INDEPENDENT BUSINESS ASSOCIATION OF WISCONSIN
ECONOMIC FORECAST BREAKFAST

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Economic Trends 2002

It's a pleasure to be here today, and to have the honor of speaking at your annual Economic Trends breakfast.

Just two years ago, we were still buoyed by the longest economic expansion in our history. Today, it's a completely different picture, complicated by the events of 9-11.

Background on Federal Reserve

By way of background, 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 Indiana, Illinois, Michigan and Wisconsin. Our head office is in Chicago, but we also have a regional office here in Milwaukee, as well as in Des Moines, Detroit, Indianapolis, and Peoria.

As president of the Chicago Fed, I serve on 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 determining monetary policy. The most visible aspect of this function is setting the short-term federal funds rate.

All 12 Fed presidents play an important role in determining FOMC policy. At each meeting, we report on economic conditions in our respective regions and share our outlook and policy recommendation for the national economy. That's why it's important to connect with local business leaders such as yourselves, in preparing for our FOMC meetings — the next of which is January 29-30.

Overview

As we look at the overall picture for the country, it's clear we are experiencing a period of weak economic activity. The roots of that weakness go back some time. In late 2000, growth in output began to be held back by a major retrenchment in capital spending and, subsequently, by a realignment of inventories. Then, we had the tragedy of 9-11.

I visited Ground Zero a few weeks after the attack. Despite countless hours of TV coverage, until you see it firsthand, it's hard to fully grasp the scale of human loss and physical devastation. This terrible tragedy also inflicted a major direct shock to certain sectors of the economy. And it increased the risk of a more general loss of business and consumer confidence.

The National Bureau of Economic Research, which is an official arbiter of economic cycles, determined that the record, decade-long expansion in the U.S. economy ended in March of last year. They noted that the events of September 11 may have been an important factor in tipping the economy into recession — even though they decided the downturn began in March. How could that be? A recession is a prolonged, pronounced, and widespread decline in activity. And, although we will never know for sure, it is possible that, without the economic fallout from the events of the 11th, the downturn would not have been significant enough to be called a recession.

Going forward, we are in a period of some uncertainty. That said, we at the Chicago Federal Reserve expect the economy to recover in 2002, with activity gaining momentum as we move through the year. Indeed, we have already seen some scattered signs of improvement, although the data are still mixed.

Furthermore, over the broader horizon, the prospects for our economy remain bright. As Alan Greenspan has noted, during the last 20 years or so, we've deregulated financial markets, we've developed more flexible labor markets and we've made major advances in technology. These efforts have enhanced the American economy's ability to absorb disruptions. And, importantly, these factors also have provided us with the foundation to foster solid economic growth.

State of economy prior to 9-11

In order to provide some background, let's take a brief look at the state of the economy prior to September 11.

Throughout the second half of the 1990s, we experienced robust growth, driven by fundamental improvements in productivity. In the second half of the nineties, increases in real GDP averaged about 4 percent. Such a period of strong and sustained growth had not occurred since the 1960s in the United States.

During the nineties, capital spending soared — especially on certain types of high-tech equipment. In retrospect, there were some excesses during this period. Returns on certain capital investments turned out to be much lower than some firms expected.

The sharp decline in business investment associated with this realization was a major factor in the economy's entering a slower period in the second half of 2000.

By early 2001, businesses also began to liquidate inventories. Economic growth remained weak, but still positive, in the first half of 2001. Incoming news on the third quarter was mixed. Spending by households — notably on big-ticket items like cars and houses — was holding up fairly well. There also were a few tentative signs that some manufacturing sectors may have been bottoming out.

But, overall, manufacturing was still struggling. Moreover, after nearly 10 years of increases, total employment levels began to fall. And weak corporate earnings did not bode well for firms' capital investment projects.

In short, there were a few tentative signs that the economic outlook was deteriorating less rapidly. But, on balance, the economy remained weak in the third quarter. Against this backdrop, we experienced the shock of September 11.

Fed's response to 9-11

In the aftermath, U.S. equity markets closed, and many other financial markets encountered major problems in executing trades. Our responsibility at the Fed is to maintain the stability of the financial system and contain any systemic risk that may arise.

In this case, we did so by using a variety of measures to supply unusually large volumes of liquidity to financial markets. This allowed the economy's payment systems to continue functioning.

In addition to taking these emergency measures, we were faced with the challenge of determining the appropriate stance for monetary policy. The Federal Open Market Committee (FOMC) had to consider what effect the attack would have on activity in the overall economy.

Because the attacks increased uncertainty in an already weakened economy, we decided that an easing of policy was appropriate. Accordingly, the FOMC cut the target federal funds rate by 50 basis points twice soon after the attack. Weakness persisted, so we cut the rate by another 75 basis points at subsequent meetings — noting that risks are weighted mainly toward weakened economic growth.

The economy since September 11

The terrorist attacks had a sharp direct impact on several sectors of the economy. Air travel fell precipitously. And — although it is coming back — as of December it was still 15 percent below the previous year. Furthermore, the reduction in air travel is having a huge negative impact on aircraft production and tourism.

As a result of the attacks, overall consumer spending fell sharply in September, partly because people were in shock and glued to their television sets.

Since then, however, spending has recovered. Some of this reflects a surge in motor vehicle sales, in response to very generous incentives. Still, even excluding autos, by November consumer outlays had recovered nearly to where they were before the attack. And recent retail sales data indicate that holiday season spending was not as weak as some had feared. Importantly, even outside of autos, price discounting appears to have supported consumer demand.

Similarly, low mortgage rates have buoyed the housing market. In most previous recessions, residential construction declined significantly. By contrast, recent data show continued strength in housing.

In the manufacturing sector, activity remains very sluggish. However, we have seen some tentative signs that the sector may be bottoming out. Recent data have shown some recovery in manufacturers' orders. Notably, reports from the semiconductor industry and other manufacturers suggest that we may be seeing some firming in the high-tech sector.

The labor market has weakened significantly, with the unemployment rate rising to 5.8 percent in December. However, the pace of deterioration appears to be moderating. Job losses in December were less severe than in October and November.

A look at the economy going forward

Looking ahead, we at the Chicago Fed believe we are in a period of transition. The economy will recover, but, as I noted, the signs are still preliminary and the timing is uncertain.

Overall, we expect moderate gains in outlays for most household purchases. Here, consumer confidence will be an important factor. The latest readings on this have been relatively positive. And, more fundamentally, real income growth has been fairly well maintained, thanks largely to three factors:

- low overall inflation, including lower energy prices;
- tax cuts;
- and wage increases supported by productivity growth.

With regard to businesses, many firms remain somewhat risk averse. That could continue to weigh on discretionary spending and capital outlays. Nevertheless, recent orders data suggest that the contraction in business spending is at least moderating. The fall in capital spending subtracted almost a full percentage point from GDP growth over the first three quarters of last year. So, even if business investment simply stops falling, this would be a significant improvement relative to the large declines of 2001.

Real GDP growth last year was reduced by about an additional percentage point as businesses moved from rapid stockbuilding to large inventory liquidations. Going forward, inventory stocks probably are lean enough so firms will no longer be able to maintain the recent pace of liquidation and still keep up with demand. Accordingly, inventory investment will likely turn from a negative factor to a source of growth for production.

I should note that these developments in capital spending and inventory investment in part reflect the basic functioning of our market economy. That is, the way business and household decisions, prices, wages and interest rates continually interact and adjust to allocate productive resources. Such adjustments can result in periods of sub-par growth, but they also give market economies a natural tendency to recover from periods of activity that are below potential.

For example, as we moved through 2001, markets were signaling that returns on certain investments — notably in the high-tech area — were not as large as some had anticipated. In response, businesses cut their spending to bring capital stocks into better alignment with their long-term earnings potential.

Though it may take some time for these adjustments to be completed, eventually it will happen — markets seek equilibrium. And in this process, growth in economic activity will tend to move back toward rates that are in line with underlying trends in productivity and underlying trends in income. These trends, of course, determine the longer-run rates of return on investment projects and the sustainable growth rates in aggregate supply and demand.

Currently, these natural market forces are also being supported by government policy.

On the fiscal policy front, last summer's tax rate cuts and rebate checks have already boosted incomes. And other provisions in last spring's budget bill are kicking in now. Furthermore, bills signed into law after the attacks are boosting government spending.

In addition, the FOMC reduced the federal funds rate from 6½ to 1¾ percent in just the past 12 months. This means that there is a good deal of monetary stimulus in the pipeline. And beyond our borders, many central banks also have cut their policy rates. And these policy moves should help foster growth in aggregate demand abroad, which in turn will help support U.S. exports.

Over the longer term, an encouraging development is the recent agreement by members of the World Trade Organization to launch a new round of multilateral talks. Aimed at further reducing tariffs and other barriers to international trade, these negotiations should lead to economic benefits both here and abroad. Indeed, open markets and expanded trade are one of the best ways to increase economic growth, particularly in developing countries.

Period of uncertainty

Now, I must emphasize that we still face a period of uncertainty. Some of this uncertainty surrounds the potential for further shocks to the economy. For example, if there were another terrorist attack, how might it depress activity? Or, will our progress in fighting terrorism abroad further boost consumer confidence and business confidence?

Additional uncertainty centers on the reaction of households to the economic environment. If this cycle is like previous ones, unemployment rates may continue to rise for a time even after the recovery has begun to take hold. Resulting income losses would likely hold down spending somewhat. And worry over job prospects could cause households to cut back more dramatically as well. Of course, not all risks to the household sector forecast are on the downside. Generous retail discounts and low interest rates could boost spending more than expected.

In the business sector, as technology advances, firms will need to upgrade their current equipment with more cutting-edge systems. As I noted earlier, some of this appears to be starting, but the timing and ultimate magnitude remain quite uncertain.

There are pluses and minuses on the international front as well. Growth abroad was sluggish, even before the attacks, and has weakened since then. Accordingly, we are not likely to receive much help from increased demand for our exports. But oil prices have declined substantially. This is a positive factor boosting the purchasing power of U.S. households and lowering the energy costs for U.S. businesses.

We also face a longer-term uncertainty, namely how the emphasis on heightened security will impact the economy. Businesses, households and government at all levels must bear the costs of achieving and maintaining a heightened degree of security. We'll have higher insurance costs, too. Not only explicitly, through increased premiums, but also implicitly, as, for example, firms insure against disruptions to supply chains by carrying higher inventories.

Paying for this higher level of security on a day-in, day-out basis, while necessary, does increase the cost of doing business. This may lower the rate of productivity growth for a time. But to what degree is not at all clear. No doubt we will make innovations over time that will lower these costs and reduce the negative impact on productivity. And, once the economy adjusts to the higher levels of perceived risk, productivity growth should pick up again.

Concluding comments

In conclusion, let me say that we at the Chicago Fed believe the economy will improve over the course of this year. The natural forces for recovery will eventually lift capital spending and inventory investment. And policy moves are helping stimulate demand. The pattern of the recovery is difficult to know at this time, but we anticipate that activity in the second half of the year will be better than in the first half.

And, over the long term, our economy's flexibility and prospects for productivity growth make me confident that America will continue to move forward with strength and with resolve.