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A PERSPECTIVE ON THE CURRENT ECONOMIC SCENE

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before the South Shore Chamber of Commerce,
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Good morning. It is a distinct pleasure to be here with you again at a South Shore Chamber of Commerce breakfast to ring in the New Year. In my view, this is a good time -- the beginning of a new year, and for those date purists among us, a new century and a new millennium -- to take stock of the present economic situation. It's also a good time to develop some perspective as well, and I'll try to take the longer view as I discuss economic developments.

It goes without saying that the period since the end of the last recession -- 9+ years -- has been extraordinary. It is the longest period of economic expansion in U.S. history. Moreover, if one sets aside the relatively brief recession of the early '90s -- which struck hard here in New England -- the economy has been expanding for over 18 years. And even more surprising is the fact that in the later years of the expansion -- from 1996 on -- good things got even better. Overall GDP growth, which averaged 3.2 percent from '92-'95, averaged 4.4 percent in the latter years of the decade. Unemployment hit a 30-year low of 3.9 percent, and rates of inflationary growth declined for a good part of the time.

What is sometimes overlooked about this long period of economic growth is the strength of U.S. final domestic demand -- the total of goods and services bought by Americans either from domestic sources or imported from abroad. This total grew at an annual rate of about 5.8 percent from '98 to '99 -- a very strong pace for an advanced, developed economy like that of the United States.

The experience of the last several years was virtually without precedent in the post-War period. Therefore, it was, and is, difficult to grasp how this combination of rising GDP growth rates, increasing job growth and decreasing inflation happened. As an example, most econometric models continually under-predicted growth and over-predicted wage and price pressures especially at the beginning of the period. Gradually as time passed, however, some of the factors underlying this very beneficial economic trend became more apparent.

First and foremost is the rise in productivity in all sectors of the economy. Whether the result of technological change; capital deepening; a more flexible workforce; the sheer determination to work

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harder and smarter in the face of intense global competition; or some combination of all of these things, the productivity of the U.S. economy grew over the latter part of the '90s at a pace more than double that of earlier years. Moreover, it actually accelerated toward the end of the nineties. In fact, by second quarter 2000, productivity was growing at a rate of 5.3 percent as compared with 2.1 percent for its 1995 to 1998 average.

Some portion of this very rapid productivity growth was simply a reflection of the rapid economic growth of the period -- strong demand can prompt more efficient use of resources over a short period of time much like all of us cope with peak activity. However, it began to be clear that a portion of the productivity growth the economy was experiencing reflected true structural change, primarily related to advances in technology induced in part by domestic and foreign competitive pressures. Estimates vary among economists as to how much of the productivity surge is cyclical versus structural, but if only a third of the recent gains are long term, U.S. standards of living could double in about half the time they could have in the '70s or '80s. Thus, consumers and businesses began to believe that the future held great potential, spurring increases in spending and leaps in confidence.

Another factor underlying the strong economic performance of the late 1990s was an increase in the efficiency of the labor market. Although we have been through several business cycles since the late 1960s, we had not approached the unemployment rates we have seen over the previous three years. In the past, the labor market would have been strained at unemployment rates significantly above the ones we have experienced since 1997. In fact, only 5 years ago, the debate was over whether such strains occurred at unemployment rates 2 percentage points above the level in 2000. It is clear that the labor market can now accommodate lower unemployment than it could over the previous 30 years. As a result, the potential for the economy to grow was much greater than was anticipated even 5 years ago.

At the same time, for most of the period, the rest of the world was experiencing relatively slower rates of growth. In particular, during 1997 and 1998 much of the developing world experienced economic crisis. These crises certainly were tragic for the countries involved, but the related excess capacity in the rest of the world absorbed excess U.S. demand and reduced price pressures. Moreover, relatively stronger U.S. growth strengthened the dollar, moderating price growth and further encouraging productivity as well.

These three factors -- rising U.S. productivity, more efficient labor markets, and increased globalization in both product and labor markets -- produced a remarkable situation. Employment and real compensation grew and U.S. workers and families became ever more confident about their futures and willing to spend that extra dollar on housing, cars and other consumer products. Consumer debts rose, and the savings rate plunged, but in the context of a booming economy with rising equity and real estate wealth, these seemed small negatives. Credit markets became more accommodative, and financial asset markets boomed as businesses invested ever greater amounts on new technology and enhanced their bottom line results.

Reflecting the very strong growth in U.S. domestic demand, the nation's trade deficit ballooned. By last year, the deficit amounted to over 4 percent of GDP, or about $400 billion. However, because of the attractiveness of U.S. investment markets financing that huge deficit has proven less than difficult, at least to date. In short, the U.S. experienced a long-sought-after "virtuous" cycle of economic growth feeding on itself.

But, as they say, trees don't grow to the sky. As 1999 progressed into 2000, it became apparent that various contributors to the virtuous cycle could be undergoing change. For one thing, price pressures began to emerge as a source of concern, as global growth rates surged -- reaching almost 5 percent -- and oil prices moved dramatically upward. Constraints on labor resources became more apparent, and the forecast, if not the reality, of accelerating inflation began to color economic prospects in the eyes of many observers. Thus, in the fall of 1999, the Federal Reserve started to tighten policy to ensure that growth could continue, albeit at a more sustainable level.

Asset and lending markets also began to reflect a need to return to a more balanced pace. Beginning in the spring of 2000, declining corporate profit growth and rising concern about future profits began to be reflected in declining financial asset values. These values continued to fall through the end of the year, with declines particularly large in the area of the newest, most unproven technology companies -- the dot.coms. By year end, blue chip stocks -- that is the Dow Jones industrial average -- was off only a modest 6 percent from its 2000 high; in contrast the NASDAQ declined over 50 percent from its peak.

Did this decline in the market for high tech stocks reflect deep underlying concerns about the future of technology, or did it largely encompass a return to more or less reasonable valuations after a period of cyclical excess? Assessing the reasons for financial asset market movements is never simple; but one must realize that the future annual growth in after-tax profits implied by peak NASDAQ valuations were well into double digits. By the end of December, after-tax profit expectations implied by NASDAQ market valuations were much closer to the long-run average for that market. Thus, there is some logic to the idea that this market change does not reflect deep concerns about the benefit of new technologies in general, but a revision, albeit sharp in particular cases, in short-term profit expectations.

Credit markets, which had never returned to the headiness of the 1997 global pre-crisis period, also became more discriminating in early 2000. Yield spreads, particularly for lower-rated securities widened considerably in the spring and again in the fall. Lending standards at major commercial banks tightened as well. I should add that given building economic uncertainties neither wider spreads nor tighter standards were necessarily bad. In this way, over the course of the year, credit markets tended to restrict funding, especially to less than investment grade customers.

These changes in financial markets began to pick up in intensity in the early summer. They helped start a slowdown in growth from the high-flying levels of 1999 and early 2000. At the same time, the continued increase in oil and gas prices was a further cause of retrenchment by acting as a tax on both consumers and businesses. Clearly, purchasing power was reduced. This reduction, combined with the squeeze on credit and equity markets and, on the part of consumers, some satiation after years of spending on big-ticket items, caused a slowing in spending in the second half of the year.

The evidence of this cooling off in spending was first seen in auto and truck sales, which actually declined in the second quarter from their historic first quarter levels. Durable goods consumption excluding autos slowed significantly from its torrid pace of 1999. As the year wore on and consumer confidence also began to falter, sharper falloffs in auto and retail sales more generally implied much slower consumption growth in the fourth quarter.

Evidence also emerged related to a slowing in business-fixed investment from its rather torrid pace over the last several years. Interestingly, this slowdown was centered largely in the non-computer part of equipment investment, though it did include sharp slowdowns in communications and software. Real computer investment taken alone, however, grew at an annualized pace of 40 percent in the third quarter, slower than the pace of the second quarter, but clearly within the very strong growth pattern of the last several years.

Slowing consumption and investment clearly signaled a significant economic shift as the year progressed to its end. Initial estimates of GDP for the third quarter were revised downward to a final of 2.2 percent (versus 5.7 percent in the second quarter) and, given that the number of hours worked in the fourth quarter remained flat, expectations are that growth will continue in that range, or perhaps be a bit lower. Foreign economies slowed as well, again from a very strong pace in 1999 and early 2000. Domestic labor market constraints began to abate too, as employment growth slowed significantly from its rapid pace of the previous several years and initial claims for unemployment rose from an extremely low level in 1999.

This process of slowing in 2000 from record levels earlier reveals, I think, a fairly important point. Perceptions of the overall economic scene changed rapidly over the year, and at least part of this change arose from the fact that the economy in late 1999 was simply running at an unsustainable pace. The transition to a slower, more sustainable growth pattern is a difficult process and some of the negative tone of recent readings is a reflection of that difficulty.

Moreover, not all of the news is bad. Sources of strength remain in the U.S. economy, and these reflect many of the positive forces that have propelled this extraordinary expansion. For one, while consumption has cooled, housing demand remains fairly robust. Starts and permits were up for the first two months of the fourth quarter suggesting that residential investment remains solid. Existing home sales rebounded in November, and the level of sales of new homes over the first 2 months of the fourth quarter is higher than the monthly average in the third quarter. One reason for this continued strength is the decline in mortgage rates since last May-they have fallen about 100 basis points since then. Perhaps more importantly, the health of the housing market is one indicator that consumers remain reasonably confident about the future.

As I noted before, business investment in computers remains robust. To the extent that such capital deepening, and the use of new technologies to enhance business processes has worked to spur productivity growth to date-and I believe it is clear that it has-this bodes well for continued productivity growth. In fact, even as the economy slowed in third quarter, productivity remained strong, and there is little evidence that the structural productivity change suggested by growth rates over the past few years has declined.

Finally, although employment growth has declined, the labor market remains tight. The unemployment rate stayed put at 4.0 percent in December, and while employment is an indicator of past not future strength, most expect the labor market to remain solid in the near future. This might suggest to some a potential for price pressures, but so far inflation has crept up only slightly in the last part of 2000, with much of that increase due to the rise in energy prices.

In sum, we have been through a year of very rapid economic change. Corporate profits have decelerated significantly since the spring, financial markets have cooled, credit conditions have tightened, consumer spending and business investment have waned, external growth is slower, and the overall pace of the domestic economy is a fraction of its late '99-early 2000 level. But again, to put this in perspective, some of this slowing needed to take place and sources of strength remain. Through mid-December, my own sense was that the economy might be approaching just the so-called "soft landing" so often discussed in the media, although with a growing measure of downside risk. I continue to believe moderate growth for the coming year as a whole is the most likely outcome, but, in recent weeks those risks have become more evident.

Under these circumstances, the FOMC decided that it was prudent to lower its target for the federal funds rate by 50 basis points, and to lower the discount rate charged by Reserve Banks as well. In our statement, the Committee noted "These actions were taken in light of further weakening of sales and production, and in the context of lower consumer confidence, tight conditions in some segments of financial markets, and high energy prices sapping household and business purchasing power. Moreover, inflation pressures remain contained. Nonetheless, to date there is little evidence to suggest that longer-term advances in technology and associated gains in productivity are abating."

Looking forward, as I noted earlier, I believe the most likely outcome for the economy in 2001 is moderate growth, that is in the range of 2-3 percent. I remain conscious, however, of the risks involved. Let me conclude by stressing the need for perspective as we view the future and for vigilance on the part of policy makers. Thank you for this opportunity to speak with you about the remarkable performance of the U.S. economy and its current evolution.

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