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Economic Outlook

It's a real pleasure to be here at the business breakfast with you and Kevin Helliker, and to have an opportunity to discuss the economic outlook.

Background on Federal Reserve

I thought I'd first say a little about the Federal Reserve and its role in the economy.

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 covers a five-state area that includes all of Iowa and most of Indiana, Illinois, Michigan and Wisconsin.

As president of the Chicago bank, 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.

At each meeting of the FOMC, we discuss current and prospective economic conditions. We then make a decision on where to set our target for the federal funds rate, the short term interest rate at which banks borrow and lend funds among one another. Our goal is to foster the monetary conditions that are most conducive to the economy achieving maximum sustainable growth and price stability.

Today, I would like to talk about my view of those current and prospective economic conditions, and some of the challenges they pose for monetary policy. The bottom line is that, while certain sectors of the economy are still experiencing hard times, overall activity has recovered from the recession we suffered last year and we appear to be on our way to a moderate expansion.

Of course, there are risks and uncertainties to this outlook that monetary policy must be ready to react to. But, overall, the longer-run prospects for the U.S. economy remain good.

Historical background

The second half of the 1990s was a period of remarkable change and prosperity in our economy. Advances in technology, increased efficiency of capital and labor markets, soaring investment — especially on high-tech equipment — all helped fuel a sustained burst of productivity growth, the likes of which we had not seen since the 1960s. As a result, economic activity surged.

But, as we turned the millennium, the picture began to change. By early 2000, it became clear that some firms had been too optimistic about the potential returns on certain capital investments — again particularly in the high-tech sector. This ultimately resulted in a sharp retrenchment in business investment for equipment and software and in moves to reduce inventories.

These developments were major factors in the economy entering a period of slower growth in the second half of 2000. The weakness intensified in early 2001, but there were tentative signs during the summer that activity may have been stabilizing.

Then we experienced the shock of 9-11. The terrorist attacks had a sharp direct impact on several sectors of the economy, particularly air travel, aircraft production and tourism. Furthermore, the blow to confidence resulted in sharp and broad-based drops in consumer spending and business orders.

The National Bureau of Economic Research — the private organization that declares when recessions begin and end — dated the onset of the recession at March 2001. This was the month in which payroll employment peaked. Even though March predates the terrorist attack, we might have avoided a recession without the events of 9-11. This is because the declines in economic activity may not have been deep or prolonged enough to have broken the recession threshold. Economists will study this question extensively in future years, but we will never know the answer for sure.

In any event, it appears that the recession, while painful, was relatively mild by historical standards. Now, I do not want to dismiss the recession as inconsequential. It was severe enough in a number of sectors, particularly manufacturing, where 1.7 million jobs were lost over the past two years. But we did not experience the more severe widespread unraveling of activity that has characterized some previous deep recessions. This time, GDP fell in only one quarter, and the decline was small — just 0.3 percent.

Why was the fall in GDP so small? Mainly because the household sector held up well. Consumers curtailed their spending, but by less than one might have expected. Significantly, the housing market remained remarkably buoyant, and sales of cars and light truck surged due to generous sales incentives. This activity showed that households were not deterred from making the large financial commitments that such purchases entail. Instead, they remained confident about their long-run prospects.

Signs are accumulating that recovery is well underway. Real GDP rose at an annual rate of 1.7 percent in the fourth quarter of 2001 and 5.8 percent last quarter. The gains were again led by the household sector. A significant portion of last quarter's growth also came from a reduced pace of inventory liquidation.

However, firms continue to be somewhat cautious about taking on new capital spending projects. Recent employment reports indicate that firms also are hesitant about hiring permanent employees. But some leading indicators of labor market conditions, especially the increased use of overtime and strong job growth in the temporary help industry, may be indicative of good news to come on the hiring front.

Cyclical uncertainty going forward

Still, we are facing a good deal of uncertainty over how the early stages of this expansion will unfold.

Aggressive inventory control means that stock levels are relatively lean, so that some further lift from inventory investment can be expected. But this can only give a temporary boost to growth — to solidify the expansion, final demand needs to gain a firmer footing. Important to this will be the degree to which business fixed investment turns around. Here, the incoming data suggest that demand may be improving somewhat; importantly, the high-tech sector appears to be stabilizing. Furthermore, household spending needs to keep moving forward.

The key to prospects for both business and household spending is productivity, or output per unit of input. On this front, we have reason to be optimistic. Productivity growth has been unusually robust over the last year, and stunningly so the past two quarters.

Why is this news so encouraging? Typically, productivity falls during contractions, in part because firms initially retain too many workers in the face of weaker demand for their products. Today, however, temporary help services and outside contractors help make the labor market more flexible. Firms can more quickly adjust their payroll to match changing conditions. This adaptability, combined with longer run improvements in technology and the skills of workers, has helped keep productivity healthier than in past slowdowns, and bodes well for its longer-run trends. And these longer-run trends are the key determinants of rates of return on investment projects and the sustainable rates of growth in household income and spending. In turn, and most important, faster productivity growth enables our standard of living to improve more quickly.

Monetary and fiscal policy have also played a positive role in this expansion. 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. After the shock of 9-11, the Fed cut rates by another 175 basis points. This accommodative stance bolstered demand throughout the economy. Fiscal policy moves, including last year's tax legislation and bills signed into law after 9-11 and early this year, also have been stimulative.

Finally, inflation remains reasonably well contained. When the Fed began lowering rates in January 2001, it was against a background of low inflation and low expected inflation. This gave us considerable room for maneuver when working to mitigate the impact of the recession. And with inflation low, we have more room to react to a slow recovery, should it unfold. This is a direct consequence of credibility earned over the past two decades. Financial markets do not expect the Fed to let inflation get out of hand.

Yet, challenges lie ahead. A great deal of capacity was added in the 1990s, which is now unused, particularly in the telecommunications equipment industry. This excess capacity could be a drag on investment during 2002.

Additionally, external developments could weigh on the future. Growth abroad looks to be recovering. However, the pace of expansion does not appear to be that robust, so we cannot expect demand for our exports to be particularly strong in the near term.

Furthermore, oil prices have been rising since December. This acts like a tax on the imported oil used by the economy, sapping consumer purchasing power and reducing business margins. Futures markets expect oil prices to recede, but the current political situation adds a good deal of uncertainty to this outlook.

Finally, we now are all aware of the risk of terrorist attack. Even without another incident, the emphasis on heightened security has impacted, and will continue to impact, the economy. The cost of doing business is now higher, both through increased insurance premiums and spending to heighten security and provide backup contingencies. Such costs may lower the rate of productivity growth for a time, but so far it is not evident in the reported data.

Projecting a moderate early expansion

Both positive and negative factors are influencing the outlook. How do we see these balancing out?

On average, we expect real GDP growth over the next few quarters to run close to the economy's potential long-run rate — which many analysts now put in the range of 3 to 3½ percent. However, on a quarter-to-quarter basis, growth could be uneven due to swings in inventory investment and other transitory developments.

Relative to some past recoveries, this performance might appear disappointing. For example, output expanded by 7.5 percent in the year following the end of the 1982 recession. However, that was a very deep recession, during which both households and businesses cut back spending sharply. The pent-up demand that resulted from this left room for a strong recovery. In contrast, given the strength in consumer spending and housing over the past year, there currently is little such pent-up demand in the pipeline.

While we believe that the expansion will solidify, it likely will take some time for vigorous growth to extend to all industries and regions of the nation. Although the early months of any expansion are often bumpy for some, it might be more noticeable this time.

Recovery from a deep recession introduces a surge in demand that can reverberate throughout the economy. Such sharp gains would feel like a more dramatic and widespread turn of fortunes than the more modest advances that are likely to follow a mild recession. As a result, in our current situation, we shouldn't be surprised if we hear negative news from some sectors or regions even as the expansion matures.

The challenge for monetary policy

As I mentioned earlier, the current stance of monetary policy is accommodative. Of course, we moved policy to this position to help counter the forces that had pushed us into a period of sub-par activity, and we were able to do so because inflation was so well contained.

Clearly, however, we cannot maintain our current stance forever. Growth in private final demand will firm as the factors that produced economic weakness are unwound. So if we simply left in place the extra stimulus

from accommodative policy, gains in demand would eventually strain the economy's ability to supply goods and services, resulting in the emergence of inflationary pressures.

We are faced with several challenges in deciding when and how to step back from this accommodative stance:

One challenge is to gauge the staying power of growth in final demand.

A second challenge is to balance this growth against our reading of the economy's ability to supply the demand in a noninflationary manner.

A third challenge is the fact that changes in monetary policy affect the economy with a lag. This means that, in addition to looking at the alignment between spending, productivity, and inflation that we see in today's data, we also must make a judgment about what these factors will look like in the quarters ahead given the policy option that we decide on today.

Conclusion

To conclude, we at the Chicago Federal Reserve expect the expansion that currently is underway to continue. Because the downturn was moderate, we expect that the early stages of this expansion will also be moderate by historical standards. Inflation likely will be well contained. And over the broader horizon, the prospects for our economy are bright. The question posed by this breakfast is, "Is there light at the end of the tunnel?" I believe the answer is "Yes."

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 have provided us with the foundation to foster solid noninflationary economic growth.