RISK MANAGEMENT ASSOCIATION

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Perspectives on the Economy

What I would like to do today is talk about the health of the economy, both in the Midwest and nationally. I'll cover where we've been, as well as where we're going.

Overview

As we look at the overall picture for the country, we are seeing some signs of recovery from the recession that the National Bureau of Economic Research said began last March. In general, analysts are more bullish now than they were two months ago.

Furthermore, over the broader horizon, the prospects for our economy remain bright. As Fed Chairman 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 — even events such as 9-11 — while providing us with a foundation that fosters solid economic growth.

State of economy prior to 9-11

These positive developments really started to show through in the second half of the 1990s, when we experienced robust growth that capped an unprecedented decade of expansion. Capital spending soared — especially on high-tech equipment. This helped fuel a sustained burst of productivity growth, the likes of which we had not seen since the 1960s.

However, in the midst of this remarkable period, some imbalances began to develop. By early 2000, it became clear that returns on certain capital investments were turning out to be much lower than some firms had expected. This ultimately resulted in a sharp decline in business investment, which 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, which weakened growth further.

Recognizing weaknesses in the national economy, the Fed began a process in January 2001 that reduced the federal funds rate target by 300 basis points over the course of the next eight months. Though the signals were tentative, by summer the economy appeared to be stabilizing, and many analysts thought that we would be able to avoid a recession. But then we experienced the shock of 9-11.

Fed's response

In the aftermath, U.S. equity markets closed, and many other financial markets encountered major problems in executing trades. One of our major responsibilities at the Fed is to maintain the stability of the financial system and contain systemic risk.

We did so in this case 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 twice soon after the attack, each time by 50 basis points. Weakness persisted, so we cut the target rate by another 75 basis points in November and December.

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 — it is still running at least 10 percent below levels of the same period a year ago. Furthermore, the reduction in air travel has had a substantial negative impact on aircraft production and tourism.

As a result of the attacks, overall consumer spending fell sharply in September. But since then, it has recovered. There was a surge in motor vehicle sales, in response to very generous incentives. Retail sales during the holiday season were not as weak as some had feared, and sales were strong in January. Importantly, even outside of autos, price discounting has supported consumer demand. Similarly, low mortgage rates have continued to buoy the housing market.

Although manufacturing remains weak, we have seen signs that the sector has bottomed out and possibly started to recover. Notably, reports from the semiconductor industry and other manufacturers suggest that the high-tech sector may at least be stabilizing.

Signals coming from the labor market have been mixed. Job losses have continued. However the rate has slowed, and new claims for unemployment insurance — often a leading indicator of labor market conditions — have fallen substantially.

On balance, we believe the recovery may very well be underway.

A look at the economy going forward

The big question is, How will this recovery unfold?

Going forward, we expect moderate gains in outlays for most household purchases. Important here, is the fact that real incomes have been supported by three factors:

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

Indeed, productivity growth has remained unusually high during this recession. Typically, productivity falls during contractions, regaining strength only when the economy's recovery is underway. In part, this is because firms initially retain too many workers in the face of weaker demand for their products.

However, in this cycle, firms seem to be taking advantage of increased flexibility in the labor market, such as the use of temporary help services and outside contractors, to aggressively cut hours during slow times. This adaptability, combined with longer run improvements in technology and the skills of workers, has helped keep productivity healthier than in past slowdowns.

With regard to business investment, 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 about a percentage point from real GDP growth over the 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. Inventory levels probably now are lean enough so that over the course of the year, firms will need to move from inventory liquidation to some stock building. Accordingly, inventory investment will likely turn from a negative factor to a significant source of growth.

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.

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 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, incomes were boosted by last year's tax bill. And other provisions in last year's legislation took effect in January. Furthermore, bills signed into law after 9-11 are boosting government spending.

In addition, the FOMC reduced the federal funds rate target from 6½ to 1¾ percent last year. Given the usual lags, we probably haven't seen the full effects of those cuts yet.

At the most recent FOMC meeting, on January 30, the federal funds rate target was left unchanged at 1¾ percent. The Committee noted that there were more prevalent signs that weakness in demand was abating and economic activity was beginning to firm, stating that the outlook for economic recovery had become more promising. However, the FOMC also cautioned that the risks continued to be weighted mainly toward conditions that may generate economic weakness rather than inflation.

View from the Midwest

Now let's talk about how the Midwest fared in this recession. While we in the Midwest like to take a leadership role in most things, this is a dubious distinction when it comes to economic downturns.

But the fact is, because of our manufacturing base, we preceded the nation into the recession. We began to hear reports of softening in the manufacturing sector as early as September and October of 2000. Foreshadowing events in the broader economy, manufacturing production was falling and inventories were rising by the late fall of 2000.

In an effort to work down these inventories, Midwestern manufacturers quickly slowed production and investment spending as they no longer needed to add production capacity. In addition, due in large part to manufacturing layoffs, regional unemployment rose faster than the nation as a whole. Since the Midwest economy is 60% more concentrated in durable manufacturing than is the nation as a whole, it took its lumps early in this recession.

Despite the fact that the recession was led by manufacturing, as the recession wore on, the Midwest did not fare worse than other regions. There are a couple of reasons why this is the case.

First, the manufacturing downturn has been most severe in high-tech manufacturing sectors in "the new economy," such as telecommunications, semiconductors and computers. Ironically, many of these high-tech firms that built their reputations on being fleet-footed, built up significant levels of excess capacity and were slow to react when the downturn occurred. The Midwest is less concentrated in these types of industries. Second, as was documented in our 1997 study, "Assessing the Midwest Economy," the region's industries have restructured and improved their production efficiency. As this study demonstrated, the resur-

gence of the Midwest in the 90s has more to do with native Midwestern firms improving their productivity than with a fundamental shift in the types of industries located in the region.

These more competitive and responsive manufacturers adopted systems such as just-in-time production methods and inventory controls that allow them to respond more quickly to fluctuations in the economy. So, even though many of the region's products are made by so-called "old line" manufacturers, some of the processes by which they are made are certainly cutting edge.

In looking ahead, it appears that manufacturing has bottomed out and that the conditions for recovery in the region look cautiously optimistic. Perhaps the greatest concern for the region's economy will be the condition of the auto industry. After near record sales in 2001, the industry is grappling with being profitable while producing fewer units.

On an optimistic note, auto sales have exceeded analysts' expectations over the first two months of the new year. As a result, GM recently announced that first quarter production estimates have been increased along with their sales forecast for the year. Auto production, which is very important to the Midwest, will bear watching over the next year.

Other factors to consider

What are some of the other positive and negative factors to consider as we look ahead at the overall economy?

In the household sector, generous retail discounts and low interest rates could boost spending more than expected.

On the other hand, if this cycle is like previous ones, unemployment rates will 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.

In the business sector, as technology advances, at some point firms will need to upgrade their current equipment with more cutting-edge systems. But the timing and ultimate magnitude remain quite uncertain. Indeed, a great deal of capacity was added in the 1990s, which is now unused. This low capacity utilization may weigh on investment for some time.

On the international front, oil prices have declined substantially. This has boosted the purchasing power of U.S. households and lowered the energy costs for U.S. businesses. And beyond our borders, many central banks cut their policy interest rates. Long term, these policy moves should help foster growth in aggregate demand abroad, which in turn would help support U.S. exports.

Having said that, 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 in the near term. And severe challenges in Japan and Argentina remain.

And what if there were another terrorist attack? How might it affect activity?

Even without another incident, the emphasis on heightened security has impacted, and will continue to 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 exact pattern of the recovery is difficult to predict, but growth should be on a more solid footing by the second half of the year.

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.