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VALPARAISO UNIVERSITY COLLEGE OF BUSINESS ADMINISTRATION

Valparaiso, Indiana
May 4, 2001

The Outlook for the U.S. Economy

I appreciate the opportunity to be here. I'm glad to see so many students in the audience. Before I came to the Chicago Fed I was a Professor at Northwestern University. It's always a pleasure to return to an academic setting and have a chance to talk with students, faculty, and university supporters.

Valparaiso is a great university and a great town. Your city is emblematic of the success the Midwest and the nation have experienced during the last decade. The economic expansion offered towns like Valparaiso many opportunities, and your business and civic leaders have worked diligently together to make the most of them. The shape of your community has changed a lot in recent years — with more commuters moving in, and new businesses opening their doors. And these prosperous years will have left their mark on the University as well — with the new campus plan building on Valparaiso's already strong national reputation for its academics. Now, we are all wondering what's next for our economy, nationally and here in the Midwest.

Indeed, our national economy is at an important juncture. I'm here to talk about the economy and the Fed's role in supporting its long-term growth. More specifically, I'll discuss how we got to where we are today and what factors will drive the economy going forward.

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 can be stated simply — to help ensure a healthy, growing economy. Now I understand there is a very popular fellow around here by the name of Homer Drew. Homer knows a few things about having a mission. His mission is winning basketball games. And he knows that to succeed at a mission, you've got to come at it from different perspectives. Sometimes, you've got to be out there recruiting. Sometimes, you have to be out there coaching. And sometimes, your job is to just stand on the sidelines and cheer. Your basketball team is successful because the coach knows the importance of wearing many hats.

The Federal Reserve is kind of like that too. Our mission is a healthy, growing economy — and we approach it from several perspectives — we wear many hats.

One of our hats is that of bank regulator. We help ensure the safety and soundness of the banking system. In this capacity we supervise about 1000 state-member banks, and 5800 bank holding companies — including many of the nation's largest and most important financial institutions. We also monitor the state of the financial industry as a whole and work with other federal and state financial authorities to help maintain stability in the financial sector.

Another that we wear is that of a provider of financial services to commercial banks and the U.S. government. We process both paper checks and electronic payments for banks. We are the Treasury's primary bank, but we compete with many private sector firms in providing financial services to commercial banks. We use our knowledge of the business to help us assess developments in the payments system. One of our key goals is to encourage the use of electronic payments, rather than paper, even though check processing is one of our major services. Why? Promoting electronic payments is just one route to helping make the economy more efficient and prosperous.

And the third role? That's the Fed activity that gets the most attention — setting monetary policy. As you probably know, monetary policy is set by the Federal Open Market Committee, or FOMC. This is the group that has reduced the target federal funds rate by two percentage points since the beginning of the year — most recently on April 18. The FOMC, which is chaired by Alan Greenspan, consists of the members of the Board of Governors and the Presidents of the Reserve Banks. All 12 Presidents take part in all discussions, but only five are voting members at any given time. We rotate that responsibility and this year I'm a voting member.

I wish I could tell you monetary policy was simple. But it isn't. It's actually a very subtle and substantive process. There is a lot of deliberation at the meetings and a lot of preparation. Decisions to change the federal funds rate are made with care because they do impact the economy, and people's lives. It may surprise you to hear from a Fed official though, that the Fed is not the most important player when it comes to the economy's future. It's you, the current and future leaders of your communities, that create growth. You are the innovators in business and technology that make our nation more productive. The Fed can't create growth directly. The job of monetary policy is to facilitate maximum sustainable growth. We do that by striking a balance between ensuring price stability, on one hand, and ensuring adequate liquidity, on the other. Our job at the FOMC is to create an economic environment in which businesses and consumers can make decisions as quickly, efficiently, and effectively as possible.

In order for us to be successful, we need to understand what's happening to the economy on a national level and here in the Midwest. Understanding is important. Or as Danny Ozark, the former manager of the Phillies once said: "Half this game is 90 percent mental." That's why members of the FOMC spend a lot of time reaching out to the public, trying to understand what's happening on the ground and gaining fresh perspective on the published economic indicators. Asking businesses and consumers how they are doing 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 if you haven't filled out the comment cards on your tables, please do so. The information will be important in formulating monetary policy.

As I said, the economy is at an important juncture. To gain some perspective on our current situation, let's take a look back at some recent economic developments.

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. You'd have to go back to the 1960s to see that sort of growth. And this time robust growth came without a significant uptick in inflation.

Of course, as you know, the new millennium brought some changes to the economy. The economy began the year 2000 with great gusts of growth. But it ended the year pretty meekly.

Why did the economy slow down? Back in early 1999 the economy began expanding at a very rapid rate. That pace couldn't be sustained without putting pressure on prices and jeopardizing the long-term viability of the expansion. The FOMC tightened monetary policy by raising short-term interest rates in late 1999 and early 2000. By the end of 2000, monetary policy was having some effect. The overheated economy was beginning to cool. Other factors magnified the slowing dramatically, especially late last year. Energy costs were one factor. The unexpected and rapid rise in energy costs sapped consumer purchasing power and reduced business profit margins.

Another factor was the weakening of the so-called "wealth effect." For much of the late-90s, 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.

In addition, it's likely that some consumers were just shopped out. In 1999 and early 2000 we saw a very rapid increase in consumption — especially in big ticket durable items like cars. But that can't go on forever. After all, there's a limit to how many new cars will fit in the driveway.

What developed 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 last fall. This 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 adjustments were aided by healthy sales through April.

Other manufacturing industries are facing similar challenges. This is especially true of high-tech. Throughout much of the latter half of the 1990s, industrial production in high-tech industries expanded at the remarkable rate of 40 percent per year. And then high-tech manufacturing really took off, hitting annual rates of over 70 percent during the first half of last year. Growth rates that high simply couldn't be maintained. Unlike the auto sector, high-tech firms were a bit slow to respond to the inevitable easing in demand. As a result they're not as far along in the inventory adjustment process.

So where do we go from here? Well, the outlook for the remainder of 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 conclusion. We are still optimistic about the underlying long-term health of the economy. Why? Productivity.

Roughly speaking, productivity measures how much workers produce in a given amount of time. That output is constantly increasing as we come up with better ways of getting the job done. 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 measuring my attempts to program my new Palm Pilot. Nonetheless, as the most recent FOMC statement reiterated, we think the prospects for long-term growth in productivity look good.

It appears that much of the faster productivity growth of the late 1990s is more than just a product of being on the upside of the business cycle. Instead, it appears to be driven in part by fundamental changes in the way we do business, and our ability to innovate in areas like technology.

In a slower economy, we expect productivity growth to slow somewhat, and that is what we have observed. But, the good fundamentals supporting productivity growth appear to remain in place. We may see weak productivity numbers in some quarterly reports. But, over the longer term, average productivity growth should continue at relatively high levels.

What about the economic outlook for this year? So far we've continued with the slower pace of late last year. In the first quarter we saw economic growth of around 2 percent — which is well below potential. Some of that was caused by the downshift in consumer and capital spending growth. But much of it was the inventory correction. For the most part, consumers continued to buy, but were buying stockpiled goods. Businesses, meanwhile, slowed production growth rates. In fact, if it weren't for the effects of slower inventory accumulation, last quarter's two percent real growth rate would have been four and a half percent. On the bright side it appears that a good portion of the inventory overhang in consumer goods has been worked off. Provided consumer demand continues to grow at a fairly solid rate, production should rebound.

What about the inventory overhang in high-tech capital goods? There is a great deal of uncertainty in the short-term outlook for this sector, in part because of its uniqueness. Computers have a shorter shelf life than cars. We tend to upgrade as soon as something newer and better comes along. And that means excess capacity should be drawn down relatively quickly. Also, high-tech equipment prices have been declining especially rapidly, which should eventually spur additional purchases. So, although growth in high-tech capital spending by business may not soon return to the extremely rapid rates of the late 1990s, many expect it to return to positive territory but at lower rates of increase.

Thus, as the year progresses inventories should be coming into better balance. This should allow production to pick up again and realign itself more closely with demand. Moreover, demand should receive some stimulus as the year progresses from the effects of the policy actions we've taken in recent months. This adds up to an outlook in which growth gradually rebounds to more satisfactory levels later in the year.

Clearly there are risks in the economic outlook. One potential obstacle to growth is consumer confidence. If Americans don't buy, production won't rebound. Surveys show consumer confidence down significantly from last year's record highs due, to some degree, to declines in equity prices. But it's spending that really counts. Last quarter, consumer spending held up fairly well, growing by over 3 percent, although the rate of increase in retail sales slowed later in the quarter.

A second risk is business capital spending. I said before that we thought the over —investment here could be worked off relatively quickly. But we have little hard data on how much firms may have over-invested. It's possible that the oversupply is worse than we think. If so, this would prolong the adjustment.

Energy prices are a third risk. Right now, prices are down somewhat from last year's highs. This helps reduce inflationary pressures and encourages growth. But energy markets are highly volatile. Shocks can happen at any time. I'm sure you've all noticed the recent increases in gasoline prices. If shocks become widespread or long lasting, naturally, the outlook would deteriorate.

Another risk is the possibility of slower growth abroad. A healthy world economy increases U.S. exports. Recently, however, growth abroad has been less robust and this has contributed to declining exports. Should foreign growth remain sluggish, it would be a negative for the U.S. outlook.

The FOMC summarized the situation at the time of the April 18 rate cut. We said the outlook is good for long-term growth in productivity. But the likely softening in capital investment, "possible effects of earlier reductions in equity wealth on consumption, and the risk of slower growth abroad, threaten to keep the pace of economic activity unacceptably weak." In other words, while the 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.

I think the most likely scenario is for economic growth to pick up from its current slow but positive pace later in the year.

There's a story about an economist's epitaph, 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 later in 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.