

WBBM NEWSRADIO ECONOMIC FORECAST BREAKFAST

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I. Introduction

- A. Last year I spoke at this Economic Forecast Breakfast, and I said I hoped to come back to discuss another winning year for the economy.
- Well, that was one part of my forecast that was right on target. I'm back, and it was a winning year and then some.
 - But I have to admit that like almost all other economic forecasters I was pleasantly surprised by the enduring strength of the economy.
- B. That points out the dangers of trying to predict the future.
- Just think if someone told you a year ago that a former pro wrestler would be elected a state governor; that it would be 50 degrees and sunny in Chicago in December; and, most amazingly, that the Cubs would make the playoffs.
 - You probably would have written off that person as a member of the lunatic fringe. Well, the economy is about as unpredictable as politics, weather, and sports.
 - That's why the old rule of thumb for economic forecasters is to give a number or a date, but never both.
- C. I'll break that rule in a few minutes, but first I wanted to take this opportunity to briefly discuss a topic that's been in the news a lot lately—Y2K.
- This is an especially important subject for the Federal Reserve because of our role as a provider of financial services and as a supervisor of banks.

- There are two key questions: Will the Federal Reserve's own systems be ready? And will the banking system be ready?
- D. I can't say exactly what will happen on January 1st, but I can say that the Fed will be ready. The Fed and financial institutions are making extensive preparations and those preparations are going well. The Fed has set some very ambitious Y2K goals and we've met all of them so far.
- Almost all of our business-critical systems are already compliant; the rest will be corrected or replaced during the coming year.
 - We began testing with banks and thrifts that use our financial services last June. More than 5000 of our customers across the nation have already conducted tests with the Federal Reserve.
 - We've also made good progress in developing our contingency plans, which will be tested and refined during 1999.
- E. Regarding the readiness of banks, we're working closely with the other federal banking agencies to ensure that the financial institutions we supervise are prepared.
- Ultimately, it's up to the banks to ensure that they are ready, but the results of our exams so far indicate that the vast large majority of institutions are making satisfactory progress.
 - We have no historical experience, so I can't say that there won't be any problems or glitches. But we've devoted a lot of time and effort to preparing for Y2K, and I'm confident that work is going to pay off.

II. Economy

- A. Now let me turn to economy. 1998 was a remarkable year.
- As Phil Jackson commented after the Bulls won one of their championships—"It's been a long, strange journey." But, like the Bulls, we ended up with a happy result—an excellent year for the economy.
- B. The numbers speak for themselves.
- Real GDP growth is expected to come in at about 3? percent—the third consecutive year of growth at that level.
 - Our current economic expansion is now in its 94th month—the second longest in our nation's history.
 - The unemployment rate last year was 4.5 percent—the lowest level since '69.
 - And inflation as measured by the Consumer Price Index (CPI) slowed from 1.9 percent in 1997 to about 1½ percent—the lowest level since 1964.

- C. One notable benefit of this outstanding economic performance is the increased opportunity for the disadvantaged in our society.
- Low unemployment rates mean that companies are more willing to hire workers who need more training than people with more education and experience.
 - This is invaluable for people in the inner cities and poor rural areas who haven't had such an opportunity in the past.
- D. All in all, 1998 was a truly remarkable year for the economy, just like 1996 and 1997. We had very robust growth, slowing inflation, and a falling unemployment rate. To put it in baseball terms, it was like hitting a grand slam in each and every at-bat.
- E. So what do I see for '99? As I have in past at this breakfast, I'd like to highlight three issues that should have a lot to do with how things shape up this year. The first two are related to the domestic economy.
- First—and this is one that's always important—Will consumers continue to spend at a rapid rate?
 - Second—Will businesses continue to invest at a rapid rate?
 - My third issue relates to the international economy. In short, how much of a negative effect will overseas developments have on our economy?
- F. Let's look at consumer spending first.
- Last year the major driver of the surprisingly strong economy was the unexpectedly high growth in consumer spending.
 - We all went out and increased our purchases of goods and services at a rapid rate, resulting in unusually strong spending growth of around five percent.
- G. Why the spending spree?
- Some of the key factors were strong employment growth, healthy gains in income, high consumer confidence, and low interest rates.
 - For example, fixed-rate mortgages rates fell to levels approaching a 25-year low. This clearly provided a boost to the housing market and related purchases of household items such as appliances and furniture.
- H. A factor that's been in the news a lot is the stock market.
- The effect of the rise in the stock market on consumer spending is hard to pin down.
 - But it certainly raised the value of household assets and probably increased peoples' comfort level in making major purchases last year.

- I. What do we see for '99? Well, I'm not going to try to forecast the market. If I could do that, I'd be in a completely different business. But we do anticipate that growth in consumer spending will continue at a solid pace, but not as fast as last year.
- It looks as though employment growth will not be as strong as the ___ million new jobs we created in '98. This will dampen income gains and help to temper spending.
 - We don't see the current levels of consumer debt as a major concern at this point. It doesn't appear that consumers are tapped out because of too much debt. But consumer spending growth did increase more than income gains during 1998.
 - With more moderate income gains in '99, consumers probably won't continue to spend at such a rapid rate. We expect that they will retrench a bit to a spending pace that's still very respectable, but slower than last year.
- J. The second key question is the pace of business investment and spending.
- Like consumers, businesses were heavy spenders last year. Business-fixed investment grew at a very strong rate of 11 percent.
 - The reason for the increase is similar to the reason for the rise in consumer spending: financing was available and growth prospects were strong.
 - Businesses found themselves with relatively deep pockets to finance investment, thanks to the lower costs of capital provided by a surging stock market, low interest rates, and strong profits (st. profits questioned by MM).
 - This year it looks as though businesses will find it difficult to maintain the high level of profits they enjoyed in '98. Among the factors squeezing profits will be the slower markets overseas, continued upward pressure on labor costs, and increasing competition, which makes it harder to increase prices.
 - As a result, we're anticipating that business fixed-investment growth will moderate this year. Like consumer spending, it should continue at a respectable pace, but not at the high levels of '98.
- K. That brings me to my third question: how will developments overseas affect the U.S.?
- It didn't take long for the shock wave from Asia to have an effect on the U.S. economy. During the first half of '98, the sharp drop in net exports knocked off about 2 percentage points from GDP growth.
 - As expected, some U.S. manufacturers have been hit hard by the increased competition from overseas.
 - The steel industry is a notable example. That's something that has a particular impact on the Midwest because we have such a heavy concentration of manufacturing. The continued pressure on the manufacturing sector is a factor that has to be considered in looking at the national outlook for 1999.

- The agricultural sector is under pressure too because of slow export growth and unusually low prices for crops and livestock.
- L. The Asian crisis also triggered some instability (?) in U.S. financial markets—an event that was less predictable than the sharp decline in exports.
- Around the middle of 1998, the problems in East Asia, combined with financial difficulties in Russia and uncertainty in Brazil and other Latin American countries, had a pronounced effect on U.S. markets.
 - There was a dramatic flight to quality and liquidity, a strong aversion to risk of any kind. Some pulling back from risk was a rational response. But the extent of the reaction was extraordinary.
 - All this raised the possibility that creditworthy borrowers wouldn't be able to obtain funding for productive investments.
- M. As a result, the Federal Open Market Committee took action last fall to cushion prospective U.S. economic growth from the effects of increasing weakness overseas and unsettled financial markets at home.
- Since then we've seen some signs of a return to calmer market conditions. Credit-risk spreads have narrowed since their peak in mid-October, although some of these spreads still remain at relatively high levels.
- N. We've also seen some stabilization in the world economic outlook. However, the prospects vary quite a bit from country to country. On the bright side, Europe is expected to experience higher growth this year.
- Canada and Mexico should have respectable growth, although substantially slower than in 1998. This is important to the Midwest, which trades heavily with Canada, Mexico, and Europe.
 - The outlook for Latin America, of course, is the subject of much discussion. Brazil will play a large role in determining the region's economic success and, as your know, Brazil is very much in the headlines lately.
 - As you probably recall, Brazil experienced a sharp outflow of capital in the middle of last year as international investors moved their money out of that country.
 - The financial troubles in Russia were one factor that triggered the outflow from Brazil as well as from other emerging market pressure.
 - A financial assistance effort led by the International Monetary Fund helped to ease the immediate pressure.
 - But a key part of that assistance package was Brazil's commitment to enact tax increases and spending cuts to reduce needs to continue to make appropriate changes to its economic policies to achieve a more sustained recovery from its recent difficulties.

- O. In Asia, it appears that the worst is over, but there will be continued economic weakness in the region. Japan is a key factor.
- Japan has announced programs to stimulate its economy and reform its banking system, but they're unlikely to boost economic growth appreciably in the near term. In fact, many forecasters expect the Japanese economy to contract again in '99.
- P. Putting this all together, U.S. export growth will continue to be held back by the weak global economy, but not as much as in '98. We should start to see exports recover during '99.
- Q. A notable bright spot for the U.S. economy last year was that we achieved very low inflation in an environment of strong growth and high employment.
- The good inflation news can be attributed in part to temporary factors such as lower oil prices, less dramatic growth in medical costs, and the strength of the U.S. dollar.
 - So far inflation continues to be benign. But we can't expect temporary factors to dampen inflation indefinitely. Already, it looks as though medical costs will rise faster in '99 as we exhaust the savings associated with managed care.
- R. We expect that U.S. economic growth will decelerate a bit during '98, but we'll continue to see tight labor markets.
- All this highlights the need for the Fed to continue to be vigilant about emerging inflationary pressures. It's possible that such pressures may build during 1999, especially if corporate profit margins continue to be squeezed and companies increase prices.
- S. To sum up, the strong economic fundamentals of the U.S. economy propelled growth last year and more than offset the significant shock of the Asian crisis. We have a dichotomy with the strong domestic economy on the one hand and the weak international economy on the other.
- This can be seen by looking at the contrasting fortunes of the auto and steel sectors—two important industries for the Midwest.
 - As I mentioned, steel has been hit hard by cheaper imports even though demand has been fairly strong in the U.S. Domestic steel producers have slowed production; some have had to lay off employees. Not what you'd expect during a year of very strong economic growth.
 - The auto industry represents the other side of the coin. They've had an outstanding year, their best since 1986. Most of the demand was for light trucks, a product line (?) that's dominated by U.S. producers, so cheaper imports weren't a critical factor.
 - It's rare to see such strong demand so late in an economic expansion. Usually consumers have completed buying big-ticket items at this point. But the domestic economy—and consumer spending in particular—continued to defy expectations last year.
- T. The bottom line last year was a tremendous year for the economy.

- Looking forward to 1999, the Chicago Fed is anticipating that consumer and business spending growth will moderate, but so will the negative effect of the Asian crisis.
 - Back in the fall, the Federal Reserve was primarily concerned about the risk of a sharp slowing in growth. Today the risks of slower growth versus inflationary pressures are more in balance than was the case just three months ago.
 - Overall, we expect that U.S. real GDP growth will be 2 to 2½ percent on a fourth-quarter to fourth-quarter basis. That's similar to the expectations of many private forecasters.
 - We anticipate that inflation as measured by the Consumer Price Index will be 2¼ to 2½ percent and that the unemployment rate at the end of the year should be about 4 ½ percent.
 - In other words, we should experience solid economic growth, with continued low inflation and a low unemployment rate.
- U. Unfortunately we run the risk of what you might call the Sammy Sosa syndrome. For years Sosa hit 30 to 40 home runs, a good performance for a star player. Last year, he hit 66—an extraordinary performance. If he hits 40 this year some will say he had a bad year. It's a case of unrealistically high expectations.
- V. We don't expect the U.S. economy to have another extraordinary year like 1998. But it shouldn't be a bad year. We expect a very solid economic performance...a year in which the economy will grow at a pace that's more sustainable over the long run.

III. Conclusion

- A. In conclusion, I'd say I'm cautiously optimistic. That's not a surprising stance from a central banker and an economist.
- I recently heard about the tombstone of a famous economist. The inscription on the stone read: "I'm guardedly optimistic about the next world but remain cognizant of the downside risks."
 - Our economy is facing an unusual number of unknown factors...potential risks on both the upside and the downside. But I'm guardedly optimistic that we'll successfully navigate the various crosscurrents in the economy, and I hope I'll have another chance next year to be here to discuss a winning economic performance.
- B. Thank you.