

## The National Economy and Monetary Policy in 2002

C. Alan Garner  
Economic Forums  
April 3, 2002

Views about the state of the economy have been shifting rapidly over the last few months. After the terrorist attacks on September 11, economic observers understandably felt that the situation was grave. The economic indicators held up better than expected, but even in the early part of this year, most observers were convinced that fourth-quarter growth was negative, and economists were focusing on how long and severe the recession would be. By the end of January, however, the Commerce Department released its initial estimate that real GDP rose slightly in the fourth quarter, and it was beginning to look as if the recovery was closer than we had thought. The latest estimate is that real GDP rose at a 1.7 percent rate in the fourth quarter, and we also know that employment rose in February, suggesting that the recovery may be well under way. In fact, a recent article in *Business Week* magazine was titled “What Recession?”

Tonight, I will try to give you a sense of the economic outlook and some key issues facing monetary policymakers. I will start with a brief overview of the recession, which was mild by historical standards. Then I will turn to the economic outlook. Prospects for growth and inflation this year are favorable. But from a policymaker’s standpoint, some challenging issues remain. I will close with quick look at the near-term risks to the economic outlook and long-run challenge of putting the economy on a sustainable growth path with low inflation.

## The Recession

I do think it is reasonable to call the recent decline in economic activity a recession, although admittedly the recession was mild by historical standards. The most widely accepted dating of recessions for the United States comes from the National Bureau of Economic Research, or NBER, a nongovernmental group. The NBER does not follow the frequently cited “rule of thumb” that a recession requires two consecutive declines in real GDP. Instead, the NBER looks at monthly indicators that are not revised frequently—industrial production, employment, sales and real personal income. Although the NBER has not yet dated the end of the recession, it appears that the recent recession was about average in length.

The recession was certainly mild. Based on current estimates, real GDP declined only in the third quarter of last year, making this the only recession since World War II in which real GDP fell for just one quarter. Another sign of the recession’s mildness is that real personal income—one of the indicators watched by the NBER—rose continually throughout the recession.

But personally, I am willing to accept the NBER’s judgment that we experienced a mild recession. Given the steep declines in industrial production beginning in 2000, the persistent decline in employment in 2001, the sharp contraction in business inventories, and the widespread layoff announcements, I would call that a recession.

The recession was mild partly because of the resiliency of household spending. Spending on consumer goods and housing stayed much firmer than in a typical recession. Business investment spending really played the key role in the recent economic slowdown. Consumers remained surprisingly optimistic last fall, refusing to buckle

under to terrorism. Higher housing prices partially offset wealth losses due to lower stock prices, and continued productivity gains helped maintain real wage growth for workers who did not lose their jobs.

Prompt actions by monetary and fiscal policymakers also kept the recession mild. The Federal Open Market Committee, or FOMC, which is the Fed's key policymaking body, responded quickly to the economic weakness. Observers sometimes described last year's cuts in the federal funds rate as being "front-loaded," suggesting the FOMC was easing faster than in a typical downturn.

In addition, fiscal policy was eased in a timely fashion. Tax cuts and rebates enacted early in 2001 started hitting the economy in the second half of the year. Although it is hard to point to definitive evidence that the tax rebates buoyed consumer spending, the fact is that household spending held up unusually well during the recession, and stimulative fiscal policy may be one of the reasons.

Some observers felt by late summer that economic activity was beginning to pick up. But of course, the economy experienced additional severe shocks from the tragic events of September 11. Fiscal policy became even more stimulative as government spending surged to pay for recovery work in New York, the military actions in Afghanistan, and increased homeland security. Moreover, the terrorist attacks prompted additional monetary easing, with the federal funds rate falling to 1  $\frac{3}{4}$  percent.

### **The Outlook for Growth in 2002**

These prompt policy actions appear to have been successful. Recent indicators suggest the economy is growing at a solid pace, although the recovery may be somewhat weaker than average.

A major contributor to growth right now is a strong rebound in inventory investment. Although the manufacturing sector remains weak, production should pick up because firms are no longer slashing their inventories as rapidly as they were, and many firms are even replenishing their stocks in response to stronger than expected sales. Other manufacturing indicators support this view—for example, purchasing managers are now reporting renewed growth in the manufacturing sector, and industrial output has risen for the last two months.

Household spending is an important force behind this recovery. Car and light truck sales, for example, held up much better than expected in recent months. These sales surged to record highs in October when the auto manufacturers introduced zero percent financing. But sales remained surprisingly strong as the incentives were reduced, causing auto manufacturers to boost their production plans. Consumer purchases of computers and other electronics have also been brisk, and consumer confidence has risen.

The housing market is also contributing to the recovery. Low mortgage rates keep home sales and construction strong despite the uncertainties created by rising unemployment and the terrorist attacks. Mortgage refinancing also helps consumers by allowing them to lower their monthly debt payments or to take out money for major purchases.

Federal spending and tax policies should bolster growth this year. Increased spending and transfer payments, the phase-in of tax cuts legislated last year, and the new fiscal stimulus package should strengthen overall demand for goods and services. Of course, spending cuts by state and local governments may partially offset the stimulus at the federal level.

These factors all point to sustained growth over the course of the year. However, there are also reasons to expect a weaker than average recovery. Some of these stem from the very fact that the recession was so mild.

Because household spending has been so resilient, little pent-up demand exists for houses, cars, and other durable goods. In addition, higher levels of household debt may restrain future spending by consumers. The continued strength in car and home sales has caused many households to take on higher debt, raising debt service payments relative to income.

Business fixed investment also may recover more slowly than in a typical recession. The manufacturing sector still has substantial excess capacity. Although there are signs of improvement, many high-tech industries also have excess capacity—the clearest example right now is unused fiber-optic capacity in the telecommunications industry.

A worsening international trade balance also may slow the economic recovery. Because the United States is leading the world economy out of recession, our exports to other countries may remain somewhat sluggish even as our imports grow.

Balancing all these factors, I think real GDP will probably expand at about 3 ½ percent rate from the fourth quarter of 2001 to the fourth quarter of 2002. This solid gain in output should be enough to keep the unemployment rate near its current level of 5 ½ percent this year.

Such a recovery would, however, be weaker than average. Real GDP has grown about 7 percent, on average, in the first four quarters after a business cycle trough, so

growth of 3 ½ percent would only be about half of what has typically occurred. But such performance would not be bad, considering the mildness of the recession.

### **The Outlook for Inflation in 2002**

The inflation outlook is also favorable for 2002. Several factors should keep the inflation rate low.

First, labor and product markets have a lot of slack at the moment. The unemployment rate is more than a percentage point higher than a year ago. And only about 74 percent of industrial capacity is currently in use, well below the long-run average.

Second, past declines in energy prices may be holding down cost pressures in many industries. Although the primary effect of lower energy prices showed up in consumer prices last year, indirect effects on production costs may take longer to show through, holding down inflation in the first half of this year. Most futures market prices are predicting relatively stable energy prices going forward, although these futures prices are not always highly reliable forecasters. In particular, political turbulence in the Middle East or cold winter weather could send energy prices higher.

Finally, strong productivity growth remains a powerful factor holding down inflationary pressures. Many of us have wondered whether the rapid productivity growth of the late 1990s could continue. Increasingly, the answer seems to be “Yes.” Nonfarm business productivity grew 2 percent last year, which is an unusually good performance because productivity typically declines in a recession. The strong productivity growth helped hold the increase in unit labor costs under 2 percent last year.

These factors imply that consumer price inflation will probably edge down this year. I expect CPI inflation to be about 2 ¼ percent in 2002. The core CPI, which excludes food and energy prices, should rise at a similar rate.

### **Monetary Policy Issues**

Although the outlook for growth and inflation is favorable this year, monetary policymakers still face some challenging issues. In closing, I want to briefly highlight some risks to the near-term economic outlook and then discuss the FOMC's longer-term objectives.

Members of the FOMC must continually assess the near-term risks to the economic outlook, the chance that things may not turn out as expected. These near-term risks are more balanced than they were last year. In fact, at its last meeting, the Committee changed its formal assessment of the risks. For the last 15 months, the FOMC said that the risks were "weighted toward conditions that may generate economic weakness." Last week, the Committee changed its view, now stating that "the risks are balanced," while holding the federal funds rate constant at 1 ¾ percent.

However, this does not mean that the downside risks have all gone away. One downside risk is that there could be another terrorist attack, which might damage business and consumer confidence. Another is that consumer and business demand might not strengthen as much as expected, meaning that growth might sputter later this year after the inventory rebuilding process has run its course.

But the time has come to contemplate some upside risks as well. For example, most analysts expect a weaker than average recovery, but suppose that's wrong. A merely average recovery would imply stronger growth and possibly more inflationary

pressure than I have depicted tonight. I think that the outlook I gave you earlier does a good job of balancing these downside and upside risks. However, FOMC members will have to monitor these conditions carefully in the months ahead.

In addition to monitoring the near-term risks, policymakers must have a long-term strategy because monetary policy works with long lags. Actions taken now will continue to have economic effects in 2003 and beyond, implying policymakers must think with a longer horizon than one year. The Federal Reserve wants to achieve sustainable economic growth and low inflation over the long run. These goals are highly consistent since low inflation provides the best conditions for long-term planning, saving, and investment—all factors that raise the sustainable growth rate.

Policymakers must make judgments about how fast the economy can grow without driving up the inflation rate. The economy's sustainable growth rate is hard to estimate, and different FOMC members may have different ideas about exactly what that rate may be. But the evidence suggests the economy's growth potential is higher than it was 10 or 20 years ago because of faster productivity growth.

New information technologies are an important factor driving the faster productivity growth. Surveys of business people find that firms have exploited only a small part of the potential from the new information technologies. These technologies create many investment opportunities, and firms will probably boost their investment spending and exploit these technologies as the economy recovers.

But even though the economy has stronger growth potential, policymakers must be careful not to provide too much stimulus. Past policy actions have added a large amount of liquidity to the economic system. The stance of monetary policy is currently



accommodative, with the federal funds rate at its lowest level in 40 years. Members of the FOMC will, therefore, need to assess whether current policy settings are appropriate for the longer term.

The FOMC's long-term commitment to sustainable growth and price stability has become highly credible in the financial markets. According to surveys, business economists over the last several years have consistently forecasted a long-run average inflation rate of about 2.5 percent annually. This low, steady inflation forecast shows that financial market participants believe the Fed is highly committed to its long-run objectives.

### **Conclusion**

In summary, the prospects for growth and inflation this year are favorable. After a mild recession, the economy is recovering solidly, while inflation remains moderate. The risks to the economic outlook are balanced right now—you can think of plausible reasons why growth might be stronger or weaker—but conditions can change rapidly. As a result, FOMC members will continue to monitor economic developments closely. Increasingly, however, the focus of policymakers and financial markets is shifting toward what actions will be necessary to keep the economy on a sustainable, low-inflation growth path in the years ahead.