The Domestic Economic Outlook

Regional and Community Bankers Conference
Federal Reserve Bank of Boston
June 3, 2002

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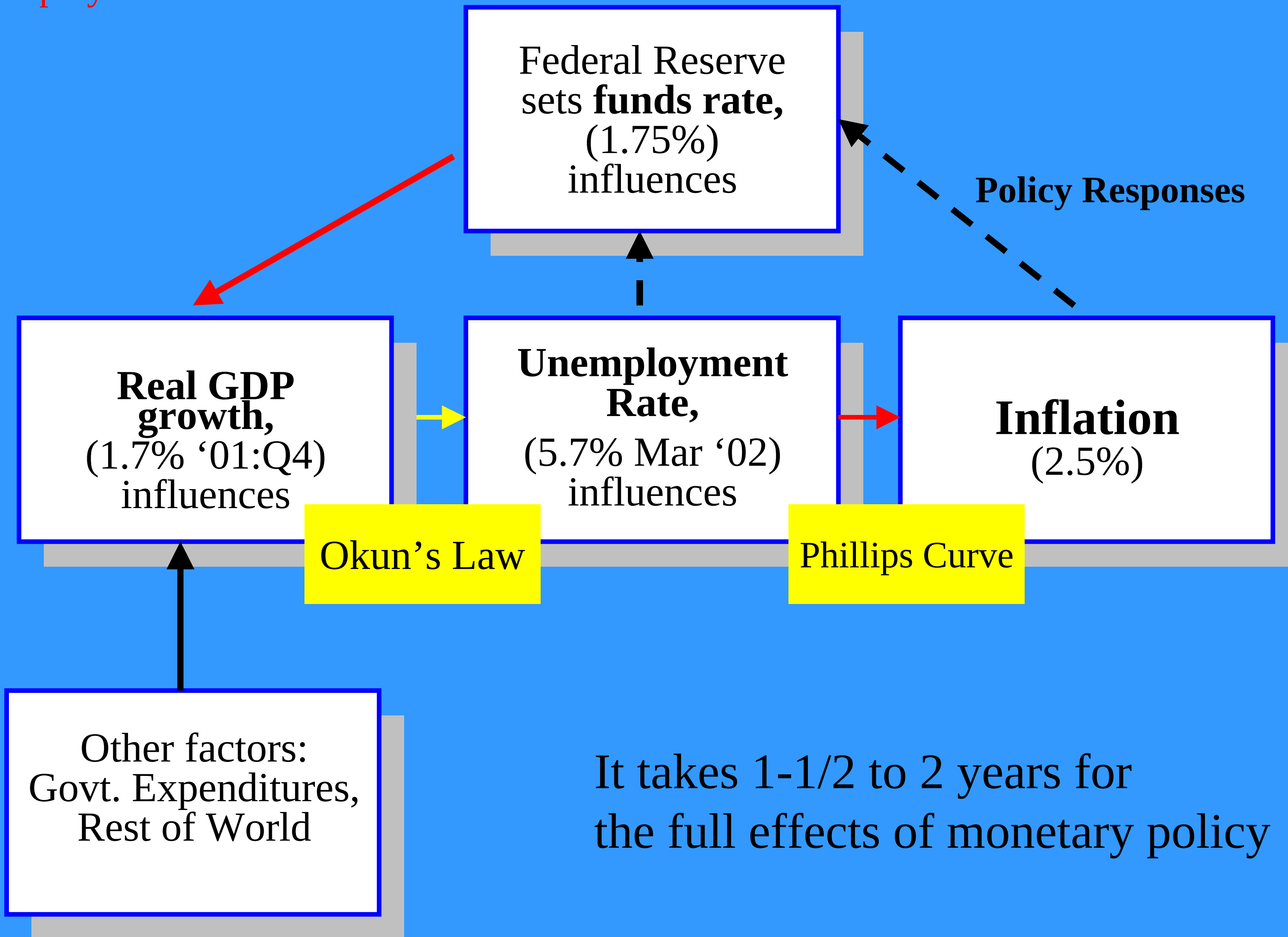
Overview

- A Simple Framework for Monetary Policy
- A Brief History of a Shallow Recession
  - How Mild Was It?
  - What Kept Us Humming During the Recession?
  - Who Gets the Credit for That?
- This Year--the Recovery?
  - How Far Have We Come?
  - Where are we going?
  - What are the Risks?
  - How About Those Productivity Numbers?
    - What do they mean?

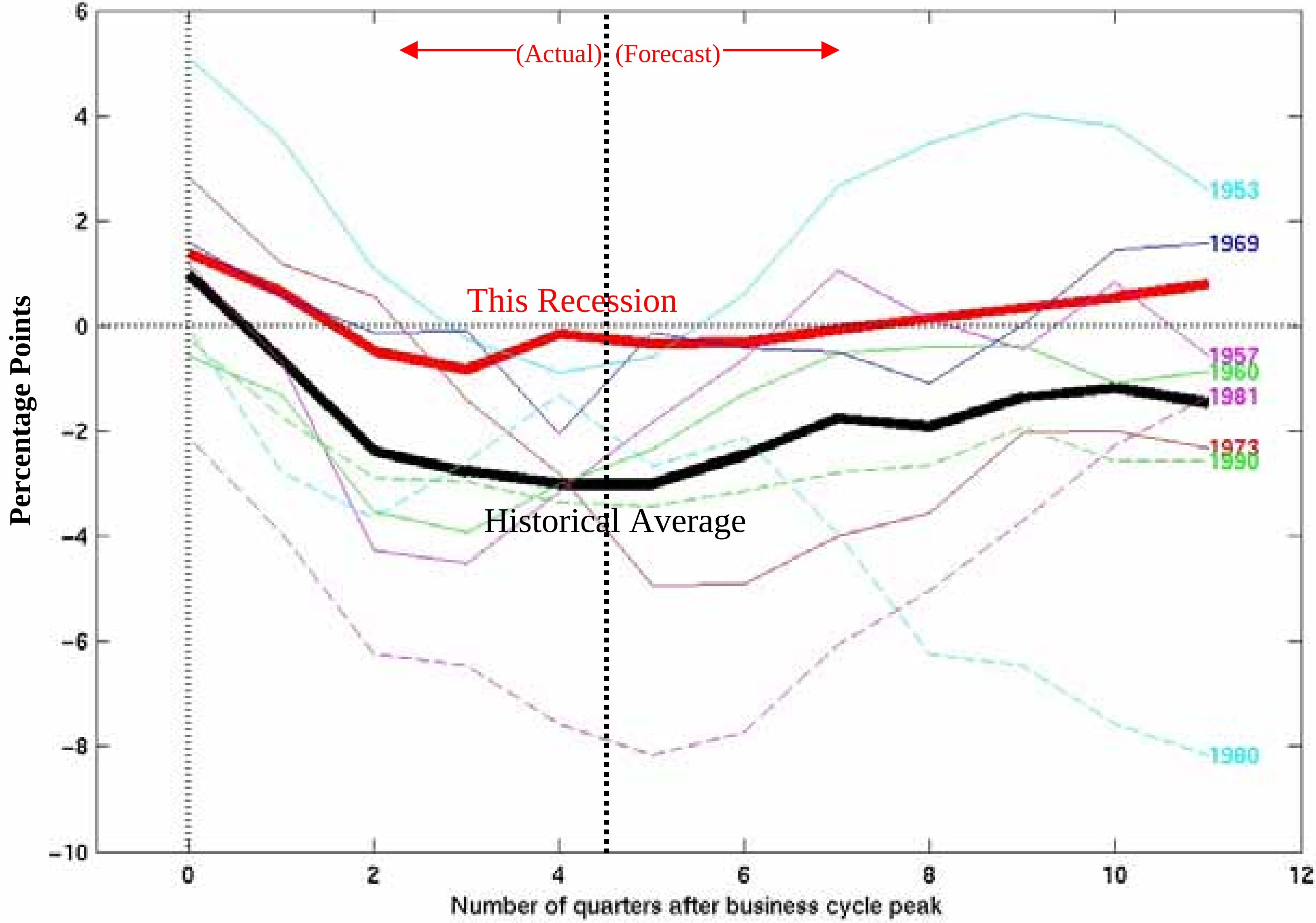
A Schematic Framework for Monetary Policy Analysis

It takes 1 to 2 quarters for
(1) Interest rates to affect spending
(2) Spending to affect employment
(3) Employment to affect inflation



It takes 1-1/2 to 2 years for
the full effects of monetary policy

How Mild Was the Recession?
"Output Gap" in this Cycle Compared to History

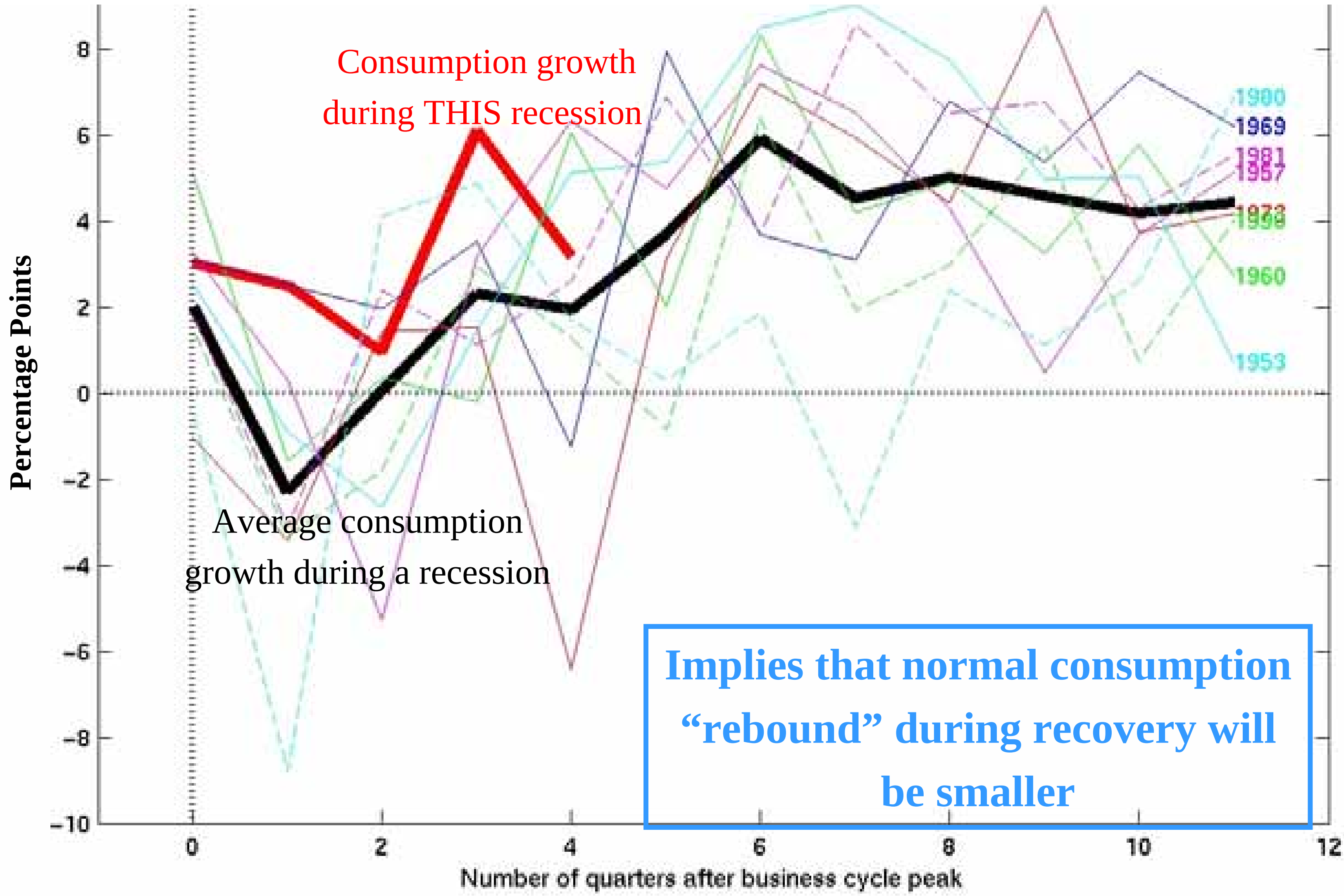


Heavy black line represents average of recessions
Heavy red line represents current experience

Source: Congressional Budget Office (potential output), BEA (GDP)

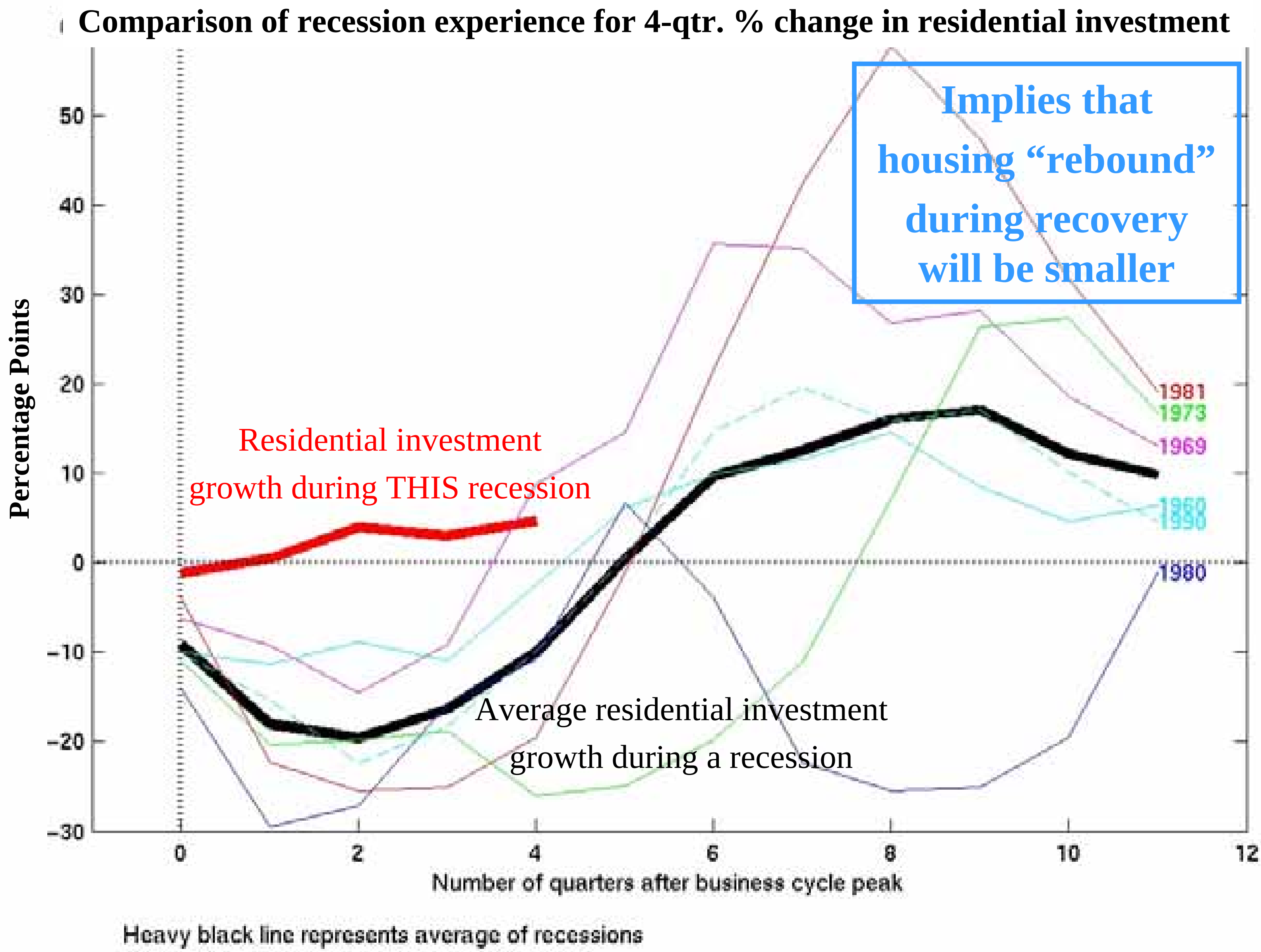
Why Was It So Mild? (1) Strong Consumer Spending

Comparison of recession experience for 1-qtr. % change in consumer spending



Source: BEA

Why Was It So Mild? (2) Strong Housing

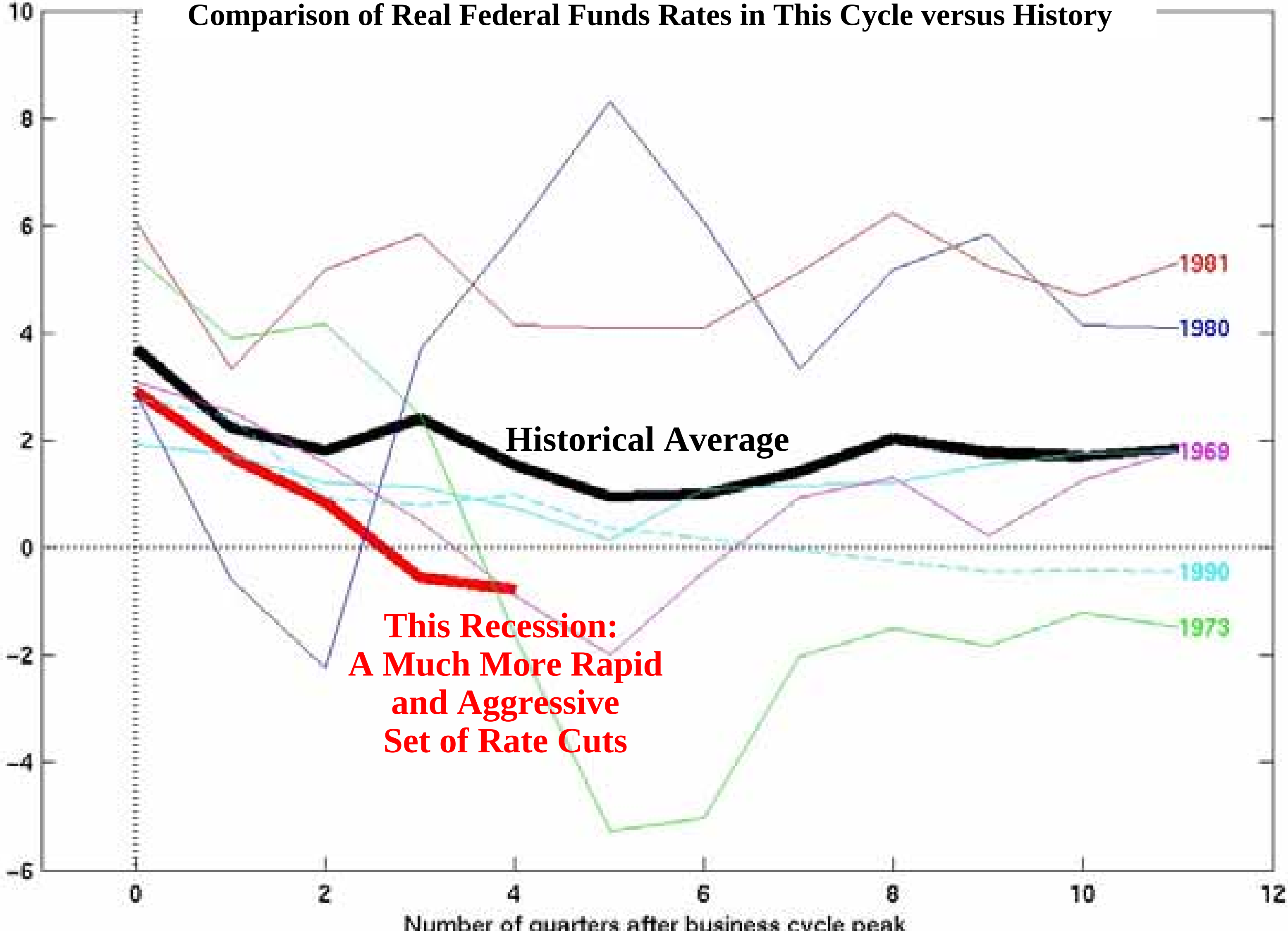


Source: BEA

What Spurred These Components (Part I)?

The Fed's Actions May Have Helped:

Comparison of Real Federal Funds Rates in This Cycle versus History



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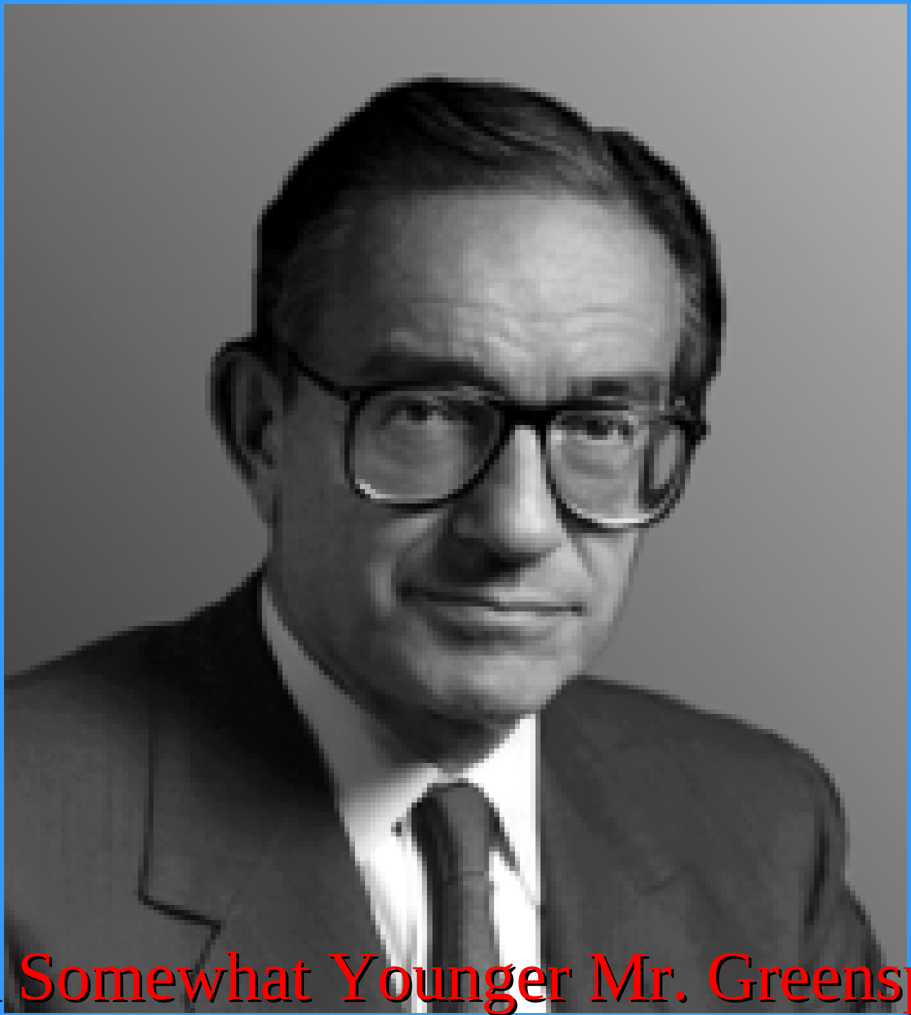
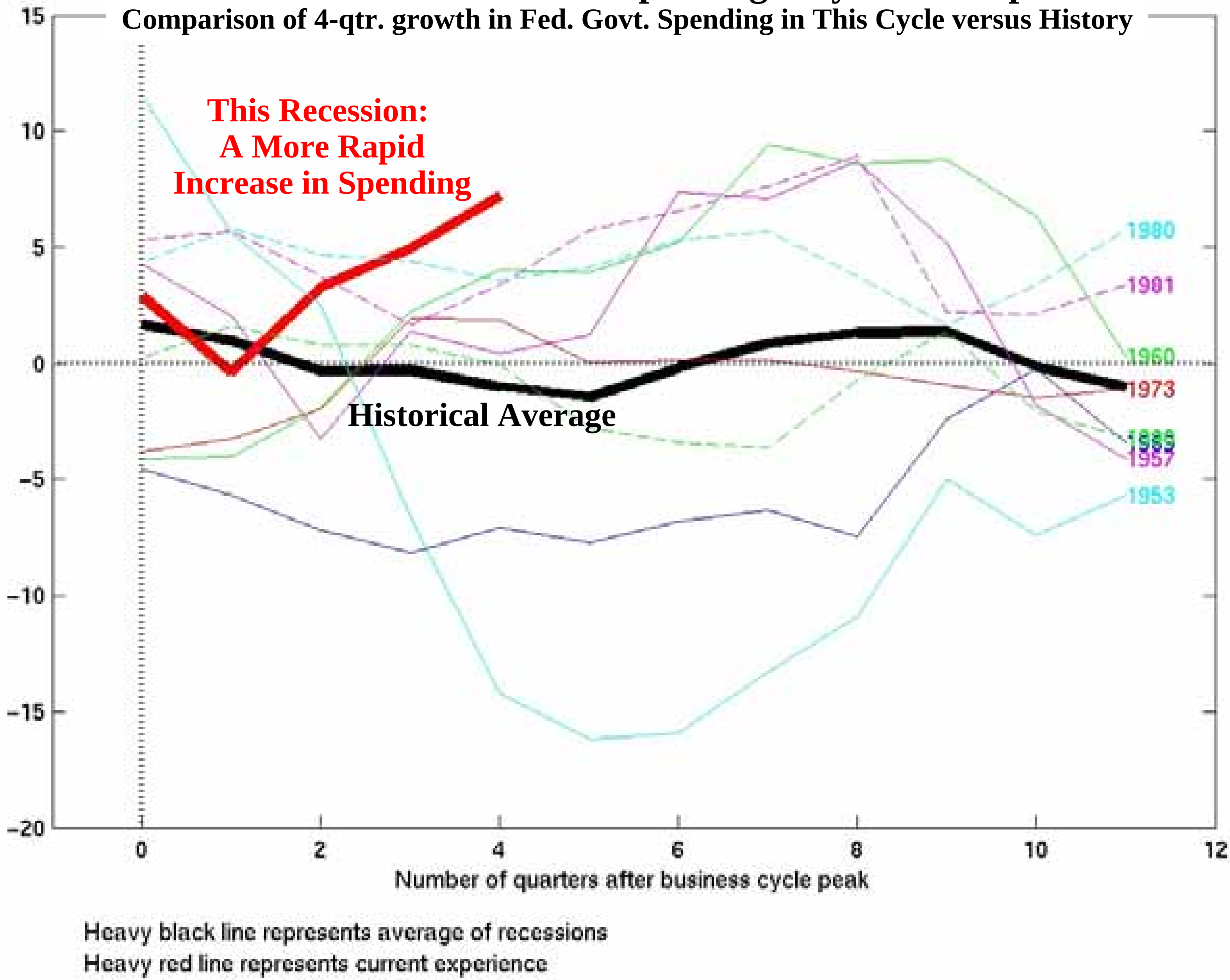
And Now, Please Rise for Our National Anthem



(A Somewhat Younger Mr. Greenspan)

What Spurred These Components (Part II)?

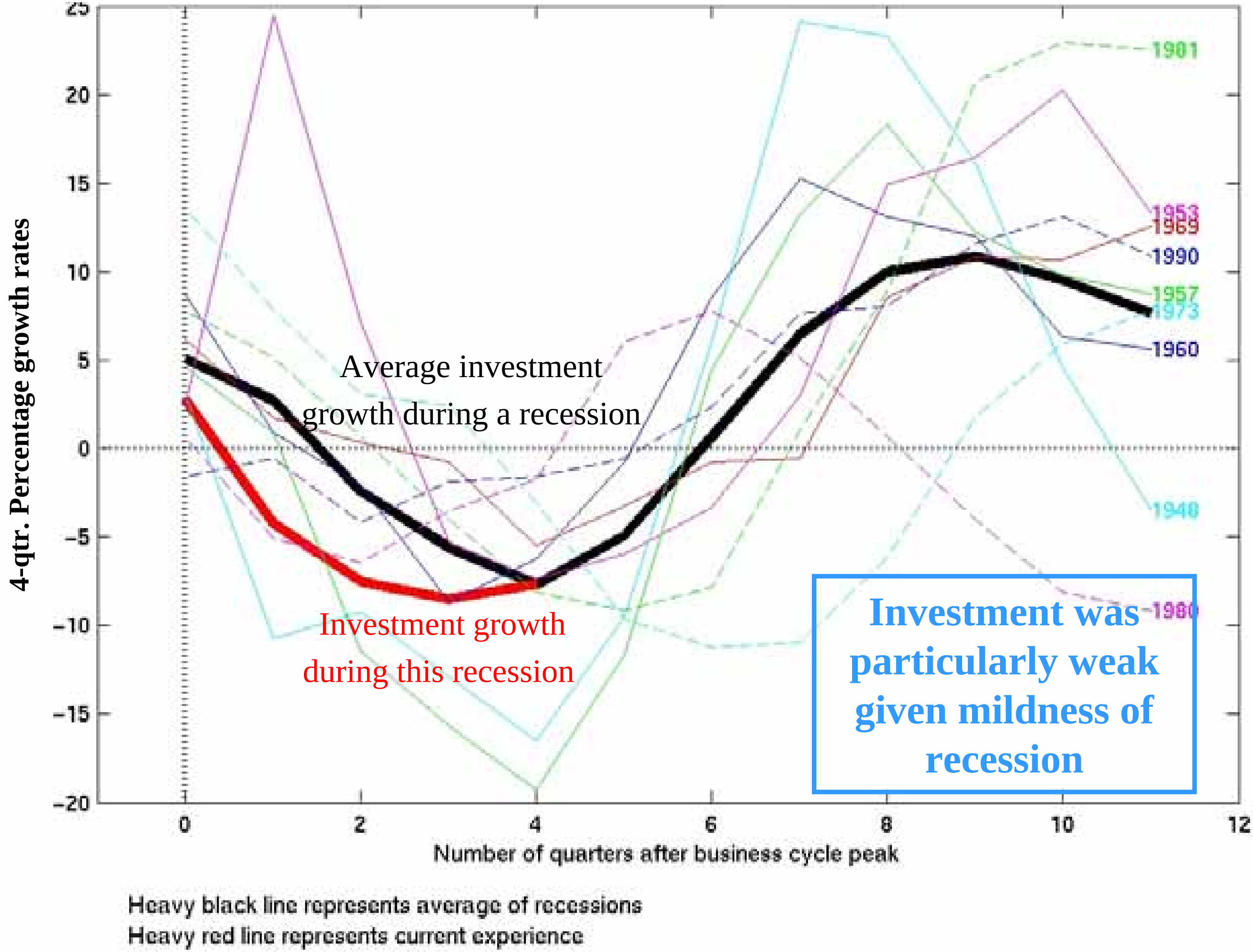
The Federal Government's Spending May Have Helped:



Source: BEA

One Component That Wasn't So Mild: Capital Investment

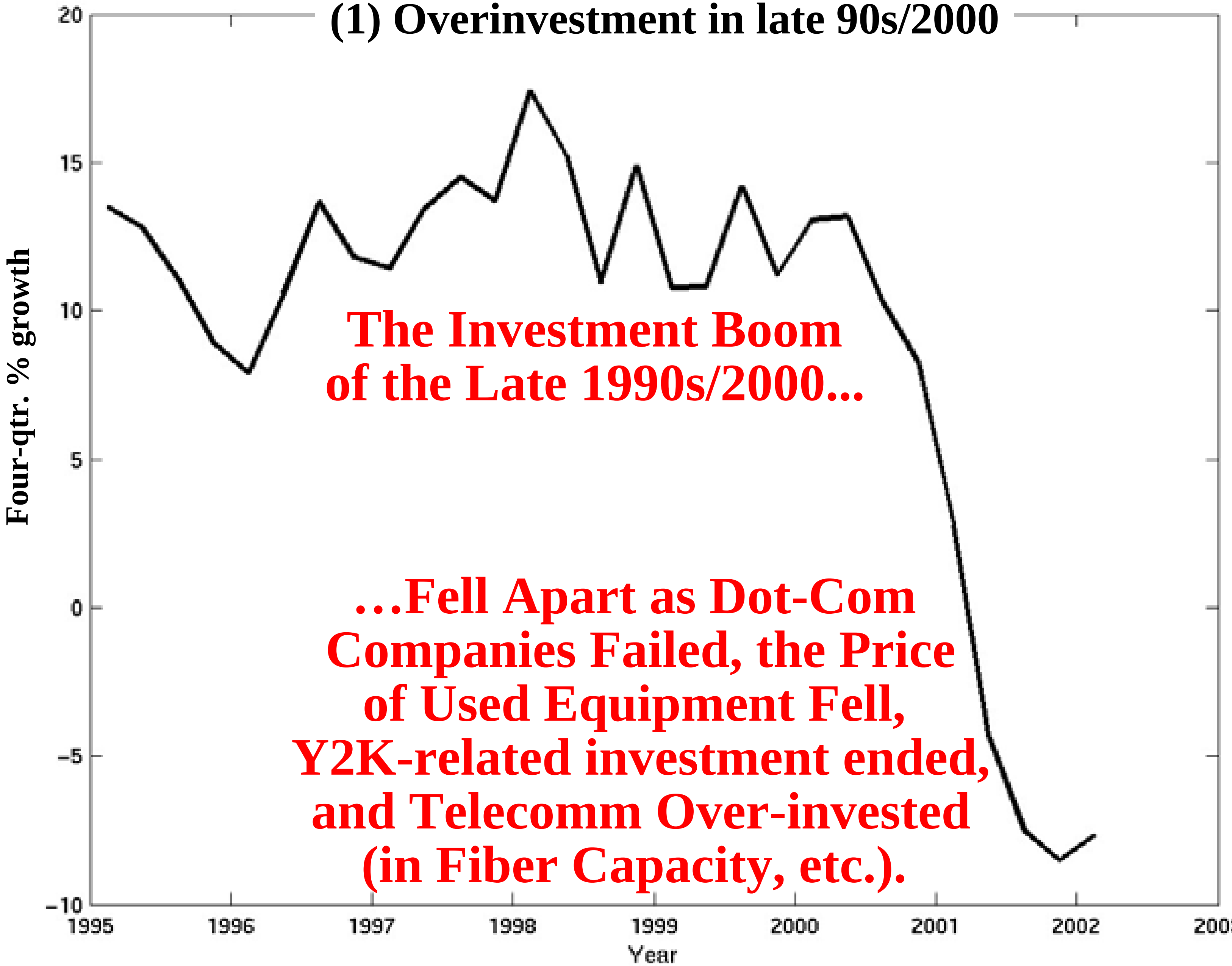
Comparison of Recession Experiences



Source: BEA

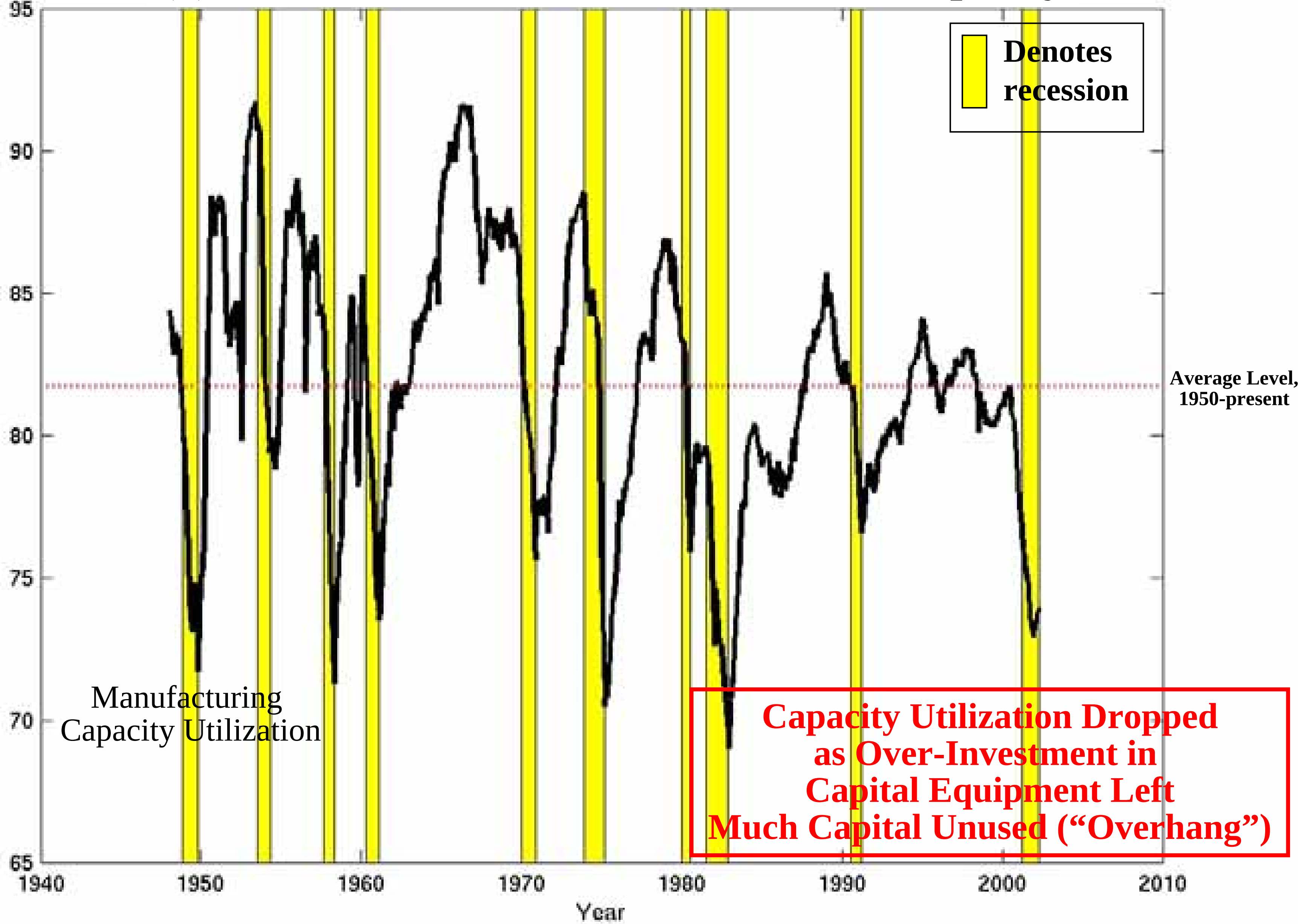
Why Was Investment Weak?

(1) Overinvestment in late 90s/2000



Why Was Investment Weak?

(2) Overinvestment Resulted in Excess Capacity



Source: Federal Reserve Board

And Now for the Recovery …

- First-quarter growth in GDP: 5.6%
- Of which 3.5% was less rapid drop in inventories
- Which means only 2.1% was Final Sales
- Blue-Chip[a] GDP forecast for rest of year: 3.3%
- Blue-Chip Unemployment forecast for end of years

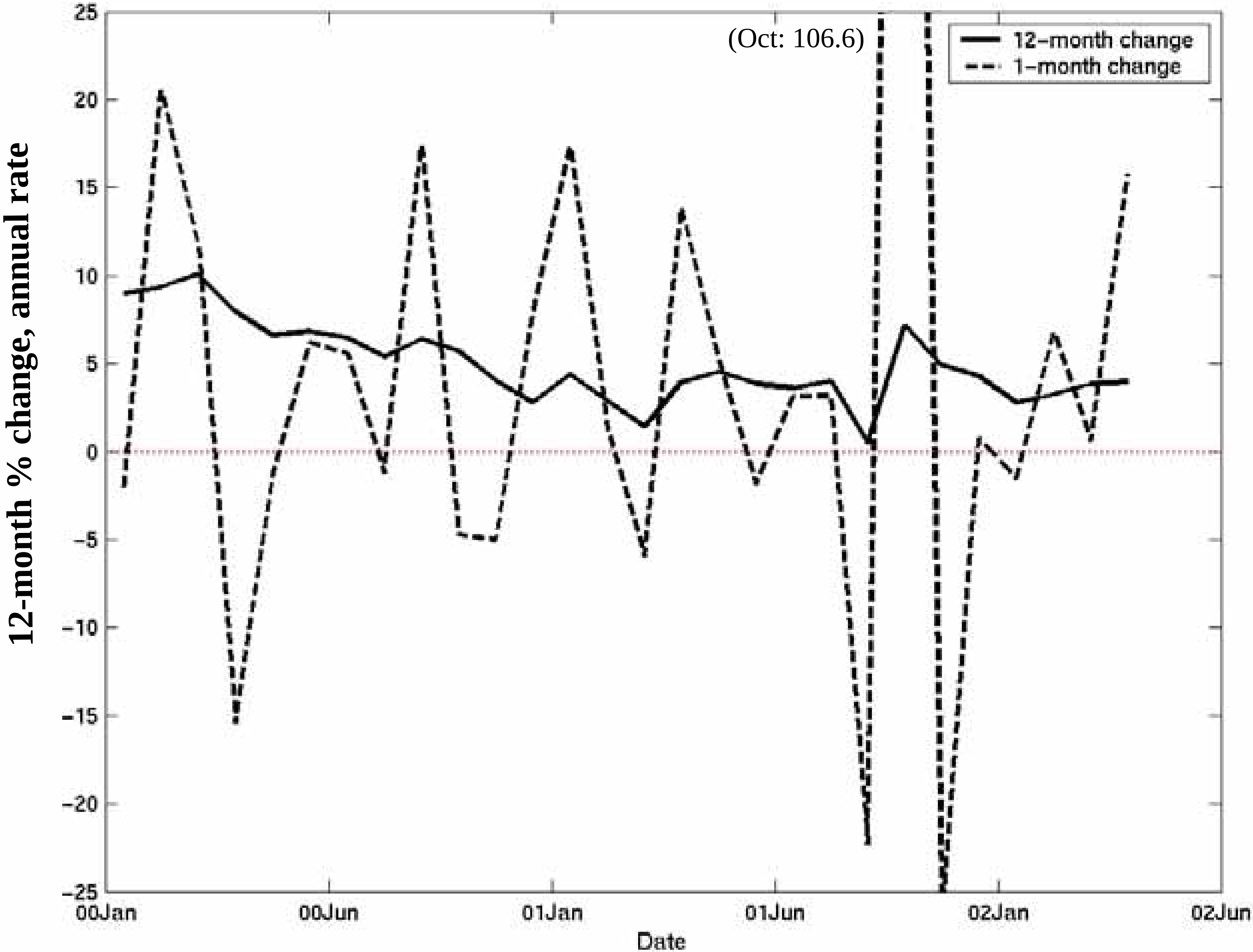
Year	
2002	**2003**
5.6%	**5.2%**

[a] May 10 forecast

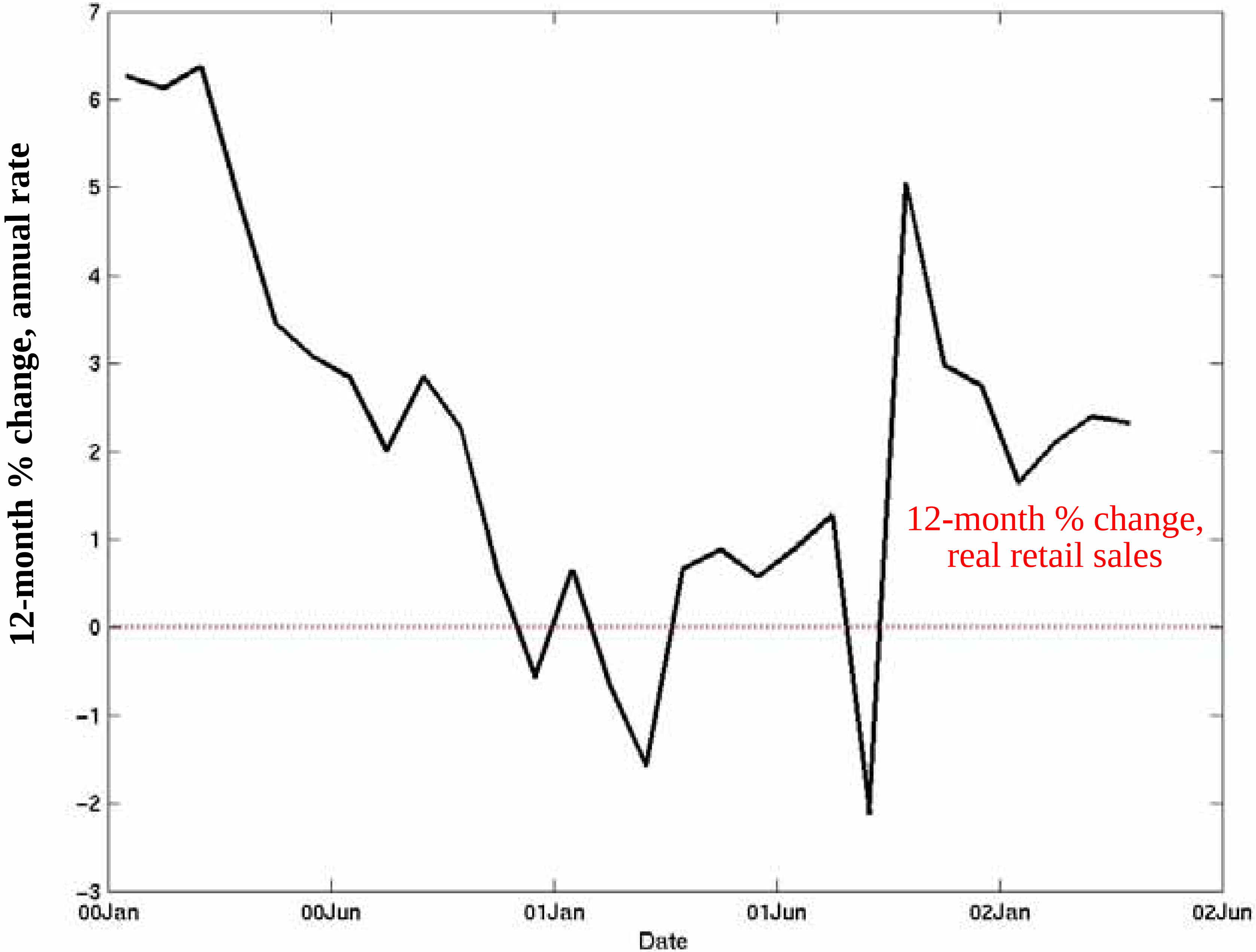
Where Does the Projected Recovery Come From?

- Moderate Consumption Growth (<3%)
- Flat Residential Spending (high *level*, but no growth)
- Weak capital investment
- Weak state and local government spending
- Some federal spending
- And INVENTORIES!!
- Look at these components in more detail

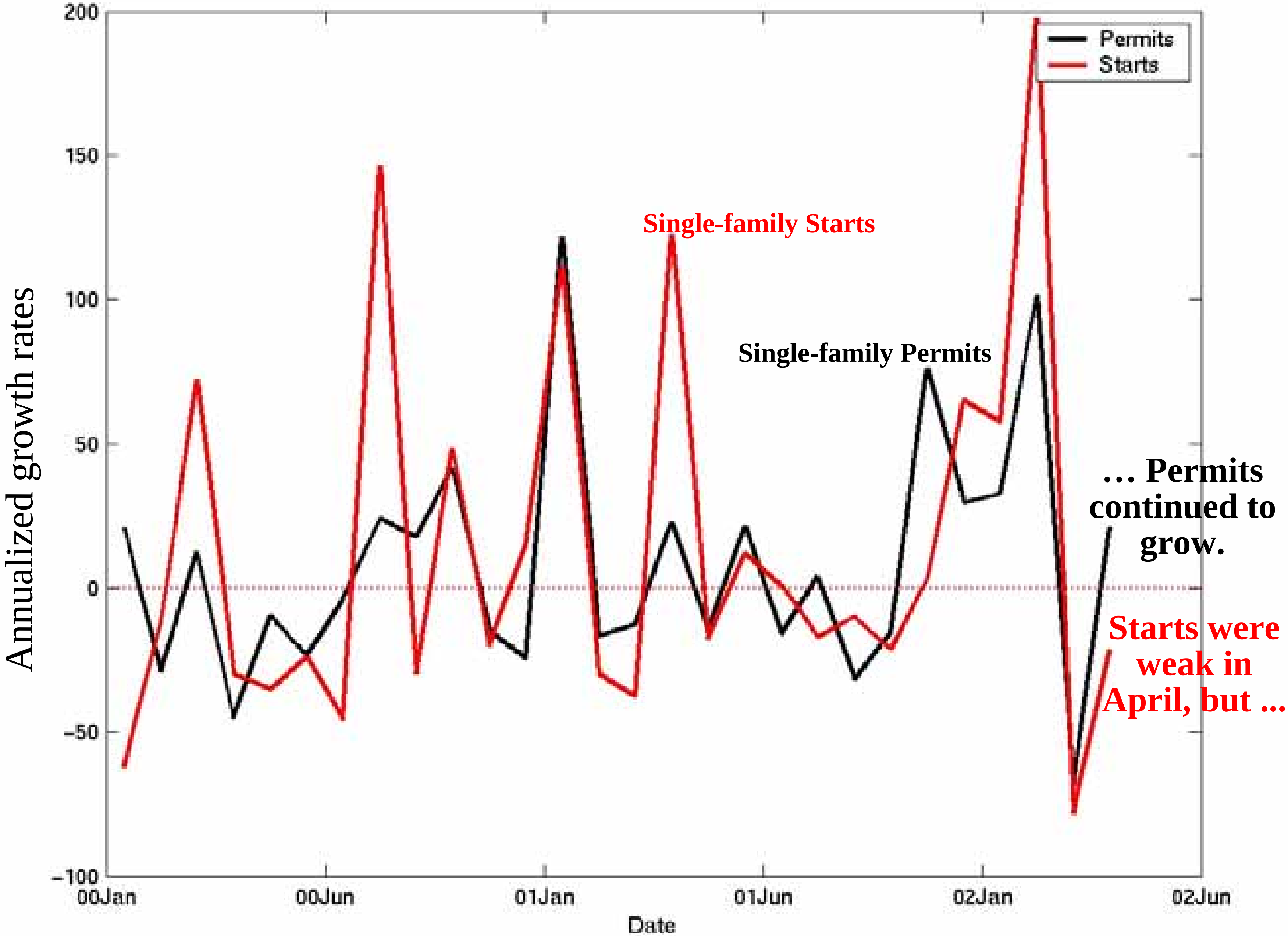
Consumption Indicator: Retail Sales Have Held Up Well So Far ...



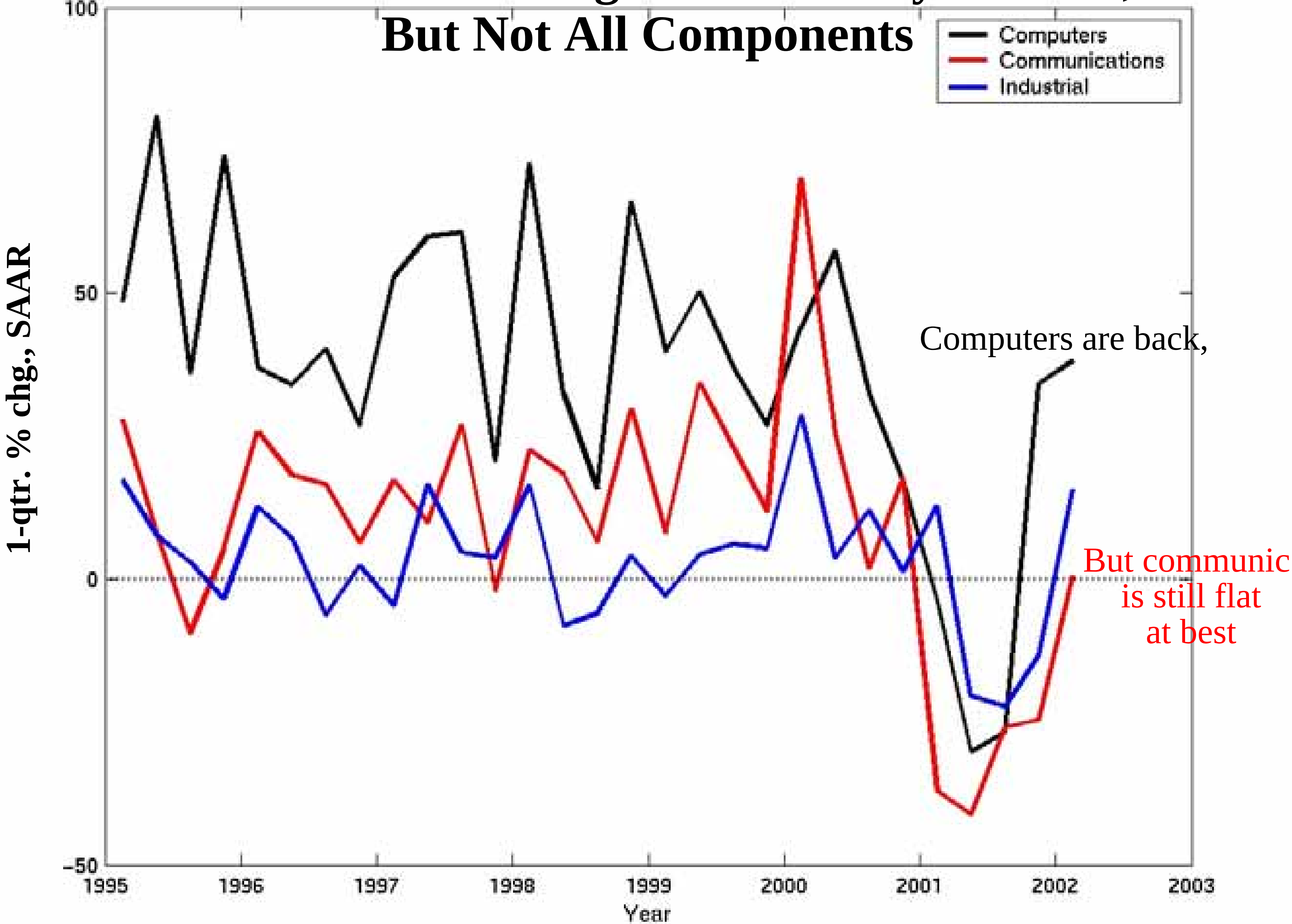
In Real Terms, As Well.



Recent Forward-Looking Indicators of Housing Activity Have Held Up Well

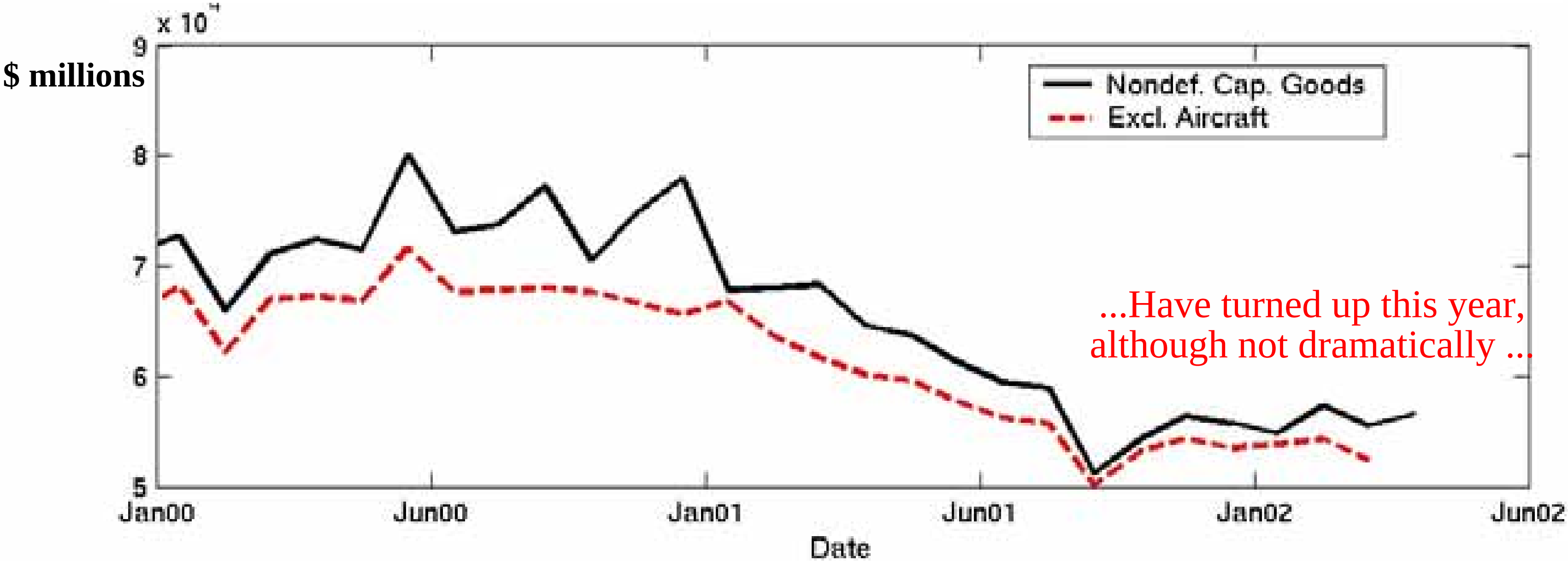


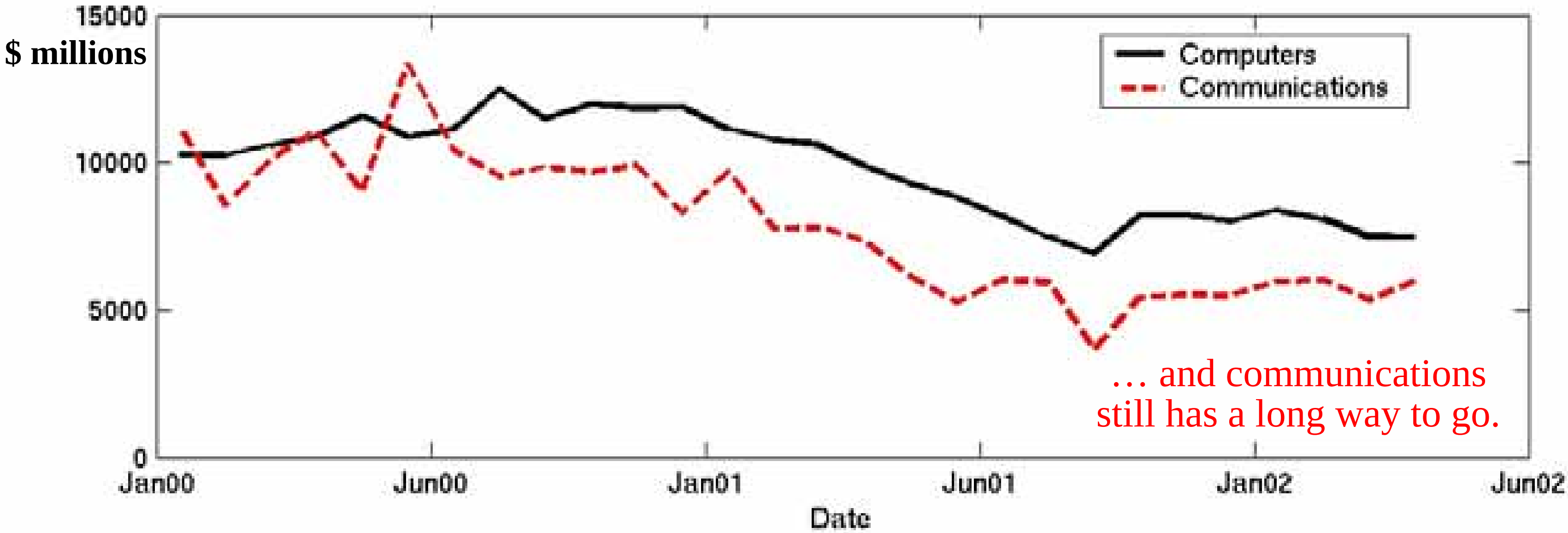
Investment Shows Signs of Recovery in Some, But Not All Components



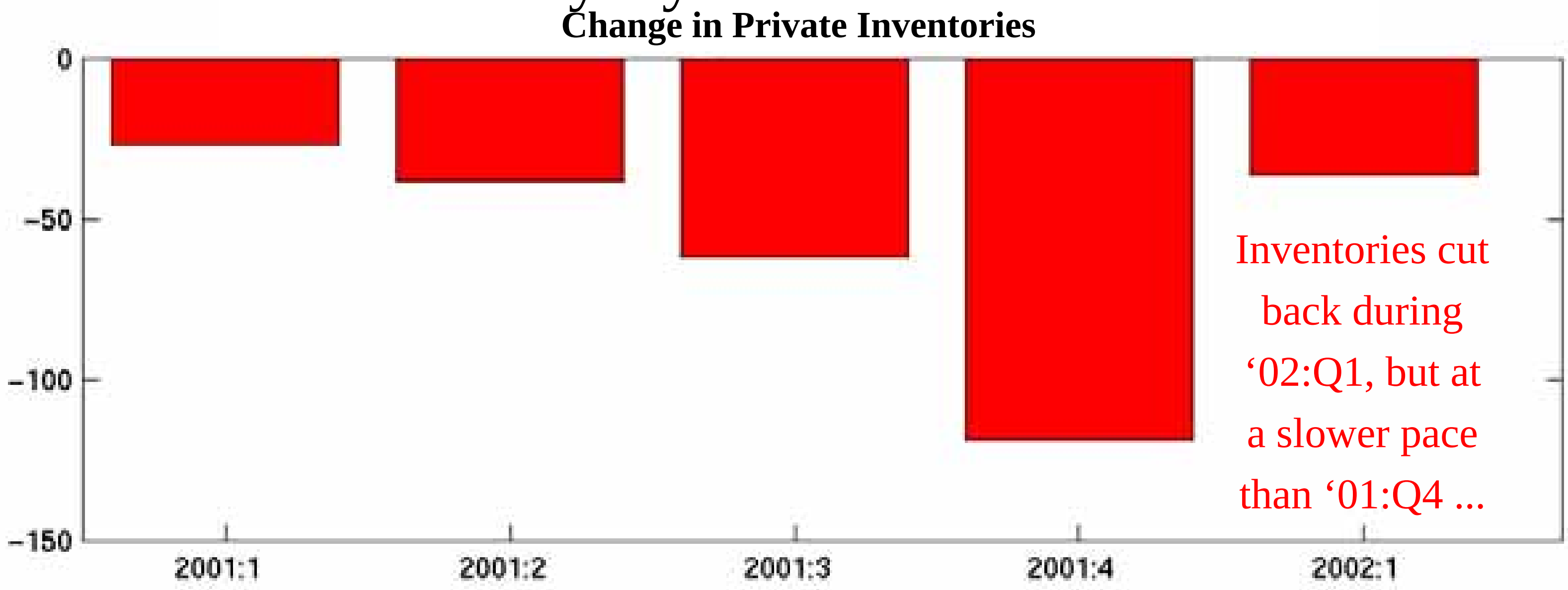
Source: BEA, NIPA

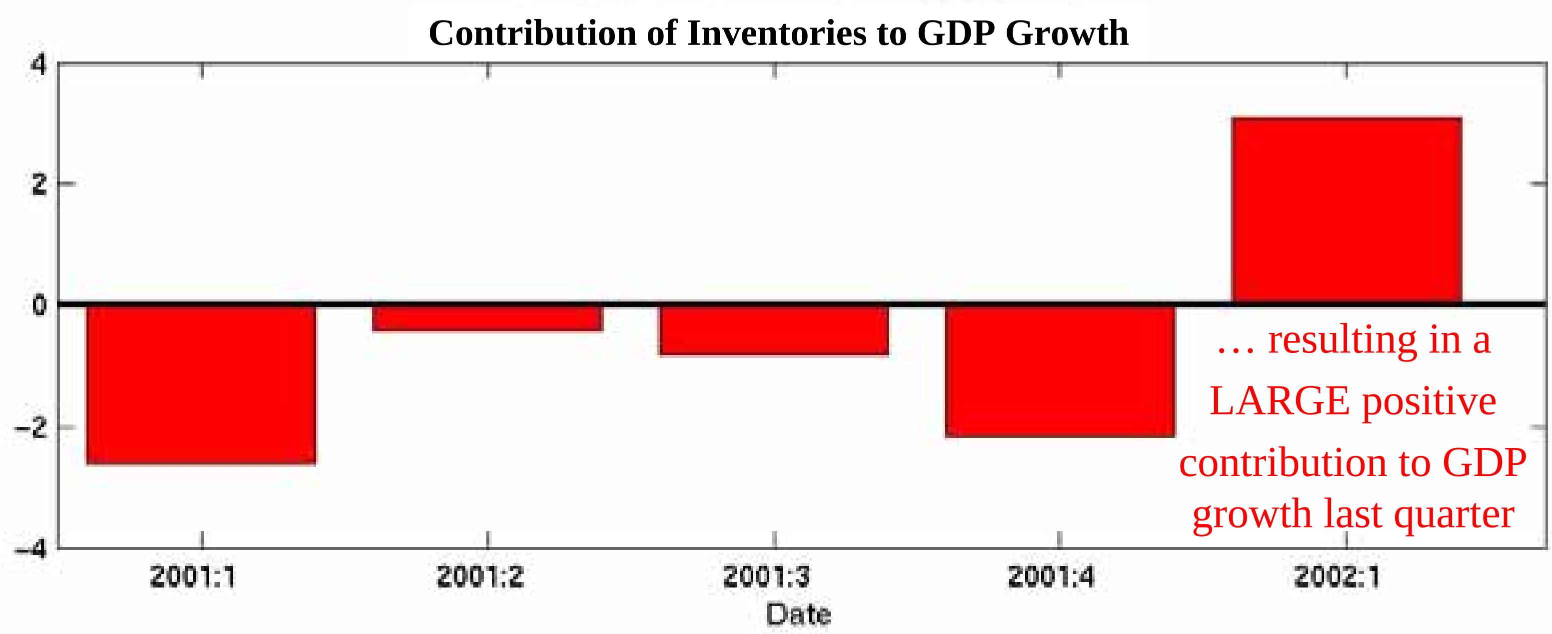
Looking Forward: Orders for Capital Equipment ...



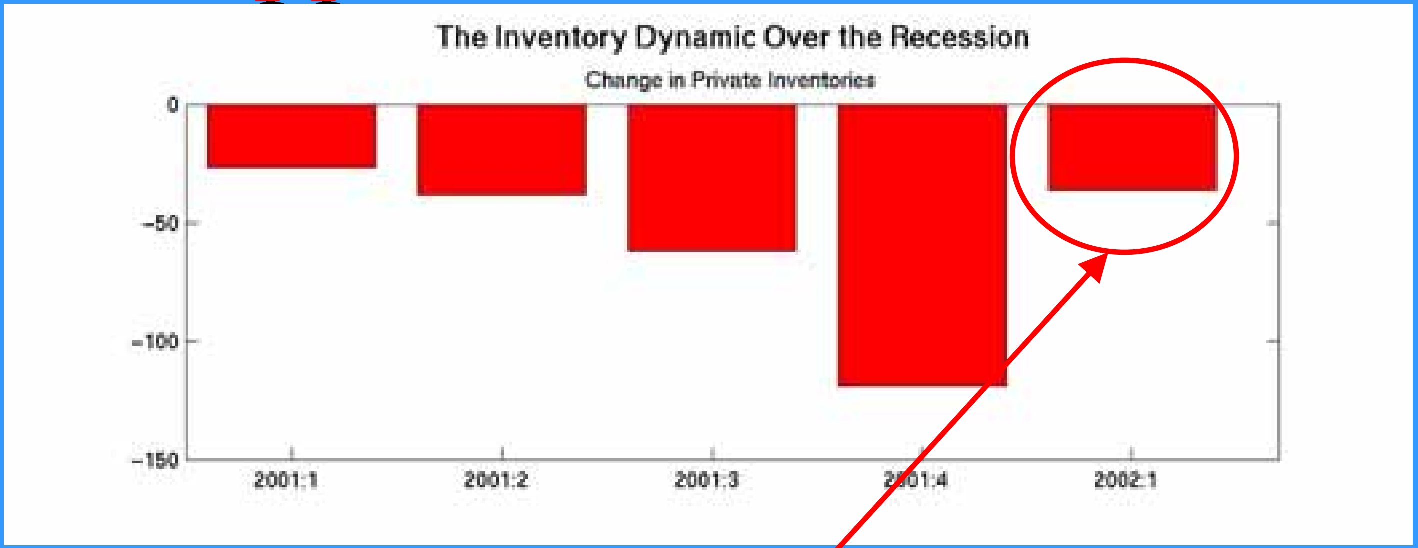


The Inventory Dynamic Over the Recession



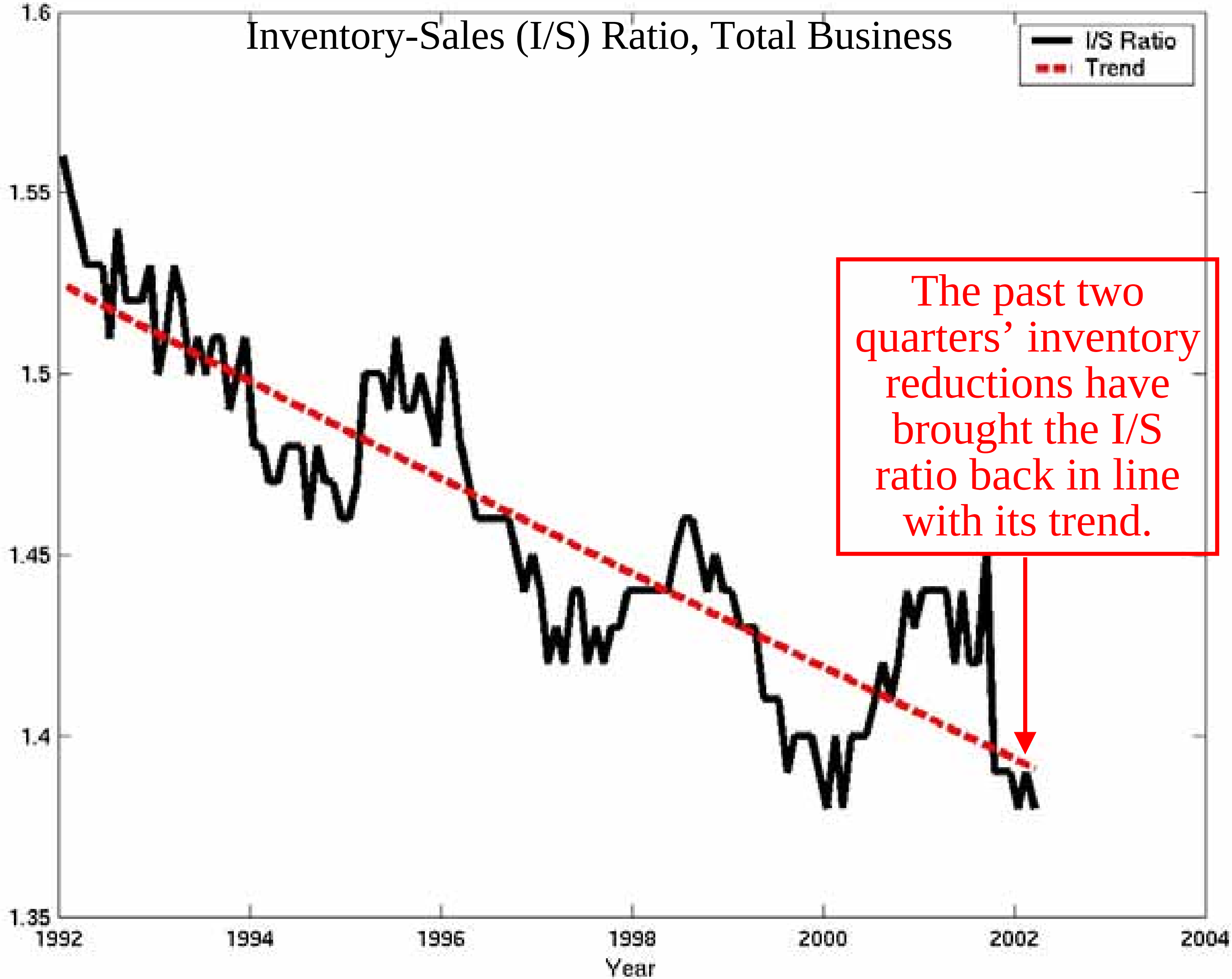


If sales persist, then what happens to inventories?



- This change in inventories, while less than the 4th quarter, is still NEGATIVE.
- At some point, if sales are growing, businesses will ADD to inventories.
- This will add to GDP growth for the balance of 2002

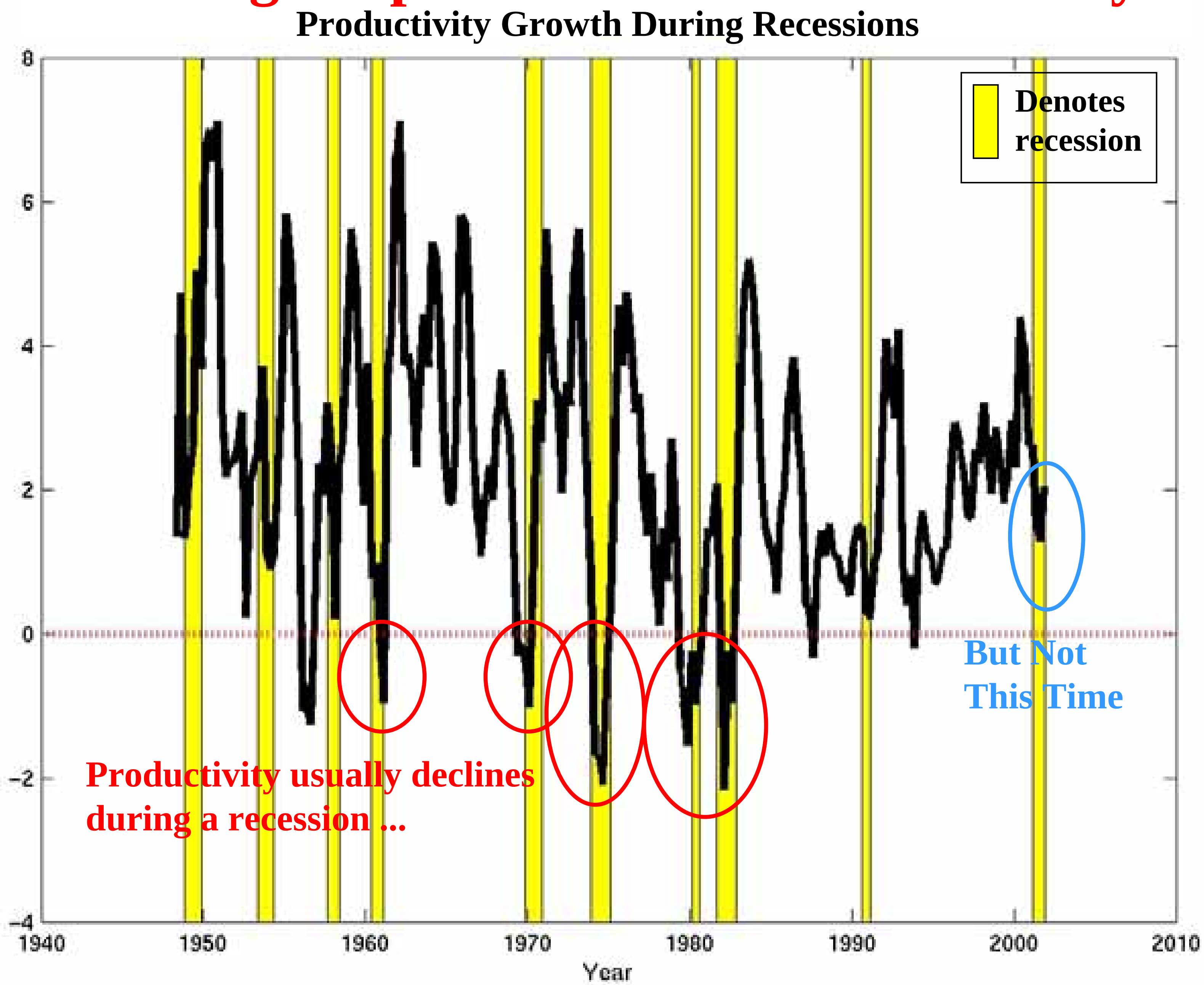
That Point Should Come Fairly Soon, As Inventory Stocks are LEAN



Risks to the Recovery

- Capital Spending: Who's Doing It?
- State and Local Spending: Are the states in any shape to spend?
- Federal spending: Deficits re-emerge
- Consumer spending and housing: Never contracted during recession→no boost in recovery (although April's retail sales data suggest consumption is OK)?
- Consumer spending: As unemployment remains high, stock prices fall, ...

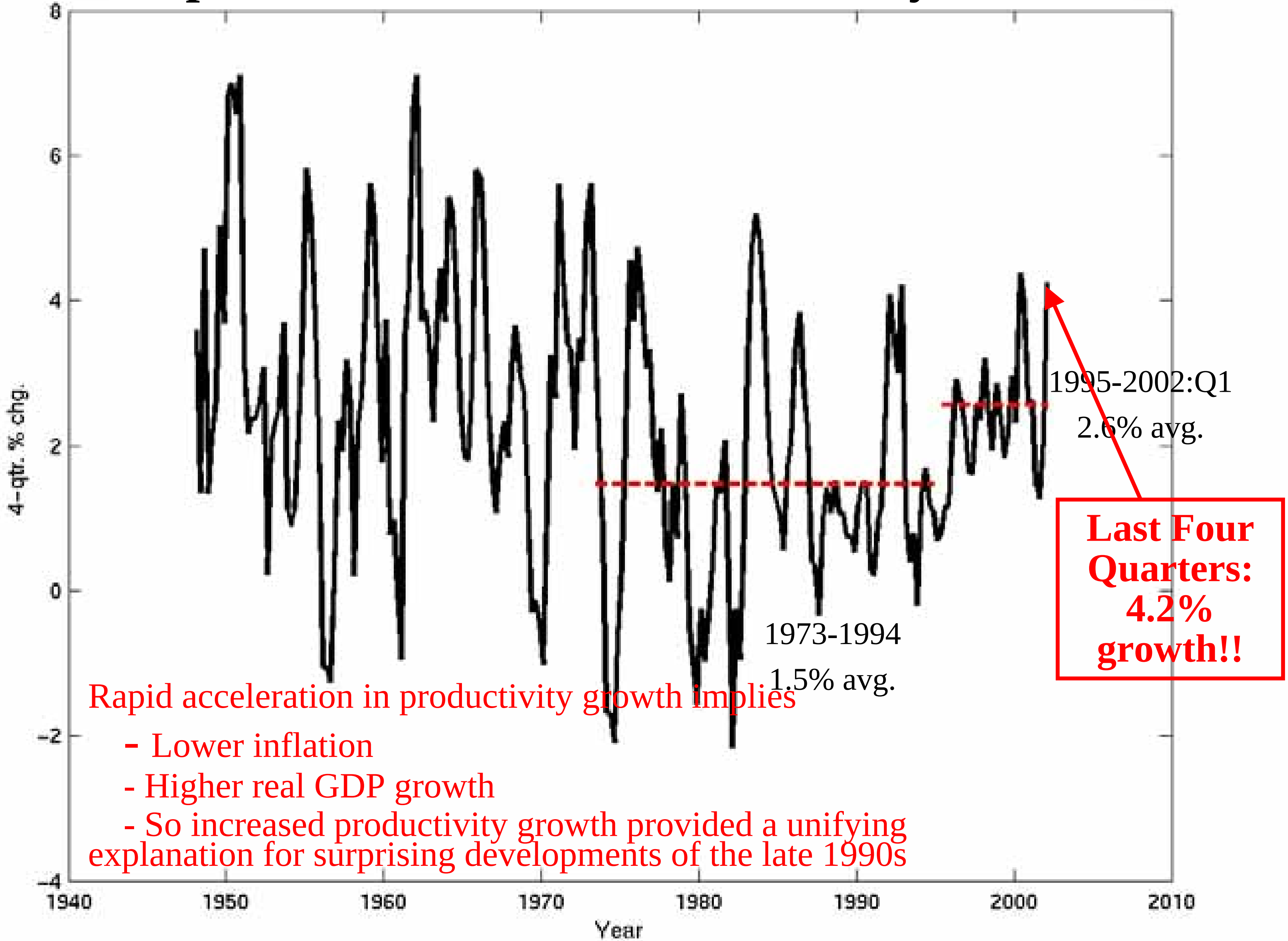
The Big Surprise this Time: Productivity



Why Has Productivity Remained So Strong?

- We Don't Know
- Some Possible Explanations:
  - <u>Structural productivity growth</u> is even stronger than we thought at the end of the 90s
  - UNCERTAINTY
    - Firms are not convinced of the strength of the recovery
    - Sales in the first quarter were pretty strong
    - So they met the sales out of inventory stocks, and
    - They didn't hire or increase hours→productivity grew

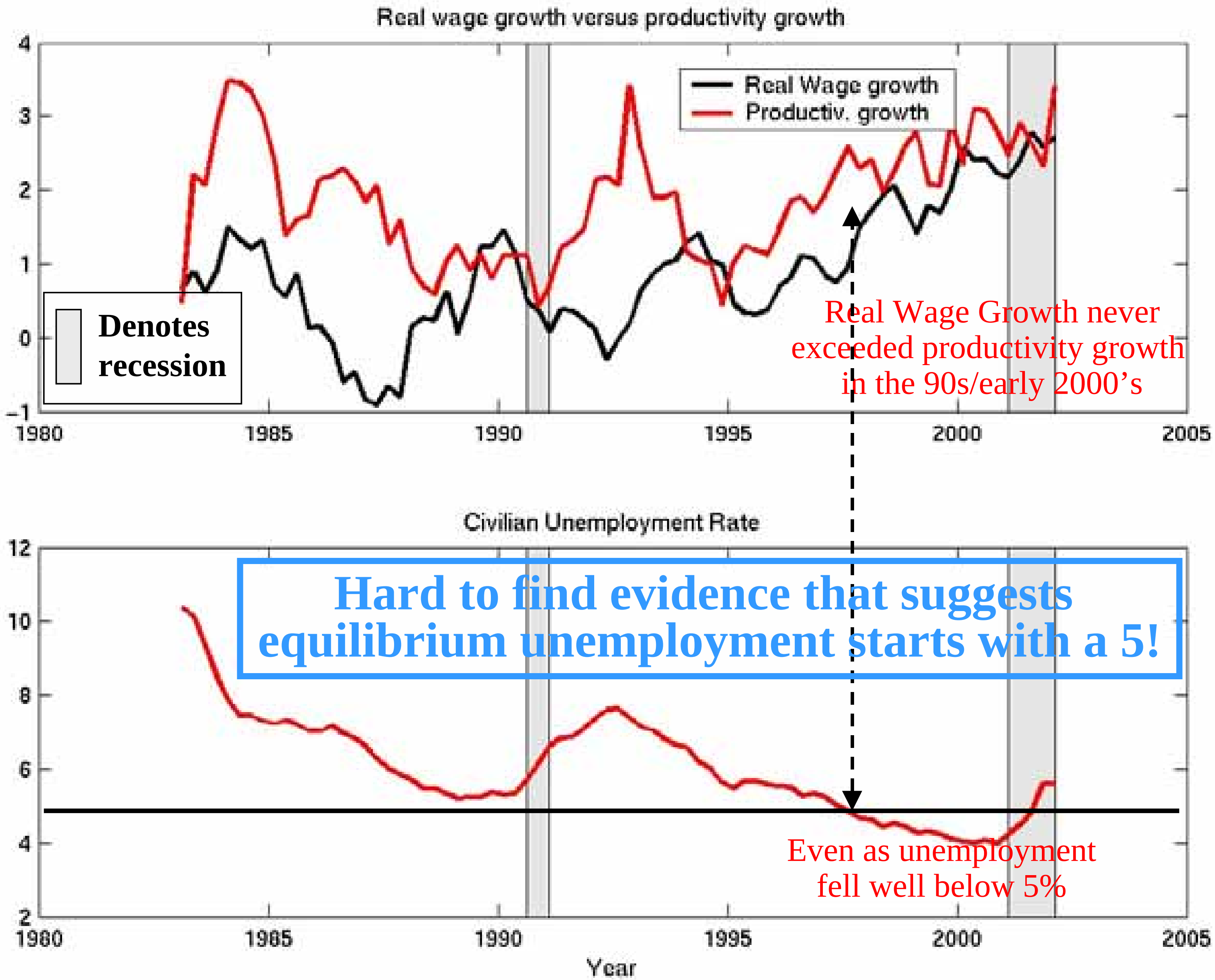
Improvements in Trend Productivity Growth



What's Equilibrium Unemployment?

- In long run, not up to the Fed
- With potential in the 3's, the outlook implies unemployment remains fairly high (Blue Chip may be optimistic)--low to mid-5's
- Is that "equilibrium unemployment"?
- We functioned pretty well in late 90s with an unemployment rate in the 4's.
- Were there signs of trouble at 4+? Look at labor market data (real wages, productivity).

What Do Real Compensation and Productivity Growth Tell Us About Equilbrium Unemployment



Real Wage defined as 4-quarter growth in employment cost index less 4-quarter inflation in the core PCE chain-weighted price index
Productivity growth equals the 12-quarter growth in nonfarm business productivity.