GERMAN AMERICAN CHAMBER OF COMMERCE

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I. Introduction

A. Thank you very much for inviting me here today to speak about the U.S. economic outlook. I will focus on the overall economy, but will stress the auto industry as it's such an important economic sector, especially here in the Midwest.

1. Also, with the DaimlerChrysler merger last year, the auto sector is now arguably the most important industry of shared interest for Germany and the United States. I hear the employees at the two companies are learning a lot from each other already.

2. Recently, in fact, some of the German employees arranged an outing to the Rhineland, and gave the Americans a few lessons in wine tasting.

3. The Americans returned the favor by arranging an outing to Florida earlier this year, and taught the Germans how to play soccer (Of course I'm referring to the U.S. national team's recent surprise victory over the German national squad).

4. Next thing you know, the Daimler employees will be hitting homers off the Chrysler pitchers at the next company softball match.

B. I have to say though that your very warm welcome worried me a bit. I hope you realize that unlike German cars that are famous for their reliability, the Chicago Fed's forecasts don't come with a warranty.

C. Forecasting of any kind has always had dubious reputation. Indeed, there is story that has been passed on from economics professor to student over the years, about an economist's experiences while working at the Pentagon.

1. This economist was assigned to a team of statisticians who were trying to predict the number of rainy days during the next month.

2. The statisticians realized after a few months that their forecasts had little to do with how much rain actually fell each month, so they decided that they should request permission from the General to stop.

3. The General sent them the following reply: "The commanding general is well aware that the forecasts are no good. However, he has to have them for planning purposes."

4. Hopefully, my economic outlook will be more useful to you than that forecast was to the General.

D. One thing that is clear about the economy is that Americans are buying. And what happens to consumer spending is a key factor influencing the economic outlook and one which I will focus on today. There are a few other factors that are also worth particular attention:

1. the remarkable length of the current economic expansion,

2. our good fortune in keeping both inflation and unemployment low so late in an expansion, and a related issue

3. how technology may be affecting productivity growth.

4. Finally, we can't overlook the sharp dichotomy between the strength of domestic spending and weakness abroad, and what that implies for the economic outlook.

E. For most of you here today, the economic environment in the United States hasn't looked so good in years.

1. Many of you are leaders in law, accounting, banking and other service industries. Some of you may be aware then that the service producing industries in the U.S. are responsible for creating nearly 2½ million new jobs over the past year alone.

2. The auto sector also reflects the thriving economy, but from a different perspective. High consumer demand has been great news for the auto industry. Sales of sports utility vehicle and sales of other luxury vehicles have been particularly strong.

3. Light truck sales in the first four months of 1999 were up over 10 percent from a year ago, compared with a more modest increase of around 4½ percent for passenger cars.

F. Strong vehicle sales can be good news for the U.S. economy on two fronts.

1. First, increases in sales can mean more jobs, both on production lines and at dealerships.

2. Second, booming vehicle sales, particularly of high-end models, suggest that many Americans are feeling so confident in their economic well-being that they are buying the cars of their dreams — and the homes of their dreams — and, judging from the latest quarter's consumer spending figures, the vacations, clothing and kitchen sinks of their dreams as well.

G. Today's strong vehicle sales are a sharp contrast to the outlook for the U.S. auto industry during the 1980s.

1. Two weeks ago I attended a meeting of the Board of Directors of the Detroit Branch of the Chicago Fed; afterwards I visited with a CEO of one of the auto companies.

2. The message was driven home to me over and over again how much more efficient and competitive U.S. domestic automobile firms are today than just ten years ago.

3. U.S. automakers got a wake-up call from Japanese manufacturers during the 1980s. And did they ever pay heed. Now domestic automakers are well positioned to compete on a world-wide basis.

4. This is a far cry from the 1980s when many so-called experts had given up on the U.S. auto industry and practically declared it doomed to being second-class forever.

II. Y2K

A. Before we move on to discussing the economy as a whole, I'd first like to take a few minutes to discuss Y2K.

1. First of all, I'd like to reassure you that there is no truth to the rumor that the Fed is stockpiling slide rules, sundials, and adding machines.

2. In fact, we are confident that the century date change will come and go with minimum disruptions. As a nation, we have worked together to meet important challenges in the past.

3. At the Federal Reserve, we believe that the public will keep the Year 2000 rollover in perspective, realizing it is one more challenge we will meet.

B. Y2K is one of the Fed's top priorities this year. As the nation's central bank, our mission is to foster a safe and sound financial system and a healthy, growing economy. We have three main responsibilities.

1. First, we are a service provider: we provide financial services such as check processing and electronic payments to depository institutions and the U.S. government.

2. Second, we are a bank regulator: we supervise and regulate state member banks and bank holding companies.

3. Finally, but certainly not of least importance, we formulate national monetary policy. We are committed to doing all we can to safeguard the operations of the U.S. financial system; and that's the reason Y2K is so important to the Federal Reserve System.

C. We've already made significant progress in preparing for the rollover; virtually all our systems are ready for Y2K and are already in production.

   1. As a financial service provider, we're confident there will be no disruptions in our ability to meet the needs of our customers, be they banks or the U.S. government.

   2. And as a regulator, we're working closely with other regulators to review the preparedness of the financial institutions we supervise.

   3. Ultimately, it's up to the banks themselves to ensure that they are ready, but the results of our Y2K exams so far indicate that the vast majority of institutions are making satisfactory progress.

D. Although no one can say for certain, we believe that as far as Y2K is concerned, the U.S. has literally little to fear but fear itself.

   1. There has been some concern that popular misconceptions about Y2K could lead some people to take unusually large sums of money out of their bank accounts. For this reason the Federal Reserve is making available to depositary institutions more than enough cash to cover any unusually large demands by the public.

   2. However, I would like to remind everyone that there is no safer place for your money than where it is, Y2K or not.

   3. Although you may want to have enough cash on hand for the long holiday weekend, remember that credit and debit cards, as well as checks, are expected to work over the New Year's holiday as they would any other time of the year.

III. Economy

A. Now getting back to the economy. We are expecting something very memorable to occur early next year, but it has nothing to do with Y2K.

B. Next February, the current economic expansion will become the longest ever in U.S. recorded history. It's already the longest peacetime expansion ever. And yet, our economy is showing few of the strains often observed late in an expansion. In fact, our economic performance in 1998 and so far in 1999 has been truly remarkable.

   1. Real GDP growth averaged 4.3 percent over the four quarters of 1998, and came in at an annual rate of 4.5 percent in this year's first quarter.

   2. The unemployment rate averaged 4.5 percent last year — the lowest since 1969 — and has averaged an even lower 4.3 percent in the first four months of 1999.

   3. Despite rapid economic growth and a very low unemployment rate, inflation as measured by the Consumer Price Index (CPI) was only 1.5 percent last year — the first time in more than 30 years that CPI inflation was below 2 percent for two consecutive years — and on a quarterly average basis CPI inflation remained at an annual rate of 1.5 percent in the first quarter of 1999.

C. Consumer spending has fueled much of our recent economic growth. Real consumer spending increased at a strong pace over the four quarters of 1998, and rose in this year's first quarter at the most rapid quarterly pace since 1988.

  1. As I've already mentioned, vehicle sales have been very robust. Moreover, many consumers opted for models like sports utility vehicles, imported high-end cars, second or even third cars, and cars to drive just for fun.

  2. And consumers extended their spending spree to other big-ticket items. Given the surprisingly strong housing market, many consumers have been furnishing their newly purchased homes with appliances, furniture, carpeting, drapes and so on.

D. Why has consumer spending growth been so rapid?

  1. One reason is that consumer confidence is high, in part due to the record number of Americans who have jobs. The strong employment picture has resulted in healthy income gains.

  2. Moreover, with inflation low, those income gains have given consumers the ability to purchase more goods and services. Nationally, per capita personal income increased 4.4 percent last year, with gains in all 50 states exceeding the rate of inflation. That's the first time that's happened since 1973.

  3. In addition, Americans have taken advantage of low interest rates to refinance their home mortgages and that's freed up funds for other purposes.

  4. Another factor is the rise in personal wealth many have experienced, as a result of both increasing stock market and property values.

  5. In 1995, 41 percent of U.S. families held stock (directly or indirectly), compared with 32 percent in 1989. Results from the Fed's 1998 Survey of Consumer Finances are in the process of being tabulated, but probably will show a further increase in the percentage of families owning stock. And the stock market continues to set new records.

E. A recurring concern is whether consumers are spending recklessly. Is the expansion built on a shaky foundation of consumer debt? I don't think that's the case.

  1. It's true that increased consumption has been accompanied by rising consumer credit. However, while consumer credit as a percentage of disposable income is at a high level, this ratio has changed little over the past few years.

  2. Certainly it's important to monitor debt ratios, but at present they do not appear to pose a major problem.

F. What do we see for consumer spending in 1999 as a whole?

  1. We anticipate that growth in consumer spending will continue at a solid pace, but not as fast as last year or this year's first quarter.

2. It appears that employment growth will not be as strong as the 2.8 million new jobs created in 1998, in part because we have a shortage of workers. At the rate we are going so far this year, we are averaging slightly under 2.4 million new jobs being created at an annual rate — a healthy total but less than last year's.

3. This means income gains will moderate and that spending growth will slow as well. We expect light vehicle sales to remain strong, but not as robust as in the first four months of the year.

4. Similarly, housing activity should moderate somewhat from the recent exceptionally high levels, and that means demand for housing-related items should moderate as well.

5. In short, consumer spending growth will be very respectable, but not as rapid as last year.

G. As I said, my economic forecast doesn't come with a warranty. There are many factors that could hurt or help the economy in unexpected ways.

1. For example, the foreign sector's effect on the domestic economy is always difficult to pin down. Growth in our imports is related to the strength of our domestic economy, but growth in our exports depends largely on the health of foreign economies.

2. Developments in Asia continue to be an important issue. There have been a few promising signs in South Korea and Thailand, but a turnaround in Japan is still some way off. In fact, most economists believe Japan's economy will contract again in 1999.

H. The situation in Latin America, including Mexico, is important for the U.S. because the area is one of our major trading regions, accounting for more than 20 percent of our goods exports and 16 percent of our goods imports. Unfortunately, growth in Latin America is expected to turn negative this year due to the problems in Brazil and several other countries in the region.

I. Europe, with its heavy dependence on exports, was adversely impacted by the economic downturns in Asia, Russia and Latin America in late-1997 and 1998.

1. Germany, for example, experienced slower growth in exports to nations both within and outside Europe. Real GDP growth in Germany is expected to slow-down to about 1½ percent this year, compared to 2½ percent last year.

2. As I'm sure you are all aware, Germany's high unemployment rate of 10.6 percent as of April continues to be a particularly difficult challenge. And job growth in Germany is not improving.

J. It has been a month now since the European Central Bank lowered interests rates. It's always difficult to estimate when and to what degree monetary policy moves will impact the real economy.

1. This is especially true at present for Europe, with the euro only five months old. , and interest rates already low.

2. However, the outlook for next year is stronger than for this year — in fact, expectations are for as much as a percentage point increase in the real GDP growth.

3. On the other hand, should conditions worsen in other parts of the world, unemployment and economic growth in Europe, Germany included, would reflect those changes.

4. Overall, given the slower growth in Europe and Latin American, we expect that the foreign sector will continue to be a drag on the U.S. economy, although perhaps not as much as last year.

K. A real bright spot for the U.S. economy is that inflation has remained low despite strong economic growth and tight labor markets.

1. But it's still important to remain vigilant regarding inflationary pressures. Some temporary factors — like cheap oil prices — are dissipating.

2. At present, despite tight labor markets, businesses have been able to hold the line on prices by increasing productivity. However, that may not be the case down the road.

J. For now, however, we are experiencing a remarkable economy. Perhaps the most remarkable aspect is the combination of low inflation and low unemployment rates.

1. It's been a generally accepted rule of economics that inflation increases when the unemployment rate falls below a certain low level. We haven't seen that in this expansion.

2. A key factor in explaining this confluence of low unemployment and low inflation is productivity.

3. On average, from 1973 to 1995, productivity increased around 1 percent per year. Over the past three years, in contrast, productivity has increased at an annual rate of around 2 percent. This is especially surprising since productivity growth tends to taper off late in an expansion.

4. The $64,000 question is how long will this productivity surge continue. How long can advances in technology, and computer technology in particular, continue to support a higher productivity growth rate? Are we going to see productivity growth remaining at a new, higher permanent level of around 2 percent, or will we soon return to the old productivity growth trend of around 1 percent.

5. One fact that tends to get lost in all this debate about a new paradigm for the economy is that even if we do move up to a new, higher level of productivity, and maintain that new level of productivity, that in itself is simply not enough to throw out all the old rules. A fundamental change requires that the higher productivity growth occur year after year after year.

K. And we must also keep in mind that some of our recent low inflation experience can be explained by temporary factors, such as low oil prices and the stronger dollar.

1. But the longer we see the confluence of low inflation and low unemployment, the harder it is to explain it away as a short-lived phenomenon.

2. The bottom line is that its still too early to know if there has been a profound and more permanent change in our nation's underlying productivity growth trend.

IV. Conclusion

A. To sum up, strong economic fundamentals propelled domestic spending growth over the past year and more than offset the significant shock from the Asian crisis. And we continued to experience this dichotomy between strong domestic spending and weak international economies in the first quarter of 1999.

B. What do I see for the rest of 1999? One way economists try to avoid being specific in forecasts is to give either a number or a date, but never both. Well, I personally would rather risk striking out than pass up the chance to hit an economic home run. So here is my forecast for 1999, which dares to venture both a number and a date.

   1. I expect growth will moderate over the course of the year, with real GDP growth in the range of 2½ to 3 percent on a fourth-quarter to fourth-quarter basis, although probably closer to the top of that range.

   2. I anticipate that inflation as measured by the Consumer Price Index will be 2 to 2½ percent and that the unemployment rate at the end of the year will be about 4½ percent or a bit lower.

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

C. Overall, the risks of slower growth versus inflationary pressures are reasonably balanced at present.

   1. On the domestic side, consumer and business capital spending will remain a source of strength but, averaged over the year, will not increase as robustly as in 1998.

   2. The foreign sector will continue to act as a drag on the economy, although perhaps not as much as during 1998.

D. If you asked me to describe the current economic expansion as if it were a car, I would have to say that it's a nice conservative family sedan — definitely domestic.

   1. It served us well for years, with plenty of room for everyone. Then, just when we thought it had seen its best days, a neighborhood teenage car enthusiast got a hold of it.

   2. Now it's still a nice conservative family sedan, but with great acceleration. I'm delighted that the old car is running so well, but I'd love to know what that teenager did to the engine and how long I can expect the car to keep running at this pace.