ECONOMIC CLUB OF GREATER LANSING
KELLOGG HOTEL AND CONFERENCE CENTER
MICHIGAN STATE UNIVERSITY

East Lansing, Michigan
November 21, 2002

Economic Outlook

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

The Federal Reserve System is made up of 12 regional reserve banks, plus the Board of Governors in Washington, D.C., that together serve as the nation's central bank. The Chicago District covers a five-state area that includes most of Michigan, Illinois, Indiana, Iowa and Wisconsin. We also have a branch in Detroit.

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. After our discussion of the outlook, the FOMC makes a decision on where to set its target for the federal funds rate. Our goal is to foster the monetary conditions that are most conducive to the economy achieving maximum sustainable growth and price stability.

Fed perspective on economy

Clearly, this is a tough job. Let me take a few minutes now to share my perspective on the economy, both nationally and regionally, and the challenges that were faced by monetary policymakers this year.

Just two weeks ago, the FOMC reduced its federal funds rate target by 50 basis points, to 1¼ percent. This was our first action to change interest rates since last year, when the funds rate target was reduced 11 times - from a high of 6½ percent to 1¾ percent in December 2001.

While acknowledging the current softness in the economy, the FOMC on November 6 said that with the action to reduce the funds rate target, the risks to the outlook were balanced between economic weakness and inflation.

As you know, the economy slipped into recession in March 2001, with real GDP falling during the first three quarters of 2001. Now the National Bureau of Economic Research — the nonprofit organization that is the arbiter of when recessions begin and end — has not yet determined an official end to the recession. But most economists think it ended sometime in late 2001 or early 2002. Indeed, real GDP growth turned positive in last year's fourth quarter, and continued to rise through the first three quarters of 2002, although growth has been uneven.

The recession, which was mild compared with other recessions, was led by sharp cutbacks in capital spending by businesses. At the same time, consumer spending and housing held up quite well. But that meant there was little pent-up household demand. So most forecasts made early this year were expecting the recovery to be relatively modest compared with the robust growth typically seen in the first year of previous economic recoveries.

The economic data for the first half of this year generally were consistent with these expectations. Industrial production rose moderately each month from January through July. Payroll employment increased each month from April though August. And as I noted, real GDP increased — with growth averaging about a 3 percent pace so far this year.

However, some of the earlier signs of strength started to fade as we moved through the summer and into the fall.

- Industrial production fell in each of the last three months.
- Payroll employment fell slightly in both September and October.
- Light vehicle sales moved down from their lofty levels of July and August.
- In addition, most of the anecdotal information we've been hearing in recent weeks suggests slower activity.

It appears that spending by consumers and businesses alike has been restrained recently by a high degree of uncertainty.

Outlook for regional economy

Before I touch on these uncertainties, though, I'd like to take a look at conditions here in our region, and how the Midwest economy has been impacted by the slowdown.

First, a little perspective. For much of the 1990s, the economy in the region outperformed the nation by some measures. For example, the unemployment rate in the region was below the national rate. Indeed, it is interesting to note that over the latter half of the 1990s, the rate of net job creation in the Midwest was only about half that of the nation. But this was not due to a lack of economic vitality. Rather, we were running short of qualified workers to fill job openings.

More recently, however, economic activity in the region began to slow before it did in the rest of the nation. Employment growth began to fall off in the region in late 2000, about six months before the nation as a whole. And when job growth here did begin to slow, there was little doubt that it was due to a softening economy. The Midwest's unemployment rate rose quickly, and for much of last year it stood above the national average.

But as the slowdown spread throughout the economy, trends in our unemployment rates have more or less mirrored the nation's since late 2001. Indeed, here in Michigan, October marks the first month in nearly two years when the unemployment rate was below the national average.

Much of the recent softness in our labor markets can be traced back to our concentration in manufacturing industries. Manufacturing was one of the first segments of the economy to feel the effects of the slowdown, as the imbalances that developed toward the end of the expansion reduced business demand for capital equipment and inventories.

Household spending, on the other hand, has held up relatively well in the District, much as it has in the rest of the nation. Although sales recently have softened somewhat, consumers continue to spend on automobiles and appliances - two industries that are vital to the region and to Michigan in particular.

Buoyed by some of the lowest interest rates in a more than a generation, sales of both new and existing homes have remained remarkably resilient. Realtors and builders here in Michigan tell us that residential real estate sales remain at very high levels. In addition, home price appreciation has been very healthy during this run, helping to keep the market active.

At the same time, commercial real estate activity has turned sluggish. Still, we are seeing some major building projects moving forward in our District. Importantly, we have not experienced as large of a rise in vacancy rates as some other markets have, such as those where commercial building took off during the boom in the high-tech sector.

Of course, the Midwest did not benefit as much from the "new economy" euphoria that some other regions did. But, when the tech bubble burst, we did not feel the pain that those regions felt either. To be sure, the Midwest did not come away completely unscathed. We do have some significant concentrations of high-tech industries in the region - for example, Michigan's information technology sector. But our high tech industries are integrated and complementary to our diverse economy, not just to other dot.coms.

Still, the Midwest economy, like the rest of the nation, has hit somewhat of a soft spot in recent months. And the factors contributing to that softness are the same as those affecting the nation as a whole. So let's now turn to the national situation.

Challenges facing economy

At the national level we face a number of uncertainties. For one thing, we are living in a different world than we did before 9-11. In addition to the uncertainty generated by concerns about terrorism, the cost of doing business is now higher, both through increased insurance premiums and the added costs of providing security and back-up contingencies.

And the economy is now dealing with accounting improprieties and failures in corporate governance.

These scandals have added to an already uncertain business climate. They also have raised the cost of financing new investment. This is evident from further increases in risk spreads on corporate borrowing — particularly for lower-grade issues — and lower prices for new equity issues.

To be sure, to the extent 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. 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.

That said, capitalism also requires a transparent system of laws and regulations that are enforced in a fair manner. So if we find evidence of criminal behavior or fraud in the executive suite, we must root it out and prosecute. Those found guilty must be punished...which in some cases should include jail time.

Another source of concern is the fact that we are operating in a world of increased geopolitical risk, with heightened concerns about developments in the Middle East, particularly Iraq. No one knows how these events will play out.

All this uncertainty can inhibit activity. Firms may become hesitant to take on capital spending projects or hire permanent workers when the downside risks are more apparent — or if the consequences of such risks appear to have become more serious. Firms may simply decide to hold off doing anything until they feel more certain that the projects will soon start showing positive cash flow. Also, to the extent that uncertainty depresses the stock market, the dent in household wealth can be a negative factor for spending.

This high level of uncertainty has been one of the reasons for the slowing in the economy this quarter. In fact, in a recent survey, private-sector forecasters are expecting real GDP to rise at an annual rate of only 1.6 percent in the fourth quarter. So, we're in a soft patch.

Factors supporting economic recovery

Nevertheless, not all the indications are negative. Consumer spending beyond autos, while softer, is still moving forward. Consumer confidence, buoyed by recent gains in the stock market, turned up a bit in early November. And the housing market has remained robust.

Furthermore, certain fundamentals are still positive for the economy.

First, aggressive inventory control means that stock levels are now very lean. Thus, some further lift from inventory investment can be expected. This would give a temporary boost to growth. But 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 and household spending keeps moving forward.

Second, inflation remains low and well contained. This has allowed monetary policy to maintain an accommodative stance for an extended period of time. This accommodative stance bolsters demand throughout the economy. Furthermore, 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.

Third, household incomes continue to rise at a solid pace. Despite the recession and the modest pace of activity early in the recovery, real disposable personal income currently stands about 5½ percent higher than it was at the time the recession began. In contrast, if we look back over the past 30 years, real disposable incomes a year and half after the onset of a recession were up only modestly, at best.

Finally, real income also has been supported by strong gains in productivity, or output per unit of input. Since the mid-1990s, the rate of productivity growth has been nearly double the pace of the previous 25 years. Furthermore, productivity was unusually well maintained during last year's downturn, and, on average, it has increased at a remarkably robust pace in recent quarters.

We know that there often is a boost to productivity growth in the early stages of recovery, as businesses demand more from their employees and trim fat from their organizations. But the continued high levels of productivity growth that we have experienced recently support the view that took hold in the late 1990s — that a more fundamental positive structural change has occurred. To the extent this is true, it is an extremely positive sign for the U.S. economy. Rapid gains in productivity growth support the growth in incomes and profits needed to maintain the economy's forward momentum.

The role of productivity growth

The high rates of productivity growth in the U.S. are particularly remarkable when we compare them with growth rates abroad. In the 1980s, Japan and many European countries achieved larger increases in productivity than the U.S. But since the mid-1990s, productivity growth in the U.S. has surpassed that in Japan and Europe.

Recent research estimates that the pickup in U.S. productivity growth is in large part due to the increased use of Information Technology — or IT- capital (that is, computer hardware, software, and communication equipment, etc.). But the increase in productivity growth we've seen since the mid-1990s is not simply a matter of increasing our IT resources — it's also how we apply those resources to the challenges in the workplace.

Over the past decade or so, we have learned to run our businesses smarter through improved management practices and significant advances in the overall logistics of producing and distributing goods and services. And, the U.S. labor market is functioning more efficiently than it used to. All of these factors allow us to organize and allocate our productive resources much more efficiently, which boosts overall output in the economy.

In the long run, productivity is key to the prospects for both the household and business sectors. Ultimately, it is productivity growth that determines our standard of living.

Conclusion

Let me conclude with some final thoughts.

The economy's road to recovery has turned out to be bumpier than expected, and we're currently in a soft spot. But the low-inflation environment has allowed us to maintain an accomodative monetary policy for some time, and also gave us room to take out some extra "insurance" with the easing action we took earlier this month.

While there is a lot of uncertainty about the outlook, we believe that the monetary policy we have put in place will support aggregate demand. Furthermore, the underlying trends in productivity are strong. As a result, we see the economic expansion regaining momentum next year, with growth reaching its potential during 2003.

Moreover, the long-term prospects are bright. The U.S. economy has proven itself resilient and dynamic, driven by an entrepreneurial culture, market-based principles and continuing technological advances. These factors have enhanced the economy's ability to handle challenges and have laid the foundation for solid non-inflationary growth in the years ahead.