PRIORITY ONE ANNUAL MEETING
CEDAR RAPIDS CHAMBER OF COMMERCE

Cedar Rapids, Iowa
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The Outlook for the U.S. Economy

Thank you for inviting me to participate in Priority One's annual meeting and giving me a chance to meet face-to-face with the business leaders of East Central Iowa. It's a real pleasure to be here in the "City of Five Seasons," especially since I hail from Chicago, the city of two seasons—winter and road construction.

The commercial growth of this region is one of the glowing success stories in the Midwest and Priority One deserves much of the credit. Thanks to the financial investment of the companies represented in this room and the hard work of Mark and his staff, both here and abroad, Cedar Rapids has become a model of economic development, civic achievement and pride.

While some communities have struggled to retain their corporate job and tax bases, yours has become stronger and more diversified. The workers and families of the Cedar Rapids area have indeed met the challenge of a rapidly changing work place environment. Agriculture, high-tech and manufacturing coexist not just as neighboring businesses, but sometimes within the same company. The Diamond V Mills facility I visited this morning is an excellent example of that.

You also have been able to attract world-class companies like Nordstrom's, GE Capital, Toyota Financial Services, Weyerhouser, and PMX. And Mark tells me Priority One was successful last fall in raising more than $5 million that will be used in coming years to attract more business, strengthen the companies that already are here, and recruit employees to fill the growing roster of available jobs.

That kind of commitment from local business to invigorate the economy is worthy of both praise and envy. So, my hat's off to all of you for helping Cedar Rapids become and remain an attractive and viable business center.

At the Federal Reserve, our aim is the same as yours. And that's to help ensure a healthy and growing economy. Of course, we operate on a much larger scale and employ a much different methodology. Our mission is carried out through three primary activities, and those are supervising and regulating banks, providing financial services to banks and to the U.S. government, and, the one that garners the most attention, setting monetary policy.

The Federal Reserve Bank of Chicago is one of 12 regional reserve banks that, together with the Board of Governors in Washington, D.C., serve as the nation's central bank. The Chicago District serves a five-state area that includes all of Iowa and most of Illinois, Indiana, Michigan and Wisconsin. Our head office is in Chicago, but we also have regional offices in Des Moines, Detroit, Milwaukee, Indianapolis, and Peoria.

As President of the Chicago Fed, I am a voting member this year of the Fed's key policymaking group, the Federal Open Market Committee, or FOMC. This is the group chaired by Alan Greenspan that is responsible for reducing the target federal funds rate by 2¾ percentage points this year.

All 12 Fed presidents play an important role in determining FOMC policy. At each meeting, we report on economic conditions in our regions and share our outlook for the national economy. That information is vital to the policy decisions we make. That's why I welcome meetings like this one so much. It gives me the opportunity to hear and see, firsthand, what is going on in the Midwest, and helps me shape the opinions and advice I take to Washington when the FOMC meets.

In addition to our discussion today, you'll see that we have some comment cards on the tables. I encourage you to fill them out and send them in — your input will be most helpful.

Incidentally, our next meeting is two weeks from today, so I hope you're in a talkative mood this afternoon. Before we get to the Q&A, I want to discuss the state of the U. S. economy, and give you a chance to peer into the crystal ball we use at the Fed to make monetary policy decisions.

I realized recently that our nation's current economy has begun to resemble my golf game. It lacks consistency, it's vulnerable to a variety of risks, and for every birdie and par, there are a lot of bogies and worse.

An underperforming economy may be rare, but it's nothing new. What is different today are the mixed signals we see in the marketplace. The combination of weaknesses and strengths and risks is both unusual and challenging.

The odd situation in which we find ourselves is the product of unprecedented circumstances. Those of us in this room have been witness to an extraordinary period of economic expansion throughout the nineties and into 2001. It was marked by higher and sustained productivity growth, a surge in corporate earnings, market valuations and investment, rising employment, increasing individual income and wealth accumulation, and high consumer demand. Internet and communications technologies deserve some of the credit for the economic boom, but virtually all industries and sectors of the economy helped drive the longest expansion in U. S. history.

A slowdown certainly was overdue, and some would say necessary because the rapid rate of growth simply was unsustainable. The tide began to turn last summer as consumer demand began to slow. There are several theories as to why this happened, but I believe it was influenced by three primary factors.

First, people had built up their own inventories during the expansion and just didn't need to buy new cars and refrigerators at the same rate because theirs were still in good shape.

Second, the Fed had tightened policy to stave off inflationary threats. From mid-1999 to mid-2000, the target federal funds rate was increased six times for a total of 1¾ percentage points.

And third was the unexpected jump in energy prices. Income that consumers might have spent on clothing and dining out was needed, instead, to fuel their cars and heat their homes.

The slowing in overall demand caused business inventories to climb in almost all sectors. The problem was especially troubling in the high-tech industry, where many companies over-forecast demand and continued to expand in the face of uncertainty. While manufacturers in other industries often were able to respond quickly and cut production, high-tech manufacturers were not as nimble and inventories in the information—processing sector rose significantly.

American business was hit hard by these events, and profits began to sag. Falling stock prices started to affect consumers' investment portfolios and ultimately, their confidence and willingness to spend. Companies were forced to reduce capital spending too and hiring plans in many organizations were curbed or put on hold.

In the past, this often foreshadowed economic recession. But, as Chairman Greenspan pointed out last month, the economy has withstood the negative forces weighing on it remarkably well.

Granted, our country's most recent economic growth is nothing to brag about. It was 1.3 percent in the first quarter of this year and 0.7 percent in the second quarter — far below its estimated potential of 3 to 3½ percent. Still, the fact that the economy has continued to expand, though much more slowly, is important to consider.

Perhaps it's because our economy became so strong in the past few years that once-crippling events have only hindered it. Though it may be hard to imagine on a hot summer day, I'm sure your winters here are as awful, if not worse, than they are in Chicago. And, 20 years ago, a severe blizzard might have paralyzed a region for days, even weeks.

Today, we're not only better equipped to battle the elements — with snow plows, better insulation and four-wheel-drive vehicles - but we also are more prepared — with better forecasts, information-gathering systems and early warning signs.

Similarly, the economy has gone through changes that help it better weather the ups and downs of the business cycle. Our ability to innovate and use technology has increased our long-term productivity and thus, the level of sustainable growth. And, improved information gathering and early warning systems have helped businesses and the Fed prepare for and respond to changes in the economic climate more effectively.

I believe the economy has improved its ability to weather economic storms. Yet, even in this age of expanding information technology, the business cycle, like winter weather, hasn't permanently disappeared. The economy is still subject to the booms and busts that are a natural part of human behavior and expectations.

That's why we at the Fed can't sit back and relax. On the contrary, we must be even more watchful for changes that are apt to take place in the economy. By aggressively easing the stance of monetary policy during the first six months of the year, the Federal Reserve has moved to support demand and, we trust, help lay the groundwork for the economy to achieve maximum sustainable growth.

Despite improved information systems, setting monetary policy that will influence and respond to future events is not an easy assignment. I have a friend in the insurance industry that compares rate setting in his business to driving a car with a solid black windshield. The driver's survival and well-being are totally dependent on what he sees behind him and what he can see to his left and right. Because he cannot see what lies ahead, he must anticipate what may be on the horizon and respond quickly and accurately to the events he encounters. And so it is with economic policy.

Our challenge is complicated further by the unusual nature of the current economy. Consider the circumstances that exist today.

On the one hand, there are the negative forces we discussed earlier — high inventories in several sectors, a deterioration in sales, profitability and cash flow, reduced capital spending throughout the economy, lower productivity growth, higher labor costs, and, though they're now coming down, high energy costs.

On the other hand, we see a few bright spots.

For example, housing activity has been strong all year. Market values are also rising, boosting the net worth of many homeowners. Auto and light truck sales have remained at very high levels, which, combined with that industry's better-than-average response to inventory excesses, has led to a modest uptrend in production.

While consumer spending is increasing at a slower rate than, say, a year ago, it too has continued to rise this year. That trend may be helped along by the tax cuts, and the rebate checks that are being mailed as we speak.

And, inflation has been relatively modest with indications it will remain contained, especially now that energy prices have backed down.

Unfortunately, added into this mix is a strong dose of uncertainty.

One risk is the possibility that falling business confidence and diminished profit outlooks could lead to even further reductions in capital spending. The overhang of high-tech capital goods has been a key factor underlying cutbacks in both actual and planned capital spending and it adds a great deal of uncertainty to the outlook.

A second potential obstacle to growth is posed by consumer confidence, which is affected by trends in unemployment, the performance of the stock market, and many other factors. If more people start losing

their jobs, consumer spending might well be reduced. One, because people without jobs have less money to spend, and two, because the money they do have is more likely to be put toward saving for the future. Recent surveys show consumer confidence is down from a year ago but still is hovering near average, historical levels. If that confidence erodes, people won't buy as much. And if they don't buy, a rebound in production would be much harder to bring about.

Energy prices are an ever-present risk because of worldwide market volatility and the ability of oil-producing nations to boost or slash production on a whim. Lower energy prices help reduce inflationary pressures and encourage growth. But, energy markets respond quickly to changing events, and shocks can happen at any time.

Growth abroad is another risk. A healthy world economy supports the demand for U. S. exports and thus the growth of our economy. Recently, though, our trading partners in Europe, Asia and Latin America have experienced a slowdown in economic growth and there are few positive signs on the horizon. Any further weakening of economic growth abroad could reduce U. S. export growth and lead to further excess productive capacity.

As you can see, the Fed's crystal ball isn't crystal clear. In fact, it's clouded considerably by an unusual assortment of positive, negative and uncertain issues we must consider when contemplating policy actions.

Now, I'm betting there aren't many economists in the room. And if you are, you might not admit it, anyway. But, you're all smart business people with a vested interest in the future of the U. S. economy and the economy here in East Central Iowa. Given all the variables I've discussed and what you know about consumer behavior, let me see a show of hands:

- How many of you believe the U. S. economy is on the verge of bouncing back?
- How many think it will get worse before it gets better?
- How many would rather be cornered by a wounded badger than have the responsibility of sorting this all out and making policy decisions that will affect everyone in America? George Bernard Shaw once said, "If you lined up all the economists in the world end to end, they still wouldn't reach a conclusion." I'd have to agree with Shaw— simply because the word "conclusion" implies a certainty of what will or will not happen.

There are no certainties, especially in the current economic environment. But, Chicago Fed economists share the opinion that growth will pick up later this year and into next year as well. Like the FOMC said in late June, we also believe the risks remain mostly tilted toward weakness in the economy.

Our outlook isn't all gloom and doom.

We believe a considerable part of the inventory-adjustment process is behind us. And as the year progresses, inventories should continue to achieve better balance. This should allow production to pick up again and realign itself more closely with demand.

Demand also should be stimulated by Federal Reserve actions that reduced the target federal funds rate from 6½ percent last December to 3¾ percent by the end of June.

Recently enacted tax cuts offer additional stimulus: short term, in the form of 92 million rebate checks that will put about $38 billion into consumers' pockets; and long term, in the form of lower overall tax burdens on the American public.

And, finally, we are encouraged by the recent downward trajectory in energy prices and the prospects that inflation will remain contained.

Of course, even these signs of hope are draped in uncertainty. For instance, we don't know what people will do with their tax rebates. How much will be spent? How much will be saved? Those decisions make a difference for our economic outlook. For all of our expertise and experience, we still have a difficult time predicting human behavior.

Assuming the key risks remain at bay, we are cautiously optimistic that our current economic situation will improve as we approach 2002 and continue into next year.

In the interim, though, while we all keep a close eye on the national economy. I encourage you to keep up the good work locally. I wish you continued success and thank you for your time today.