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The Economic Outlook in a Turbulent Period

Remarks by

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It is a pleasure to be with you today, although I have to confess that I am not very alert because I had a nightmare last night. I dreamed that war had just begun in the Middle East. There was substantial uncertainty about short-term prospects for oil supplies and hence oil prices. Consequently, there was more than even the usual, substantial uncertainty about near-term prospects for the economy and financial markets – so much so that the Federal Open Market Committee had simply dropped the so called "bias" sentence from its policy directive at its FOMC meeting the week before. Financial markets were especially volatile. All that was bad enough. What gave me the nightmare, though, was that in the midst of all this uncertainty, I had to make a talk about the economic outlook to students, faculty, and alumni of the Johns Hopkins Graduate Division of Business and Management. Nonetheless, I am happy to have this opportunity to be with you, and I appreciate your invitation.

I will follow my usual format in remarks like these. First I will offer a little background information. Then I'll speculate a bit about the outlook, and finally close with some comments about Fed monetary policy and the role the Fed needs to play in a situation like the one we face today.

By way of background, the recovery from the 2001 recession started late that year, and it continued throughout 2002. But it continued at an unusually tepid pace for the early stages of a recovery. Real GDP grew only 2.9 percent last year, fourth quarter to fourth quarter. And 2002 was a year of *uneven* growth, due mainly to the off-again, on-again new car sales incentive programs. Real GDP grew at a 5 percent annual rate in the first quarter of the year as the inventory liquidation spawned by the initial round of incentives in October and November of 2001 wound down. Growth slowed sharply in the spring, as the stimulus from reduced inventory liquidation diminished. But it jumped back up to over a 4 percent rate in the third quarter following the renewal of incentives, before dropping back to about a

1½ percent rate in the final quarter of the year, when the incentives once again were pared down, at least until late in the quarter. At the time, Chairman Greenspan referred to this late-year deceleration as a "soft-patch." For 2002 as a whole, I would make this comparison: Most recoveries from recession resemble the way most people feel in the morning hours after a good night's sleep – strong, energetic, and able to get more done on average than they will later in the day. This recovery is more like how you feel the morning after a poor night's sleep. You're moving forward, but in fits and starts, sustained by intermittent doses of Starbucks.

So the recovery to date has been uneven across *time*. It has also been uneven across *sectors* of the economy. Household spending for goods, services, and housing has held up remarkably well and has been a principle support of the recovery to date. Residential investment in the GDP accounts rose almost 7 percent, fourth quarter to fourth quarter, in 2002. Consumer spending increased less robustly, at a 2½ percent rate. But that's actually a fairly impressive performance in a year in which payroll employment declined, the unemployment rate rose, and consumer confidence declined appreciably. Federal government spending was also strong last year, due in part to sharp increases in defense outlays throughout the year.

In contrast, business investment in new plant, equipment, and software declined for the second year in a row. The rate of decline, however, diminished significantly from the big drop during the recession. Also, spending in the equipment and software component of business fixed investment turned up in the second quarter of the year after six consecutive quarterly declines, which reflected a revival of spending for computers that was probably stimulated by the partial expensing investment tax incentives implemented early last year. Finally, state and local outlays rose only modestly in 2002 due to the severe budget pressures most states confronted during the year. Net exports were also a drag on activity, due to a sharp deceleration in growth in Europe, continued recession in Japan, and increased competition from China.

In any case, these are the broad contours of the recovery so far. I think it's important, though, to identify the headwinds and tailwinds that have produced these mixed results, since distinguishing those likely to diminish from those likely to remain strong can shed light on the economy's prospects going forward. Among the headwinds restraining business investment, of course, was the continuing process of working through the excess capacity – especially in the manufacturing sector – created by the investment boom of the late 1990's, and the negative impact of the further decline in the stock market on both business and household attitudes and spending.

But there were also powerful *positive* forces at work buttressing the recovery last year – tailwinds if you will. Close to home for me, monetary policy was very stimulative throughout 2002 following the pronounced easing of policy in 2001. The real federal funds rate was close to zero through the first three quarters of the year, based on the core personal consumption expenditures index, and it probably turned negative when we dropped the rate 50 additional basis points in November. Moreover, persistently low core inflation, and the nearly universal expectation in financial markets that the low inflation would be sustained, help bring nominal long-term interest rates down to their lowest levels in decades. This decline included mortgage rates, which obviously were a principal driver of the exceptionally strong increases last year in both new and existing home sales, home prices and housing starts. The low rates, and the at times frenzied refinancing activity they generated, also helped support consumer spending. The main driver for consumer spending however, was the biggest increase in real disposable household income since at least the mid-1990's – about 6 percent. This increase in income, in turn, reflected two things: first, implementation of the personal income tax rate reductions enacted in 2001, and, second, very strong growth in productivity overall. The healthy productivity growth, of course, was a double-edged sword last year, since it was an important factor restraining job growth. But it clearly helped sustain real wage and income growth for workers who *had* jobs.

As we moved into 2003, economic developments have been dominated by rising concern about Iraq, the reliability of oil supplies, and the sharp actual increases in gasoline, heating oil, and natural gas prices. The severest winter in several years on the East coast has exacerbated the current squeeze in energy markets. It has also stymied housing activity – temporarily, I believe. All these developments have further restrained business spending and job growth, as underscored by a much-larger-than-expected decline in payroll employment in February. They have also produced a further drop in consumer confidence. So we seem to be entering the war with Iraq on a relatively soft economic footing.

Where do we go from here? Will the recovery strengthen, now that the tension of waiting for war is over? Or will it remain soft, or even weaken further? Obviously, no one knows. As any professional forecaster will tell you, the hardest thing of all to forecast is the future. As I said earlier, the FOMC was unsure enough of the very immediate outlook that we omitted the bias statement from our directive at our meeting on March 18.

Typically when I make talks like this, I downplay my personal view of the outlook and focus on the Blue Chip consensus forecast or some other consensus forecast. But since the economy's prospects right now are anybody's guess, let me give you my guess for what it's worth, which obviously is not necessarily representative of the views of any of my FOMC colleagues. In a situation like the current one, I think it is essential to look through the swirl of unfolding events and commentary, and market volatility, to a point several weeks or months down the road when conditions presumably will have settled at least to some degree, and the fundamentals will be reasserting themselves.

When I do that, I am personally more sanguine about the economy over the next several quarters than a lot of people I talk to regularly about the economy seem to be.

Don't misunderstand me. I am certainly not giddy with optimism; but I am more confident than some. I think the recovery is solid enough to withstand the shocks it is currently experiencing and to accelerate moderately as the year progresses. If the war were to last significantly longer and be more difficult than expected, and there were a sustained sharp increase in oil prices, obviously the recovery could be undermined. But currently there is no compelling reason to expect this. Indeed, oil futures markets are predicting declines in prices by mid-year. Participants in these markets are well informed, and they have money on the line. Beyond Iraq and oil, the weakness in most of our export markets, and the restraint strong productivity growth is exerting on job growth could keep the recovery tethered. But sustained high productivity growth eventually will coax out new business investment to capture the higher productivity, despite excess capacity in some industries. Moreover, monetary policy remains stimulative. The federal funds rate, again, is just over 1 percent in nominal terms, and probably slightly negative in real terms. Further, since both actual and expected inflation are low, many intermediate- and long-term interest rates remain at historically low levels as well. Also, the fiscal stimulus from the 2001 tax cuts is still at work, and there is a possibility of additional fiscal stimulus later in the year. These points about policy support for the recovery may strike some as naively conventional in the context of the war and the current gyrations in financial markets, but they are fundamental and powerful in my view.

Finally, the overall financial condition of the U.S. economy currently – that is, the combined financial condition of households and business firms, and the ability of credit markets and banks to provide credit and liquidity to worthy borrowers – seems clearly adequate to support, and perhaps help induce, a stronger recovery. My FOMC colleague Ben Bernanke reviewed U.S. financial conditions comprehensively in a speech last month. As he indicated, conditions in the household sector are in relatively good shape currently. The negative impact of the decline in the stock market on household wealth has been partially offset by the recent rise in home prices. Moreover, as a by-product of the equity extraction accompanying mortgage refis, many households have been able to substitute lower-cost, tax-advantaged mortgage debt for ordinary credit card and installment debt. Many households, in other words, have in effect strengthened their balance sheets, as businesses often do, by refunding their debt.

Financial conditions in the business sector are less favorable, and this has undoubtedly been one more factor restraining business investment. For example, corporate earnings have been negatively impacted by the need to shore up pension funds that have suffered losses from the stock market decline. And risk spreads on corporate debt currently are at high levels by historical standards, indicating continuing concerns about credit quality. But spreads have declined from the stratospheric levels produced by the corporate governance and accounting scandals last summer, and many companies have been able to fund short debt in the bond markets. Also, as Bernanke indicates, weaknesses in business finance have been concentrated in a relatively small number of industries like telecommunications and the airlines. Finally, the banking industry as a whole is in good shape. Most banks are well capitalized and profitable, and while they have faced challenges with some corporate loans, they don't face anything resembling the severe credit problems they faced, for example, with commercial real estate in the early 1990's.

Bottom line: Financial conditions are clearly capable of supporting and reinforcing the stronger recovery going forward I personally anticipate. This includes conditions in the business sector, if business spending revives at least to some extent this year, as I think likely. Consequently, while I recognize the downside risks in the current outlook – how could anyone fail to recognize them – I think there is a reasonable case for seeing the cup half full.

Let me close with a few observations about monetary policy. In tough times like these it is especially important for the Fed to keep its priorities straight. Think of the economy as a ship. When the economic seas are stormy, as they are now, a ship needs a firm anchor. With this in mind, one of the Fed's highest priorities is to provide that firm anchor in the form of a highly credible monetary policy focused squarely on maintaining price stability. Fortunately, we have been able to do that pretty well recently. We've spent almost twenty years, starting in the early 1980's, bringing inflation down and establishing credibility for low inflation in financial markets and the economy generally. I believe that this credibility has served us well over the last three quite challenging years.

In this regard, it is useful to recall all the negative shocks the economy has sustained during this period: a boom-bust investment and stock market cycle, a cowardly but devastating terrorist attack, a crisis in corporate governance, and now war in Iraq. In the face of all this, it is really quite remarkable that the recession was so brief and relatively mild, and that the recovery has progressed as far as it has. I think the absence of inflation and inflation expectations has played a role in this. Specifically, our high credibility for low inflation empowered us to ease policy aggressively in 2001. We dropped the funds rate four and a half percentage points that year, from 6½ percent to 1¾ percent. That easing almost certainly helped cushion the economy's decline and end it sooner than would have occurred otherwise. It would have been difficult, to put it politely, to act this decisively in the absence of credibility. Also, the recent increase in oil prices has not spawned much if any concern that other prices will now come under upward pressure. To be sure, this absence of spillover reflects the expectation that the increase will be temporary. But I would argue that it also demonstrates the public's confidence that we would resist any spillover much more forcefully than we did in the 1970's. I don't think this would be the situation if inflation were at, say, 5 percent, and we lacked credibility. Thus, it is crucial that we sustain credibility for price stability in this turbulent period.

Sustaining credibility for price stability, however, presents a different set of challenges when underlying core inflation is at 1½ percent or maybe even lower, as it is today, than when it was at 5 percent, 6 percent or 7 percent. Specifically, we have to be concerned about the risks of price *de*flation as well as price *in*flation. Let me emphasize here, as I have when I've made these kinds of comments earlier, that I do not think deflation is an immediate threat. But we obviously need to give the *possibility* of deflation more attention now in thinking about monetary policy *strategy* than we did ten or twelve years ago, when underlying inflation was much higher than it is today.

We *have* been giving it more attention, in our research and in our longer-term strategic policy discussions. In particular, the Japanese experience has reminded us that deflationary pressures – just like inflationary pressures – must be resisted decisively and preemptively if they are to be successfully contained. Further, just as we built credibility for low inflation by convincing markets and the public that we were unalterably committed to containing inflation, we will need in a similar way to establish credibility for containing deflation should deflationary pressures arise. In this regard, we now recognize that our credibility as an inflation fighter is not automatically extended to credibility as a deflation fighter. The Fed has not had much experience fighting deflation. And the one experience we had, seventy years ago in the early 1930's, was not a high point in the Fed's history.

I believe that our increased focus on the possibility of deflation has positioned us to resist effectively any deflationary pressures that might arise. In this regard, it is natural to ask exactly how we would accomplish this if we had to ease further, and the funds rate declined to zero or very close to zero. Wouldn't we run out of anti-deflationary ammunition? Well, no, we wouldn't. There are other channels we could use to undercut any incipient deflation, such as purchasing long-term bonds to increase broad liquidity. We know what these channels are, and we know how to use them if we need to.

To sum up, these are challenging times, and the current economic and financial environment is hardly devoid of risk. But the U.S. economy, fundamentally, is still extraordinarily strong and resilient. With this in mind, as I've tried to show, I think the odds are good that the recovery will strengthen as the year progresses. Rest assured that we at the Fed will do all we can with monetary policy to make these odds even more favorable.

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