

ASSOCIATION OF COLLEGE AND UNIVERSITY BUSINESS OFFICERS

Chicago, Illinois
October 6, 1998

.....

I. Introduction

A. Great pleasure.

1. I began my career in academia teaching economics. And I taught at Northwestern University just prior to joining the Chicago Fed.
2. It's always a pleasure to return to my roots and speak to an audience representing Midwestern colleges and universities.

B. I'm here today to discuss the economy—a subject that's very much in the news.

1. As business officers, you need to go beyond the short-term orientation of news headlines and look at long-term implications for the economy. So it's appropriate that I was asked to discuss the Midwest economy and its long-term prospects.
2. I'll also take a few minutes to provide an update on the national economy. Hopefully, this will provide some useful background for you in your jobs and for your discussions at the conference.

C. To begin, let me give you a little background about the Federal Reserve. As the nation's central bank, of course, our mission is to foster a safe and sound financial system and a healthy, growing economy.

1. We have three main responsibilities.
 - We help formulate monetary policy;
 - we provide financial services to banks and the U.S. government;

- and we supervise and regulate banks and bank holding companies.
2. The Chicago Fed is one of 12 regional Reserve Banks and serves a five-state area consisting of most of Indiana, Illinois, Michigan, Wisconsin, and all of Iowa.
 - We have a head office in Chicago as well as offices in Detroit, Des Moines, Indianapolis, Milwaukee, and Peoria.
- D. Today I'd like to discuss the Midwest economy and its long-term prospects. I'll also take a few minutes to provide an update on the national economy. Hopefully, this will provide some useful background for you in your jobs and for your discussions at the conference.

III. Midwest Economy

- A. First, the longer-term prospects for the Midwest. The basis for this discussion is a comprehensive study on the regional economy by the Chicago Fed.
 1. The goal of our study was to better understand the region's future by studying its past —specifically the Midwest's dramatic comeback since the early 1980s.
- B. How did the Midwest do it? And what can the Midwest do to build on its past success? Well, let me read three quotes that touch on key challenges facing the Midwest.
 1. First — Mark Twain—"Everybody talks about the weather, but nobody does anything about it."
 2. Second — Horace Greeley—"Go west, young man."
 3. And third—Henry Ford on his workers—"Why do they insist on bringing their heads when all I need is their hands and feet?"
- C. You may be asking yourselves what these quotes have to do with the Midwest economy, which is doing so well with unemployment rates a full percentage point below the national average.
 - Actually they deal with three issues that are essential to the future of our region—the weather; migration patterns; and worker skills.
- D. These issues emerged as our researchers looked at the performance of the Midwest economy. In doing so, they refuted a couple of lingering myths:
- E. One myth is that the Midwest was successful because of diversification and de-industrialization.
 1. Actually, the source of the Midwest's recovery was its old mainstays — basic manufacturing and agriculture.
 2. The Midwest has not changed what it does. The region continues to be the nation's manufacturing center as well as its breadbasket.
 3. But there's a crucial difference—we're doing it much more efficiently...at a world class standard.

- F. Today the Midwest is still heavily dependent on manufacturing.
1. The Midwest's share of earnings derived from manufacturing was 27 percent in 1997, compared to the national average of 18 percent.
 2. Our fortunes are still heavily tied to our manufacturing base.
- G. Myth number two is that the Midwest succeeded because it was in the right place at the right time. In other words, the Midwest was helped by developments beyond its control.
1. This is true to a degree. Lower energy costs helped. So did increased exports of capital goods and agricultural products.
 2. But a critical factor in the Midwest's success was its willingness to reinvent itself. Midwest businesses reduced costs, created new product lines and made remarkable productivity enhancements.
- H. Research by Chicago Fed economists highlights this accomplishment.
1. According to common wisdom, the Midwest benefited from the declining dollar, which made its exports cheaper for overseas buyers.
 2. This is a logical conclusion if you look at the value of the dollar relative to currencies of the nation's major trading partners.
 3. Our economists looked at the value of the dollar relative to currencies of the Midwest's major trading partners.
 4. They found that the dollar did not decline against currencies of those countries. So the Midwest did not have a built-in price advantage from the weaker dollar.
 5. In fact, the region had to swim upstream against an appreciating U.S. currency in relation to the region's key trading partners.
- I. The fact that external forces don't always go our way reinforces the importance of continuing to improve productivity. How do we do this?
1. In many ways, private firms have held the key and will continue to do so. But one important area that the public sector can influence is the Midwest's human capital.
 2. There are two issues here.
 - One is simply finding enough workers.
 - The other is finding workers with the necessary skills and training.
 3. Unlike Henry Ford, today's employers do need workers who use their heads. Certainly, education and training are crucial, a fact that was emphasized in our study.
- J. The Chicago Fed recently co-sponsored a conference with the Hudson Institute that focused on some of these issues. It's clear that the Midwest faces some major challenges in the area of human capital. Looking at demographic trends for the entire country doesn't provide much comfort. Two factors

determine the labor supply.

1. One is demographics—how many are born and enter the work force; how many retire or die and leave the work force.
 2. The second is labor force participation—how many in the U.S. will participate in the labor force and how many will enter the labor force from abroad.
 3. Based on those factors, it appears that national growth in the work force in the next twenty years will be much slower than at any time since World War II.
- K. Looking at the demographics, we'll see the Baby Boomers retiring in heavy numbers in the not too distant future. Consider the ratio of Americans 65 or older to Americans aged 20 to 64.
1. Right now we have about 4.5 people in the working age category for each person 65 or older.
 2. That ratio is expected to stay about the same until 2010. But by 2030, the ratio is expected to decline to slightly more than 2.5 to one.
- L. It doesn't look as though we'll receive much help from increased work force participation.
1. We've been helped in the past by an increasing number of females joining the work force. But it looks as though participation rates by both males and females will increase only slightly in the future.
 2. The bottom line is that we may have slow growth in the work force during the next decade, followed by no growth and even possible declines in some years.
- K. What does this mean for the Midwest? Slow growth in the work force is especially serious for this region because of migration patterns.
1. Currently, the Midwest is experiencing net internal out-migration. In other words, there are more residents leaving the Midwest for other U.S. regions than there are coming in.
 2. According to the Census Bureau, we lost 154,000 residents to other states between 1996 and 1997.
- L. The Midwest would actually have experienced a decline in population if it wasn't for immigration from abroad.
1. Such migration from the Midwest has affected our population relative to the nation.
 2. Our population share has fallen from nearly 16% in 1969 to just above 13% in 1997.
 3. Many people are still following Horace Greeley's advice.
- M. Why are individuals leaving the Midwest? Well, widespread economic growth across regions has provided greater migration opportunities. Individuals typically base their migration decisions on factors such as job availability.
1. In the early 1990s, the Midwest enjoyed an advantage in this area, with strong job growth com-

pared to the coastal economies. That's no longer the case.

2. While the Midwest continues to have very tight labor markets, so do other regions. When job availability and wages are less of an issue, individuals are less likely to migrate, but those that do tend to base their decisions on quality of life concerns.
- N. This is where the weather becomes a factor. States with warmer climates begin to have greater appeal. A job in Wisconsin versus one in California may not be quite as appealing in January.
1. Many Americans must share these feelings.
 - 61 of the nation's 272 metropolitan areas had population increases that exceeded 10 percent between 1990 and 1995. Of those 61, only 18 have extremely cold winters.
 - Similarly, 15 of the 21 metropolitan areas that experienced a decrease in population have extremely cold winters.
 2. Regardless of what Mark Twain said, people can do something about the weather—they can move.
- O. The shortage of workers may already be affecting the Midwest's job growth. From 1987 to 1993, the region's job growth was better than the nation. But since then, the region has lagged the nation. Is it a lack of demand or a lack of supply?
1. Chicago Fed economists looked at this question and confirmed that demand for workers remains strong, but that available supplies are becoming limited.
 2. In other words, our region may be running out of workers. And it appears that the shortage of workers has affected our job growth.
- P. What can we do? Well, planting palm trees along Michigan Avenue and hoping that global warming kicks in may not be the best strategy. But we do have other feasible options.
1. We could focus our attention on enhancing those amenities that can make the Midwest a better place to live...amenities such as low crime rates, clean environment, open space, outdoor recreation, and cultural entertainment.
 2. We can look to cities such as New York, Indianapolis, and of course, Chicago, whose efforts to manage their urban assets are starting to pay some dividends in economic growth.
 3. More important than amenities, we must focus on education and training. The workers in greatest demand will be those who have the knowledge and the skills to succeed in a more complex work place.
- Q. I'm sure we'd all agree that education is important. The problem is how to improve it.
1. The U.S. college and university system is generally acknowledged to be the best in the world. But we have problems in our elementary and secondary schools.
 2. There have been a number of reform efforts throughout the nation. The Midwest has become somewhat of an incubator for such efforts. We're seeing experiments in school reform in

Michigan, a voucher program in Milwaukee, and right here in Chicago the responsibility for public schools shifted from the school board to the mayor.

3. But such innovations remain small in proportion to the number of students.
- R. I don't pretend to have all the answers regarding education reform. But I think a fundamental issue is imposing market discipline on public schools by allowing consumers to choose among alternatives.
1. This has been tried on a limited basis, but most of these experiments have involved choices among public institutions.
 2. Do we need competition from the private sector to bring about meaningful reform?
 3. And should that choice include the ability to use public money to attend private schools?
 4. I think we need to address those fundamental questions if we are to truly reform our schools.
 5. Obviously, you're in a better position than I am to comment on reform. I'd be interested in hearing your thoughts and comments at the end of my remarks.

III. National Economy

- A. The second topic I'd like to cover today is the national economy.
1. As I'm sure you know, the Federal Open Market Committee (FOMC) recently decided to ease the stance of monetary policy slightly, expecting the federal funds rate to decline from about 5 ½ percent to 5 percent.
 2. As the FOMC noted on September 29th, the action was taken to cushion prospective U.S. economic growth from the effects of increasing weakness overseas and less accommodative financial conditions domestically.
- B. Let me take a step back and briefly sketch what's happened in the economy recently.
1. There's been a lot of good news about the economy in recent years.
 2. 1997 in particular was an extraordinary year with a remarkable combination of strong growth, high employment, and low inflation.
- C. What was the most unexpected feature of our economic performance in recent years? I'd have to say the continued mild inflation in the face of very low unemployment rates.
1. The Consumer Price Index (CPI) has risen at a 1.6 percent annual rate through the first eight months of 1998. The CPI last year increased only 1.9 percent—the lowest since 1986.
 2. And core CPI inflation, which excludes volatile food and energy prices, came in at 2¼ percent. We haven't seen core CPI inflation that low since 1965.

- D. At the same time, the unemployment rate has fluctuated between 4¼ percent and 4¾ percent during the past twelve months. The last time unemployment rates were this consistently low was nearly three decades ago.
- E. Historically, of course, inflation usually accelerated when labor markets were so tight. What's different this time? The change is due in part to temporary factors.
1. Oil prices have dropped and the strong dollar has contributed to a fall in import prices.
 2. And there's been slower growth in benefit costs, particularly health care costs, although we have seen increases in this area recently.
- F. Another factor may not be temporary—trend productivity growth may have risen to a higher level as a result of strong investment in computers and high-tech equipment.
- We finally may be seeing the return on that investment. But we won't know for some time if the productivity improvement is temporary, cyclical phenomenon or a permanent change.
- G. Given this background, our paramount concern in recent years was inflationary pressures.
1. That concern was generated in part by strong growth in real GDP during the last two years—3.9 percent in 1996 and 3.8 percent in 1997 on a fourth-quarter to fourth-quarter basis.
 2. That growth in aggregate demand simply wasn't sustainable over the long term.
- H. More recently, we've seen some slowing in the economy.
1. Real GDP expanded at a very robust 5.5 percent annual rate in the first quarter, but slowed sharply to 1.8 percent in the second.
 2. The real GDP slowdown in the second quarter was largely due to three factors: the strikes at General Motors; a marked slowing in inventory accumulation; and a further increase in the gap between imports and exports.
- I. The GM strikes are behind us. And the sharp slowdown in inventory accumulation suggests that businesses should have their stocks near desired levels so any further inventory adjustments should be modest.
- J. The third factor is the deterioration in our net exports. Here the outlook is more uncertain.
1. As expected, U.S. export growth slowed due to lower demand in Asian countries and a strong dollar against Asian currencies.
 2. Last year, the U.S. shipped 28 percent of its exports to Asia. That figure dropped to 24 percent during the first half of 1998.
- K. On the import side, we've seen an increase in Asian imports, although it hasn't been as strong as some expected.

1. Asian imports are up about 6 percent in dollar terms compared to a year ago. The prices of these imports are well below year-ago levels—prices on goods from newly industrialized Asian countries are down 9.4 percent.
 2. So the developments in Asia have helped to dampen inflationary pressures.
- L. How will overseas developments affect the U.S. economy in the future? That was an important question facing the FOMC on September 29th. And it continues to be an important question for the future.
1. Will the U.S. economy continue to surge forward even though other countries are faltering?
 2. One important factor is consumer and business spending. Last year's strong GDP growth was driven by robust consumer spending and business investment and that trend has continued this year.
- M. In some ways the Asian crisis has actually boosted domestic spending.
1. The flow of international capital seeking a safe haven in the U.S. has contributed to a decline in medium- and long-term interest rates.
 2. The low rates have helped fuel buying of homes, consumer durables and business equipment.
- N. However, the developments overseas have added risks to our economy.
1. We don't know how much longer the problems in East Asia will continue.
 2. The more recent problems in Russia and other countries only add to the uncertainty.
 3. A key factor will be Japan's success in strengthening its economy and reforming its financial system.
- O. We had a major disturbance in East Asia. The full extent of the after-shocks to our domestic economy is hard to gauge.
1. Will the U.S. continue to experience relatively mild tremors? Or will something a bit more serious register on the economic Richter scale?
 2. Those are questions that no one can answer with certainty at this point.
- P. This uncertainty has undoubtedly contributed to the recent volatility in U.S. stock markets. And the volatility in stock prices may trim the growth in consumer and business spending to some degree.
1. In addition, problems overseas have reduced foreign demand for our goods and services.
 2. This has offset some of the potential inflationary consequences from tight labor markets and strong domestic demand.
- Q. We're also seeing signs of increased tentativeness by U.S. lenders...a reduced unwillingness to take on additional risk given the uncertainty in the global economy.

1. Companies have cut back on their borrowing in the capital markets.
 2. And Federal Reserve surveys and other sources indicate that banks are less willing to lend to some borrowers.
- R. I should stress that we haven't seen signs of actual weakness in our domestic economy...the fundamentals remain strong.
1. Employment is high and measured inflation remains low. And we continue to see tight labor markets.
 2. Nevertheless, it appears that the drag generated by developments overseas is more likely to increase than to decrease.
- S. Just a few months ago it seemed that the risks of inflationary pressures generated by our domestic economy outweighed the risks presented by developments overseas.
1. Later in the summer, these risks moved into closer balance.
 2. And most recently, the risk of slower economic growth has become more prominent.
- T. For this reason, the FOMC moved to ease monetary policy slightly. The Fed acted to cushion the effects on *prospective* economic growth.
1. Monetary policy works like a time-release capsule, with a lag of a year or even longer. So it's necessary to anticipate developments rather than wait until after the fact.
 2. Given this background, the FOMC felt that events overseas and the resulting adjustments in U.S. financial markets meant that a moderate change in policy would be consistent with achieving the Fed's goal of low inflation and sustainable economic growth.
- U. To conclude, I'd like to return to where I started at the beginning of this talk—not losing track of longer-term considerations. Certainly that's part of the job description for central bankers.
1. Our monetary policy is aimed at fostering *sustainable* growth...growth that won't burn out in a short time.
 2. Looking at the long-term is an important part of the mission of our educational institutions too.
 - Education and training will be a key factor—probably *the* key factor—that will determine the future success of the Midwest economy.
 - So the continued high quality of the region's colleges and universities will be essential... for attracting students and potential future workers into the region and for preparing students for an increasingly demanding workplace.
 3. We have an idea of what to expect; starting to plan now will help the Midwest to build on its current strength and continue to prosper in the global economy.
- T. Thank you.