Our Economic Prospects: One Economist's Perspective

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On September 10, the U.S. economy was limping along but with the promise of faster growth before too long. The next morning, we suffered grievous and vicious terrorist attacks. It is too early to speak with any confidence about the likely short-run economic effects of the attacks. Tonight, I want to share with you my conviction that our long-run prospects, though changed in detail, remain bright and unchanged in fundamentals. I also want to speak in quite general terms about the short run. Our economy is resilient, both because our people are resilient and because we rely so greatly on decentralized markets. These markets will assist us in reallocating our economic resources in ways that will deal effectively with the new realities we face.

Before proceeding I want to emphasize that the views I express are mine and do not necessarily reflect official Federal Reserve positions. I thank my colleagues at the Federal Reserve Bank of St. Louis for their comments. Bob Rasche, Research director, and Dick Anderson, vice president in the Research division, were especially helpful. However, I retain full responsibility for errors.

In assessing our short-run prospects, we need to understand the special features of the pre-attack economy and then examine the likely effects flowing from the events of September 11. I will not attempt to provide any detail on the short-run outlook, for I do not believe that any economist can have great confidence in detailed assessments. What I'm going to do instead is outline the major considerations as I see them. I hope that this framework will prove useful in thinking about developments as they occur.

THE ECONOMY AS OF LABOR DAY

As the country made its usual transition from summer vacations to autumn's back-to-work season, the U.S. economy was growing slowly, if at all. Let's begin our analysis by asking: What happened to 2001? What can we say about why the economy was limping along? This analysis is highly relevant to our current prospects because what we will observe in coming quarters will be a mixture of adjustments flowing from the state of the economy as of Labor Day and adjustments from the tragic events of September 11.

This year's slowdown has been atypical, an unusual mixture of reasonably strong household demand and extremely weak business investment spending. Corporate profits have fallen at almost a 20 percent rate. Business investment in equipment and software, which had grown at double-digit rates through the first half of 2000, slowed during last year's third quarter and has declined for the last three quarters. After adjusting for inflation, business demand for information-processing equipment had grown at a 16 percent annual rate from the first quarter of 1992 to the end of last year. This year, that demand fell at an annual rate of more than 12 percent in the first quarter and almost 20 percent during the second quarter. The speed of the slowdown in business investment demand has left many firms, especially in the telecommunications and high-tech sectors, with significant excess inventory. Contributing to the slowdown may be the fact that the relatively young age of business capital equipment, due to

the rapid pace of investment, makes it less costly to defer replacement.

Manufacturing, especially telecommunications and electronic equipment, has borne the brunt of the fall—but as of Labor Day there were some signs of emerging weakness for the entire nonfarm business sector. During the second quarter, hours worked fell at a sharp 2.6 percent annual rate, the largest since the trough of the last recession during the first quarter of 1991. Smoothing through quarterly fluctuations, since the fourth quarter of last year, output in the nonfarm business sector is approximately flat and total hours worked down only slightly.

Unlike business spending, household spending has continued to grow moderately this year, despite being buffeted by changes in income, wealth and consumer confidence. Although unemployment has increased, labor markets through August remained favorable for workers; employment levels remained relatively high and real earnings continued to increase. Compensation per hour in the nonfarm business sector during the second quarter increased at a 4.8 percent annual rate after increasing at a 5.1 percent pace during the first quarter.

Demand for light motor vehicles and housing has been robust, with record or near record sales rates in both markets. The inventory of completed homes remained low. Although longer-term interest rates have fallen little this year, last year's large decreases left mortgage rates at perceived bargain levels. From highs in May 2000, conventional 30-year mortgage rates have decreased by approximately 1½ percentage points. Existing-home sales have remained at a 5.2 million unit annual rate since January 1999. Private housing starts remain above a 1.6 million pace, with some builders reporting low inventory and substantial order backlogs. In addition, despite some fluctuations, light motor vehicle sales have held up well. Sales in August, at a 16.4 million unit pace, were comparable to the strong pace of late 1998 and early 1999, although slower than the rate of 17.5 million units sold during the same month last year. The modest slowdown in light vehicle sales did create an inventory buildup last winter, but the industry responded quickly and effectively to return inventories to a normal level relative to sales.

Although real consumer spending remained reasonably strong through August, it had slowed from the pace of recent years. During both 1998 and 1999, measured from fourth quarter to fourth quarter, real consumer spending increased approximately 5 percent. During 2000, spending growth slowed to a 4.2 percent pace. This year, spending decelerated to a 3.0 percent rate during the first quarter and a 2.2 percent pace during the third. Despite decreases in equity prices that have reduced the ratio of household wealth to income, the ratio remains significantly above its pre-1995 level. But, on the other side of their balance sheet, households also have a great deal of debt; debt-service payments remain high relative to household income.

From a somewhat longer perspective, the recent slowing of aggregate household demand broadly resembles its behavior during previous economic slowdowns. During the two years prior to the business cycle peak in July 1990, real personal consumption expenditures, on a fourth-quarter to fourth-quarter basis, increased 4½ percent during 1988 and 2 percent during 1989. Prior to the December 1969 cyclical peak, real expenditures increased 6½ percent during 1968 and 3 percent during 1969. Prior to the April 1960 peak, real expenditures increased 4¾ percent during 1959, and then 2 percent during 1960. This year's slowdown in aggregate consumption expenditures, then, is not out of line with previous periods of slowing consumption.

When, however, we examine consumer expenditures in more detail, current experience is atypical. Because interest rates have remained relatively low during this slowdown, spending on durable goods including light vehicles has slowed considerably less than might be expected from historical experience. Purchases of durables increased 5.3 percent during 2000 (fourth quarter to fourth quarter), slower than its growth rates of 12.7 percent during 1998 and 11.3 percent during 1999. Prior to July 1990, however, the numbers were much worse: a 0.4 percent decrease during 1989 following a 6.3 percent increase during

1988. During the recession year of 1990 itself, durables purchases contracted by 3.5 percent. If we go back further, a similar pattern is evident prior to the December 1969 cyclical peak. The recent experience isn't nearly as weak.

But, looking forward, some caution was in order even as of Labor Day. Consumer confidence had fallen significantly, and many analysts thought falling equity prices might depress spending. It was not unreasonable to expect that a weakening labor market might also affect spending in the months following Labor Day. Firms had announced the layoff of more than 1 million workers so far this year. Manufacturing employment is down from one year ago by 940,000. Nonfarm private payroll employment, although greater than one year ago, has decreased on average by 106,000 per month since April, a pace typical for the early stages of an economic slowdown. For households, the Bureau of Labor Statistics August survey showed a decrease in employment of 1 million. Net of the 400,000 who ceased looking for work and hence are no longer classified as unemployed, the overall unemployment rate jumped to 4.9 percent.

Although the August labor market report was dismal, some analysts questioned the estimates, noting that an unusually large number of teenagers became unemployed. That fact raises concern regarding the accuracy of seasonal-adjustment factors as schools opened in August. Aggregate hours for nonfarm private payroll employees shrank only 0.4 percent during August, low relative to prior slowdowns; for manufacturing, hours decreased 1.3 percent. New claims for unemployment insurance have been relatively high—near or above 400,000 per week since April—but appeared to have stabilized.

In addition to a shift in business optimism, causes for the slowdown this year likely include higher energy prices, lower equity prices, tighter credit standards (both at banks and in private placements), and slower economic activity overseas. Sorting out the interactions among these factors will keep economists well employed for several years.

One factor—"the dog that didn't bark"—is the absence of inflation. Past cyclical downturns have been characterized, almost as a signature, by an acceleration of inflation prior to a cyclical peak either due to a supply shock (such as sharply higher energy prices) or overly expansive monetary policy that contributed to aggregate demand growing more rapidly than supply. In 2001, I believe an increase in the rate of inflation was forestalled by the preemptive monetary policy tightening that began in mid-1999.

In summary, the economy as of Labor Day was characterized by a weak manufacturing sector, led by a tech downturn of major proportions. However, consumption spending and housing were holding up very well. Notable were continuing good sales of consumer durables, especially autos and light trucks, and a robust housing market. Households, and the firms that lend to them, apparently had a favorable outlook for the future, for otherwise they would not have been assuming these large financial commitments.

ADJUSTMENTS TO COME

The decline in spending on high-tech equipment and software will end at some point, and growth will resume. I do not know when the recovery will begin; nor do I know how vigorous the revival will be. Certainly the outlook may have changed somewhat from the view as of Labor Day, which was a reasonable expectation of a revival in the fourth quarter of this year.

We should note, however, that the current capital-adjustment process is not a new phenomenon in economics. Economists have studied these matters in considerable detail. One of the oldest ideas in macroeconomics is that business investment spending depends on expectations of future sales and profits. In his *General Theory*, for example, John Maynard Keynes noted that it was impossible to assess the rate of return on an investment project until one knew expectations of future economic conditions. Further, in comments that foreshadowed the dot-com IPO phenomenon of the 1990s, Keynes observed that

excessive investment ("overinvestment") is likely to occur if the shares in a new firm can be sold in an equity market for more than the cost of the investment. In this manner, expectations can be self-fulfilling and reinforcing. A shift in sentiment to malaise can bring a very abrupt halt to the business investment boom.

It is unlikely that excess investment optimism, followed by the shift in sentiment, accounts for all of the 2001 economic slowdown in the United States. But, it seems clear that the tech reversal has played a major role. What I think is notable is not that overall growth slowed but instead that a recession had apparently been avoided as of Labor Day.

Why had the tech tumble not spilled over to the rest of the economy to a significant degree? Three factors were at work. First, without question, monetary policy easing starting in January played an important role. Second, interest rates fell last year, reflecting a reduction in credit demands to finance tech expansion and anticipations of future monetary policy easing. These rate declines were important in sustaining housing activity and household demand for consumer durable goods this year. Third, and perhaps most important of all, widespread optimism about the longer-run course of the economy sustained spending on a wide range of goods. People saw, I believe correctly, that the tech troubles were likely to be temporary. By "temporary" I mean that the duration of the problem was measured in quarters rather than years.

It is very important that we maintain a long-run perspective. Years from now, it will be of interest to economists, but few others, just how many quarters it took to move along the adjustment curve. The basic fact is that the U.S. economy allocates resources across all the different types and varieties of goods and services through highly competitive markets. These markets are very efficient in adjusting to changing demand and supply conditions.

Let me now apply this same analysis to the situation we face in the wake of September 11. Clearly, the airline and hotel industries, and related services, have been greatly affected. No one knows how long these effects will persist. What we do know is that markets will do a good job in reallocating resources. I am not saying that the affected industries will not suffer great pain; I am saying that the economy as a whole need not, and I believe will not, suffer great pain. Resources—both capital and labor—will flow from some industries to other ones and the aggregate economy will grow.

THE LONG-RUN OUTLOOK

It is my conviction that the U.S. economy contains very powerful forces promoting growth and full employment. Our society rewards entrepreneurs and innovators. We are much better off living in a society where people may be sometimes excessively exuberant—as some may have been in the late 1990s—than one in which few are prepared and able to take risks. Our strengths include a resilient people, efficient markets, and low inflation. The Federal Reserve has made clear for many years its commitment to maintaining low inflation, and that commitment is widely believed in the financial markets. Let me talk briefly about each of these long-run strengths.

Our culture and institutions reward entrepreneurial activity. They are intact, completely undiminished by the tragedy of September 11. People are motivated by the intellectual and financial rewards of building companies and serving markets. They will be looking for opportunities to move the U.S. economy forward. Government policies and the structure of our labor and capital markets enable entrepreneurs to be successful. Those conditions are in place, undepreciated.

A market system works most effectively when price signals are not confused by inflationary expectations. There is no evidence that behavior since September 11 has been motivated by fear of inflation. We saw a few lines at gas stations Tuesday of last week, based on unfounded fears of a physical shortage rather than a fear of sharply higher prices. I emphasize this point because in previous crises—the outbreak of the Korean War is a clear example—fear of rising prices consider-

ably complicated the situation. That we take price stability almost for granted is a great strength of our current condition. Equally important, a market economy requires that households and firms be able to make and receive payments reliably. The Fed provided a huge amount of liquidity through various channels and made cash readily available so banks could keep their ATMs stocked. In these and other ways, the Federal Reserve labored long, hard, and effectively since September 11 to keep the payments system working. We succeeded.

I've emphasized that near-term adjustments are already occurring in response to the tech tumble and now also, even more importantly, in response to the events of September 11. These adjustments need not have a major persisting aggregate economic impact. Let me use a sailing analogy, drawn from my many years of sailing small boats. I know the racing mark I have to go around, but sometimes get pushed off course by an adverse wind shift or squall. Those short-run events do not prevent me from reaching my objective, although they may make my passage slower. The natural state of the U.S. economy is growth and full employment. We'll get there.

I do not want to minimize the size of the current shock; I do want to caution against maximizing it. The economy has pushed ahead following previous shocks. In my personal experience, I think back to the Korean War, the Cuban Missile Crisis, the Kennedy assassination, and other shocks. I will not try to rank them against the current situation. But I am confident, given our prior experience, given our economy's characteristics and the characteristics of our people, the economy will be fine. We will get back on course before too long.