ROTARY CLUB OF WILMETTE ECONOMIC BREAKFAST FORUM

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The Outlook for the U.S. Economy

I appreciate the opportunity to speak with members and friends of the Wilmette Rotary Club. Rotarians can be relied on to have great insights on the economy. That's because you take to heart your commitment to being informed and constructive participants in the local, national, and international communities you share with your fellow Rotarians worldwide. And I have that from a well-informed source. I have the honor of chairing the board of Global Chicago, which is currently being run day-to-day by Michael Diamond. Some of you may know Michael from his many years with Rotary International, overseeing Polio Plus and other Rotary humanitarian programs. I understand Michael will be speaking to this club in July on Global Chicago. Like Rotary, Global Chicago encourages constructive links between local business and the increasingly global environment in which we live.

The Federal Reserve also understands that what's happening on the local level is important to the big picture. That's why the Federal Reserve System includes 12 regional banks throughout the U.S., as well as the Board of Governors in Washington, D.C. Part of my job as a member of the Federal Open Market Committee, and President of the Chicago Fed, is to reach out to the community we serve and gain direct feedback on economic conditions. We want your opinion on the local and regional economy. So if you haven't filled in the comment cards on your tables, please do so. The information will be important in formulating monetary policy.

Now let's move on to our main subject of discussion. I'm here today to talk about the economy from a national perspective. More specifically, I'll address how we got where we are today and what factors will drive the economy going forward.

The economic expansion offered the businesses and residents of the North Shore many new opportunities. In recent years, we've done so well that the main challenge many businesses have faced is simply

finding room for expansion. Now, we are all wondering what's next for our economy, here in the Midwest and nationally.

Certainly, the national economy is at an important juncture. It is currently growing below potential. The Fed has responded aggressively to this weakness. We now expect to see improvement later in the year, but there are significant risks facing us. 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 four percent. You'd have to go back to the 1960s to see that sort of growth over an extended period. 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 the slowdown? 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. This led the FOMC to tighten monetary policy by raising short-term interest rates from mid-1999 through mid-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. The cost of energy was 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 of big-ticket durable items like cars. But that couldn't go on forever. After all, there's a limit to how many new cars will fit in the driveway.

Indeed, developments in the auto sector played an important part in the economy's slowdown. Last year 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 the year, automakers have made good progress adjusting their inventories, a task made somewhat easier by relatively healthy sales.

Other manufacturing industries are facing similar challenges, but in general have not made as much progress. Many sectors still have inventory levels that are not necessarily high by historical standards, but are higher than they would like. Over time, logistical capabilities and communication systems have improved steadily, allowing companies to better align production and sales, and reducing the need for high inventories. As a result, the inventory/sales ratio has trended down since the mid-1980s. But that

ratio jumped up last year when sales slowed. Until these inventory levels come down sufficiently, production growth will lag sales growth for some time longer.

The challenges are especially great for the high-tech sector. Throughout much of the latter half of the 1990s, industrial production in high-tech industries expanded at the remarkable rate of 40% per year. And then high-tech manufacturing really took off, hitting annual rates of over 70% during the first half of last year. Growth rates that high simply couldn't be maintained. Unlike the auto sector, high-tech firms were slower to respond to the inevitable easing in demand. As a result, they appear to have quite a bit further to go in adjusting their inventory levels, especially in the communication equipment sector. Moreover, many of their customers are reporting that they have their own stocks of unused equipment.

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 per hour increases as we come up with better ways of getting the job done. Productivity growth is key to improving our standard of living. Simply put, the faster productivity increases, the faster wages can increase without triggering inflation. 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, as the most recent FOMC statement reiterated, we think the prospects for long-term growth in productivity look good.

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

Of course, 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 be intact. We may see weak productivity numbers for some quarters, like last quarter for example. But, over the longer term, we are optimistic that average productivity growth will 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 ¼ percent — which is well below potential. One culprit was weak capital spending by business firms. But the biggest factor in determining first quarter economic growth was the inventory correction. For the most part, consumers' spending continued to rise at a reasonable rate, but individuals often 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 ¼ percent real GDP growth rate would have been almost ½ percent. On the bright side, the inventory reduction is an essential step before the economy can start growing at a more rapid rate. Provided demand continues to grow at a fairly solid rate, production of consumer goods will eventually rebound.

What about the 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. Optimists note that computers have a shorter shelf life than cars — we tend to upgrade as soon as something newer and better comes along. That means excess capacity might come down more quickly in high-tech than it would in similar situ-

ations in more traditional sectors. In addition, the prices of high-tech goods are dropping quickly, and that should also increase purchases and help bring down inventories. But there isn't a lot of hard data on the degree of oversupply. The excess stock is in the hands of customers as well as in the storerooms of manufacturers and is difficult to measure. There is a possibility it could be quite large. That could prolong the adjustment. Either way, growth in capital spending on high-tech equipment should eventually return to positive territory. Most likely though it will be at rates of increase that are lower than the extremely rapid rates of the late 1990s.

In sum, inventories should be coming into better balance as the year progresses, although at different rates in different industries. This should allow production to pick up again and realign itself more closely with demand. Moreover, as the year progresses demand should be stimulated by the effects of the substantial policy actions we've taken in recent months — the FOMC has reduced the target federal funds rate by two and a half percentage points since the beginning of the year. All this adds up to an outlook in which growth gradually improves later in 2001, and continuing into next year.

Clearly there are risks to the economic outlook. One potential obstacle to growth is consumer confidence. If Americans don't buy, production won't rebound. Surveys show that despite some rebound lately, consumer confidence remains significantly below last year's record highs due, to some degree, to declines in equity prices. But it's spending that really counts. Recently consumer spending has held up fairly well.

Energy prices are a second risk. Right now, prices are down somewhat from last year's highs, though they have ticked up recently. Lower energy prices help reduce inflationary pressures and encourage 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 change.

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 declines in 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 May 15 rate cut. On the positive side, we noted the significant reductions in inventories, and that consumption and housing expenditures have held up reasonably well. And we noted that long-term prospects for productivity growth are good. But we also said that several factors are "likely to hold down capital spending going forward." In addition, the possibility of a negative wealth effect, and the risk of slower growth abroad, are factors weighing on the economy. We concluded that the risks were still weighted mainly 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 facing a recession. It just 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 said, I think the most likely scenario is for economic growth to pick-up later in the year from its

current slow but positive pace — with improvement continuing next year. The FOMC's prompt response to the subpar economic growth of recent quarters reduced the likelihood that economic weakness would continue in 2002.

Let me also add that while the risk of economic weakness is currently greater than that of increasing inflation, we can never ignore inflation. We always carefully examine trends in inflation and the outlook when we make policy. Price stability and low inflation expectations are essential for our economy to achieve the Fed's goal of maximum sustainable growth.

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 later in the year. Now we come to the most interesting part of the program, where we open the floor for discussion. I'm really looking forward to your questions and comments.