ROCKFORD ECONOMIC FORUM

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The Outlook for the U.S. Economy

I appreciate the opportunity to be here for a couple of reasons. First, Rockford has a lot to teach policy makers. Your city is a good example of how business and community leaders can work together to make progress in such areas as affordable housing. Second, Rockford is one of the most important manufacturing cities in the Midwest. The national economy is at an important juncture. Manufacturing is the pulse point of the economy right now, both here in the Midwest and nationally. So I want to know how Rockford is doing. I want to see how things look on the factory floor. I want to hear directly from workers and managers. That's why I went to Woodward Governor this morning. But this afternoon, I want to hear from you. And talk with you about the state of the economy.

You know a lot of people don't understand what the Fed actually does. I had one person tell me they thought the Federal Reserve was the national bird sanctuary. Actually, our mission is very simple — to help ensure a healthy, growing economy. We do that in several ways: by supervising and regulating banks; by providing financial services to banks and the U.S. government; and — the Fed activity that gets the most attention — by setting monetary policy.

Our key policymaking group is the Federal Open Market Committee, or FOMC. This is the group that reduced the target federal funds rate by one-and-a-half percentage points since the beginning of the year. The FOMC, which is chaired by Alan Greenspan, consists of members of the Board of Governors and Reserve Bank Presidents. All 12 Presidents take part in all discussions, but only five are voting members at a time. We rotate that responsibility and this year I'm a voting member. 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 my job as a member of the FOMC is to help the Committee understand what's happening here in the Midwest economy. Understanding is important. Or as Danny Ozark, the former manager of the Phillies once said: "Half this game is 90 percent mental." But on the serious side, that's where you come in. 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.

Meetings like this are an important part of our efforts to reach out to businesses and communities across the country. The Fed's regional structure helps us get feedback from people living and working in each of the 12 Federal Reserve districts. The Chicago Fed serves a five-state area consisting of most of Illinois, Indiana, Michigan and Wisconsin, as well as all of Iowa. Our head office is in Chicago. But we also have regional offices in Detroit, Des Moines, Milwaukee, Indianapolis, and Peoria.

The Bank's boards of directors in Chicago and Detroit consist of prominent banking, business, labor, and community leaders. They provide an important source of information on the economy. Our advisory council on small business, labor, and agriculture also keeps us updated on the latest developments in the economy. I'd like to thank Lloyd Falconer, of Seward Screw Products located just outside Rockford, for his service as a past member of this council.

Why is it so important for us to keep our ears to the ground? Monetary policy takes a while to have an impact, as long as a year. The sooner we understand what's happening on the ground, the sooner we can take action if appropriate. We do have a whole staff of economists analyzing numbers on consumer confidence, employment, housing starts, inventory levels, and so forth. Such statistics give us a detailed picture of the economy. But the trouble is published statistics only measure what's already happened. Asking you how your business is doing now gives us a sneak preview of what's going to be reported a month or so from now. Hearing directly from you keeps us ahead of the statistical curve and on top of economic developments. So please take a few minutes to fill out the brief questionnaire we've handed out. The information you provide us is an essential part of the monetary policymaking process.

Outreach is also important in helping the Fed pursue another important goal: financial empowerment. What is financial empowerment? I'd define it as having the opportunity to be a full participant in sound, competitive financial markets. Not everyone has this opportunity. For example, some people and families don't have any idea where to get good financial guidance. Others lack access to credit, or even a bank account. We work with business and community leaders to address these problems. One example is Project Money$mart — a new Chicago Fed program that targets financial literacy. Another is a new joint initiative with the Treasury, which focuses on people who don't have bank accounts — by some estimates, 10 percent of Americans. We also have many programs that help to eliminate barriers affecting the ability of creditworthy customers to obtain loans.

So at the Fed we spend a lot of time staying in touch. But what is all that outreach, all that input telling us about the economy today? I had a feeling you'd ask. So let's start with a brief look back.

The economic expansion that began ten years ago is the longest ever in U.S. history. It's 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 early-1997, when the expansion was already about six years old, the economy has grown at an average annual rate of over 4 percent. Compare that with the rate of just over 3 percent it grew during the first six years of the expansion.

Of course, as you know, the new millennium brought some changes. The year 2000 was like the month of March — which comes in like a lion and goes out like a lamb. The economy began last year with great gusts of growth. But it ended the year pretty meekly.

Why? Back in early 1999 the economy expanded at a very rapid rate that couldn't be sustained without putting pressure on prices and therefore jeopardizing the expansion. The FOMC tightened monetary policy by raising short-term interest rates. By the end of 2000, monetary policy was having some effect. But other factors magnified the slowing dramatically, especially late last year. Energy costs are one example. The unexpected rapid rise in energy costs sapped consumer purchasing power and reduced business profit margins.

The weakening of the so-called "wealth effect" is another. 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 as stock prices started to decline, the wealth effect to some extent began working in reverse. Plus, it seems likely that some consumers were just shopped out. After all, there's a limit to how many new cars will fit in the driveway.

What occurred in the auto sector is indicative of what happens across industries when consumer spending growth eases. Two thousand was a record year for auto and light truck sales, with 17.2 million light vehicles sold in the U.S. But light vehicle sales slowed after mid-year and inventories started to mount. Automakers had to reduce production to cut stockpiles. That's why we saw the sector soften so noticeably starting in the Fall, which had a significant impact on the Midwest where many automobile plants and suppliers are located. Since the first of this year automakers have made good progress adjusting their inventories. The cutbacks were aided by healthy sales in the first quarter. Other manufacturing industries have faced the same challenges. On the whole, they are not as far along in the adjustment process, but are also making progress.

So where do we go from here? What factors are likely to drive the economy in 2001?

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. We anticipate that we will see the economy's growth rate improve over the course of the year. We think this year will be a reversal of last year in many ways, with slow growth in the first half likely followed by stronger growth in the second half. We're going to see some rough spots, but we're optimistic about the long term.

Why are we confident in the underlying health of the economy? The primary reason is productivity.

Roughly speaking, productivity increases when workers produce more in the same amount of time. As you probably know, productivity growth has been unusually strong in recent years. Obviously, the people who track such things haven't gotten around to measure my attempts to program my new Palm Pilot. Nonetheless, the most recent FOMC statement reiterated that we think the prospects for long-term growth in productivity look good.

Why? It appears that much of the faster productivity growth of the late 1990s is more than just a product of cyclical growth. That is, the productivity improvements are not just the result of being on the upside of the business cycle. Instead, they appear to be driven by fundamental changes in the way we do business, and our ability to innovate in areas like technology.

So productivity growth is likely to continue at relatively high levels, even with the slower economic growth we're experiencing now. It's important to note that productivity growth will vary from quarter to quarter. Even so, we can expect productivity growth to be higher than in the early 1990s.

What about this year's outlook for the economy? Well that will be determined largely by aggregate demand, which includes consumer spending, business investment, and exports. When aggregate demand falls, the economy stumbles. Recent slower economic growth is largely connected with less rapid consumer spending growth, and a slowing in business capital spending. But we believe that both consumer spending and business investment should pick up again in the second half of 2001, for several reasons.

On the consumer side, continuing employment gains should support spending. And energy prices are expected to retreat, which means more cash should be available to spend on other goods and services. Similarly, lower long-term interest rates should spark some spending. For example, the increase in mortgage refinancing should free up additional cash for home improvements and similar types of purchases. Consumers also should 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.

On the business side, lower energy prices should reduce costs. Business spending on technology has been very strong in the current expansion although we've seen a lull recently. We'd expect lower financing costs to help revive that capital spending. Technology investment is important to support productivity improvements that can boost real wages. And higher real wages, in turn, help increase rates of consumption.

As I discussed, the manufacturing sector is an important part of the outlook for the overall economy. Once inventories are back in line with sales, production levels should increase. That will be good for the Midwest in general and Rockford in particular. Many of Rockford's key employers are manufacturers. Despite a recent uptick in the unemployment rate, Rockford has been successful over the past decade in reducing unemployment — due to strong growth in manufacturing and diversification into high-tech. I know you are eager to see production levels increase so you can continue the progress you've made in building a vibrant local economy.

So what are the risks in this outlook? Well, one potential barrier to growth is consumer confidence. Surveys show consumer confidence down significantly from last year's record highs, though some of these measures have moved up recently. If Americans don't buy, inventories will continue to be a problem. So far consumer spending hasn't slowed as much as suggested by the declines in consumer confidence.

A second risk is business capital spending. I said before that I was confident in the long-term health of the economy because of our high productivity growth rate. But a significant decline in capital investment could temper productivity growth. Why? Take, for example, high-tech. If businesses are so concerned about short-term sales and earnings that they stop investing in improved technology, productivity growth probably won't grow at its late-1990s' pace.

Energy prices are a third risk. Right now, the fact that they are down from last year's highs will help reduce inflationary pressures and encourage growth. But energy markets have been highly volatile. Shocks can happen at any time, that could affect the outlook for both inflation and economic growth.

Another risk is the possibility of slower growth abroad. U.S. exports fell by 6½ percent in the fourth quarter of 2000 following strong growth of 14 percent in the preceding quarter. As you know, trade has become a larger share of the U.S. economy, so a strong international economy can, to some degree, offset the effects of a slowdown in domestic spending.

All told, the FOMC summarized the situation at the time of the latest rate cut in March. While the outlook is good for long-term growth in productivity, we said that the recent emergence of "excess productive capacity â?? and the potential for weakness in global economic conditions suggest substantial risks that demand and production could remain soft." In other words, while inventory adjustment appears to be well underway, the risks are still weighted toward economic weakness in the foreseeable future.

What does this mean exactly? Well, our statements after FOMC meetings distinguish between two types of risk: increasing inflation and economic weakness. When you survey the U.S. economy right now, the risk of economic weakness is greater than that of inflation. That doesn't necessarily mean we're in recession. It means that our economy is operating below its potential. A recession would certainly qualify as economic weakness, but so would the kind of slow growth we are currently experiencing.

As I mentioned earlier, I think the most likely scenario is for economic growth to be slow, but positive in the first half of this year. And, I expect that growth will pick up in the second half.

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. There's a great deal of uncertainty about the economic outlook right now. 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 the most interesting part of the program, where we open the floor for discussion. Think of this as your chance to participate in the setting of monetary policy. I'm really looking forward to your questions and comments.