, my prognosis is that as the international issues recede from the foreground, the U.S. economy will gradually improve its performance. I see economic growth accelerating over the course of this year toward a healthy and sustainable pace of around 3 to 4 percent by year's end and into 2004. As output growth picks up, the employment picture will also improve. Job losses will abate, and then the economy will gradually begin to add jobs. At the same time, overall inflation should remain in a comfortable range.

Now let me take a few minutes to explain how and why I think the recovery will unfold this way. Then I will open the floor to your questions and comments.

## **Reviewing the Current Business Cycle**

This has been an unusual business cycle. Usually, it is the consumer who leads the economy through the cycle. Business simply follows the consumers' lead.

Typically, the recession gets started when some event or combination of events --- like a spike in oil prices or interest rates --- causes consumers to cut spending. In response to soft demand, businesses cut output and employment. They trim their inventories and put off investment projects. The economy falls into recession.

Then, after a while, some combination of factors --- interest rate cuts, stabilization in employment, and pent-up demand from postponed spending --- causes consumers to step up their spending. Big-ticket items, like houses and cars, begin to sell briskly. Output and employment rebound, and growth accelerates rapidly.

Once companies see the recovery is underway, and become more confident that consumer demand will continue growing, they begin rebuilding inventories and investing in new plant and equipment to expand their capacity to meet that demand. Their actions further bolster income and spending, and thus generate a self-sustaining expansion.

That is the typical pattern. The consumer leads the economy into recession, and the consumer leads the way out. The business sector follows the consumers' lead. But, as I said, this business cycle is not adhering to the usual pattern.

This time it was a sharp decline in business spending that led the economy into recession. During the late 1990s, firms had invested heavily in new equipment --- particularly in new computing and telecommunications equipment. When the tech bubble burst, taking the stock market down with it, firms quickly slashed their spending on new technology. Business investment spending fell precipitously.

At the same time, anticipating weaker overall demand, businesses aggressively cut their inventories of goods across the board. They slashed production and payrolls. Industrial production fell sharply. Payroll employment fell by over 2 million jobs over the past two years.

## **Households**

However, while the business sector contracted sharply, consumers did not follow. Growth in consumer spending slowed from its rapid pace of the late 1990s, but consumer spending has not declined in any quarter of this cycle.

The persistent strength of consumer spending has been something of a surprise, particularly when you consider the threat to people's financial security posed by stock market declines, and the threat to their physical security posed by both September 11 and prospect of future terrorist acts.

But, timely fiscal and monetary policy actions helped counter those forces. Swift enactment and implementation of the president's ten-year tax reduction program in 2001 bolstered people's disposable income. Meanwhile, a sharp decline in interest rates provided support for strong sales of autos and homes, and --- through home mortgage refinancings and cashouts --- for consumer spending more broadly. And so, thus far, consumer spending has held up relatively well.

Looking forward, as the focus of public attention shifts away from Iraq, I believe that we will see consumer spending continue to grow at a moderate pace.

Low interest rates will continue to support relatively healthy levels of home and auto sales, but these sales have now likely reached a plateau. Meanwhile, mortgage refinancings --- and the flow of fresh cash they generate --- are beginning to slow, capping that source of stimulus to overall consumer spending. In addition, while the debt burdens consumers have accumulated over the past several years remain manageable, they are beginning to inject some caution into spending decisions. All of these things suggest growth in consumer spending will proceed at a moderate pace.

And let me add that an important ingredient for achieving that moderate growth in consumer spending is improvement in labor market conditions --- an end to payroll job losses and the beginning of job gains. We are not there yet.

## **Businesses**

That leads me to the question of when the business sector, which led the downturn, will begin contributing significantly to the recovery. This sector had begun to turn around until concerns about the Iraq situation began to dominate decision makers' thinking in the first few months of this year.

Some of that geopolitical uncertainty has now abated. To the extent this uncertainty was the main damper on the recovery earlier this year, the business sector should begin to show some improvement. But, this improvement is also likely to be a gradual one. I say this for a number of reasons. Let me highlight just two that are particularly important.

First, businesses are still working through the investment overhang from the late 1990s. It has taken some time for companies to take full advantage of their substantial investments in equipment and software. The evidence suggests they have put their investments to good use. Growth in labor productivity, which accelerated with the investment boom in the late 1990s, has remained remarkably strong throughout the recession and recovery thus far.

And despite sluggish growth in revenues, corporations managed to increase their profits in the fourth quarter of last year. This suggests to me that businesses continue to find new ways to use the technology they already have to increase the efficiency of their operations and improve their bottom line in a very difficult environment.

Of course, in the near term, productivity gains have allowed businesses to delay investments in new plant, equipment, and software, and also to defer hiring permanent employees. But, there are limits to what businesses can accomplish with their existing operations. In this age of rapid technological innovation, existing equipment depreciates in value more quickly than it used to. Indeed, business investment spending in equipment and software showed some modest increases in the second half of last year.

Admittedly, capacity utilization rates are still relatively low. Over time this will change. One factor favoring increased capacity usage in the manufacturing sector is that with inventories lean, increases in the demand for goods --- consumer goods or capital goods --- will directly translate into increases in production.

Still, with consumer spending growing at only a moderate pace, it will take some time to bring existing productive capacity back on line, and thus set the stage for more robust capital expansion.

Likewise, it will take some time for growth in demand to generate healthy growth in businesses' demand for permanent employees. Given the natural growth in our labor force and the return of reservists to the economy, the delay in job growth may elevate unemployment rates in the near term. However, as growth accelerates we should see unemployment rates decline.

The second factor attenuating the recovery is the pervasive risk aversion evident in the business sector. For businesses to make the commitment to expand their operations, they must be confident of sustained growth in the demand for their products and services.

It is difficult to develop that kind of confidence when one is hit by a constant barrage of potentially damaging events --- a relentlessly declining stock market, the persistent threat of renewed terrorist attacks, ongoing lapses in corporate accounting and corporate accountability, and a military engagement with unknown implications for the energy markets. This is hardly the kind of environment that invites commitment to an expansion program.

Looking ahead now, the question is how quickly will businesses develop some confidence in future growth, and how aggressively will they commit to expansion. Considering the broad range of risks before us, I believe that businesses will commit only gradually.

Putting this together, moderate growth on the consumer side combined with gradual improvement on the business side will produce a moderately paced economic recovery as the year progresses, setting the stage for healthy expansion and full employment as we move through 2004.

Before closing, I want to touch on two other issues that bear on our economic outlook: the international economy and government economic policy.

### **The International Environment**

As you well know, the subpar economic performance we are experiencing here in the U.S. economy is part of a global phenomenon. Growth in other developed economies remains weak. Much of Europe has been hit even harder than the U.S. Asian markets, which until recently had shown solid growth, are now threatened by SARS (Severe Acute Respiratory Syndrome). Latin America has problems as well.

While our recovery is not contingent upon improvement in the economies of our trading partners, we all recognize that healthy economic growth in one part of the global economy benefits all. So stronger growth overseas would certainly help support our recovery, just as more rapid growth here would help support growth there.

Perhaps we will see stronger economic performance internationally. The resolution of the military conflict in Iraq is now showing through to favorable financial market conditions around the world. I am hopeful that is the harbinger of a steady recovery in the global economy.

### **Policy Prospects**

Monetary and fiscal policies, both here and abroad, are supportive of recovery.

Here in the U.S., the fiscal stimulus from the phase-in of the 2001 tax cut package is still in the pipeline, and the President's more recent proposals for additional tax cuts are the subject of ongoing discussion in Congress.

For our part, the Fed is maintaining an accommodative monetary policy stance intended to help reinvigorate the economy, create jobs, and sustain growth. As the Iraq situation moves toward resolution and the economic recovery seems poised to move to a new phase, developments bear careful watching. We are watching the incoming statistics closely and, as always, we are listening attentively to people and businesses in our Districts.

In that regard, I should mention that each Reserve Bank regularly contacts key business people in its District, and reports its findings in a volume we call the Beige Book. We make the Beige Book public and I am sure many of you are familiar with it. I want to take this opportunity to thank the Pennsylvania Automotive Association, which has long been providing us with up-to-date information on shifting trends in this important industry.

### **Conclusion**

In closing, the U.S. economy has proven strong enough to weather an extraordinary sequence of events over the past several years. We are beginning to emerge from these experiences with renewed confidence in our ability to meet the challenges that the future inevitably holds.

As we proceed, we must remember that no recovery is a smooth, even process, but the U.S. economy is resilient. I believe we can expect gradual acceleration in economic growth this year, followed by sustained expansion and full employment in the years ahead.