

COLE-TAYLOR GOVERNMENT/BUSINESS LEADER ROUNDTABLE

Oak Brook Terrace, Illinois
October 15, 1998

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I. Introduction

- A. Thank you. Happy to be here on the program with such esteemed speakers. Bruce Taylor and Bob Corey of Cole Taylor Bank have done an excellent job putting together this roundtable.
- B. I think sessions like this with government and business leaders are very useful. They help develop common ground and promote the public/private partnerships that can play a key role in solving area problems. So I'm pleased to be a part of this process.
- C. I'm here today to discuss the economy—a subject that's very much in the news.
 1. But I'm going to take a longer-term view than our first two speakers did.
 - Mike's time horizon was the November election and Tom's discussion on crime had an even shorter time frame.
 - Certainly our current economic situation is very important. And I will take some time today to provide an update on the national economy.
 2. But as government officials and business leaders, we also need to look at the longer-term changes in the economy.
 - So I think it's appropriate that I was asked to discuss the Midwest economy and its long-term prospects.
- D. Before I begin discussing the Midwest economy, 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 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.

II. Midwest Economy

- A. So as a regional institution we have an interest in looking at the longer-term prospects for the Midwest.
 1. The basis for my remarks today is a comprehensive study on the regional economy conducted by the Chicago Fed.
 2. The goal of the 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.
 - 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 is doing the same thing. The region continues to be the nation's manufacturing center as well as its breadbasket.

3. But there's a crucial difference—we've changed how we're doing it — we're doing it much more efficiently...at a world class standard.
- F. Today the Midwest is still heavily dependent on manufacturing.
- The Midwest's share of earnings derived from manufacturing was 27 percent in 1997, compared to the national average of 18 percent.
- 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 when it sent goods to its 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 head. 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.
1. National growth in the work force in the next twenty years will be much slower than at any time since World War II.
 2. Baby Boomers will retire in heavy numbers in the not too distant future.
 - Right now we have about 4.5 people in the working age category for each person 65 or older.
 - By 2030, the ratio is expected to decline to slightly more than 2.5 to one.
 3. We've been helped in the past by an increasing number of females joining the work force. But it looks as though a continued increase in participation rates by females will be offset by declining participation rates by males.
 4. 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 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.
 3. Migration from the Midwest to other regions of the U.S. has affected our population relative to the nation.
 4. Our population share has fallen from nearly 16% in 1969 to just above 13% in 1997.
 5. Many people are still following Horace Greeley's advice.
- L. 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 compared 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.
- M. 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 winters¹.
 - 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.
- N. 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's. But since then, the region has lagged the nation.
1. Demand for workers remains strong, but 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.
- O. What can we do? Well, planting palm trees along Lake Michigan 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.
- P. One issue that emerged from our Midwest study is the localized decision making in metropolitan areas, which has developed as population and housing have spread out far beyond the central city.
1. Some feel metro-area decision making has become too fragmented as metro economies outgrow the artificial boundaries established by city governments.
 2. In some cases, small government entities are making land use and development decisions that have wide ranging effects.
 3. A more thought-out approach to some problems such as land use, promotion of the region-wide economy, and planning of transportation infrastructure may be helpful.
 4. But at the same time, we must continue to preserve local control for those suburban services that are working reasonably well.
- Q. Improved amenities can help, but even more important is education and training. The workers in greatest demand are those who have the knowledge and the skills to succeed in a more complex work place.
- R. 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 such as school reform in Michigan and a voucher program in Milwaukee.
 - And one of our speakers this morning, Paul Vallas, will discuss one of the most successful reform efforts — the restructuring of the Chicago Public School System.
 3. But such innovations remain small in proportion to the number of students nationwide.
- S. 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're to truly reform our schools.
- T. Clearly, given our current and expected labor supply, education and training is a fundamental issue.
- It's perhaps the key to the future of the Midwest. But there are many hard questions and few easy answers.
 - So I'm looking forward to hearing Paul Vallas' comments on the Chicago school system. I'm sure there are some valuable lessons we can learn from the experience in Chicago schools.

III. National Economy

- A. The second topic I'd like to discuss today is a bit more topical—current developments in 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 5½ percent to 5¼ 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. What was the most unexpected feature of our economic performance? I'd have to say the continued mild inflation in the face of very low unemployment rates.
 - The Consumer Price Index (CPI) last year increased only 1.9 percent—the lowest since 1986. During the first eight months of 1998, the CPI has risen at a 1.6 percent annual rate.
 - 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.

- C. 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.
 2. That growth in aggregate demand simply wasn't sustainable over the long term.

- D. 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.

- E. 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.

- F. 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.

- G. 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.
 2. So the developments in Asia have helped to dampen inflationary pressures here in the U.S.

- H. 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.

- Will the U.S. economy continue to surge forward even though other countries are faltering?
 - One important factor is consumer and business spending.
- I. 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.
- J. However, the developments overseas have added risks to our economy.
1. We had a major disturbance in East Asia.
 2. The more recent problems in Russia, and Brazil and other countries in Latin America only add to the uncertainty.
- K. One indication of the increased risks in the global economy was the change in the world economic outlook by the International Monetary Fund.
1. Last May, the IMF forecast 3.1 percent world GDP growth during 1998.
 2. On September 30, The IMF revised its forecast to 2 percent.
 3. The downward revision for world growth during 1999 is even more dramatic—from 3.7 percent to 2.5 percent.
- L. 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?
 2. Or will something a bit more serious register on the economic Richter scale?
 3. Those are questions that no one can answer with certainty at this point.
- M. This uncertainty has undoubtedly contributed to the recent volatility in U.S. stock and bond 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.
- N. We're also seeing signs of increased tentativeness by U.S. lenders...a reduced willingness 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.
- O. I should stress that we haven't seen many 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.
- P. 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.
- Q. 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.
- R. To conclude, I'd like to note the importance of 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. For those of us in the Midwest, longer-term considerations should also be a concern.
 - One approach is to follow Horace Greeley's advice and head out West looking for palm trees.
 - But I think most of us are staying right here.
 3. The Chicago Fed's study of the Midwest economy indicates that we can affect our destiny as a region.
 - By developing effective public/private partnerships...
 - by upgrading our human capital...
 - by starting to work now to anticipate events...
 - we can build on our current strength and help the Midwest prosper in the global economy.
- S. Thank you.