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I. Introduction

A. Thank you, Fred [Kasten, Chairman, RW Baird and Co. Inc., a Milwaukee-based securities firm].

B. Pleasure to be back on a college campus again, and especially here at Marquette University, home of one of the country's top 10 international business programs.

C. As Fred said in his introduction, I'm an economist by trade so I'm pleased to help develop a scholarship fund for an economics student at Marquette.

D. One task economists are called upon to do is make forecasts — a very dangerous undertaking.

1. Just think of all of the unusual things that happened in the last 12 months.
2. If someone told you 12 months ago that the Cubs would make the playoffs, the weather in Milwaukee on February 11 would hit 68 degrees, and that a former pro wrestler would be elected a state governor, you probably would have written off that person as member of the lunatic fringe.
3. The economy is about as unpredictable as sports, the weather, and politics. That's why the old rule of thumb for economic forecasters is to give a number or a date, but never both.

E. I'll break that rule in a few minutes, when I discuss the current outlook for the national economy. But first, I'd like to discuss the long-term structural changes that have taken place in the Midwest economy.

1. In discussing these two topics, there's a common theme that emerges — the crucial role of the international economy.

2. Today, one of the key questions for the national economy is how quickly Southeast Asia can bounce back from its economic difficulties.

3. Back in the early 1980s, one of the key questions facing the Midwest was how quickly the manufacturing sector could bounce back from intense overseas competition.

4. Two sides of the same coin. Each situation highlights the interconnected nature of our global economy.

II. Midwest & Manufacturing

A. The Midwest's manufacturing sector continues to be influenced by the global economy. This is particularly important since manufacturing makes up a significant portion of the Midwestern economy.

   1. In 1997, the Midwest's share of earnings derived from manufacturing was 27 percent compared to the national average of 18 percent.

   2. Today, I'd like to focus on the Midwest manufacturing sector because it's such a key part of the regional economy and because it provides an interesting case study on the importance of the international sector.

B. As some of you may remember, the manufacturing industry in the Midwest experienced an extreme downturn during the 1970s and 1980s.

   1. The Midwest lost over one-fifth of its manufacturing work force.

   2. The mid-1980s were also disappointing, as export sales remained flat despite a depreciating dollar.

C. One explanation for the severity of the downturns for the Midwest was the region's technology and stock of physical capital.

   1. They tended to be older and less efficient in comparison to the rest of the U.S. and abroad.

   2. However, during these rough times, manufacturing was re-thinking how it did business. The industry understood that it had to change or perish.

   3. So it changed its management techniques, slimmed down its workforce, and remade its productive processes.

   4. These changes took time. It wasn't until the late 1980s that these efforts finally began to pay off.

D. The turnaround can be seen by looking at the auto industry, which has reconcentrated in the Midwest.

1. In past years, assembly plants were closer to population centers to reduce distribution costs. Now the proliferation of car and truck models makes it more efficient to produce the entire output of a specific model at one plant.

2. Auto manufacturers now can exploit economies of scale in assembly and reduce costs of distribution by centrally locating in the Midwest.

3. In 1979, 27 auto plants could be found in the region; Today we have 31.

III. Case Study of Milwaukee Electrical Tool Corporation

A. There are many examples of Midwest companies that are incorporating new technologies.

1. One of these companies is headquartered in nearby Brookfield, Wisconsin — Milwaukee Electrical Tool Company, which produces professional quality power tools and accessories.

2. They operate 5 plants with approximately 1,100 employees in North America.

B. Until 1990, Milwaukee Electrical's plants were organized on the traditional "batch" or mass production techniques.

1. These techniques, as you may know, require excessive material handling and the need for large amounts of floor space.

2. The completion of the entire manufacturing process could take weeks or months.

C. In the early '90s, Milwaukee Electrical Tool began to reorganize its plants to implement cellular manufacturing. Cell manufacturing is a team-based approach to production.

1. Under this system, a plant consists of several cells that each produce specific products or components.

2. Each cell has between 20 and 40 workers and operates like an independent business with total responsibility for the quality, manufacturing and delivery of the product to the consumer.

D. Why did Milwaukee Electrical Tool make the switch? It wasn't because it was suffering financially, but because it anticipated increased competition from Europe and Asia.

1. Now all the plants use a flexible cell approach with dramatic results: inventories have been cut in half, sales have more than tripled, both quality and productivity have increased, and incoming orders are largely filled within a day.

E. Looking back at the achievements of Midwest manufacturers, we can see that foreign competition was a common element in their success. It was competitive pressure from foreign companies that forced the painful restructuring within the industry.

1. It reminds me of the runner in the women's 100-meter finals at the 1992 Barcelona Olympics. She finished 6/100ths of a second behind the winner. For that she came in fifth place!

2. Think of it — there was only 15 inches and 6/100ths of a second difference between the gold medal winner and the runner who came in fifth.

F. The emergence of foreign competition can pose a threat, but for those that survive there are many direct benefits.

1. Foreign competition in our domestic and overseas markets has allowed us to learn from the interaction.

2. Worthy competitors compel us to rethink our old practices and adopt new management strategies and productive techniques.

3. For another example, lean manufacturing practices in the domestic auto industry—which emphasizes teamwork, low inventory, flexible production equipment, and close relationships with suppliers—were originally developed by Honda and Toyota.

G. What challenges and opportunities are facing the manufacturing industry in the future? One challenge is the changing dynamics of the labor force.

1. The graying of the labor force coupled with population migration trends in the Midwest will affect the number of people available to work.

H. Currently, the Midwest is experiencing net out-migration. In other words, there are more residents leaving for other regions than there are coming in. According to the Census Bureau, the Midwest lost 154,000 residents to other states between 1996 and 1997.

I. Tightening labor markets and favorable climates in the South and West have drawn Midwestern residents away.

1. Immigration and natural increases have helped offset these losses and has kept the Midwest population increasing in absolute terms, but at a slower rate than the rest of the nation.

2. Population growth in the Midwest is 0.5 percent per year, only half the national rate of 1 percent.

3. While these numbers are relatively small, over time they can have an adverse effect on our labor markets.

J. The public and private sector must develop new strategies to retain people or run the risk of running short of workers at competitive wages.

1. One approach is working to make the Midwest a better place to live by improving the quality of life through low crime rates, a clean environment, open space, outdoor recreation, and cultural entertainment.

2. Even more important is enhancing educational opportunities to expand and enhance the existing labor pool, either by attracting new workers or retraining previously unemployable individuals.

K. As many of you already know, offering opportunities for retraining and education is simply good business. Improved education will be necessary in the future to remain competitive.

   1. Our strength in the future will be our ability to compete on quality rather than on price. Competitors from abroad will have natural cost advantages due to their plentiful labor supply.

   2. By focusing our efforts on education and training, we enable our workers to add more value to the production process. And as they become more productive, they receive higher wages.

L. Slower growth of the national economy also presents a potential challenge for Midwest manufacturing.

   1. As a nation, we've enjoyed a period of strong economic growth. In recent years, economic growth has been above trend, but we'll experience slower growth at some point.

   2. While the slowing of growth will present new challenges, the Midwest is well positioned to meet any adversity in the future.

   3. Our previous successes have clearly demonstrated that the region can rise to the challenge.

IV. National Economic Developments

A. Rising to the challenge is a natural lead-in to my second topic this afternoon — the national economy.

   1. 1998 was a remarkable year.

   2. As Phil Jackson commented after the Bulls won one of their championships—"It's been a long, strange journey." And, like the Bulls, we ended up last year with a happy result—an excellent year for the economy.

   3. The outlook for the economy is still good. Unfortunately, the outlook for the Bulls is more dubious. But then again, maybe the Bulls' outlook isn't unfortunate for Bucks fans.

B. The 1998 economic numbers speak for themselves.

   1. Real GDP growth was 4.1 percent. A surprisingly strong 4th quarter brought the number in higher than what we expected it would be throughout much of the year.

   2. This was the third consecutive year of growth near that level. Our current economic expansion is now in its 95th month—the second longest in our nation's history. The longest is 106 months in the 1960s. Next January we could tie that record.

   3. The unemployment rate last year was 4.5 percent—the lowest level since '69.

   4. And inflation as measured by the Consumer Price Index (CPI) slowed from 1.9 percent in 1997 to about 1½ percent — the first time in more than 30 years that the CPI has been below 2 percent for two consecutive years.

C. All in all, 1998 was a truly outstanding year for the economy, as were 1996 and 1997. We had very robust growth, low inflation, and a falling unemployment rate.

1. To put it in baseball terms, it was like hitting a grand slam in 3 consecutive at-bats.

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

1. First—and this is one that's always important—Will consumers continue to spend at a rapid rate?

2. Second—Will *businesses* continue to invest at a rapid rate?

3. And third, how will overseas developments affect the U.S.?

E. Let's look at consumer spending first.

1. Last year the major driver of the surprisingly strong economy was the unexpectedly high growth in consumer spending.

2. 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.

F. Why the spending spree?

1. Some of the key factors were strong employment growth, healthy gains in income, high consumer confidence, and low interest rates.

2. For example, fixed-rate mortgages averaged below 7 percent for the year—that's the first time that's happened in three decades.

3. This clearly provided a boost to the housing market and related purchases of household items such as appliances and furniture.

G. A factor that's been in the news a lot is the stock market.

1. The effect of the rise in the stock market on consumer spending is hard to pin down.

2. But it certainly raised the value of household assets and probably increased peoples' comfort level in making major purchases last year.

H. What do we see for consumer spending in '99?

1. We anticipate that growth in consumer spending will continue at a solid pace, but not as fast as last year.

2. 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.

3. In short, consumer spending growth will be very respectable, but slower than last year.

I. The second key question is the pace of business investment. Like consumers, businesses were heavy spenders last year, increasing their investment at a strong rate of about 12½ percent.

1. But the pace of business investment varied over the course of the year. It started strong in the first half but was more moderate in the second half. We expect a moderate pace in '99.

J. One of the reasons for this trend is continued pressure on business profits because of slower growth overseas, higher labor costs, and intense competition, which makes it harder for firms to increase prices.

1. Overall, business investment should continue at a respectable pace, but not at the high levels of '98.

K. That brings me to my third and toughest main 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. In 1998 the sharp drop in net exports knocked off about 1½ percentage points from GDP growth.

L. As expected, some U.S. industries have been hit hard by the reduced demand and lower prices from overseas. Steel and agriculture are notable examples.

- That's particularly important for the Midwest because we have such a heavy concentration here of these two industries.

M. Overseas developments also had an impact on U.S. financial markets.

1. 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.

2. 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.

N. 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.

1. Since then we've seen some signs of a return to calmer market conditions.

2. Credit-risk spreads have narrowed since mid-October, although some of these spreads still remain at relatively high levels.

O. We've also seen some stabilization in the world economic outlook. However, the prospects vary quite a bit from country to country.

1. Canada, Mexico, and Europe are expected to have respectable growth, although slower than in 1998.

2. This is important to the Midwest, which trades heavily with Canada, Mexico, and Europe.

P. The outlook for Latin America, of course, has been the subject of much discussion in recent weeks. Brazil will play a large role in determining the region's economic success. And, as you know, Brazil has experienced some problems.

1. It's still too early to know how this situation will turn out, but it's very important that Brazil make progress in addressing its fiscal deficit problems.

2. Brazil accounts for only about 2 percent of U.S. trade. But it's an important trading partner with other Latin American countries.

3. The health and stability of the Brazilian economy is critical to the economic well being of the whole of Latin America.

4. And Latin America is very important to U.S. trade, accounting for more than 9 percent [9.3 %] of our exports and 5½ percent of our imports.

5. Clearly it's a situation that bears close watching.

Q. In Asia, it appears that the worst may be over, but there will be continued economic weakness in the region. Japan is the key factor.

1. 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.

2. In fact, most forecasters expect the Japanese economy to contract again in '99.

R. 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.

S. Perhaps the most notable accomplishment last year for the U.S. economy was that we achieved very low inflation in an environment of strong growth and low unemployment rates.

1. The good inflation results were due in part to temporary factors such as lower oil prices and the strength of the U.S. dollar.

2. So far inflation continues to be benign. But we can't expect temporary factors to dampen inflation indefinitely.

T. 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.

1. It's possible that such pressures may build during 1999, especially if corporate profit margins continue to be squeezed and companies respond by increasing prices.

V. Conclusion

A. 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 experienced a dichotomy between the strong domestic economy and the weak international economy.

B. The bottom line — ’98 was a tremendous year for the economy.

1. 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.

2. Back in the fall, the Federal Reserve was primarily concerned that growth could be unduly slowed by unsettled international and financial conditions.

3. Today, I see the risks of slower growth versus inflationary pressures as more in balance than was the case just five months ago.

C. Overall, we at the Chicago Fed expect that U.S. real GDP growth will be in the range of 2½ percent to 2¾ percent on a fourth-quarter to fourth-quarter basis.

1. We anticipate that inflation as measured by the Consumer Price Index will be 2? to 2? percent and that the unemployment rate at the end of the year will be about 4½ percent.

2. In other words, we should experience solid economic growth, with continued low inflation and a low unemployment rate.

D. Unfortunately we run the risk of what you might call the Sammy Sosa syndrome.

1. For years Sosa hit 30 to 40 home runs, a very good performance for a star player. Last year, he hit 66—an extraordinary performance.

2. If he hits 40 this year, some will say he had a bad year. It’s a case of unrealistically high expectations.

E. 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.

F. In conclusion, I’d say I’m cautiously optimistic about the national economy. That’s not a surprising stance from a central banker and an economist.

1. 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.”

2. Our economy is facing an unusual number of unknown factors…potential risks on both the upside and the downside.

3. But I'm guardedly optimistic that we'll successfully navigate the various crosscurrents in the economy, and have another winning economic performance.

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How quickly can Asian countries such as Japan bounce back? Ironically, it was overseas developments that were the key factor in my second topic today—the revival of the Midwest economy. Today, we're wondering how much the domestic economy will be affected by problems overseas. In the case of the Midwest back in the early 1980s, the question was how quickly could the region bounce back in the face of stiff competition from overseas.