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Economic Outlook

Thank you Congressman Green. It's a real pleasure to be here this morning at the Fox Valley Chamber of Commerce Executive Committee Breakfast.

I appreciate your invitation to share my perspective on the economy.

Background on Federal Reserve

First, I'd like to give a little background on the Federal Reserve and its role in the economy.

The Federal Reserve System comprises 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 Federal Reserve Bank of Chicago, 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, we report on regional economic conditions and share our outlook and policy recommendation for the national economy. That's why it's important to connect with people throughout our region such as yourselves, in preparing for our FOMC meetings.

After our discussion of the outlook, the FOMC makes a decision on where to set its target for the federal funds rate. As you may know, that's 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.

Clearly, this is a tough job. With regard to our current situation, while overall output has recovered from the recession we suffered last year, the economy is still experiencing uncertain times. The road to recovery is turning out to be bumpy. Now the Fed cannot — and should not — try to smooth out every bump. Monetary policy simply is not capable of doing so.

But we do try to set conditions that best support sustainable noninflationary growth. At last week's FOMC meeting, the Committee left the federal funds rate target at 1¾ percent, the accommodative level it has maintained since last December.

However, the Committee did change the accompanying "balance of risks" statement. Since March, that statement had said that risks were balanced between economic weakness and inflation. Now, we see the risks as being weighted mainly toward conditions that may generate economic weakness.

We made the change because "...the softening of growth of aggregate demand that emerged this spring has been prolonged in large measure by weakness in financial markets and heightened uncertainty related to problems in corporate reporting and governance." I'll address this issue a little later in my talk.

Recent economic history

Let's look now at the national economy, and see how we got to where we are today.

The second half of the 1990s was a period of remarkable advances in technology, increased efficiency of capital and labor markets, and soaring investment. These 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.

The 10-year expansion was the longest in our history. In retrospect, we can now see that some excesses built up in the system during this period. In particular, as we turned the millennium, it became clear that some firms had been too optimistic about the potential returns on certain capital investments — particularly in the high-tech sector. The realization of this ultimately resulted in a sharp retrenchment in business investment for equipment and software and in moves to reduce inventories.

And as you all know, by early 2001, our record expansion came to an end. Indeed, although initial estimates indicated that real GDP edged up in the first half of that year, the GDP revisions just recently released show that output actually fell during the period. Still, there were some tentative signs during the summer of 2001 that the economy may have been stabilizing.

Then, we experienced the shock of 9-11. The attacks had a sharp direct impact on several sectors of the economy such as airlines and travel, and were a blow to confidence. And GDP fell a bit further — ¼ percentage point (annual rate) — in the third quarter.

Output began to recover in the fourth quarter of last year and growth continued through the first half of 2002. However, the recent news on the economy has been somewhat mixed, and challenges lie ahead.

Recession and recovery

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 in a number of sectors, particularly manufacturing, where nearly 1.8 million jobs were lost over the past two years.

But we did not experience the sharp and widespread unraveling of activity that has characterized some previous deep recessions. This time, although GDP fell for three quarters, the overall decline was relatively small — just 0.6 percent. By comparison, real GDP fell 1½ percent during the 1990-91 recession and 2¼ percent, on average, during the previous four recessions.

Why was the fall in GDP relatively small? Mainly because household sector spending was better maintained than one might have expected. Significantly, spending on big-ticket items — especially housing and motor vehicles — was remarkably strong. The fact that households were not deterred from making the large financial commitments that such purchases entail indicated that they remained confident about their long-run job and income prospects.

As I noted, since the declines of last year, real GDP has risen for three consecutive quarters. Overall, growth has averaged nearly a 3 percent annual rate, with much of the support coming from the household sector and a reduced pace of inventory liquidation. But even though a recovery in overall output clearly has already occurred, the path of GDP growth has been uneven.

Before turning to the outlook, let's take a brief look at the economy here in the Midwest.

Our regional economy is growing, but much like the rest of the nation, it is doing so unevenly. The Midwest took its lumps early on, largely as a result of our reliance on so-called "old-line" manufacturing such as heavy machinery. Manufacturing was the first sector to feel the effects of the slowdown — as early as the summer of 2000. As a consequence, our region's unemployment rate rose — and total employment fell — sooner and more sharply than in the nation as a whole.

As softness spread throughout the economy, however, labor market trends in this region generally mirrored those in the nation. More recently, it appears that total employment declines from year-ago levels have narrowed more here than nationally.

Indeed, here in Wisconsin, the employment picture is relatively brighter. Payroll employment was above year-ago levels in both June and July, the only one of the five states in our district for which this is true.

On balance, it appears that the region's economy has been doing somewhat better than the nation in recent months. In part, this reflects the fact that demand has remained strong for some of our mainstay products — particularly automobiles and appliances. And sales of both new and existing homes have been robust, in line with the rest of the nation, thanks in part to the lowest fixed mortgage rates since the 1960s.

Looking ahead, the nation's economy is still facing a good deal of uncertainty over how the subsequent stages of this expansion will unfold. Although we believe that the outlook points to continued expansion in the economy, the current balance of risks points more to conditions that may generate economic weakness rather than higher inflation.

What will keep the economy growing? 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. Furthermore, household spending needs to keep moving forward.

While a large number of factors will influence business and household spending over the near term, the key to the longer-run prospects for both of them is productivity, or output per unit of input. On this front, we have reason to be optimistic. Productivity accelerated beginning in the mid-1990s, more than doubling the rate of growth of the previous 25 years. It was unusually well maintained during last year's downturn, and, on average, productivity has increased at a robust pace over the past three quarters.

Factors supporting economy

Why is this 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 past slowdowns, and bodes well for its longer-run trend. And this longer-run trend is the key determinant 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.

In our current situation, monetary and fiscal policy also have supported aggregate demand. 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 in the last four months of 2001, and we have maintained this low level of the funds rate since then.

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 to maneuver when working to mitigate the impact of the recession, and 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.

Challenges to economy

I have just cited a number of factors supporting the economy. Yet challenges lie ahead. We now are all aware of the risk of potential 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 the costs of providing heighten security and back-up contingencies.

Furthermore, businesses purchased a great deal of capital equipment during the 1990s, boosting their productive capacity. Much of this capacity is now idle, particularly in the telecommunications industry. This excess capacity could be a drag on future investment. Orders for capital equipment appear to have stabilized this past spring — even in the high-tech sector. But capital spending clearly has a long way to go before the level of activity returns to where it was prior to the recession.

Corporate governance another challenge

The economy is facing another important challenge today — How do we deal with the recent revelations of accounting improprieties and failures in corporate governance?

One of the cornerstones of capitalism is a transparent system of laws and regulations that are enforced in a fair manner. Executives convicted of fraudulent or criminal behavior should be dealt with severely.

Indeed, the revelations of these scandals have added a great deal of skittishness to an already uncertain business climate. They also have undoubtedly raised the cost of financing new investment — as evident from both the increased risk spreads on corporate borrowing, particularly for lower-grade issues, and the lower prices that would be coming to any new equity issues. And if lower stock prices were maintained, the resulting dent in households' balance sheets would be a negative factor for future household spending.

To be sure, to the extent that the news on misreported earnings and other accounting irregularities reveal that markets had been mis-evaluating risks and returns, then investors should be demanding higher premiums. The concern, however, is that they may go overboard in this regard.

In fact, capitalism cannot thrive without entrepreneurial risk taking. If we are too risk-averse, we will stifle innovation and, with it, our ability to generate continual increases in our standard of living.

So the proper pricing — and regulation — of risk is a key element in shaping the future of our economy.

Economic outlook

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

On average, we expect real GDP to increase over the next several quarters, and growth eventually 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.

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 resulting pent-up demand 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.

Although the stages of any expansion are often bumpy for some, without such a surge in spending, it might be more noticeable this time. And the shock of accounting and corporate governance failures, so soon after last year's downturn, certainly has added to the uneasiness about the course of the economy.

Conclusion

Looking ahead, for a while we may continue to receive negative news from some sectors of the economy or regions of the nation. But, once we have worked our way through the current rough patch, the long-term prospects for the U.S. economy appear to be good.

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 in the years ahead.