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Economic Outlook

[Introduced by Gerry Fitzgerald, chairman of Cornerstone National Bank and secretary/treasurer of WPO — Chicago Chapter]

Thank you, Gerry. I'm honored to have been asked to speak as part of the WPO's education program at the Chicago Chapter.

- Before I begin, I've got to tell you, the year is off to a fast start…
- It's not often that you get to have lunch with the President of the United States on Tuesday, and dinner with a roomful of world presidents on Wednesday night.
- I don't have anything confirmed….but I'm really looking forward to Thursday and Friday

As Gerry said, I'm president of this bank, but I'm also CE0…and an economist to boot…

- Given the current business and economic climate, however, I sometimes feel that's two strikes against me…

Not that long ago, CEOs were up there with movie stars in terms of glamour and influence…

- But we all know how opinions have changed, given the behavior of companies such as Arthur Andersen, Enron. Tyco and WorldCom.
- I saw a cartoon recently that had a mother trying to break up a fight between her two children. "Mommy, Mommy!" one of them cried, in tears. "Billy just called me a CEO."

Well, before I was a CEO I was a Ph.D. economist and I have to say that economist jokes have been around a lot longer than CEO jokes.

- You've probably all heard the one about the economist who was asked, "How did the industrial Revolution affect world economic growth?" The answer: "Too early to tell."
- Or "What do you get when you cross the Godfather with an economist?" Answer: "An offer that you can't understand."

When I joined the Chicago Fed, one of the first things I had to learn was what is called "Fed Speak."

- This is a language in which it is possible to speak, without ever saying anything.
- As you might expect, Chairman Greenspan is the master of Fed Speak.
- Here's how he put it once when testifying to Congress: "Since becoming a central banker, I have learned to mumble with great incoherence. If I seem unduly clear to you, you must have misunderstood what I said."

Well, I'll try tonight to mumble coherently…

- I must say I'm really glad there are no press here and that my comments are off the record….
- I'll give you my perspective on the U.S. economy in light of major events and trends.
- I'll also briefly discuss what I believe is a key measure of economic success –namely productivity improvement.

Role of Federal Reserve

But before I address these issues, I'd like to give a little background on the Federal Reserve.

- 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.
- Our aim is to help ensure a healthy and growing economy.

We carry out this mission through three primary activities. They are:

- Supervising and regulating banks.
- Providing financial services to banks and to the U.S. government, and,
- Conducting monetary policy…which garners the most attention.

Even though we're a quasi-governmental organization, we are not immune from the types of challenges that you face in the private sector.

- For example one of the core services we provide is check processing – or more specifically, clearing paper checks.

- You know from your own lives and businesses, however, that the use of credit cards, debit cards and electronic payments has exploded.

- So while we're not a cash-less society yet, we're moving closer to becoming a check-less society.

I should mention that the Fed has consistently worked with the private sector to encourage the shift from paper to electronic payments because it is a more efficient method of payment that benefits business and consumers.

- But as a consequence, our revenue from check processing has fallen significantly.

- At the same time, we are still mandated to recover our costs, including profits, over the long term.

- So we are in the painful process of making significant changes in our check business. including downsizing and consolidation. Sound familiar?

Another challenge is supervising and regulating banks.

- Although the banking industry has performed very well despite the recession and recent soft spot in the econ only, loan portfolios have shown some deterioration.

- Even though banks are much stronger financially today than after prior recessions, we do see some credit problems — particularly in loans to selected large corporations. Industries such as telecommunications and airlines are noteworthy examples.

- We're also monitoring consumer portfolios continually.

- We are keeping an eye out to see whether rising debt loads and bankruptcies are affecting consumers' ability to meet their payments.

- Real estate markets generally continue to hold up, but given banks' exposure, we also are monitoring the impact business conditions may have on these markets.

As supervisors, we want banks to vigorously address their loan problems.

- But we don't want them to shut off the supply of credit to sound borrowers, which would impede the economic recovery.

- It's a difficult balancing act.

Another challenge is monetary policy.

- 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.

- Clearly, this is a tough job

Fed perspective on economy

Last month, the FOMC voted to keep its federal funds rate target at 1-114 percent — the lowest the actual federal funds rate has been in 41 years.

- This followed the 50 basis point cut in November that was our first action to change interest rates since late 2001, when the funds rate target was reduced 11 times – from a high of 6½ percent to 1¾ percent in December.

- While acknowledging the current softness in the economy, the FOMC last month — on December 10 — said that the risks to the outlook were balanced between price stability and economic growth.

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 the fourth quarter of 2001, and continued to rise through the first three quarters of 2002, and probably the fourth quarter as well, although growth was uneven.

The 2001 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 last 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 last 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 nearly a 3½ percent pace for the first three quarters of 2002.

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

- On balance, since July, industrial production has moved somewhat lower and payroll employment has changed little.

- In addition, most of the anecdotal information we've been hearing over the last month or so suggests that economic activity slowed in the fourth quarter.

- Light vehicle sales moved down from their lofty levels of July and August, but bounced back sharply in December.

Mixed reports on holiday spending have received a lot of attention.

- But I would note that the timing of the holidays this year relative to last year make it a bit difficult to read the holiday sales data.

- We'll know more next week, when the retail sales data are released. [Release scheduled for the January 14.

Overall, it appears that spending by consumers and businesses has been restrained to varying degrees by a high level of uncertainty.

Uncertainties facing economy

What is causing this uncertainty?

- 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.

Another source of uncertainty is the fact that we are operating in a world of increased geopolitical risk.

- We face heightened concerns about developments in Iraq and Korea.
- No one knows Vet how events will play out.

And the economy is dealing with accounting improprieties and failures in corporate governance, which have added to an already uncertain business climate.

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 was a big reason for the slowing in the economy last quarter.

- Private-sector forecasters are expecting that real GDP rose at an annual rate of only about 1 percent in the fourth quarter [based on WSJ survey reported Jan. 2, 2003]
- So, we have been in a soft patch.

That said, forecasters generally expect the economy to rebound this year.

- For example, the average forecast reported in last week's Wall Street Journal forecasting survey [Jan. 2] sees growth of a bit more than 3¼ percent over the course of 2003 [Q4/Q4].
- This suggests that growth this year should be fairly close to the economy's long-run potential.

Factors supporting economic recovery

Given the weakness apparent at the end of last year, why are forecasters reasonably optimistic about this year?

- To start with, not all the indicators are negative. Consumer spending is still moving forward.
- The housing market has remained robust.
- And the ISM Report on Business [formerly known as the Purchasing Managers Survey] suggests that manufacturing grew in December for the first time in four months.

- Furthermore, certain fundamentals are still positive for the economy.

First, aggressive inventory control means that stock levels are 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.

Third, fiscal policy moves, including the 2001 tax legislation and bills signed into law after 9-11 and early in 2002, also have been stimulative.

- And the Administration just this week proposed additional stimulus.

- I should note that state and local governments are, of course, unlikely to provide much fiscal stimulus, given their poor budget situations.

Fourth, we could get a modest boost from the international sector, though probably only a small one.

- Projections for Europe and Asia show growth picking up, but they're generally weaker than for the United States over the course of 2003.

- Forecasts for Germany and Japan are particularly weak.

- Latin America overall should see some rebound – again, mainly reflecting the anemic economic conditions of the past two years.

Fifth, 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 more than 6 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.

I would note that robust income growth has allowed households to not only maintain consumption, but also to increase their saving.

- The personal saving rate rose to 3½ to 4 percent of disposable income in 2002, up-from a 2001 average of only 2.3 percent.

- A factor contributing to higher saving rates, of course, is a desire to shore up. balance sheets in the wake of stock market declines.

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 the 2001 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.

- Ultimately, over the long run, it is productivity growth that determines our standard of living.

What creates success?

Bottom line, when we say a country has succeeded economically, we mean that output per worker — or perhaps the closely related concept of output per capita is very high.

- Hence, labor productivity – output per hour worked – is the proximate reason why some economies have succeeded and others haven't.

- So understanding the successes and failures of economies in the world means, in part, understanding labor productivity.

Economists identify several reasons why labor productivity can grow:

- Because workers are more educated,

- Because they have more capital to work with.

- Because of innovation, or

- Because of better government policy (for example, more efficient regulation).

In major countries other than the U.S., labor productivity performance was stronger in the period before 1995 than it has been since.

- Chicago Fed research suggests that the U.S. productivity acceleration reflects a broad-based acceleration of innovation, not temporary or cyclical factors.

- And potential output is growing faster in the U.S. than in Europe or Japan, with the gap widening in the last few years.

So understanding why some economies have succeeded and others haven't comes down to understanding why some countries have managed robust investment in people, capital and ideas.

- In large part, capitalism succeeds best when it creates incentives for private businesses to invest and to invest wisely.

Conclusion

Let me conclude with some final thoughts on the overall U.S. economy…

- The economy's road to recovery has turned out to be bumpier than expected, and we've been in a soft spot.

- But the low-inflation environment has allowed us to maintain an accomodative monetary policy for some time.

So while uncertainty about the outlook remains, 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 in 2003, with growth reaching its potential this year.

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.