

## CREDIT UNION NATIONAL ASSOCIATION

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### **U.S. Economic Forecast**

We in the Federal Reserve System work very hard to maintain the soundness of our nation's financial system. I hope that my remarks today and the other sessions you attend during the conference will help you make more informed decisions in the future.

#### **Challenge for 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 a 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 allow the economy to achieve maximum sustainable growth and price stability.

Clearly, this is no easy task. But the current economic environment has made it even more difficult. Output is rising, but it does not feel like an expanding economy for many people because of the stagnant job market. Solid productivity trends, fiscal stimulus, and low interest rates have laid the groundwork for stronger growth. But corporate governance issues and geopolitical events have left many business managers with a diminished appetite for risk. The degree to which activity picks up depends largely on how firms work through these issues.

This morning, I'd like to discuss, in more depth, our perception of current conditions and the near-term

outlook, as well as how both affect our policymaking decisions. I'd also like to shed some light on our thinking about inflation rates that are now lower than many of us have seen in our lifetime.

## Recent Economic Conditions

Let me start by giving you some background on how we got where we are today.

Between 1991 and 2001, the U.S. economy enjoyed its longest expansion of the post-World War II era. According to the National Bureau of Economic Research — which is widely acknowledged as the arbiter of business cycle dating — that expansion ended in March 2001 and the economy entered a recession.

By historical standards, this recession was mild, both in terms of its duration and its effect on total output. The recession ended in November 2001, just eight months after it began. And, real GDP contracted only 0.6 percent between its peak and trough, about one-fourth of the average decline in every other recession since 1960.

During this time, low interest rates helped keep sales of light vehicles and homes relatively strong, even though both normally drop off sharply during an economic slowdown. As a result, real household spending continued to expand and that, in turn, cushioned the decline in GDP.

But, what was a blessing during the recession has complicated the recovery. Typically, as output begins to expand again, pent-up demand and rising inventory investment contribute to a surge in growth that is markedly above trend. For example, after the deep recessions in the early 1980s, real GDP jumped up at annualized growth rates between 7 and 9 percent in some quarters. But, this has not been the case since GDP began to increase again in the fourth quarter of 2001, in part because there is no pent-up demand for vehicles, homes, and many other cyclical goods.

To be sure, the recovery has also failed to gain momentum because of a string of unique shocks to economic activity and business decisionmaking. First, were the events of September 11 and the start of the war on terrorism. Second, were the revelations of corporate malfeasance and the changing environment of corporate governance.

And then, earlier this year, the growing certainty that there would be a war in Iraq led to heightened uncertainty about the economy. In February, many of our business contacts reported that they were taking a “wait and see” attitude toward many spending decisions, pending the progress of the war. So, there was reason to be optimistic that the end of major combat operations would lead to a pickup in growth.

But, businesses continue to be very risk averse in their decisionmaking. Many firms have chosen to take advantage of low interest rates to restructure their balance sheets, rather than use the funds to finance purchases of new equipment or facilities. Don't get me wrong, balance sheet restructuring is important, but so long as companies perceive that new capital spending projects bear too much risk relative to their expected returns, low investment will remain a factor restraining economic activity.

And, unfortunately, much of the economic data following the war in Iraq was initially disappointing. In June, payroll employment fell to a new low since its peak in February 2001, representing a total loss of over two and a half million jobs since then. Factory capacity usage rates also remained very low.

However, other data have been somewhat more promising. Durable goods orders increased more than expected in June. Industrial production increased slightly in both May and June. The nonmanufacturing business activity index suggests that the service sector is expanding at a faster rate. And, nationally, home building remains quite strong.

It is easy to get lost in the sea of incoming economic data, particularly when each new wave seems to suggest a different movement in the tide. At the Chicago Fed, our overall assessment of recent conditions is that growth has been improving, but there is still considerable slack in the economy.

### Near-term Outlook

Looking ahead to the second half of the year and into 2004, there are reasons to be optimistic for stronger growth.

Some market dynamics should stimulate activity. Strong productivity gains have kept real personal incomes rising throughout this time of sluggishness and should continue to be a key foundation for growth into the future. Despite recent increases, the value of the dollar is down 4½ percent since the start of the year, which should help promote export growth. And, financial conditions have improved, with major equity indexes rising well above their recent lows.

Fiscal policy should also stimulate growth. According to Administration estimates, tax cuts scheduled to take effect this summer should put nearly \$50 billion into consumers' and businesses' pockets by the end of this year, and nearly \$100 billion more next year.

And the Federal Reserve has maintained an accommodative monetary policy. This has reduced financing costs and kept liquidity flowing into the economy.

Furthermore, many of the factors that have hindered business spending - including worries about terrorism, corporate governance issues, and excess capacity - should have a diminishing impact moving forward.

Terrorism remains a real concern, but companies have been tightening their security and taking steps to reduce the potential impact of any new attacks. On the corporate governance front, many issues continue to be addressed by various regulatory agencies and by increased diligence in corporate offices and boardrooms.

And even though there are still appreciable amounts of excess capacity in some businesses, this will change over time. Capital equipment depreciates - and does so very rapidly for computers and many other high-tech investments. Thus, much of the excess will be reduced - a good portion of it as technological innovation makes older machines obsolete. When this happens, the need to replace out-of-date equipment will help support investment.

As such, we are expecting growth to pick up during the second half of the year and into 2004. In the Fed's recent Monetary Policy Report to Congress, our central tendency forecast calls for real GDP to rise 2½ to 2¾ percent this year, and we expect even faster growth in 2004.

We are not alone in this assessment. Private sector economists in the Blue Chip consensus forecast call for growth to average 3.7 percent during the second half of 2003, up from 1.6 percent in the first half. They also expect a faster pace of growth next year. Furthermore, the increase in equity prices suggests that financial markets expect a pickup in activity, too.

But, it is important to remember that the economy always faces risks of shocks — in both positive and negative directions. On the upside, business sentiment could rebound more dramatically than we expect, producing a pop-up in spending. On the downside, there is the risk that consumer spending could lose its forward momentum. Or, residential investment could pull back substantially from its red-hot level. While considerable uncertainty remains, we at the Chicago Fed believe that the higher probability outcome is for economic growth to increase for the remainder of this year and again in 2004.

### Inflation Outlook

At the same time that we are forecasting a pickup in activity, we expect inflationary pressures to remain subdued. The Fed's latest forecast for inflation in 2003 - as measured by the price index of personal consumption expenditures - is only 1¼ to 1½ percent. Moreover, we forecast a similar, if not lower, inflation rate for next year.

There are two main reasons for anticipating such low inflation. One is the high productivity growth rate that we've seen in recent years, which allows output to increase more rapidly with minimal upward pressure on prices. The other is the idle capital and labor resources currently available in the economy.

Our expectations for inflation were little changed from our forecast in February. But, some signs suggest that consumers and businesses have revised their short-term inflation expectations down somewhat from where they were earlier in the year.

### Discussion of June Rate Cut

With inflation expectations subdued, the FOMC decided on June 25 that a 25-basis-point reduction in rates “would add further support” for the expected improvement in the economy. Although there were signs that spending was firming and financial markets were improving, there was little hard data in hand to suggest growth was picking up to a sustainable pace. So, the Committee voted to cut its target federal funds rate by 25 basis points, to 1 percent, pushing the actual rate to its lowest level since the late 1950s.

Almost as closely watched as our decision on interest rates is the so-called “balance of risks” statement, where we assess the risks we face in achieving our goals of sustainable growth and price stability.

In June, we stated that “the upside and downside risks to the attainment of sustainable growth” were roughly equal in the near term. But, though small, the chance “of an unwelcome substantial fall in inflation” was greater than the probability “of a pickup in inflation.” We added that, on balance, our concerns about an unwelcome decline in inflation would likely predominate the risks to sustainable growth for the foreseeable future.

## Implications of Disinflation

This statement was similar to the one we released after our May meeting, when, for the first time, we stated publicly that we are now in an environment where lower inflation is a greater risk than higher inflation. To be sure, this is an unusual situation for the FOMC and puts the term price stability in a new light.

Economists refer to this phenomenon of falling inflation rates as disinflation. This is related to, but not the same thing as, deflation — which occurs when the overall price level declines and the inflation rate turns negative.

Now, a reasonable question to ask is just what does the FOMC mean when it refers to “unwelcome” disinflation? Does this mean there are examples of “welcome” disinflation?

Well, yes, there are instances where disinflation, and even falling prices, are signs of good things. For example, when productivity increases lead to lower input costs, and competition forces firms to pass along the savings to their customers. It is easy to find many such cases in individual industries. One is in computers, where prices have been falling for decades.

However, we are concerned about “unwelcome” disinflation, where lower price inflation or outright deflation are symptoms of unfavorable economic developments. This occurs, for example, when there is a large and persistent amount of excess capacity perpetuated by falling demand. The Great Depression is a widely recognized example of this, when unemployment rates soared above 30 percent, output declined five years in a row, and prices plunged 25 percent over those 5 years. In the Depression, deflation contributed to the protracted downward spiral in activity.

Today, however, is a far cry from the early 1930s. Output is increasing, the unemployment rate is 6½ percent, and inflation, while low, remains positive. Still, there are reasons to be concerned about further disinflation today. If the economy were hit by an unfavorable shock, then it might be more difficult for the Fed to use our usual tools — lowering short-term interest rates — to stimulate growth.

To see this, we first must recognize that what matters most in purchasing decisions is not the nominal interest rate, but rather the real interest rate - that is, the nominal rate less the expected rate of inflation. Why is this so? The nominal interest rate determines the number of dollars a borrower must pay back on a loan; the expected rate of inflation represents the perceived decline in the purchasing power of those dollars over time. So the real interest rate determines how many real resources a borrower must pay tomorrow for taking out a loan today.

Real interest rates can rise for a number of reasons. The one we are most familiar with is an increase in nominal interest rates. Another reason is if the underlying trend in productivity increases, then real interest rates will rise to reflect the higher real returns generated by investment opportunities.

Real interest rates also can rise if inflation expectations fall. Let me give you an example of this. In January, our target for the fed funds rate was 1¼ percent and the Blue Chip Forecast for the Consumer Price Index inflation rate in the year ahead was about 2 percent. So, using this measure, the real fed funds rate was minus ¾ percent. In early June, our fed funds target was still 1¼ percent, but the Blue Chip CPI

forecast had moved down to  $1\frac{3}{4}$  percent, making the real fed funds rate minus  $\frac{1}{2}$  percent. So, without any change in the nominal interest rate, the real fed funds rate moved up 25 basis points, from minus  $\frac{3}{4}$  percent to minus  $\frac{1}{2}$  percent.

Now, I realize I shouldn't give complex numerical examples 20 minutes into a speech, but this is an important idea we consider when managing monetary policy in a disinflationary environment.

So, suppose nominal interest rates were at zero. If some detrimental shock were to hit the economy and cause inflation expectations to move down, then real interest rates would increase. In this case, the Fed might want to cut real interest rates in order to stimulate demand and offset the shock. But we would not be able to do so using our normal policy tool - lowering the nominal funds rate - because at zero, it's as low as it can go.

Now, we aren't at this so-called "zero-bound" and we believe that it is unlikely we will face this problem. But the Federal Reserve needs to be prepared for all contingencies. So, we have studied alternative courses of action to ensure that monetary policy would not be impotent if the nominal funds rate were at zero. Still, we think it's prudent to avoid having to turn to such alternatives. Accordingly, even though the chances of substantial, further disinflation are low, our rate cut on June 25 was taken in part to provide extra insurance against this scenario.

## Conclusion

In conclusion, let me just say that the road to recovery has been bumpier than expected. But we believe that the monetary policy we have put in place, along with other sources of stimulus, will support aggregate demand and that the most likely outcome is that the economy will regain momentum through the end of this year and into 2004.

Moreover, despite recent events, 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 growth and price stability in the years ahead.