

The Tide Has Turned for the U.S. Economy

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Presented to

Maquiladora Downturn: Structural Change or Cyclical Factors?

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Federal Reserve *Beige Book*

Oct. 15, 2003

- U.S.: “The pace of economic expansion has picked up since the last report. Ten of the twelve districts indicate that activity has been expanding, while two...report steady levels of economic activity.”
- Dallas District: “...activity showed signs of slowly improving in September and early October.”

Backdrop

- May/June, 2003: Fed officials discuss **deflation**
- June 25, 2003: Fed cut rates 25 basis points
- Aug./Sept./Oct. 2003: FOMC says “... policy accommodation can be maintained for a **considerable period.**” (*emphasis added*)

The U.S. economy: overview

2003 first half

- Sub-par growth
- Jobless recovery
- Iraq War soft patch

2003 second half

- Strong growth
- Improving labor markets
- Fiscal stimulus added to monetary stimulus

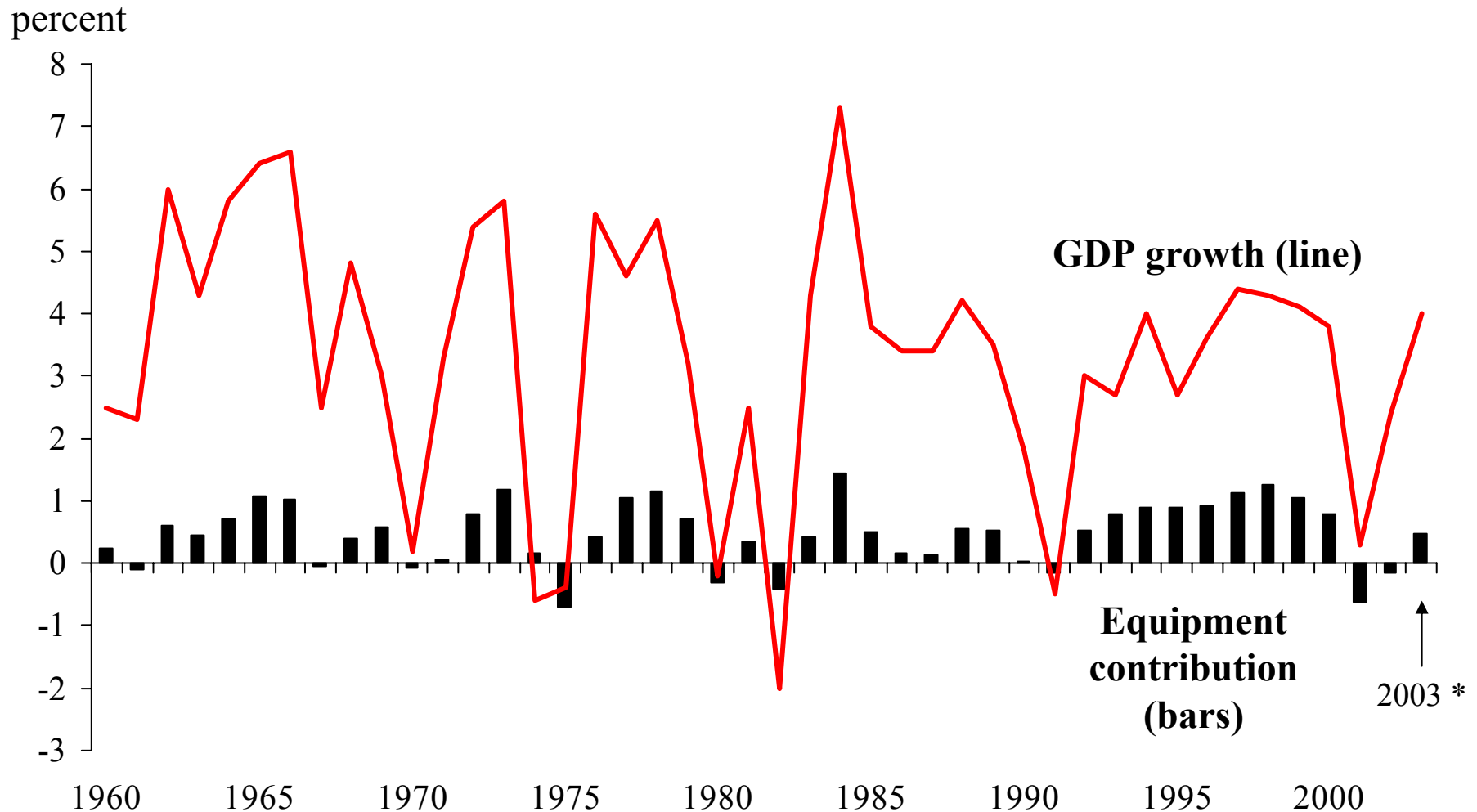
2004: improving conditions more widespread

- Investment, profits, hiring

A look back

- The 2001 recession: an investment bust
- Unusual pattern:
 - Housing & consumption holds up: low rates & easy mortgage availability offset wealth effects
 - Geopolitical risks delay recovery
- Recovery fueled by:
 - Policy stimulus
 - Reduction of imbalances & geopolitical risks

Equipment investment drove the 1990s' expansion and the 2001 recession



* Average of 2003:Q1-Q3

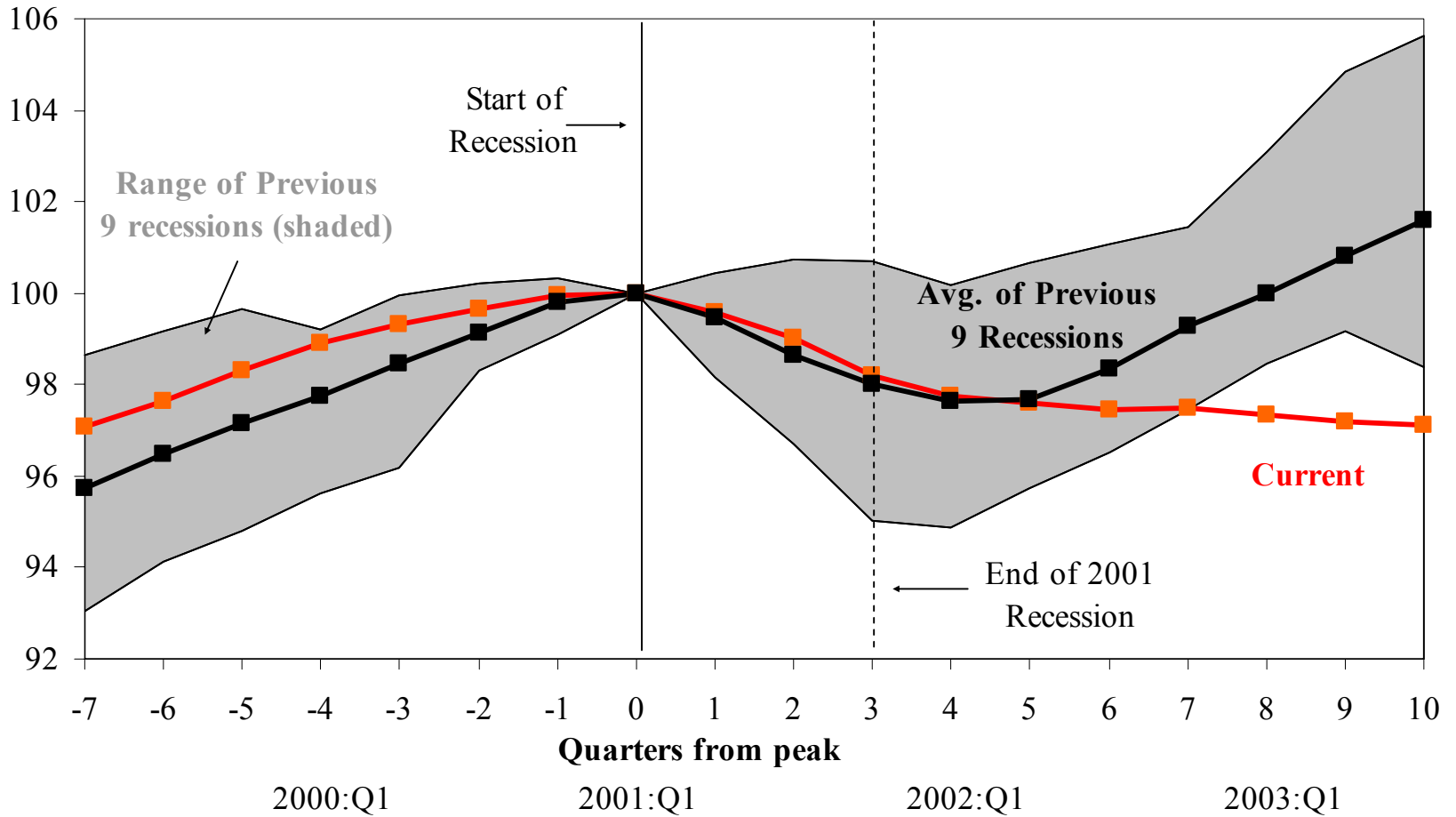
Some factors behind profit disappointments of early 2000s

- “High-Tech Arms Race” of late-1990s ends
- Y2K affects timing of **global** investment
- Pick-up in productivity growth did not deliver as much profit growth as was expected
 - Wages catch up with faster productivity growth
 - Competition: deregulation & high-tech cuts pricing power, link between profits & productivity weakens

Private Payroll Employment

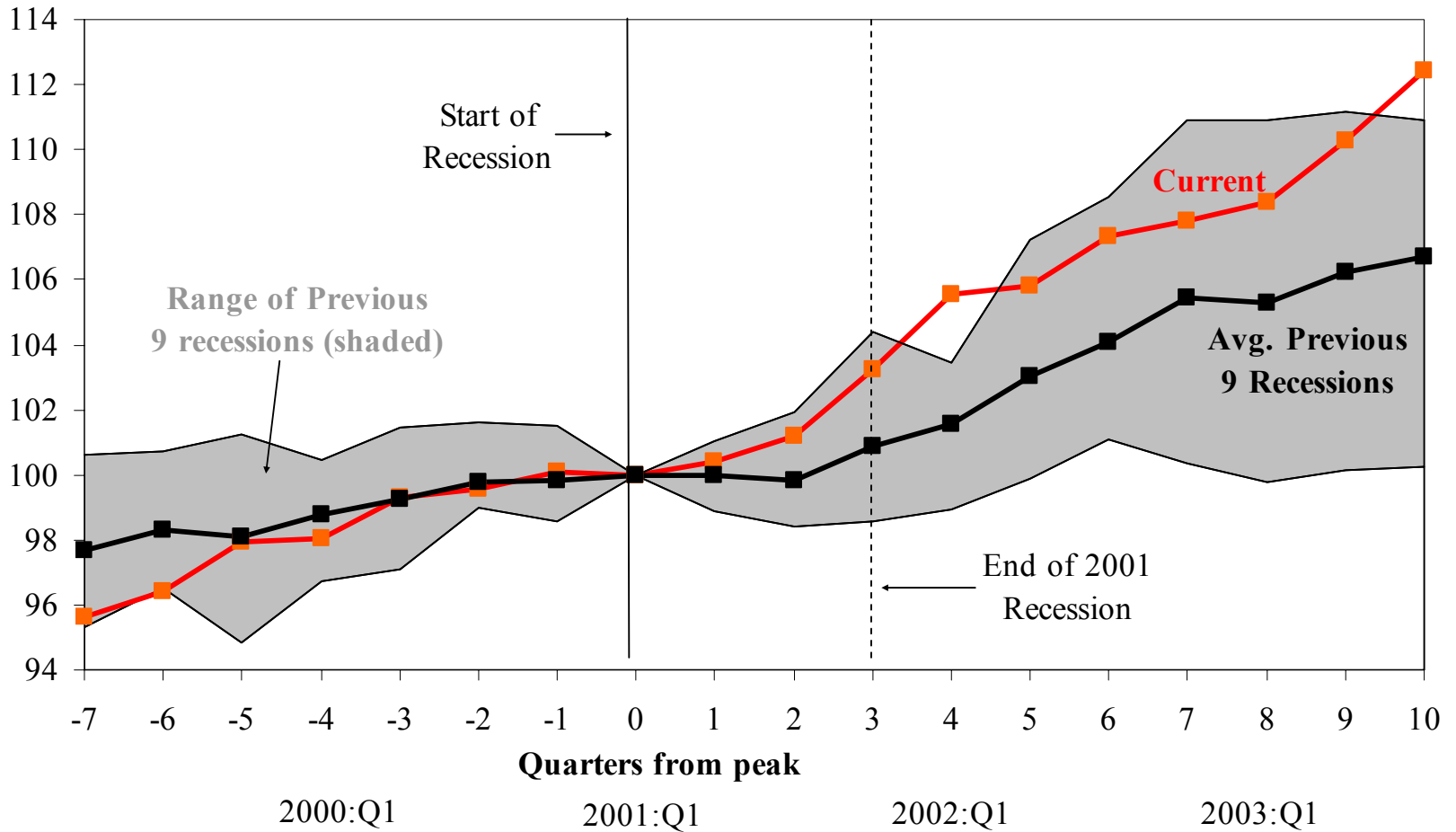
Lags During Current Recovery

Index, Peak = 100

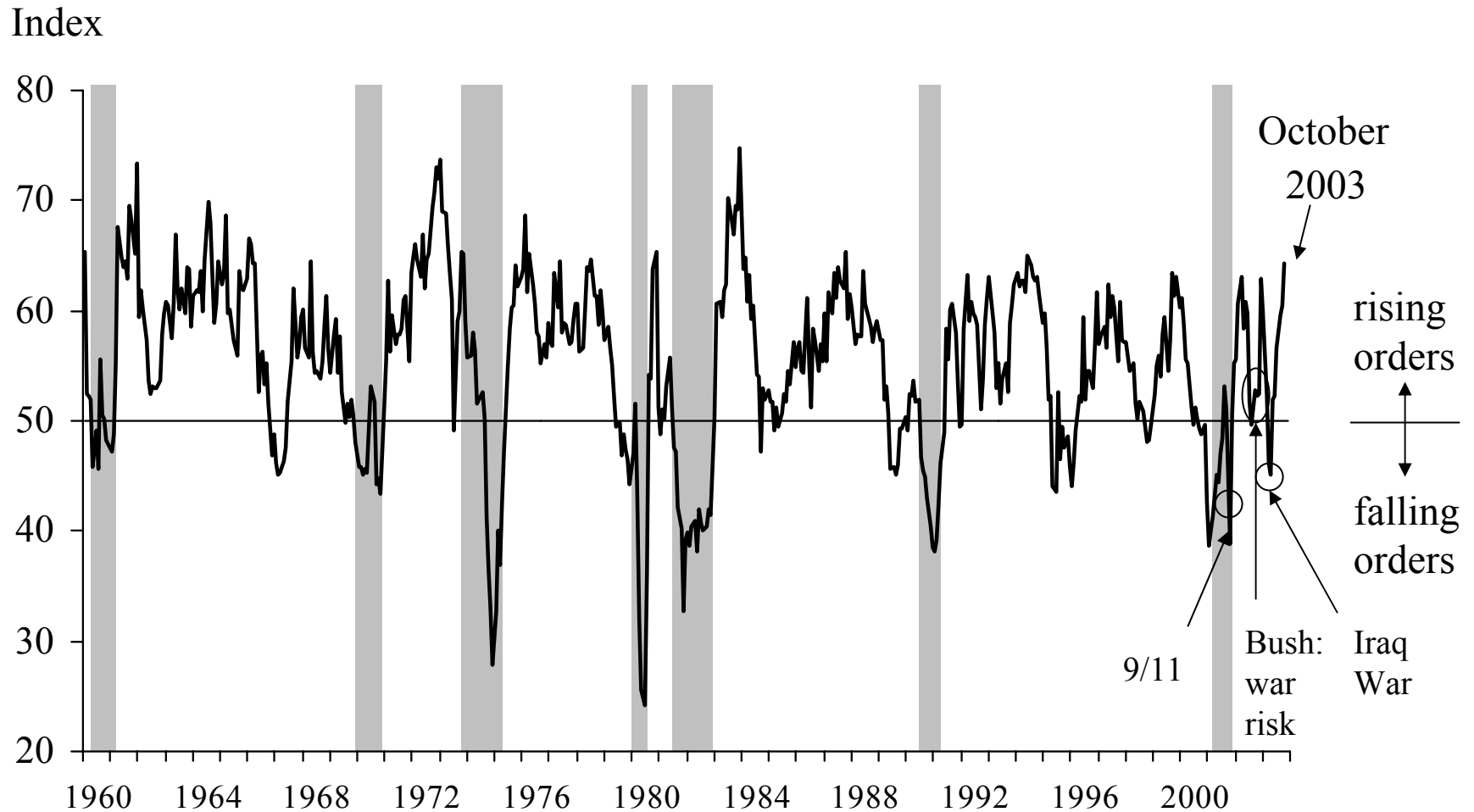


. . . As Firms Boost **Productivity** To Restore Profitability

Index, Peak = 100

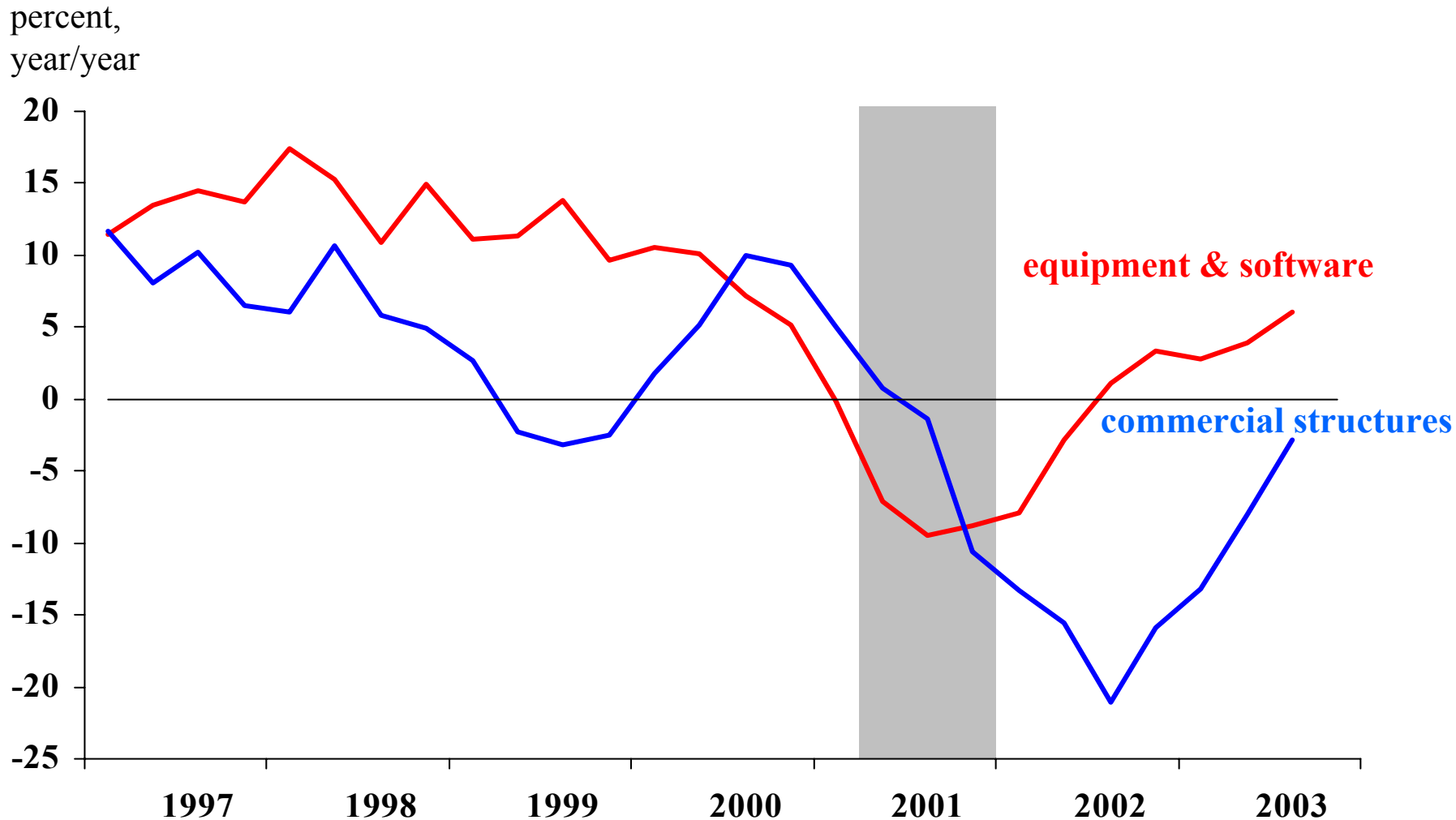


ISM survey: manufacturing orders resume rising after the Iraq war pause



Source: Institute of Supply Management

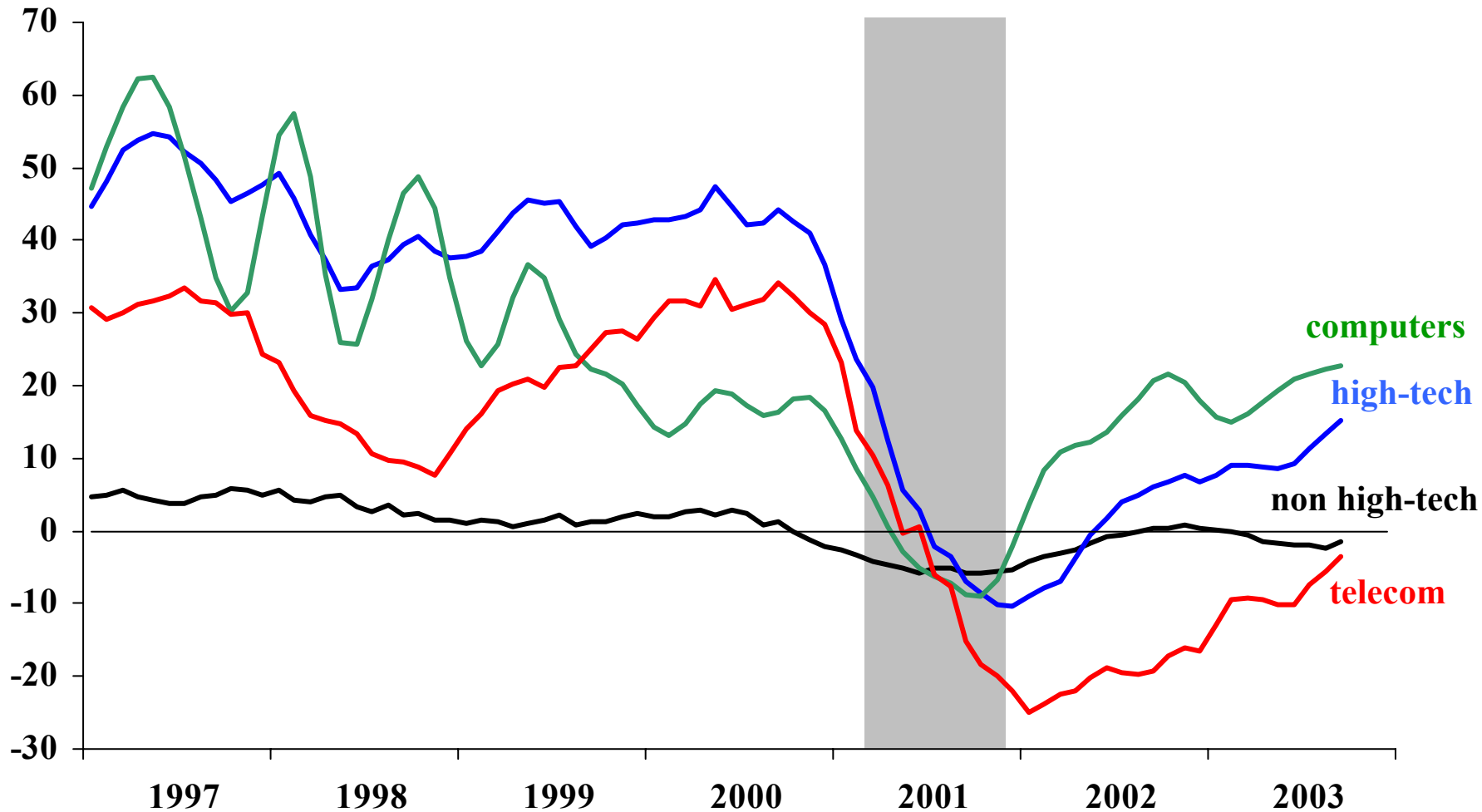
Equipment & software investment recovering, commercial construction still soft



The last recession is depicted by the shaded area.

Growth in non-telecom high-tech output leading the recovery in manufacturing

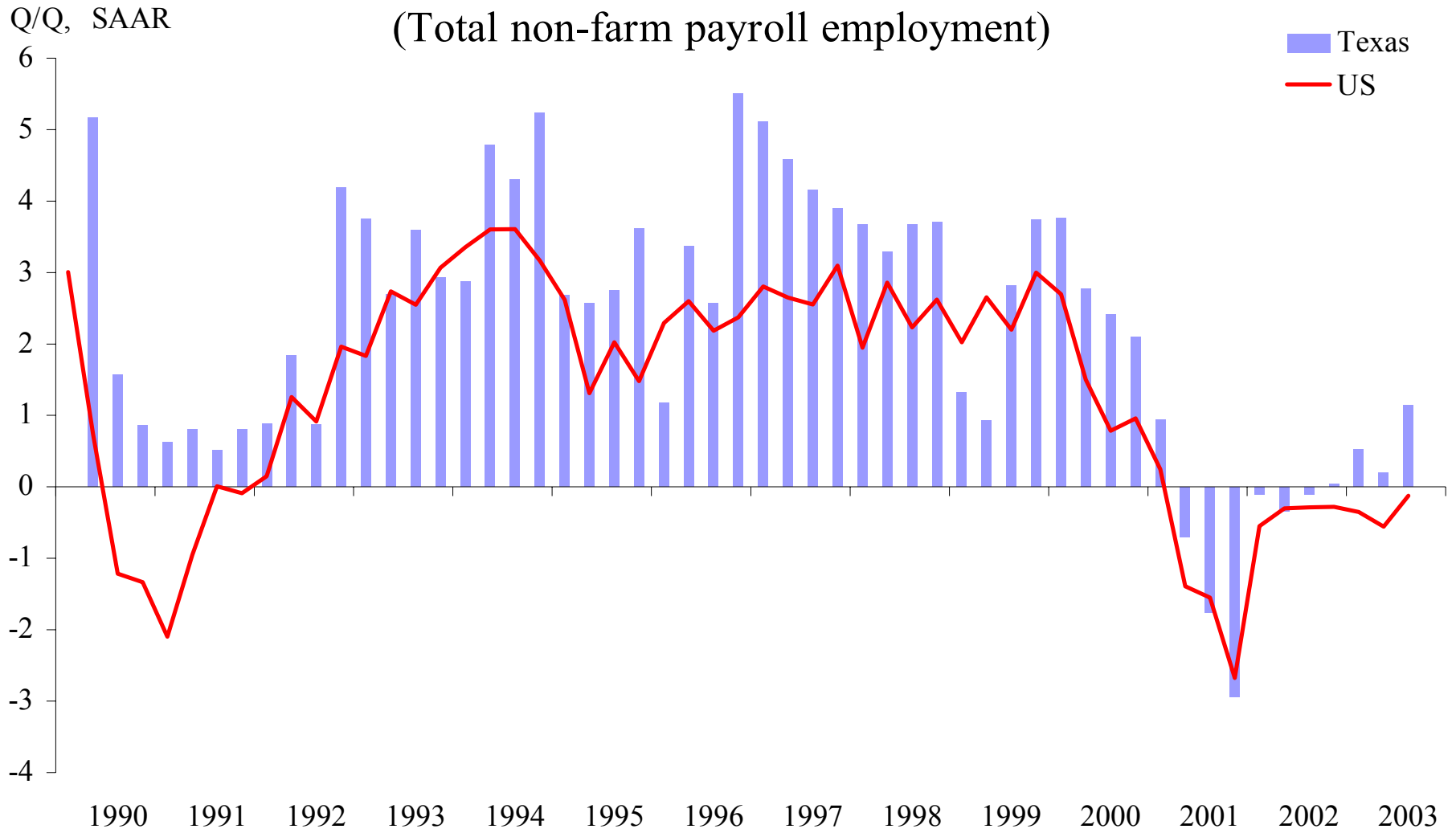
percent,
year/year



The last recession is depicted by the shaded area.

What about Texas?

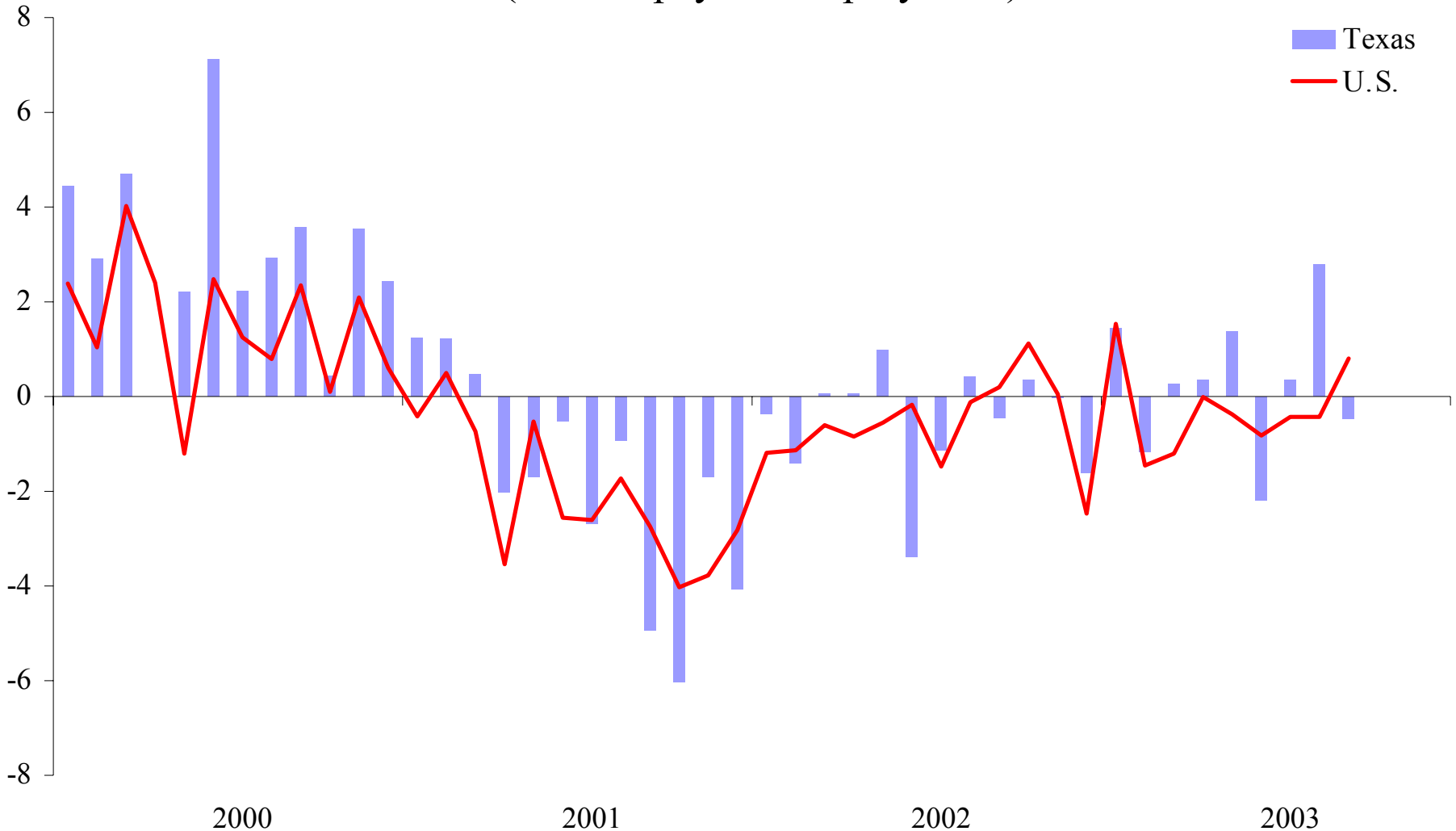
3Q Texas employment growth: taking the *less* out of jobless recovery?



Downside to recent Texas job growth: fickle private sector gains

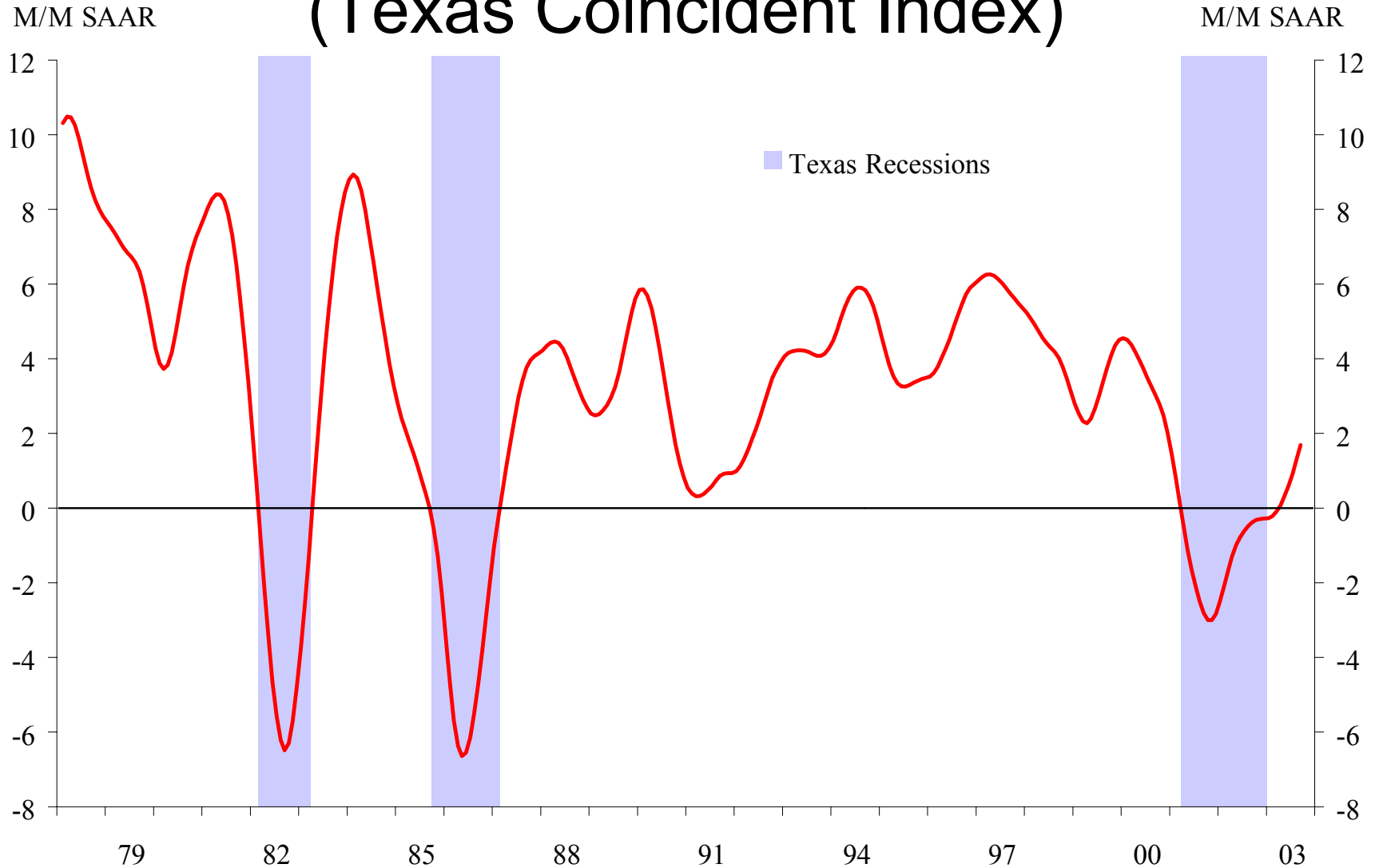
M/M, SAAR

(Private payroll employment)



Texas out of recession

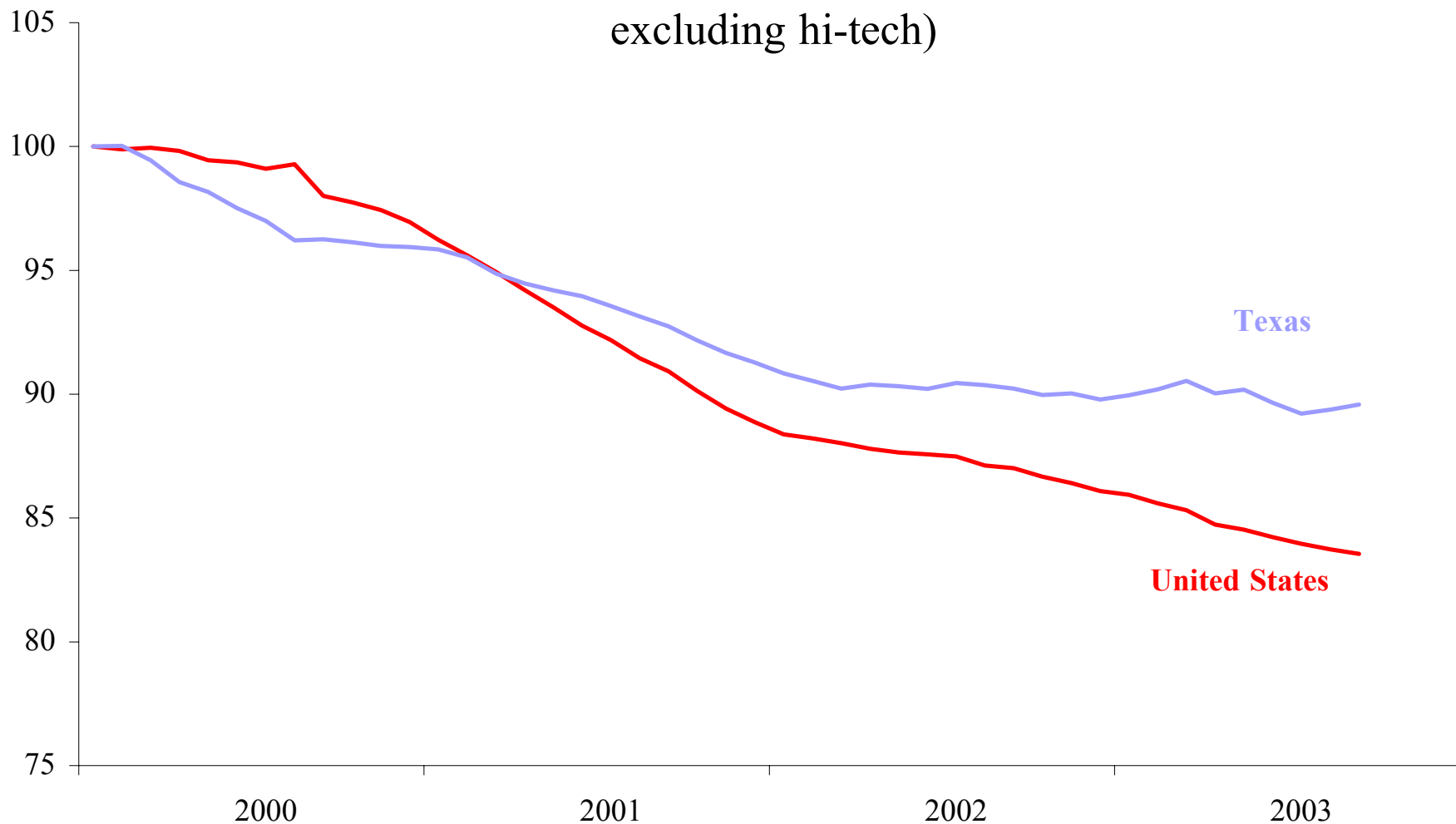
(Texas Coincident Index)



Outside of hi-tech, Texas mfg employment outperformed the nation

SA, Jan. '00 = 100

(Texas manufacturing employment
excluding hi-tech)



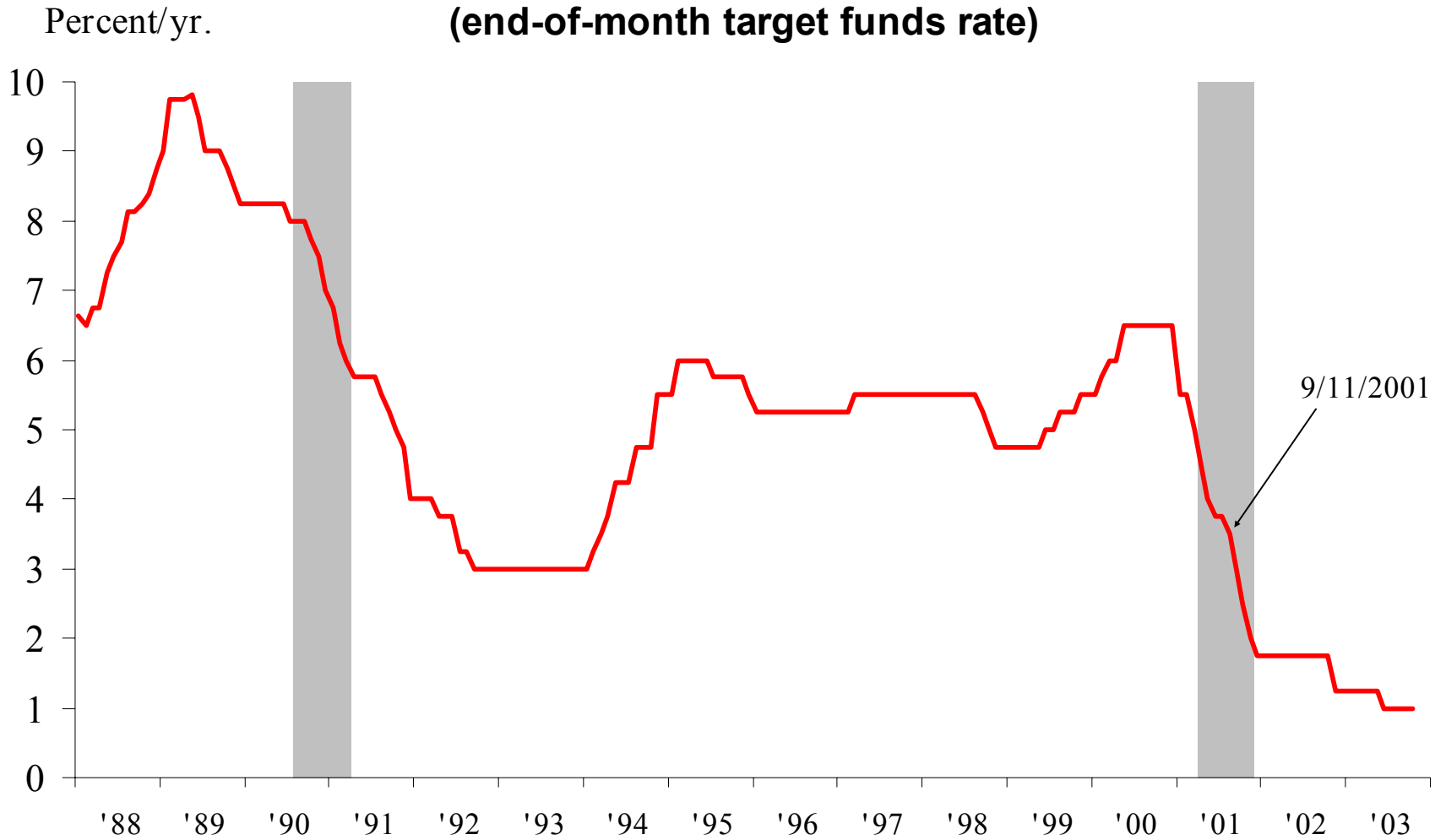
Texas hit heavily by high-tech and transportation

- In 2001 and 2002, Texas lost 120,000 jobs
- Almost 90% of job losses came from high-tech manufacturing, telecom services, and transportation
- These industries are 5.6% of employment but 88% of job losses

Financial underpinnings

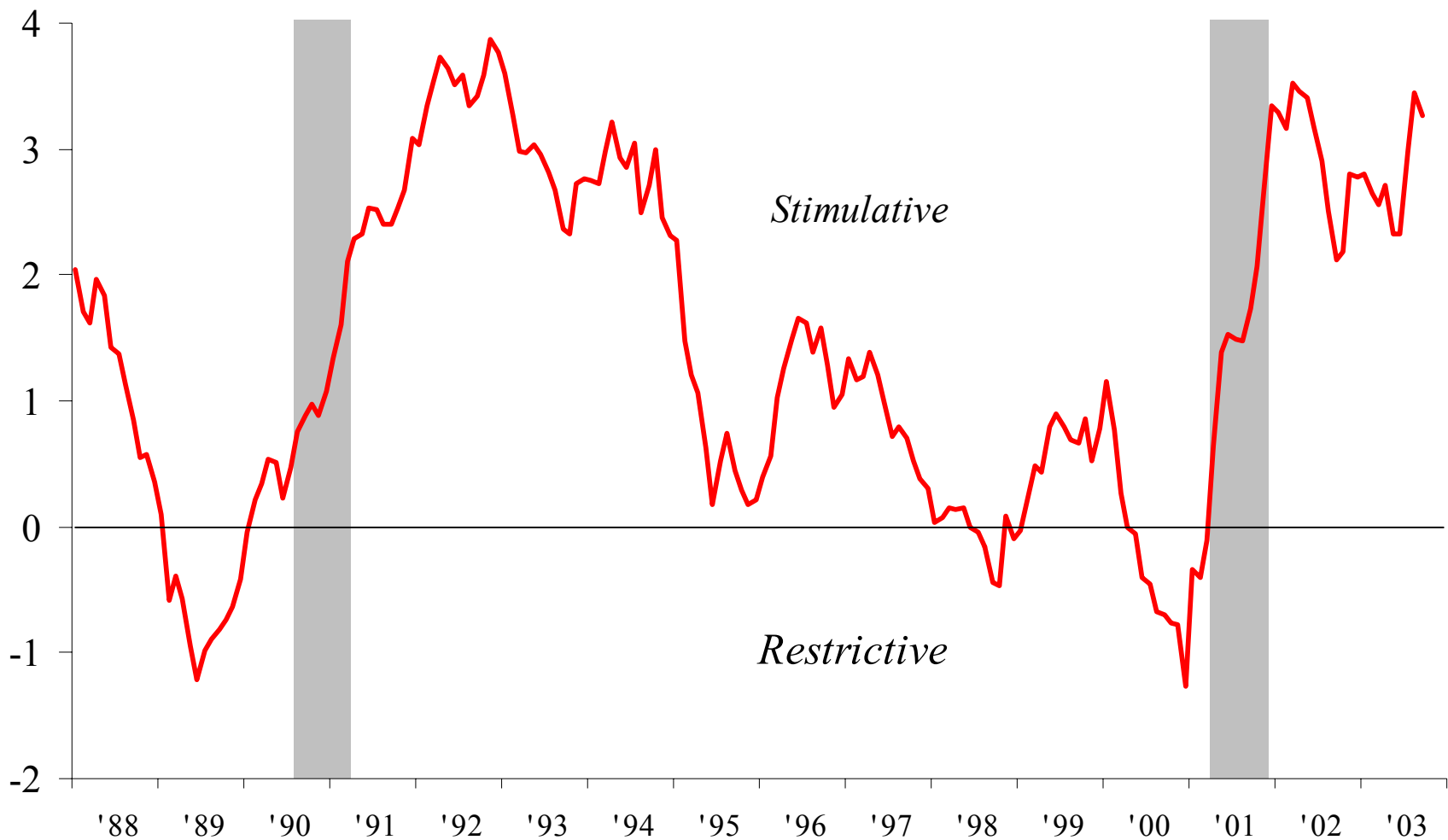
- Price stability
- Rapid productivity growth
- Improved equity markets
- Accommodative monetary policy

The Fed has cut short-term interest rates aggressively since 2000 (end-of-month target funds rate)



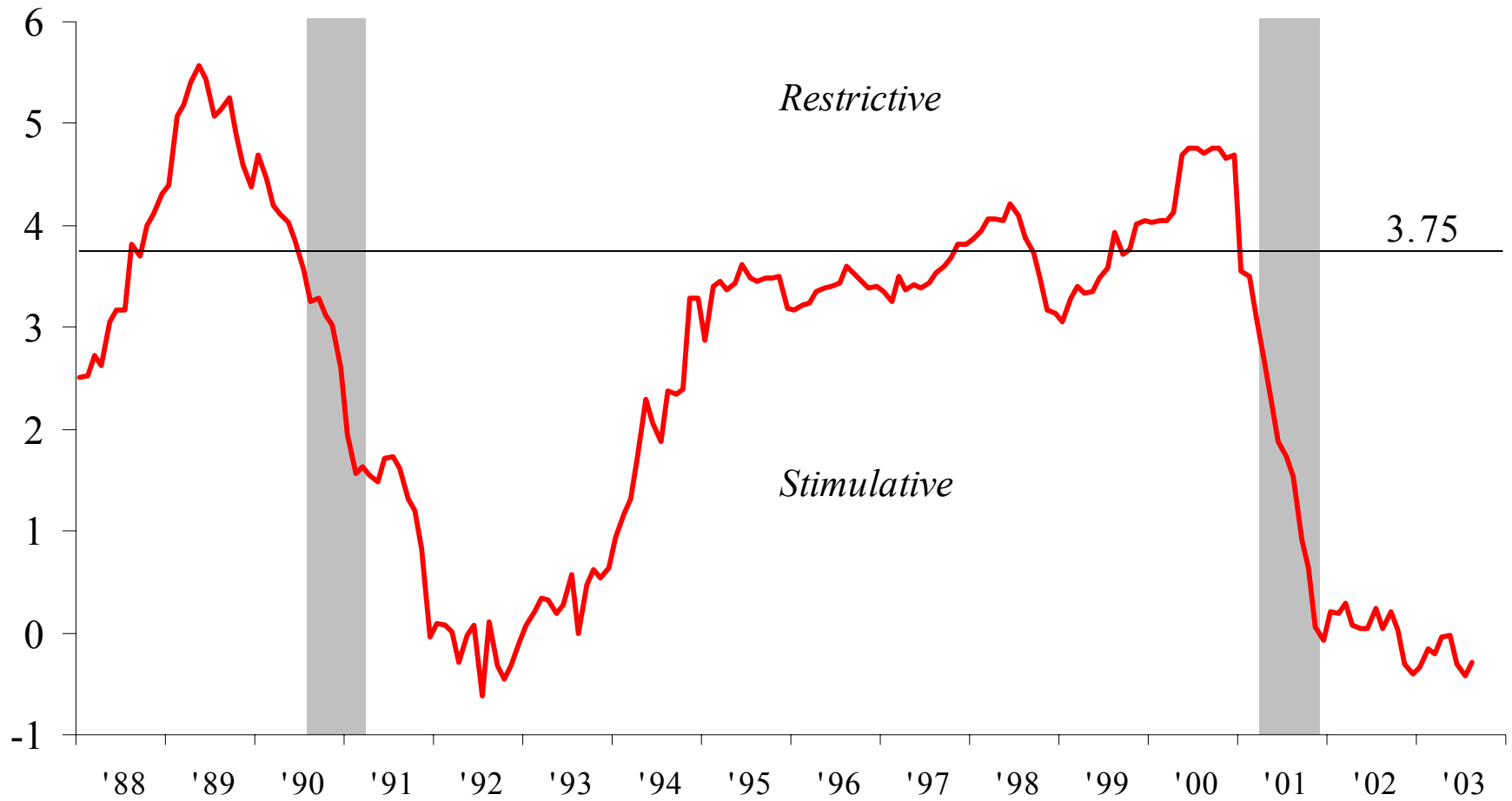
The yield curve signals policy highly stimulative (10-yr T-bond - funds rate)

Percentage pts.



The real funds rate signals policy highly stimulative (funds rate - core PCE inflation)

Percent/yr.



Current monetary policy issues

- What is the optimal long-run inflation rate?
 - Greenspan: low enough not to matter
 - Poole: zero, properly measured
 - Bernanke: 1-2 percent core PCE
 - FOMC: any significant decline “unwelcome”
- How will the FOMC know when it’s time to start raising rates?
 - Prospective inflation and real growth
 - Current or prospective inflation and slack
- Should the FOMC make its answers to these questions public?

Summary on monetary policy

- U.S. monetary policy is currently highly stimulative.
- The perennial question: How will the FOMC know when it's time to start raising rates?
- Financial markets expect rate increases to start next year.

Conclusion

“The times, they are a’ changing.”

Bob Dylan

