THE ECONOMY IN 2002:
A CHALLENGING TIME FOR MONETARY POLICY

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I appreciate this opportunity today to share my views with you on the national economic outlook for 2002. I don't have to tell you that the U.S. economy has not performed well over the past two years. The current recession, which officially started in March of last year, marked the end of the longest peacetime expansion in our nation's history. Moreover, the tragic events of September 11 cast a long shadow over the prospects for economic recovery in the coming year.

Recently, however, we have received some very positive information on the economy, suggesting that economic activity is rebounding much more rapidly than expected. As a result, the economic outlook for 2002 now appears to be much brighter than it was a few months ago, and many economic forecasters now believe that the recession has ended and an economic recovery is under way.

Today, I would like to offer an assessment of the U.S. economic outlook and also provide my perspective on some of the challenges for monetary policy in the coming year. Most people agree, it seems to me, that the current stance of monetary policy is very accommodative. While such a policy stance is appropriate for an economy in recession, it will, if it remains unchanged as the economy strengthens, impinge on efforts to maintain long-run price stability. The difficulty in saying this of course is that determining the timing of future policy adjustments is to some degree art and not just science. As always, the FOMC must balance the need to anticipate inflationary pressure and the conditions that facilitate it against the existence of uncertainty about both the strength of the recovery and the behavior of productivity.

The outlook for 2002

Let me begin by looking at some of the reasons behind the improved economic outlook. If we go back a few months — to the period just after September 11 — we find that the consensus economic forecast was for negative real GDP growth in the third and fourth quarters of 2001 and very weak growth in the first half of this year. At that time, most forecasters saw sustained economic recovery beginning only in the latter half of this year. In fact, to many individuals' surprise, growth turned out to be positive in the fourth

quarter, and strong data for the first quarter have led many forecasters to up their estimates of first quarter growth to a range of 3 to 5 percent.

One reason why last fall's forecasts were so far off the mark is that the economic effects of September 11 turned out to be somewhat different than expected. Although the direct effects of these events on sectors such as the airline and travel industries were large and persistent, the overall effects on the macro economy appear to have been smaller and more temporary than originally thought. In particular, consumer confidence and spending dropped sharply in the weeks after September 11 but then rebounded toward the end of the year. Record consumer spending on autos, spurred by zero interest financing, was a significant factor behind fourth quarter growth. Moreover, the events of September 11 led to sharply higher federal government spending for defense and national security. Taken together, higher consumer and government spending in the fourth quarter offset other negative factors, such as a record decline in business inventories.

As to the improved outlook for the first quarter of this year, much of the additional economic strength reflects a turnaround in the inventory situation. After a year and a half of allowing inventories to shrink, businesses are beginning to gear up production to adjust inventories to more normal levels. Consequently, a lesser pace of inventory reduction followed by a restocking of inventories to desired levels will likely give a sharp boost to output growth in the first half of this year.

For the remainder of the year, however, there is more uncertainty about the strength of the recovery. Currently, the consensus forecast of business economists is for solid growth to continue in the second half of the year and into 2003. Realistically, though, there are likely to be sectors of strength as well as areas of weakness. Depending on how they balance out, they will determine to what degree growth is stronger or weaker than the consensus outlook.

One likely source of strength is federal government spending, which reflects both greater defense and security outlays and a continued high level of payments to agriculture. Another source of strength, which could be something of a surprise, is business fixed investment. As you know, the collapse of business investment spending is one of the principal causes of the current slowdown. And, certainly, there is still considerable excess capacity in some sectors, notably telecommunications equipment and business structures. However, we are seeing signs of stabilization in other areas of business equipment spending, and the recent fiscal stimulus package provides considerable tax incentives for businesses to accelerate their investment purchases as we move forward into 2003. Thus, there is a reasonable case to be made that we could see stronger than expected investment spending during the course of this and next year.

On a more cautionary note, two other areas of recent strength — inventories and housing — are likely to be less stimulative going forward. The positive effects of inventory rebuilding are likely to diminish after midyear as stocks settle in at desired levels. Moreover, housing, which has been unusually strong throughout the slowdown, is likely

to make a smaller contribution to growth in the period ahead, as the recent rise in mortgage rates deters new home purchases and reduces the incentive to refinance.

There are also some key sectors, notably foreign trade and state and local government spending, which are likely to be a drag on the economy in the coming year. Like the United States, many other industrialized and developing countries have experienced an economic slowdown during the past year. Their recoveries while likely to occur, are also likely to lag that of the U.S. Although our imports should rise noticeably as our economy strengthens while our exports are restrained both by slower foreign growth and a strong dollar. Consequently, most forecasters see the trade balance as a continuing drag on U.S. economic performance.

Additional weakness may come from the deteriorating fiscal position of many state and local governments. Because the recession has led to a significant shortfall in revenues, many state and local governments are facing the prospect of substantial tax hikes or spending reductions to achieve budgetary balance in the current fiscal year. Thus, the weakened condition of state and local finances is likely to offset some of the stimulus at the federal level.

In the presence of these conflicting forces, the consumer will continue to hold the key to the strength of the economic recovery. One of the primary reasons why the current recession has been less severe than previous downturns is that the consumer has continued to spend despite rising unemployment and a weaker stock market. Indeed, as I noted earlier, consumer spending was exceptionally robust in the fourth quarter of last year in response to low-interest automobile financing. In the first quarter of this year, while consumer confidence has risen, spending has slowed somewhat, and we will want to watch how the consumer behaves as we move through the remainder of this year. In any event, I believe businesses' attitudes toward investment and the strength of the recovery itself will depend importantly on what the consumer does over the balance of the year.

Challenges for monetary policy

I would like to take a closer look at some of the challenges facing monetary policy in the current economic environment. As you know, the Federal Reserve responded to the economic slowdown and the events of September 11 by aggressively lowering its target federal funds rate from 6 ½ percent to 1 ¾ percent during the course of the year. Short-term interest rates are currently the lowest they have been in almost forty years.

As economic conditions have improved during the past few months, however, talk in the financial press has shifted abruptly from whether the Federal Reserve will ease further to when the Federal Reserve will begin to move to a less accommodative posture. As you are aware, the Federal Open Market Committee left the federal funds rate target unchanged at its first two meetings this year. Moreover, at its March meeting, the FOMC altered its assessment of the balance of risks in the economy to reflect the improved economic outlook. Market interest rates have also moved higher in recent weeks,

suggesting that financial market participants are anticipating some upward movement in policy later this year. Both investor surveys and interest rate futures suggest that the federal funds rate could reach 3 percent by year-end and move still higher next year.

In thinking about the implementation of monetary policy in the period ahead, it might be helpful to distinguish between the likely direction of interest rate movements and the timing of possible changes. I would like to take a few minutes to provide my perspective on these issues.

Direction of interest rate changes

As to the direction of interest rate changes, as I said earlier, most analysts perceive that the current level of short-term interest rates is clearly accommodative and unsustainable in the longer run. Real short-term interest rates (nominal interest rates minus expected inflation) are essentially zero. The longer rates stay at this level, the greater is the likelihood that credit-financed growth will accelerate to the point that inflationary pressures begin to develop. In fact, many economists believe that monetary policy contributed to the severe inflation problems in the 1970s and early 1980s because real interest rates remained too low for too long.

A second reason for adjusting policy might be a concern about excessive credit creation and its implications for debt burdens, and the fragility of the financial system. The easing of monetary policy during the past year has provided substantial liquidity to the financial system. In a recession, this is appropriate, as increased liquidity and lower borrowing costs help stimulate spending and assist in relieving financial stress for consumers and businesses. With the real cost of short-term borrowing near zero, however, going forward there is a risk that credit availability will become too easy. If so, one result could be an undesirable increase in the debt burden of households and businesses. Another possible outcome is a speculative increase in asset prices fueled by easy credit availability. To the extent that these developments increase the fragility of the financial system, they also increase the downside risks for long term economic growth.

Timing of monetary policy actions

In contrast to the direction of policy, the timing of monetary policy actions is a more complex issue. As I outline above, moving too slowly runs the risk of allowing inflationary pressures to build up. However, moving too quickly could hinder the economic recovery.

I believe that we can gain some insight regarding this issue by looking at past situations where the Federal Reserve was faced with a similar issue of how to unwind an accommodative monetary policy stance. One interesting episode is the recovery from the 1990-1991 Gulf War recession. As you may recall, rather than tightening monetary policy early in that recovery, the Federal Reserve actually lowered its federal funds rate target during the next year and a half. In fact, monetary policy did not become more restrictive until early in 1994. One reason for this, of course, was that the banking crisis

in the early 1990s acted as a significant brake on the strength of the recovery. In this environment, the Federal Reserve determined that additional liquidity was needed for a prolonged period to counter the effects of the reduction in bank credit availability.

In contrast, two episodes where a monetary policy easing was unwound more rapidly occurred in the aftermath of the 1987 stock market crisis and the 1998 Asian financial crisis. In the 1987 episode, after easing policy from October 1987 through January 1988, the Federal Reserve moved quickly to a less accommodative stance in March 1988. More recently, after easing policy in the fall of 1998, the Federal Reserve began to tighten policy in June 1999. In both of these situations, compared with the early 1990s, the effects of the financial shocks on the economy turned out to be less persistent and less pernicious than originally thought, leading to a faster reversal of its earlier easing.

The lesson that I would draw from these historical episodes is that we need to look carefully at the magnitude and persistence of the factors that have contributed to the current economic slowdown and that might also hinder the recovery. Take for example the fact that the macroeconomic effects of September 11 seem to have been smaller and more temporary than we first anticipated. In this situation, one could argue at least that it would be prudent to unwind the policy actions taken in response to September 11 in a relatively timely fashion. At the same time, given the current uncertainty about the economic outlook, we may need additional information before we can conclude that the economy is on the road to full recovery so that the remaining monetary stimulus can be safely removed.

One piece of information that is likely to be especially important in this regard is the behavior of trend productivity growth. As you may know, an increase in trend productivity growth was a key factor behind the exceptional performance of the U.S. economy in the latter half of the 1990s. Increases in productivity raised the potential growth rate of the economy and helped dampen inflationary pressures. We have also seen unusually strong productivity growth during the current recession, suggesting that productivity gains may be continuing. If productivity growth remains strong, inflationary pressures may not develop as rapidly as in past recoveries. Conversely, if productivity growth should falter, inflationary pressures could materialize more rapidly. Thus, the behavior of productivity deserves considerable attention in monetary policy deliberations in the period ahead.

Concluding comments

Let me conclude with a somewhat broader perspective on the events of recent months and their implications for the future. During the past few months, we have weathered not only a slowing economy but also significant domestic and international challenges. These events have given me a greater appreciation of the underlying strength and resilience of our economy and our economic system. As a result, I am optimistic that the worst is now behind us and, with appropriate monetary and fiscal policies in place, we can return to strong, noninflationary growth in the period ahead.