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Economic Outlook for 2001

I'm delighted to be here, for a couple of reasons. First, because this is a little like old home week. I spoke here five years ago, just a year and a half after I came to the Chicago Fed. Second, it gives me a chance to renew acquaintances with Cal Bellamy, who is a former member of the Chicago Fed's Community Bank Council, and who extended the invitation for me to speak here today. I want to congratulate Cal and all of you for helping this outstanding school fulfill its mission and reach its goals.

I'm also delighted to be here because occasions like this are an important part of my job. As most of you know, the Federal Reserve sets monetary policy. We also supervise and regulate banks. And, we provide financial services to banks and the U.S. government. All of these activities help us accomplish our overall mission: to help ensure a healthy, growing economy. One way we do that is through the Federal Open Market Committee, or FOMC. This is the Fed's key policymaking group. I know some folks think we simply shut the doors and get out the Ouija boards before deciding what to do about interest rates. But the meetings are actually much more substantive. There is a lot of preparation, and a lot of deliberation. An important part of that discussion focuses on what presidents from the regional Federal Reserve Banks report about economic conditions around the country. And that's where you come in.

As you may know, the FOMC meets later this month, on March 20. My main responsibility as an FOMC member is to help determine the monetary policy that is most appropriate for the nation. That includes helping Alan Greenspan and other members of the FOMC understand what's happening with business and the economy here in the Midwest. And your job is to help me understand. So at the end of my remarks, I'll be happy to answer any questions you might have. But I also want to ask some questions of my own. How does the economy look to you? What challenges are you facing? What opportunities are you pursuing? I'm looking forward to hearing your thoughts and your suggestions.

First, though, I've been asked to talk about the current state of the economy, and the Chicago Fed's outlook for this year. Mark Twain said: "Predicting is pretty risky business, especially about the future." But that's part of what we get paid for at the Fed. Even though any forecast has a large degree of uncertainty, forecasting is an integral part of formulating monetary policy. So I'll discuss how we got where we are today; what factors will drive the economy in the coming year; and the outlook for growth, inflation and unemployment for 2001.

Let's start by reviewing a little history. The ten-year economic expansion we've experienced is the longest ever in U.S. history. It's also been marked by both low unemployment and low inflation. And while most expansions, like most athletes, are strongest when they're young, this one saved some of its most spectacular moments for later. Since mid-1997, when this expansion was already six years old, the economy has grown at an average annual rate of 4.4 percent. Back then, in the fall of 1997, some thought the Asian financial crisis would bring the party to an end. But the U.S. economy continued to flourish and monetary policy continued to focus on increased inflationary risks. Then came the Russian default in the summer of 1998. Financial markets seized up. The real economy was still fundamentally sound, but there was a shortage of short-term capital. Credit-worthy businesses just couldn't get the financing of loans they needed to be able to conduct daily business. The FOMC reduced the Fed Funds rate in order to lower interest rates and provide liquidity.

The tight credit situation quickly eased over the following months. And by early 1999, growth was accelerating once again. But so were inflationary pressures. Reversing its 1998 rate cuts, the FOMC responded by increasing interest rates starting in June 1999. Growth continued to accelerate through late 1999.

Like everyone else, the economy held its breath a bit at the end of that year, in anticipation of Y2K problems. But the first of the year came and went uneventfully. Who knew that would be about the last calm moment we had in 2000?

Like the month of March — which comes in like a lion and goes out like a lamb — the economy began 2000 with great gusts of growth. But it ended the year pretty meekly.

What happened? Simply put, the economy was growing at an unsustainable rate, going back to 1999. Inflationary pressures continued to build. That's why the Fed took back its earlier rate cuts, and gradually tightened policy through May of 2000. The goal was to return the economy to a more sustainable pace of growth as 2000 progressed. But as we moved through the second half of the year, the economy didn't just slow, it slowed dramatically.

Why? Tighter monetary policy certainly contributed to some of the slowing. But other factors intervened later in the year that magnified the slowdown significantly. Energy costs, for example. Oil prices rose from around 13 dollars per barrel in the fourth quarter of 1998, to around 25 [dollars] per barrel a year later. At the end of 2000, it had risen to 32 dollars per barrel. Gas prices rose even more considerably in 2000. And bad weather merely made things worse, as families were forced to turn up the heat. The severe weather conditions this winter also discouraged some holiday shoppers. Sales were below expectations, and that contributed to a buildup in inventories.

Speaking of shopping, the slowdown also reflected the reduced stimulus from the so-called "wealth effect." For much of the late-1990s consumers were feeling affluent and confident, thanks in part to the rising values of their stock portfolios and other properties. But when stock prices started declining, it

curbed the wealth effect. Part of the recent slowing in big-ticket durable goods purchases is likely due to this change. Plus, it seems likely that some consumers were just shopped out. A portion of consumer demand had already been satisfied during earlier periods of very rapid consumption growth. This was probably most true for big-ticket items — things like washing machines and autos. After all, there's a limit to how many new cars will fit in the driveway. So the dominoes were beginning to line up. Once sales slowed after mid-year 2000, manufacturing inventories started to mount. That's why — despite a record year for light vehicle sales — we saw the sector soften so noticeably starting in the fall. Automakers had to reduce production to cut inventories that had been built up in anticipation of high sales.

Industrial production actually declined, in the fourth quarter. This had a particularly big impact on the Midwest, since we have more than our share of manufacturing industries. Employment in the manufacturing sector also dropped sharply in the fourth quarter. That's one reason employment growth slowed overall nationwide.

Still, there were some bright spots as 2000 came to a close. Falling mortgage rates bolstered the housing sector. Productivity growth continued to be strong. The unemployment rate held near 4 percent, although it has since increased slightly. And inflationary pressures, outside the energy sector, remained relatively subdued.

And that's where things stood when we began 2001. The FOMC noted in its January 31 statement that weakness in the economy, combined with contained inflationary pressures, "called for a rapid and forceful response of monetary policy." So, as everyone knows, the Fed lowered interest rates twice in January, each time by half of a percentage point. These actions reduced the fed funds rate target from 6½ percent to 5½ percent.

Which brings us to today, March 8. Clearly, demand has weakened faster than most businesses and forecasters anticipated. Inventories climbed above desired levels in many sectors. Ironically, the cutbacks in production may have been accelerated by new technologies that make sales information available more quickly than in the past. But that's actually good news. Imagine if managers had been three months slower in realizing that their production rates were running above sales potential. Inventory bloating would be worse than it is and we would have seen or be facing even deeper production cuts. This same technology should also help increase the speed of the economy's rebound as inventories return to more desirable levels.

So where do we go from here? What factors are likely to drive the economy in 2001? And what will growth, unemployment and inflation look like?

Well, the outlook for this year is even more uncertain than usual. George Bernard Shaw said: "If you lined up all the economists in the world end to end, they still wouldn't reach a conclusion." But at the Chicago Fed, our economists have reached a consensus, if not a conclusion, and we anticipate that we will see improvement over the course of the year. We think this year will be a reversal of last year in many ways, with a slow first half likely followed by a strong second half. Two key factors will be productivity growth and aggregate demand.

Let's talk first about productivity growth. Roughly speaking, productivity growth occurs when workers produce more in the same amount of time. As you probably know, productivity growth has been unusually strong in recent years. Fortunately the people who track such things haven't gotten around to meas-

uring my attempts to program my new Palm Pilot. Despite my personal struggles with PDAs, the January FOMC statement noted that longer-term gains in productivity "exhibit few signs of abating and these gains, along with lower interest rates, should support growth of the economy over time." What is encouraging is that much of the faster productivity growth, which fueled much of our success during the last half of the 1990s, doesn't seem to be cyclical. Instead, it appears to be driven by fundamental changes in the way we do business, and our ability to innovate in areas like technology.

So there's every reason to believe that productivity growth will continue at relatively high levels, even with slower economic growth. That, in turn, should help spur growth this year. And there's no question that productivity will continue to play an important role in determining the health of the economy in the future.

What about aggregate demand, which includes consumer spending, business investment, and exports? Well, when aggregate demand falls, the economy stumbles. As I said earlier, this year's diminished growth is largely connected with slower consumer spending growth, although business investment has also slowed. But we believe that both consumer spending and business investment should pick up again in the second half, for several reasons. First, with energy prices expected to retreat, consumers should have more cash to spend on discretionary goods and services. Similarly, lower long-term interest rates should spark mortgage refinancing, which also frees up cash for home improvements and similar types of spending. Consumers should also benefit from continued real wage growth, linked to productivity gains. As productivity growth increases, so do real wages. That's because the more productive we are, the more our employers can afford to pay us. In addition, business spending should continue to hold firm, despite its recent easing in the fourth quarter. Why? Because lower interest rates will encourage companies to continue their investment plans. Also, business investment in technology has been very strong in the current expansion and lower financing costs should stimulate those spending plans as well. These investments, in turn, will support the impact of productivity on real wages. And that, in turn, should increase rates of consumption.

I said earlier that inventories are an important part of the forecast puzzle right now. Industries like automakers are currently reacting to overproduction in past quarters with substantial cutbacks this quarter. Once inventories are back in line with sales, production levels should increase.

Abroad, the global economy is not currently experiencing the inventory adjustments that we feel here in the U.S. As long as those economies continue to expand, their demand for our exports lift U.S. aggregate demand. Of course, there are some significant risks.

So what could go wrong? Well, the most likely potential barrier to growth is energy prices. Energy supplies relative to demand are expected to improve. But supply pressures have not retreated fully and could hold the economy back. Further shocks could cause trouble. There are risks in terms of aggregate demand as well. For example, there's consumer confidence. The recent drop in consumer confidence is expected to be temporary. But there is a risk that it will linger and reduce spending. And on the supply side, business expectations could also be a risk. If businesses expect slower growth, they're less likely to continue capital investment spending. Such a shift in business expectations would reduce aggregate demand further.

The FOMC summarized the situation at the time of the latest rate cut in January. While the situation looks good for continued growth, the statement read that on balance "the risks are weighted mainly

toward conditions that may generate weakness in the foreseeable future." In other words, if there's trouble ahead it's more likely to be economic weakness than high inflation.

What do we — at the Chicago Fed — think the numbers might look like in 2001? We think real GDP growth will come in between 2 and 2½ percent on a fourth-quarter to fourth-quarter basis. This range is about one or two points below what we believe is the trend growth rate — that is, the rate at which we have maximum sustainable growth. As a result, the unemployment rate will probably rise to 4½ to 5 percent by the end of year. News on the inflation front is somewhat better. Energy prices are expected to decline, so in the Consumer Price Index should be lower than last year's 3½ percent, even with an expected increase in aggregate demand in the second half of 2001. But a better measure of underlying inflationary pressures comes from the core CPI, which does not include food and energy prices. We expect core CPI will increase in 2001 by about the same percentage as in 2000, that is 2½ percent.

So that's a look at our forecast for the rest of this year. There's a story about an economist's epitaph on his tombstone, which read: "I am guardedly optimistic about the next world, but remain cognizant of the downside risks." That's sort of how we feel at the Chicago Fed. We recognize there are downside risks. But we're cautiously optimistic that inflation will remain in check, while economic growth will return to higher levels by the end of the year.

Now we come to my favorite part of the program, where you get to participate. So let me open the floor for discussion.