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The U.S. Economy after September 11

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In many ways—even for those of us who have not lost friends, loved ones, and livelihoods—our world has become a different place since the horrifying events of September 11. In terms of the nation's economy, the attacks struck while we were vulnerable, pushing us from sluggish growth to an outright contraction. In these remarks, I'd like to review those difficult days against the background of where the overall economy seemed to be at the time. Then I'll take a look at where we are now, and finally where I think we're heading over the longer term. To put it briefly, I'd say that, over the short term, the outlook isn't great, and there's a lot of uncertainty. But I think it's important to emphasize that the longer-run outlook is good. Our economy is fundamentally strong, and it still affords tremendous opportunity. And those qualities do bode well for our economic future.

The U.S. economy before September 11

Before the attacks, the national economy had been in the midst of a cyclical slowdown that actually started back in mid-2000. What caused the economy to slow? Much of the cause appears to stem from the consequences of some over-reaching during the five years before, when strong fundamentals propelled growth to phenomenal rates. Specifically, the technology boom led to huge investments in information processing equipment and software, and with that came a huge run-up in equity values.

By mid-2000, then, there was a pullback. Firms had already accumulated a lot of capital equipment and inventories, so they just weren't in the market to buy more for a while; and equity values began to drop as investors re-evaluated the long-run profitability of many high-tech firms. This isn't to say that the technology surge was merely a phantom. Rather—even though the surge was real and substantial—markets appear to have gotten carried away. As a result of these developments, we saw large declines in business investment and manufacturing output.

So the slowdown was essentially part of a natural process—a correction—that would eventually lead back to robust growth. In fact, up through the spring quarter, growth was still in the positive range, if only barely, thanks largely to moderate strength in consumer spending. Consumers appeared to be "looking through" the downward part of the business-investment cycle, confident that the longer-run fundamentals were still sound. So the durability of the expansion depended importantly on consumer confidence. And though the data for August and early September were mainly downbeat, we expected to see more acceptable growth before too many more quarters passed.

And then came September 11.

The Federal Reserve's response to the attacks

I'd like to speak briefly about the Fed's immediate response to those terrible events. The literal response was in our press statement that day: "The Federal Reserve System is open and operating. The discount window is available to meet liquidity needs." Those 17 words were meant to assure the public and the markets of two things—the Fed stood ready to play its regular role in the payments system, and the Fed stood ready to play its role of providing liquidity in times of crisis.

In terms of the payments system, we worked to ensure the continuation of vital services like electronic funds transfers, check-clearing, and currency processing. This took some extraordinary efforts—especially with air transport shut down for three days—and, for the most part, the system worked.

In terms of providing liquidity, we were concerned that the disruptions to the financial markets could have dire consequences for the economy as a whole, so we provided additional funds until orderly functioning could be restored. This included injecting massive amounts of liquidity through discount window loans and open market operations: on the three days after the attacks, the total injection amounted to over $100 billion a day. In addition, we lowered short-term interest rates twice over the next three weeks by 100 basis points in total.

To help foreign banks operating in the U.S. and their customers meet their obligations, the Fed also set up swap lines with several foreign central banks. This also was a time to bend and give firms some room to deal with the disruptions. So we temporarily suspended our usual fees and penalties on daylight and overnight overdrafts to ease banks' problems in managing their reserve positions. And we also temporarily suspended our rules on securities lending to make additional collateral available to the markets. As markets returned to more normal functioning, we let the federal funds rate fall below the formal target for a few days to ensure that there was ample liquidity.

These actions helped ensure that the financial markets could function efficiently as soon as possible, thereby minimizing disruptions to economic activity.

The economic outlook over the short run

Besides the disruptions to financial markets, there were other reasons for activity to stall in the weeks and months after the attacks. As I already said, we were in the midst of a cyclical slowdown before the attacks, and it was largely consumer spending that was keeping real GDP growth barely positive. [Note: On November 26, the National Bureau of Economic Research announced that it had determined that the U.S. economy entered into a recession in March 2001.] By undermining consumer confidence, the attacks hit directly at the economy's main pillar of support. And, of course, it's not surprising that business confidence also suffered, since consumer spending represents about two-thirds of overall demand for goods and services.

Indeed, the latest surveys show that consumer confidence is way down. Most categories of consumer spending plummeted in September but recouped a good bit in October. Of course, auto sales have been strong because of temporary sales incentives. But industrial output and business investment spending still appear to be dropping sharply, as they have for several quarters.

One of the clearest monthly measures of our economic performance is payroll employment, and recent news is grim. In October, private payroll employment fell by 439,000 jobs—the largest one-month decline in more than fifteen years—and the unemployment rate jumped from 4.9% to 5.4%.

In terms of overall economic activity, real GDP contracted at about a half a percent annual rate in the third quarter, after being pulled down in the last three weeks of the quarter by the aftermath of the attacks. For the current quarter, I'd have to agree with what most forecasters are saying. We almost certainly face further rises in the unemployment rate, which could put even more of a damper on consumer confidence, and the falloff in activity is likely to be sharper than it was in the third quarter.

Of course, there are a lot of wild cards, and an important one going forward is the spread of economic weakness around the world. Part of this is related to our own downturn, as softer U.S. demand for foreign products slows production and job growth abroad. But part also is related to developments originating in other countries. For example, Japan is suffering from a deflationary spiral, and efforts by the European Central Bank to ease policy have been limited by inflationary pressures. So, in effect, the world economy has been hit by several different shocks at the same time.

A longer-term perspective

So far, I've focused on the short run, and, admittedly, what we can see looks pretty rocky. But let me turn now to the longer run, where the picture is a good deal more positive. Why? Because there are several important sources of stimulus that should make economic activity rebound.

First, the Fed has cut short-term interest rates ten times since January. The federal funds rate now stands at 2%, compared to 6½% back then. The second source of stimulus is fiscal policy, which is coming in three programs: the major tax reduction in June, including the recent tax rebates, the emergency spending bill enacted just after the attacks, and the fiscal stimulus bill currently in the Congress. These fiscal programs add up to a major amount of stimulus—perhaps around $160 billion in fiscal year 2002. Third, energy prices have declined this year. The price of imported oil has fallen by nearly half since last November, and the price of natural gas has fallen even more dramatically. These price declines give firms and households more purchasing power, and they should help stimulate demand. Fourth, the "overhang" of capital equipment and software, as well as inventories, that I mentioned earlier is one that will correct itself with time. At some point, the stocks of these assets will get to low enough levels that firms will need to start spending on them again.

Nowhere is a recovery in business demand for high-tech equipment and software more critical than here in the Bay Area. About a third of our economy depends directly on these sectors. Although high-tech manufacturers go through periodic downturns, the heights reached during the recent technology boom meant that the industry had further to fall this time. Moreover, this tech downturn is unique because the hardware slump was reinforced by the dot-com implosion. The resulting losses in jobs and wealth have spilled over to other sectors and pulled the rug out from under the area's expansion. For example, the job count has fallen substantially this year, and the number of individuals looking for work has increased by over 100,000 since last December.

The effects in commercial real estate markets have been startling. Vacancy rates on office space shot up this year, with the rate in San Francisco rising above that in Los Angeles for the first time in recent memory. And with sub-leases by struggling companies accounting for much of the available space, the full financial shock to landlords has yet to be felt.

The events of September 11 have largely served to reinforce these trends. The timeline for recovery in the high-tech sector has been pushed out by business uncertainty in the aftermath of the attacks. And Bay Area commercial real estate markets will remain weak until the high-tech sector, and the national economy in general, are back on their feet.

Looking toward economic recovery

When will the recovery kick in? Most likely sometime next year. But, frankly, there's no way to know exactly when. I do know this, however. The economy *will* recover, and, in the long run, its fundamentals are strong.

First, both monetary and fiscal policies were sound going into the current situation. Inflation in the U.S. has been relatively low and stable. This allows our market system to work efficiently, and it has allowed the Fed the flexibility to ease policy aggressively. In terms of fiscal policy, we came into the current situation with the federal budget in surplus. That promoted private saving and investment, and it allowed fiscal policy to ease aggressively.

Second, our economy has a resilient structure—financial markets are deregulated, the banking system is sound, and our labor markets are flexible—so we can adjust relatively quickly to the kinds of shocks we've recently suffered.

Last, but by no means least, the kinds of technological advances that propelled the economy in the latter half of the 1990s are still in train. These developments operate on a long time scale, and they're not likely to be affected much by the kinds of cyclical developments we face today.

The key point is that the outlook for productivity over the long haul continues to be bright, and this is what matters for our standard of living. These positive fundamentals are just as pertinent for the Bay Area—and with this region's focus on technology, perhaps even more so. Over the longer run, the technology and entrepreneurship we've become famous for will be a source of strength to the economy both in the nation and here at home.

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