

COMMONWEALTH CLUB  
CATHEDRAL HALL, UNIVERSITY CLUB

Chicago, Illinois  
April 24, 2003

.....

**Economic Outlook**

Over the course of a year I give many presentations, most of them to business audiences in forums similar to this one. In this role, I'm often asked to make predictions about the course of the economy...which is one reason you invited me here today.

But earlier this week, I had a different kind of opportunity. I was asked to speak at Greene Elementary School on the south side of Chicago. It was part of our support of financial literacy efforts during Money Smart Week, which I'll touch on a little later.

I had a wonderful time talking with a roomful of fifth graders about the importance of saving and investing... I was somewhat surprised when one 11-year-old raised his hand and asked me to explain "supply and demand"...and I was even more surprised when he understood my answer...

They were a great audience, and must have liked my presentation, because they lined up for autographs afterwards. I must say that's a first in my career at the Fed... I hope all of you are as grateful... Seriously, I would encourage you, whenever you have the opportunity, to make yourselves available to our public school students. It's people like us who can help them understand the economic principles that will make them prosperous.

**Challenge for monetary policymakers**

Let's turn now to the national economy, and start by looking at the challenges faced by monetary policymakers.

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. As you know, this is the group chaired by Alan Greenspan that sets monetary policy.

At each meeting, we report on regional economic conditions and share our outlook and policy recommendations 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, which currently is made even more difficult by the large uncertainties regarding the economic outlook. While overall output has recovered from the recession we suffered in 2001, the economy is still experiencing uncertain times related to the war in Iraq as well as corporate governance issues and other factors. As a result, the recovery has been uneven. Productivity growth has supported gains in household income and spending, but business investment in new capacity has been weak. And firms haven't increased their work forces.

Going forward, the strength and duration of the recovery depends largely on the underlying cause of businesses' hesitation. Is it excess capacity from the extremely high level of investment during the late 1990s, the unusual confluence of geopolitical uncertainty and ongoing corporate governance scandals, or some combination of these factors?

Against this backdrop, the FOMC met on March 18, just hours before the start of the war in Iraq. We kept the target for the federal funds rate unchanged at 1½ percent. This is the lowest the actual federal funds rate has been in 41 years.

What was most unusual is that the Committee decided not to characterize the current balance of risks with respect to economic weakness or inflation, as we usually do. We decided that, because of "the unusually large uncertainties clouding the geopolitical situation in the short run, and their apparent effects on economic decision-making," we could not make a useful statement about these risks at that time. And we emphasized the need for heightened monitoring of current conditions.

Over the longer term, however, we and most private-sector analysts believe that the accommodative stance of monetary policy and the strong underlying trends in productivity should fuel continued recovery in the economy.

### Fed perspective on economy

Now let me give a little background on the current state of the economy.

Between 1991 and 2001, we experienced the longest economic expansion in post-World War II America. The late 1990s were a time of particularly robust growth. Businesses invested heavily in plant and equipment to expand capacity and enhance productivity. They also added many new workers to their payrolls. Indeed, payroll employment increased by 24.1 million jobs during the decade from 1991 to 2001 — an average of 201,000 jobs per month.

That expansion ended in March 2001. The economy then entered a mild recession by historical standards. After three quarters of contraction, expansion in real GDP resumed in the fourth quarter of 2001.

However, as I mentioned before, the current recovery has been uneven. The level of real GDP is well above where it was when the recession started. And most forecasters expect that data to be released tomorrow will

show that the first quarter of 2003 was the sixth consecutive quarter with positive GDP growth. But, on the downside, employment has yet to turn up.

In fact, the most recent labor market reports were quite weak. The level of payroll employment in March 2003 was the lowest since the March 2001 business-cycle peak, and represented a total loss since then of more than 2 million jobs.

Another aspect of this cycle's unevenness has been the unusual role of households in moderating the recession and leading the subsequent recovery. In contrast to other business cycles since 1960, total consumer spending increased through both the contraction of real GDP in 2001 and its subsequent recovery. Residential construction also has been robust. Indeed, the decline in GDP in this recession entirely reflected reductions in business investment in fixed capital and in inventories. And even though overall GDP has been expanding since late 2001, investment still remains well below its peak levels.

Why is this notable? Because until this most recent recession, one of the most typical features of business cycles was that consumer spending and business capital spending tended to expand and contract together.

This synchronized movement should reappear some time in the future. That's because, over the long run, supply and demand will grow at the same rate. Increases in productive capacity must follow gains in consumer demand; otherwise, unsustainable imbalances will arise in the economy.

So two logical scenarios — or some combination of them — seem likely to arise:

- Investment could accelerate if businesses begin to mimic consumers' behavior,
- Or household spending could stagnate if consumers' expectations for the future diminish to the more conservative outlook of business.

In the first scenario, the current recovery will gain a more solid footing. In the second, the recovery's unevenness will become the seed of its eventual undoing. Whether you are an optimist or a pessimist depends on how much you think the economy will tilt towards one scenario or the other.

In making this judgement, there are several key factors to consider.

The first is the continued robust pace of productivity growth. Rapid productivity growth was a hallmark of the late 1990s. From 1995 through 2000, it averaged 2.5 percent per year — nearly double the growth rate of the previous two decades.

Even in 2001, productivity growth was 1.9 percent, an impressive performance given the declines in output during the first three quarters of that year. In 2002, productivity accelerated to 4.8 percent, the largest increase in the growth rate since 1992, when the economy was in the early stage of rebounding from the 1991 recession.

Productivity growth in 2002 was an important factor contributing to an equally impressive growth in real disposable personal income of 4.3 percent. Rapid gains in productivity growth support the growth in incomes and profits needed to maintain the economy's forward momentum. So the recent productivity figures support the notion that the U.S. economy's long-run prospects are good.

The second factor to consider is that much of the growth in spending by households has been on big-ticket items. Sales of new homes and light vehicles hit levels in 2002 that would have been dismissed as wildly optimistic only a few years ago.

Why is this important? Buying a house or a car typically includes a commitment to making an extended stream of payments. So financially savvy consumers must consider not just their current purchasing power, but also how they will make future payments. For this reason, durable goods and housing purchases reveal, to some extent, households' expectations about their future earnings prospects. Low interest rates have been an important factor, but the fact that these purchases, on balance, have held up reasonably well also indicates that households appear to be confident in their earnings prospects.

The third factor is that, while businesses clearly are not as ebullient as they were in the late 1990s, they are not without confidence. So, as we moved through 2002, they stopped cutting back on overall capital spending and, later in the year, even began to increase investment somewhat. Furthermore, despite some well-known exceptions — the airlines, for example — businesses' balance sheets are in fairly good shape overall. And with financing costs currently low, firms are in position to expand more rapidly once they are convinced that the fundamentals for their businesses are in place.

#### Uncertainty and downside risk

So the fundamentals of productivity growth and consumer spending are apparently in place for the recovery. But the hesitation of businesses to invest in new plant and equipment and to expand their payrolls certainly suggests that the recovery's foundations have not been as solid as they could be. The climate of uncertainty, which arose in late 2001 — first with the war on terrorism, then with the wave of accounting scandals, and most recently with the war in Iraq — has repeatedly been tagged with responsibility for this hesitation.

And, as I noted earlier, some very recent data have not been encouraging. February and March data pointed to widespread weakness in payroll employment. In this way, the current recovery resembles that following the 1990-91 recession, which we call the "Jobless Recovery." Signs of slowing activity in February were also apparent in national surveys of purchasing managers both in the manufacturing sector and elsewhere, and these indicators deteriorated further in March.

These indicators — and the general failure of capital spending to keep pace with consumers' — raise the concern that the veil of uncertainty has masked a more fundamental source of weakness in the business sector. If so, we could continue to have below-potential growth for an extended period of time — with business spending falling short of the gains in consumer expenditures. Or, we could even see some softer spending by households. And, as a cautionary note, growth in consumer spending has slowed in the past six months or so.

## Summary

So it is possible that growth in the economy will continue to be sluggish.

On the other hand, we think the more likely scenario is that the economy will improve in the second half of the year.

The fundamentals to generate growth appear to be in place. As has been the case for some time, economic activity continues to be supported by low interest rates and a strong productivity growth trend. Furthermore, the current low-inflation environment has allowed the Fed to maintain an accommodative monetary policy. It has given us room to take out some extra “insurance” against downside risks, for example, with the easing action we took last November.

### Importance of financial literacy in this environment

With economic signals mixed and uncertainties still clouding the future, it’s especially important for consumers to have as much knowledge as they can when making financial decisions. That’s why, as I alluded to earlier, I’d like to spend a moment talking with you about how essential it is to help people become better educated about managing their money.

We’re all aware of many factors, including technological advances, that make financial decision-making so much more complex and challenging today:

Changes in many retirement and savings plans require people to take more responsibility for their personal investments.

Credit is more broadly available, particularly to youth, seniors, and low- and moderate-income people.

Technology makes it possible to offer more complex and customized financial products, and plays a role in the conduct of virtually every traditional financial transaction.

In truth, there’s no shortage of information and expertise available to address such issues through both public- and private-sector avenues. The problem is, people often are unaware of these channels or how to access them.

So, to publicize a range of resources for personal financial education available throughout Chicago, we are sponsoring the second annual Money Smart Week — this week, April 21-26. The week is coordinated by the Federal Reserve Bank of Chicago with the help of nearly 60 local partner organizations that include the City

Treasurer's Office, the Chicago Public Schools, the Chicago Public Libraries, banks, community groups and government agencies.

Together, we are sponsoring more than 85 educational programs and activities that help teach consumers how to make good choices about their money. I hope you've seen some of our excellent coverage in the media. During Money Smart Week, participating organizations work together to share their information and resources with the people of Chicago. The goal is to help make it easier for everyone — regardless of income level — to learn how to budget, save, use credit wisely, and make good investment decisions.

Bottom line, helping people become smart about money helps the economy.

## Conclusion

Let me conclude now with some final thoughts on the economy...

The economy's road to recovery has turned out to be bumpier than expected. But 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, although there is still a great deal of uncertainty, the most likely outlook is that the economic expansion will regain momentum as the year progresses.

Moreover, our 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.