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Economic Outlook for 2000

It's a pleasure to be here with you today to start the new millennium with some old news. And that news is similar to past years: The economy performed quite well in 1999, and we can anticipate more of the same for 2000.

Looking back, the 1990s turned out to be a remarkably good decade. After a slow start, we ended the decade with an appropriate flourish. Real GDP growth is expected to come in at just under 4 percent for 1999. That would be the fourth straight year we've had growth of around 4 percent. The unemployment rate averaged 4.2 percent – the lowest since 1969. The outcome for inflation, as measured by the Consumer Price Index, was not quite as positive, as we estimate that the CPI rose 2.6 percent, an increase from 1.5 percent in 1998.

With apologies to Dickens, these are both the best of times and worst of times for economists. It is the best of times because economists are able to deliver a steady diet of mostly good news. But it's the worst of times when it comes to forecasting the economy. There have been so many surprising changes, that forecasting GDP is about as easy as figuring out what to name this decade we've just entered.

Fortunately, the 1990s were largely a decade of pleasant surprises. Last year at this breakfast, for example, I said the economy in '99 might fall prey to what I called the "Sammy Sosa syndrome"– unrealistic expectations for another spectacular year. Well, the economy exceeded expectations in '99 and so did Sammy. If only we could say the same for the Cubs.

The good news on the economy can be summed up with one observation: Next month this expansion will be 107 months old and become the longest in U.S. history. Of course, one of the great advantages of such strong, sustained growth is low unemployment. This extended period of growth has given many Americans new opportunities – opportunities to work; to receive training; to invest in their own businesses, homes and families;

and to break the cycle of poverty. A long, sustained expansion greatly benefits America's poorer workers because the last-hired workers are often the first fired — before they have a chance to accumulate valuable work experience.

That's one reason why the Federal Reserve works to foster sustained growth that doesn't burn itself out. Boom/bust cycles fueled by high inflation are ultimately a losing proposition. The key is ensuring a low inflation environment – an environment that encourages investment and savings, and, ultimately, stronger growth.

So the Fed's goal is maximum sustainable growth. But at what point is growth no longer sustainable? Just a couple of years ago, most economists would have said that sustainable growth was 2 to 2½ percent. Today, however, the sustainable rate seems to be higher than previously estimated. Current estimates of sustainable growth are in the vicinity of 3½ percent. That's not to say that this figure is fixed for all time. As the economy changes, so will estimates of sustainable growth. I should also note that roughly half a percentage point of this upward revision reflects changes made by the Commerce Department in the way it computes GDP.

Roughly speaking, the 3½ percent figure is determined by adding 1 percent growth in the labor force and 2½ percent growth in productivity. The change has not occurred in growth in the working-age population — that's been constant at about 1 percent. It's productivity growth that has increased dramatically in recent years. In fact, the average annual productivity growth of the past four years is one percentage point higher than what it was during the previous quarter century.

A significant portion of this dramatic increase is due to the kind of innovative products and services provided by the technology industry. So it's particularly appropriate to have Whittman-Hart represented on today's panel. And the increase in efficiency hasn't been limited to hi-tech computer applications. The labor market as an institution seems to be functioning more efficiently than it used to. In the past, an unemployment rate as low as we have now was possible only through an inappropriate increase in aggregate demand that exceeded the economy's ability to meet that demand. The result? Bottlenecks emerged, inflation increased, growth stalled and the unemployment rate went up. We're not sure how low the unemployment rate can be today without inflation rising and curtailing growth. But the old belief that a 6 percent or so unemployment rate was as low as we could go without problems arising is surely out of date. John Challenger and others in the staffing industries have had a lot to do with the increased flexibility that has made labor markets more efficient.

So what does the Chicago Fed anticipate for the national economy in 2000? As you all know, the economy is extraordinarily complex – it's hard to track and even more difficult to forecast. I could pull out a lot of charts and graphs produced by econometric computer models. But somehow a lot of visual aids don't seem appropriate at an event co-sponsored by a radio station. More importantly, I have only 15 minutes. So I'm going to take a simpler, low-tech approach using this very ordinary, standard-issue BIC pen.

If you're trying to get a handle on how things will develop in the economy this year, I'd focus on three factors and think of the acronym BIC, or B-I-C: B for business investment; I for the international sector; and C for consumer spending.

Let's start with business investment, which includes spending on structures, equipment and software. We estimate that business investment increased nearly 10 percent last year – a very strong rate of growth. We expect that there will be some moderation in 2000, but business investment will continue at a healthy pace this year. Higher long-term interest rates should slow investment growth. But we should continue to see a

high rate of growth in technology investment. There's still a high payoff for investing in this area, especially with high-tech equipment prices continuing to fall. And there is considerable pent-up demand for computer applications that were delayed last year due to Y2K preparations.

Now for the C. Spending by consumers is always a key factor, as it accounts for roughly two-thirds of real GDP. To put it simply, all of us in the U.S. have been on a spending spree. Growth in consumer spending was very strong last year – about 5 percent. Many consumers apparently agreed with Evel Knievel who summed up his philosophy on spending by noting, "If God meant you to hang onto money, he'd have put handles on it."

We don't expect to see handles sprouting on money, but we anticipate that consumer-spending growth will be slower than last year, although it will continue at a solid pace. The rise in long-term interest rates should contribute to the slowing, especially in sectors that are sensitive to interest rates, such as housing and autos. These sectors did extremely well last year. In fact it was a record year for existing home and light vehicle sales. Light vehicle sales, which are so important to the Midwest economy, not only set a record at 16.8 million units, but registered a significant increase over the previous record set in 1986. However, it will be hard to repeat the record-breaking performances in housing and autos, much less improve on them. It looks as though housing activity peaked in mid-1999, and we expect the moderating trend since then will continue this year. We also expect that light vehicle sales will slow. A similar story should develop for other consumer durables, such as washing machines and TVs.

At the same time, consumer confidence was at a near-record level in December, and real incomes have been growing at a very healthy pace. Americans have money to spend and feel confident enough to spend it. The increase in consumers' wealth in recent years is likely a big factor, too, as stock prices and home values have increased sharply. And the large volume of home financings last year benefited consumers in the first half of 1999, just like a tax cut. All of this has made consumers more inclined to save less and spend more. Overall, we expect consumer-spending growth to stay strong, although not as rapid as last year.

That brings me to I — the international sector. Last year, the international sector served as a safety valve of sorts for the domestic economy. Real Gross Domestic Product growth last year was a strong 4 percent or so, but domestic spending growth was even stronger at about 5 percent. In other words, we consumed more in the U.S. than we produced. That difference was reflected in the rising trade deficit last year, as we financed the extra domestic consumption through foreign investment.

An increase in the trade deficit was not surprising. There was weakness abroad and good investment opportunities in the U.S. But that situation is changing. Growth and investment opportunities are improving overseas. The ongoing recovery in Asia and South America, the stronger growth in Western Europe, and the continued healthy demand in Canada and Mexico — all will have an impact on the U.S. economy. Overall we expect the U.S. will see an increase in export growth and a slowing in import growth. This will translate into a trade deficit that increases little, if at all, after the large increases of the last two years.

Putting all this together, we anticipate that consumer spending and business investment growth will continue at a healthy pace, but not as fast as in '99. Last year, domestic demand growth was higher than real GDP growth, and the difference was made up by a surge of imports into the U.S. This year we don't expect that the international sector will be acting as a safety valve. To achieve sustainable real GDP growth, domestic demand will need to slow enough to offset the increased demand for goods and services from overseas. We expect that will occur and that real GDP growth will come in close to a sustainable rate of about 3½ percent on a fourth-

quarter to fourth-quarter basis. Given this expected healthy growth, the unemployment rate at the end of 2000 should be roughly the same as it is today.

The concern for monetary policymakers is that growth in aggregate demand in 1999, and the late '90s in general, was higher than could be sustained in the long run. The Federal Reserve has been careful not to set arbitrary limits on growth. The son of one of my associates at the Chicago Fed attends a grade school that has a motto that captures that idea well: "No bird flies too high who flies on his own wings." Now that's a very ambitious motto for a grade school. When I went to grade school, back in the Dark Ages, the directive was to always stay between the lines, on the lines or in a line, and individual soaring of any kind was discouraged. But it's clear today that an inspiring motto is appropriate for both grade schools and the economy. Our economy has hit new heights that were hard to imagine just a few short years ago.

However, we don't want to artificially boost growth in demand with an overly accommodative monetary policy. Recent growth has likely been too rapid to sustain for the long run. Sustainable growth is ultimately determined by our growth in productivity and the number of available workers. Even with the excellent productivity growth of the last few years, the pool of available workers has continued to shrink. That can't go on forever. The opportunity for more people to enter the job market and increase their standard of living is a very positive development with lasting benefits. However, assuming no change to our current immigration laws, our pool of available workers is limited by demographics. In the long run, we can't continue to grow faster than the limits imposed by productivity and available workers. Trying to do so risks creating the kind of inflationary imbalances that would threaten the health of the expansion.

As I mentioned earlier, we did see an increase in overall CPI inflation last year, largely due to a sharp jump in oil prices. Energy prices shouldn't double again. In fact, they may even go down a bit. On the other hand, a number of special factors that helped keep inflation low the last several years are starting to turn the other way. Health care benefit costs were moderating; now they're rising more sharply. Import prices were declining; that's no longer true. We also expect to see the after-effects of last year's jump in energy costs as that increase works its way through the rest of the economy and impacts other prices.

In conclusion, we expect inflation in 2000 as measured by the overall CPI to be even lower than last year. However, we do anticipate a modest increase in core CPI inflation, which excludes the volatile food and energy sectors, as higher oil prices feed their way through the rest of the economy and several favorable factors reverse themselves. Our economy should continue to prosper in 2000 with solid but sustainable growth, low unemployment and subdued inflation. But with healthy domestic demand as well as rising foreign demand, the Federal Reserve will need to remain vigilant regarding inflationary pressures to ensure that our economy sustains its strong performance for years to come.