Realizing Our Potential:
The Outlook for The U. S. Economy

Thomas M. Hoenig
President
Federal Reserve Bank of Kansas City
Omaha
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I appreciate this opportunity, today, to share my views with you on the outlook for the U.S. economy. As you know, much has happened in the economy over the past twelve months. At this time last year, we were celebrating the economy’s exceptional performance. The longest business expansion in history had resulted in strong economic growth, rising employment and real income, a booming stock market, and lower inflation. So good was the economy’s performance we were told that we were in an era of a "New Economy" and traditional business cycles were a thing of the past.

Over the past few months, we have seen an abrupt turn of events. Growth has slowed dramatically as consumer spending and business investment spending have weakened, job losses have mounted, the stock market has declined, and higher energy prices have pushed up inflation. There is now widespread concern about the current economic situation and greater uncertainty about the longer-term outlook.

Today, I would like to offer my views on the economic outlook and on the prospects for a return to strong, noninflationary growth. In the near term, I am cautiously optimistic. While there are certainly downside risks to the short-run outlook, there are encouraging signs that economic conditions are stabilizing. Consequently, I believe we are likely to see an improving economy by the second half of the year. Over the longer term, I am even more optimistic that we can realize the economy’s potential if we can continue to achieve strong productivity gains and if we pursue fiscal and monetary policies that promote economic growth. Before turning to these longer run issues, let me begin my discussion with a closer look at the near-term outlook.

The Outlook for 2001

By almost any measure, the U.S economy has turned in an exceptional performance over the past decade. We have experienced strong growth in output and employment, low inflation, and a dramatic increase in stock prices. To put this performance in perspective, consider that when the last recession ended in 1991 we had an unemployment rate that was rising toward 8 percent, a core CPI inflation rate of over 4 percent, and the S&P 500 stock index was under 400. Last year, the unemployment rate fell below 4 percent, core inflation was 2 ½ percent, and the S&P 500 reached an all-time high of almost 1500.

Over the past six months, however, the economy has slowed dramatically. Where real GDP growth averaged over 5 percent in the first half of last year, second half growth was only about 1½ percent. Indeed, fourth quarter growth of 1 percent was the slowest in five years. Two key factors behind the slowdown were the sharp reductions in consumer and business investment spending. Consumers were adversely affected by a number of factors including a weaker stock market, the rapid rise in energy prices, and higher interest rates. In addition, business investment spending weakened after businesses completed Y2K projects and as investment in Internet-related and telecommunications activities collapsed. The business slowdown hit manufacturing industries especially hard as firms cut back production and employment to deal with lower sales and rising inventories.

Consequently, at the beginning of this year, the economic outlook looked quite weak, and there was increased talk in the news media that the slowdown might turn into a recession. In this environment, and with inflationary pressures generally contained, the Federal Reserve began a series of easing actions designed to provide additional liquidity to the banking system and to lower interest rates. With two 50-basis-point reductions in January and an additional 50-point reduction in March, the target federal funds rate has been reduced from 6 ½ percent to 5 percent and both short and long-term interest rates have fallen as a result.

Over the past two months, economic conditions appear to have stabilized somewhat. You certainly don't see this yet in the stock market where stock prices continue to be under pressure from lower earnings estimates. However, housing and nonresidential construction have shown continued strength, consumer spending on autos and other durable goods has bounced back somewhat, and consumer confidence, after falling sharply, appears to have stabilized. Consequently, many forecasters have now upped their estimates of first quarter growth from negative territory to around 1 percent, and talk of a possible recession has diminished.

While the outlook for the remainder of the year remains uncertain, my own views are similar to those of many other forecasters. I expect growth in the second quarter to remain weak as manufacturers continue to hold back production to eliminate inventory imbalances. With slow employment growth, we are likely to see some further increase in the unemployment rate over the next few months. The economy should strengthen in the second half of the year, however, and I currently expect growth to move back toward 2 ½ or 3 percent over the final two quarters.

Three factors are likely to contribute to stronger second half growth. First, once the current inventory adjustment is complete, businesses should return to more normal production schedules, which will stimulate output and employment. Second, over time the effects of lower interest rates should spread through interest-sensitive sectors of the economy, and the lower cost of funds should encourage higher consumer and business spending. Third, fiscal policy is likely to be quite stimulative. The expected passage of a tax cut should provide a boost to consumer spending and perhaps help solidify consumer confidence as well. In addition, federal government spending is likely to increase as Congress and the Administration spend part of the growing budget surplus.

At the same time, though, my optimism is tempered somewhat by the presence of some significant downside risks. As the Federal Open Market Committee indicated in its most recent press release, these downside risks to the economy warrant continued monitoring of economic developments that might indicate that the economy is weaker than expected.

In my view, the principal concern is that consumer spending may not be as strong as forecast. Over the past several years, consumers have spent far in excess of their current incomes. This is reflected in both a negative saving rate and increased indebtedness. If consumers decide to retrench in order to build up savings or cut back debt, the short-run effect will reduce the stimulus to the economy in coming months. An additional factor is the potential impact of a weak stock market on consumer spending. To the extent that the robust stock market over the past few years helped fuel consumer spending, the recent stock market weakness may dampen spending going forward. I also believe that we need to keep close tabs on the energy situation. If energy costs do not come down as expected, both consumer confidence and consumer spending may be slow to recover.

A second downside risk is possible weakness in business investment spending. Strong business investment spending has been a key factor in the growth of the economy over the past few years and has been especially important in the rapid productivity increases that we have experienced recently. Given the sharp slowing in investment spending in the past two quarters, the development of excess capacity in manufacturing, and the weakness in the Internet and telecommunications sectors, there is some concern that investment spending might not be as strong as expected.

A third downside risk is the possibility that the world economy might not grow as rapidly as anticipated. Slower growth in Europe, South America and Asia could weaken U.S. exports, which would lower our domestic growth and also could lead to a worsening of our trade imbalance.

Despite these risks, I continue to be cautiously optimistic about the near term outlook. I believe that the economy is sufficiently sound to weather the current turmoil and that we are likely to see increased signs of economic strength in coming months.

The Longer Run Outlook

Let me turn now to the longer run outlook for the economy over the next several years. The key question is whether we can return to the strong, noninflationary growth path of recent years. I am very optimistic that we can if we continue to have strong productivity growth and if we pursue appropriate fiscal and monetary policies.

Productivity Is Key

Productivity is critically important. With productivity increases, businesses can produce more output with given labor and capital inputs or, equivalently, the same output can be produced with fewer inputs or at lower cost.

Productivity is the key to noninflationary growth. When economic growth is entirely demand-driven, inflationary pressures tend to rise as capacity is more fully utilized and supply limits are reached. When demand growth is accompanied by productivity gains, however, additional capacity is added and inflationary pressures are mitigated.

Over the past several years, we have seen very rapid demand growth spurred by consumer spending. We have not experienced serious inflationary pressures, however, because we have also seen very strong productivity growth. Indeed, over the past five years, growth of nonfarm business productivity has averaged 2.6 percent. In contrast, over the previous 25 years, productivity growth was only 1.6 percent.

How can we achieve continued productivity growth over the long term? The key is business investment that incorporates new technologies. Thus, it is extremely important to have an economic environment supportive of the creation of new technologies and where businesses have the incentive to make the necessary investments to bring these new technologies to the market.

With the recent slowing of business investment spending, the decline in the stock market, and the bursting of the Internet/DotCom bubble, some doubts have emerged as to the strength of the environment for investment spending. And if investment spending is weak, what are the prospects for long-term productivity?

I would certainly agree that investment spending is likely to be somewhat weaker going forward. Business preparations for Y2K provided a strong boost to investment spending that will not be repeated. Moreover, industries with excess production capacity currently will have little immediate need to expand capacity as sales and economic activity strengthen.

However, I don’t think that this necessarily means that we will see a significant slowing of long-term productivity, for two reasons. First, businesses will continue to have an incentive to invest in new cost-saving technologies. In a highly competitive global marketplace, businesses have little pricing power. In this environment, the key to higher earnings and profitability is the ability to control or reduce costs. And, investment in new technologies that improve production, distribution, and other work processes is the principal way of generating significant cost savings. Thus, I believe that businesses will continue to have a strong incentive to make productivity-enhancing investments.

Second, I don’t think that we have seen all of the productivity benefits arising from the surge in investment spending over the past few years. As I talk to people in the IT industry and to businesses that are heavy IT users, I have the impression that much of the recent surge in investment spending was driven by Y2K needs and by peer pressure to stay abreast of technology trends rather than by explicit cost-saving objectives. If so, then businesses that have made these investments are likely to devote considerable energy, going forward, to making these investments pay off in terms of higher productivity. Thus, I am optimistic that we can continue to see strong productivity growth over the next several years even with slower investment spending.

Fiscal and Monetary Policies for Growth

The environment for investment and growth will also depend critically on whether we pursue appropriate fiscal and monetary policies in the years ahead. Businesses are better able to make long-term investment decisions in a macroeconomic environment with a low and stable inflation rate and low interest rates. Sound fiscal and monetary policies are essential to this end.

Currently, the budget surplus provides us with a tremendous opportunity to accomplish a number of important economic and social objectives. While the ultimate choice on how to use the surplus will involve a balancing of competing political views, I believe that it is useful to highlight those fiscal actions that can contribute most to long-run economic growth.

One way of promoting growth is to use part of the surplus to pay down the outstanding national debt. Government borrowing competes directly with private sector borrowing for the supply of savings and tends to drive up interest rates. Reducing the supply of government debt will promote growth by lowering interest rates and stimulating private investment spending.

An additional benefit of reducing the supply of government debt is that this action lowers the tax burden on future generations who will be responsible for making interest and principal payments on this debt. This may be particularly desirable given the large burden that is likely to be placed on future generations by the need to fully fund social security in the latter half of the century.

A second option that also would promote growth is to use the surplus to reduce taxes. While much of the recent discussion of tax cuts has focused on the short-run stimulus to the economy, lower taxes, in the form of reductions in marginal tax rates, can contribute to longer run growth as well. One way that lower tax rates promote growth is by increasing incentives to work and invest. Lower tax rates also remove distortions and inefficiencies resulting from tax avoidance behavior. In addition, part of a tax cut likely will be saved, and the increased supply of saving will flow to private borrowers to finance new investment spending.

Finally, monetary policy will most certainly play a key role in ensuring a return to strong, noninflationary growth. The recent actions taken by the Federal Reserve will provide a short-term stimulus to the economy by lowering borrowing costs and by contributing to increased consumer and business confidence. Over the longer run, if we are to have growth without inflation, the Federal Reserve must maintain its commitment to price stability by ensuring that demand grows in line with increases in the economy’s productive capacity. This means, of course, that policy will need to be tightened in situations in which demand growth threatens to exceed supply growth and eased, as in the current situation, when demand growth weakens. I believe that the Federal Reserve has been successful in this endeavor over the past several years, and I am confident that this success will continue in the future.

Concluding Comments

Let me close with a brief summary of my views on the economic outlook. Although the current slowdown in the economy is a serious concern, it is likely to be relatively brief, and growth should strengthen in the second half of the year. I also recognize that there are down side risks that could slow the recovery. At the same time, I continue to be very optimistic about the longer-run outlook. Long-term productivity growth is likely to continue to be strong as businesses invest in new cost-saving technologies. Moreover, with low inflation and a sizable budget surplus, we are in a fortunate situation that gives us considerable flexibility in the use of macroeconomic policies to enable us to realize our long-run economic potential.