

LATIN AMERICAN CHAMBER OF COMMERCE

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1999 Economic Outlook

Great pleasure to be here at the Latin American Chamber of Commerce to discuss the outlook for 1999. As you might guess, I'm often asked to discuss the economic outlook. Trying to predict the future is always tough. I have to admit that like almost all other economic forecasters I was pleasantly surprised by the enduring strength of the economy last year.

That points out the pitfalls of trying to predict the future. Just think if someone told you a year ago that it would be 70 degree in Chicago on December 5th; the Cubs would make the playoffs, and that a former pro wrestler would be elected a state governor. You probably would have written off that person as a member of the lunatic fringe. Well, the economy is sometimes about as predictable as weather, sports, and politics. That's why the old rule of thumb of economic forecasters is to give a number or a date, but never both.

I'll break that rule in a few minutes. But first I'd like to briefly cover three topics. First, I'd like to give you a little background about the Federal Reserve, as a reminder. Second, I'd like to briefly discuss a topic that's been in the news a lot lately—Year 2000. And third, I'd like to review the Fed's activities in promoting fair access to credit for small businesses.

As the nation's central bank, of course, the Fed's mission is to foster a safe and sound financial system and a healthy, growing economy. We have three main responsibilities—providing financial services such as check processing and electronic payments to depository institutions and the U.S. government; supervising and regulating state member banks and bank holding companies; and formulating national monetary policy.

The Chicago Fed is one of 12 regional Reserve Banks and serves a five-state area consisting of most of Indiana, Illinois, Michigan, and Wisconsin, and all of Iowa. We have a head office in Chicago as well as offices in Detroit, Des Moines, Indianapolis, Milwaukee, and Peoria.

One of my responsibilities as CEO of the Chicago Fed is to serve as a rotating member of the Federal Open Market Committee, the Fed's most important policymaking body. I'm a voting member this year. However, I take part in all FOMC meetings every year as all 12 Reserve Bank president attends all the meetings and participates in the discussions, regardless of voting status.

Given our responsibilities as a bank supervisor and as a provider of financial services, the year 2000 issue is an important one for the Fed. There are two key questions: Will the Federal Reserve's own systems be ready? And will the banking system be ready?

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. Our most important systems are already compliant. We began testing with banks and thrifts that use our financial services last June. More than 5000 of the Fed's customers across the nation have already conducted tests with the 12 Federal Reserve Banks. We've also made good progress in developing our contingency plans, which will be tested and refined during 1999.

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 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.

Another area where we feel our hard work is paying off is our efforts to encourage fair credit access for small businesses and consumers. You're probably familiar with the Community Reinvestment Act, or CRA, which encourages financial institutions to help meet the credit needs of their communities, particularly low- and moderate-income neighborhoods. The Chicago Fed, like the other Fed Banks, has a variety of programs in place to encourage banks and community organizations to work together to promote local economic development. We stress that community investment isn't just the right thing to do; it's good business.

As part of its responsibility under CRA, the Federal Reserve gathers and distributes information on the loans made to small businesses and consumers each year. Gathering this type of statistical information is very important, but it provides a broad-brush view of lending patterns. To get a better understanding of the underlying dynamics of the financing process, the Chicago Fed has been involved in some studies that take a closer look at financing in specific neighborhoods in Chicago.

For example, a University of Chicago study conducted by a Chicago Fed consultant analyzed the formal and informal financing decisions of the people and businesses of Little Village. As I'm sure you know, Little Village is a low- to moderate-income Hispanic community on the city's West Side. Informal financing includes borrowing from friends, family, or business associates, rather than borrowing from financial institutions like banks.

In this study we found that these informal sources were very important to both consumers and small businesses in Little Village. Why are they using these informal channels? It will take more research to

develop a clear answer (check). The study does suggest that financial institutions may be able to gain the business of creditworthy customers who use informal financing by being more flexible in their credit arrangements.

Our interest in Little Village didn't end with this study. We're currently undertaking a follow up, which compares the financial opportunities and constraints among households and small businesses in Little Village and Chatham, an African-American community on the southeast side of the city. The follow up study is still in progress, but we're already finding that informal sources of credit remain very important in both Little Village and Chatham.

CRA has traditionally focused on credit access for consumers. But recently we've increased our focus on fair access to credit for small businesses. I'd like to mention a new initiative the Chicago Fed is undertaking with small businesses—the Small Enterprise Capital Access Partnership or SECAP.

The program will address barriers to credit and capital for small business owners in the Chicago metropolitan area. This partnership brings together the major players in the small business arena, including banks, community economic development groups, chambers of commerce, and other groups that can provide skills for small businesses, like accounting, data processing, and management.

We'll be looking at issues related to technical assistance, training, loan products, underwriting, credit enhancements, and other areas. The major focus of SECAP will be minority- and women-owned businesses as well as other traditionally underserved market segments.

The program is in a very early stage. We're still seeking participation in shaping the goals and issues to be addressed. We'd welcome your involvement in the program. And we'll be contacting the Latin American Chamber soon to get their input.

Now let me turn to the outlook for the 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 last year with a happy result—an excellent year for the economy.

The 1998 numbers speak for themselves. Real GDP growth is expected to come in at about 3½ percent—the third consecutive year of growth near 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 best level since 1964.

One notable benefit of this sustained 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. This is invaluable for people in the inner cities and poor rural areas who haven't had such an opportunity in the past.

All in all, 1998 was a truly remarkable year for the economy, just like 1996 and 1997. We had very robust growth, low 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.

So what do I see for '99? I'd like to highlight three issues that should have a lot to do with how things shape up this year.

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?

Third, how much of a negative effect will overseas developments have on our economy?

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.

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 averaged below 7 percent for the year—that's the first time that's happened in three decades. This clearly provided a boost to the housing market and related purchases of household items such as appliances and furniture.

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.

What do we see for consumer spending in '99? We 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 2.9 million new jobs we created in '98. This means income gains will moderate and therefore spending growth will slow as well. In short, consumer spending growth will be very respectable, but slower than last year.

The second key question is the pace of business investment. Like consumers, businesses were heavy spenders last year. Business-fixed investment grew at a strong rate of about 10 percent. The pace of business investment changed during the course of the year. It started strong, but moderated in the second half. We expect that more moderate pace to continue in '99.

One of the reasons for this trend is continued pressure on business profits because of slower markets overseas, continued pressure on labor costs, and intense competition, which makes it harder for firms to increase prices. Overall, business investment should continue at a respectable pace, but not at the high levels of '98.

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 three quarters of '98, the sharp drop in net exports knocked off about percentage points from GDP growth.

As expected, some U.S. industries have been hit hard by the increased competition from overseas. Steel and agriculture are notable examples. That's something that has a particular impact on the Midwest because we have such a heavy concentration of these two industries.

Overseas developments also had an impact on U.S. financial markets. 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. Some pulling back from risk was a rational response. But the extent of the reaction was extraordinary.

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 mid-October, although some of these spreads still remain at relatively high levels and we have seen some volatility in recent days.

We've also seen some stabilization in the world economic outlook. However, the prospects vary quite a bit from country to country. Canada, Mexico, and Europe are expected to have respectable growth, although slower than in 1998. This is important to the Midwest, which trades heavily with Canada, Mexico, and Europe.

Latin America is expected to experience sluggish economic growth. Brazil will play a large role in determining the region's economic success and, as you know, Brazil is very much in the headlines lately.

In Asia, it appears that the worst may be 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, most forecasters expect the Japanese economy to contract again in '99.

Putting this all together, U.S. export growth will continue to be held back by the weak global economy. But as Asia improves, we should see exports starting to recover during 1999.

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 low unemployment rates. The good inflation news can be attributed in part to temporary factors such as lower oil prices 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.

We expect that U.S. economic growth will decelerate a bit during '99, 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 are able to increase prices.

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've had a dichotomy between the strong domestic economy and the weak international economy.

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 sharply; 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. The industry had an outstanding year, its best since 1986. Most of the demand was for light trucks, a segment that's dominated by U.S. producers, so cheaper imports from Asia weren't a critical factor. It's rare to see such strong demand so far into an economic expansion. But the domestic economy—and consumer spending in particular—continued to defy expectations last year.

The bottom line for '98 was a tremendous year for the economy. Looking forward to 1999, the Chicago Fed is anticipating that growth in consumer spending and business investment will moderate, but so will the negative effects of the Asian crisis. Back in the fall, the Federal Reserve was primarily concerned that unsettled international and financial conditions could unduly slow 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 will be about 4 percent. In other words, we should experience solid economic growth, with continued low inflation and a low unemployment rate.

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.

We don't expect the U.S. economy to have another extraordinary year like 1998. But it certainly won'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.

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 tombstone 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 have another winning economic performance.

Thank you.