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Regional and National Economic Conditions

If you ever complain about the rain or the snow or the heat in the Great Lakes states, chances are a native Midwesterner will tell you, "If you don't like the weather, stick around—it will change." For better or worse, the same could be said about our economy.

Over the past two decades, the economic climate of the Midwest has swung from cold with freezing rain to warm and sunny to cold and windy. In the early 1980s, the Midwest was hit particularly hard by the national recession and it took longer to recover than other areas. But ten years later, when the nation was hit with another recession, the Midwest was impacted much less than before. And now, with the nation again recovering from an economic slowdown, the Midwest finds itself lagging behind.

This afternoon, I'd like to start by talking about these changes in the Midwest economy, and how they affect Chicago. With the rest of my time, I'd like to talk about the outlook for the national economy in the year ahead, and its effect on the region.

Economic trends in the Midwest and Chicago

By many measures, the Midwest is highly dependent on manufacturing industries—much more so than the rest of the nation. Manufacturing generates nearly 20 percent of our income and 16 percent of our jobs. By comparison, 13 percent of the nation's income and 11 percent of its jobs are in manufacturing.

This is a double-edged sword for the region: Manufacturing, especially durable goods production, is highly cyclical. Generally, when the economy is doing well, income from manufacturing is high; when the

economy turns sour, factory output and employees usually suffer more than other sectors. This pattern was apparent in the early 1980s. From 1979 to early 1983, one in five manufacturing jobs in the Midwest evaporated, and conditions here were easily the worst during the nation's double-dip recession.

The Chicago economy mirrored the Midwest's experience at that time, which became the impetus for the Commercial Club's "Jobs for Metropolitan Chicago" report, and the genesis of the Civic Committee. In some sense, the timing for that effort was impeccable as both the Chicago and Midwest economies subsequently worked their way back to prosperity.

Following the early 1980s, the regional economy never looked back, as both private industry and government leaders invigorated what had been a half-hearted approach to global competition. Midwest companies restructured their operations for a long-term rebuilding, and they improved their productivity and competitiveness dramatically. State and local governments reformed their tax structure, and began to rebuild an infrastructure that also contributed to the Midwest revival.

During the early 1990s, the nation once again experienced a recession—but the Midwest rode it out with much less pain than in the early 1980s. In part, the recession of 1990-91 was milder in the Midwest because other regions experienced somewhat unique economic shocks, including the cutbacks in defense spending and the fallout of the Savings and Loan crises. Meanwhile, durable goods manufacturers here enjoyed surging demand from around the world.

Favorable trends continued throughout the 1990s, but over the past 3-4 years, the Midwest economy has struggled. The regional economy softened a bit sooner than the national economy did, and employment here declined at nearly twice the national rate. Even before the national recession began in 2001, Midwest manufacturers were reporting to us at the Chicago Fed that their sales and orders were falling sharply. Much of the region's subsequent weakness — especially in terms of job losses — has been centered in the manufacturing sector.

Whether manufacturing continues to languish, some basic long-term trends have not been altered. Most notably, it is clear that, decade after decade since the 1950s, manufacturing has comprised a diminishing share of personal income and employment, both in the nation and the region.

Ironically, this declining share has not occurred because manufacturing has under-performed, rather it is because we continue to innovate and prosper. We have continued to produce more and more output by using less labor and more know-how in manufacturing operations. While such productivity gains deliver higher incomes and standards of living to both Midwestern households and the rest of the country alike, it also gives rise to a constant and very concerted struggle to re-employ manufacturing employees into other industries.

I believe that, wherever possible, we must strive to ease this transition for these workers and their families. One way that we can do so is to maintain a commitment to expanding worker education and development. I'm proud to serve on the business leadership group of the Workforce 2.0 initiative here in Chicago, which promotes effective workforce learning and development practices.

As the manufacturing sector continues to evolve, all of us here today are left to wonder: What is Chicago's place in the changing economy? How can we understand the evolution of Chicago's economy — that is, what do these changes mean in terms of its challenges and opportunities?

The Chicago economy is not easy to characterize because it is so big and diverse. But I think it best to look back and remember that Chicago has long been the business capital of the Midwest. In particular, it was — and still is for that matter — the regional leader in manufacturing, distribution, wholesale and retail trade, business services, education, and a whole host of more specialized and more narrowly-defined business activities. At one time, when the Midwest's mainstay activities of agriculture and manufacturing were growing, Chicago's role as the Midwest's business capital was sufficient to keep it healthy and growing.

However, as Midwest manufacturing and agriculture become less prominent industries, Chicago's challenge is to move beyond its regional leadership role. Fortunately, Chicago has many foundations it can build upon to become even more of a national and global city.

First is its financial exchanges. Although they now share the market with others around the world, Chicago's futures and options exchanges remain leaders in the field, and they continue to serve world markets for the exchange and management of financial risk.

Second is Chicago's status as a hub for national and international air transportation, which gives rise to potential growth in many other industries. When combined with its infrastructure of hotels, restaurants, and convention centers, such as McCormick Place, Chicago has become a national leader in business meetings, and conferences. And Chicago's thriving business service sector — in areas such as advertising, management consulting, law, and research and development — also benefits from the depth of the travel offerings at O'Hare and Midway.

Third is Chicago's size and the diversity of its business and cultural activities. With a wide range of career possibilities, Chicago serves as a magnet for talented professionals from around the Midwest. This status is only enhanced by the education opportunities offered by its world-class universities and colleges.

In addition to building on these and other foundations, Chicago and the Midwest at-large must discover and develop other niches — especially in the industries which are likely to propel the nation in coming decades. We don't know what many of those industries are yet, but in some of those that are identifiable — such as biotechnology, computer equipment and software development — Chicago's performance so far has not been as strong as many had hoped. Nonetheless, we must keep investing in innovation if we are to sustain our growth and high standards of living.

Recent economic conditions

For the most part, Chicago's current struggles do not reflect any fundamental or structural changes in its economy from the boom times of the 1990s. Rather, Chicago's peculiar economic specialties have been buffeted by what should turn out to be transitory events. In particular, personal air travel and business meeting activity have been impacted by the slow economy and security-related shocks to air travel. To a modest extent, air travel has begun to recover; skies around O'Hare and Midway are once again congested.

Also, much of the Chicago economy's current softness can be traced to weakness in the surrounding Midwest economy. And as manufacturing companies and related activities throughout the Midwest begin to grow once again, it would not be surprising to see Chicago's business service companies begin to pick up as well — both in sales and employment.

While the national economy continues on its recovery, the Midwest has been lagging behind. Even though the nation has seen modest job growth, employment in the Midwest has yet to show any consistent improvement.

However, manufacturing is now beginning to ramp up, so the Midwest probably won't trail the nation for much longer. In recent months, the Chicago Purchasing Managers' Business Barometer — a key gauge of Midwest manufacturing activity — has been suggesting a strong pace of expansion. Some of the components of this measure — strong new orders, high order backlog, and low inventories — indicate that the pickup in activity should continue in the coming months.

As for the national economy, we finally began to see signs in the second half of last year that the recovery was gaining traction. Household spending, which had held up quite well throughout the recovery, posted solid gains. More importantly, business spending on capital equipment rose strongly. In sum, real Gross Domestic Product, or total output, grew at an annualized rate of 6.1 percent in the second half of 2003, the fastest rate in any two-quarter period during the last twenty years.

The growth in output has led to some modest improvement in labor market conditions. Our business contacts report that the pace of layoffs has diminished significantly; but they also say that they remain very cautious about hiring new workers. The economy only added about 370,000 jobs during the last five months, and even though the recession ended in November 2001, payrolls are still more than 700,000 jobs below where they were at that point. This is disappointing, especially when we compare it to the recovery from the 1990-91 recession, which is known as the jobless recovery. In May 1993, the recovery had been underway for just as long — 26 months — yet employment had surpassed not only its level at the end of that recession, but also its previous peak.

Growth outlook

The big question going forward is whether the most recent surge in demand will sustain itself and lead to substantial job growth, or whether this one will falter like the spurts we saw in 2002. While there are always uncertainties, I think there are reasons to be optimistic that economic growth will remain solid and lead to an acceleration in employment.

The first reason is productivity. Strong productivity gains have kept real personal incomes rising throughout the recession and recovery, and should continue to be a key foundation for growth into the future. Some of the recent job losses are attributable to efficiency gains. But, higher productivity generates higher income, higher income generates higher spending, and the higher spending helps create the new jobs that eventually put unemployed workers back on payrolls.

Second, the recent round of tax cuts should also support growth. According to Administration estimates, these tax cuts will put nearly $100 billion into consumers' and businesses' pockets in 2004.

Third, the Federal Reserve's highly accommodative monetary policy stance, combined with improved financial balance sheets, should help keep financing costs for consumers and businesses at low levels.

Finally, improving conditions abroad should provide some additional support for the expansion. Most of our trading partners — particularly those in Asia, which account for a quarter of our exports — experienced sig-

nificantly stronger growth in the second half of last year. As these countries grow faster, they typically demand more of our exports, and, in turn, contribute to the growth of our economy overall.

All told, these conditions lay the foundation for strong economic growth. The latest consensus of private sector economists expects real GDP growth to average around 4¼ percent in 2004. In the Fed's recent Monetary Policy Report to Congress, the central tendency forecast is somewhat stronger and calls for real GDP to rise 4½ to 5 percent this year. Such a pace of growth should foster improved labor market conditions. As a result, we forecast that the unemployment rate will fall to the 5¼ to 5½ percent range by the end of this year.

Inflation outlook

On the inflation front, core price inflation is currently in a range that appears consistent with price stability — a key objective of the Federal Reserve and a prerequisite for maximum sustainable growth. Even though the outlook calls for strong GDP growth, inflation rates are unlikely to increase significantly.

Often, such as in the late-1990s, rapid output growth rates like we saw in the second half of last year have signaled rising inflation. However, at that time, the level of output was at or above the economy's potential, and any rapid growth would only place additional strain on the economy's resources and lead to higher inflation.

This is not the case now. During the recession and sluggish recovery, the economy developed what economists call an output gap — in other words, the economy has not been producing at the level of its potential. As a result, the economy has developed excess resources, which are evidenced by the elevated unemployment rate and below-average utilization of industrial capacity. In turn, these excess resources have exerted a downward influence on inflation.

Even with the solid growth expected as we move forward, slack resources could persist for some time. To close this output gap, the economy needs to expand, for a time, faster than the growth rate of potential output — which economists many estimate at 3 to 3½ percent.

To be sure, this downward influence on inflation could be neutralized by other factors. For example, unused resources might not move efficiently to the sectors where demand is growing fastest. Or, the recent fall in the dollar could significantly raise the price of imported goods.

While these and other factors are risks to be mindful of, we believe the effect of slack resources remains predominant at this time and we expect inflation to remain low this year — somewhere in the range of 1 to 1¼ percent.

With inflation low, the Fed can be patient in removing its policy accommodation. However, this stance cannot be maintained indefinitely. The Federal Funds rate is currently very low, but the real Funds rate (that is, adjusting for inflation) is also unusually low by historical standards. In fact, today it is negative. As the economy picks up and the output gap narrows, this real rate will have to rise to a level more compatible with sustainable trends in economic activity.

Conclusion

In conclusion, I'd just like to say that time and time again the nation and the Midwest have proven resilient in the face of economic challenges. For example, in the early 1990s, the U.S. was in the midst of another jobless recovery, yet it was a jobless recovery that launched a decade-long expansion, during which the economy created well over 20 million new jobs. And in the early 1980s, the Midwest met the challenge of global competition through aggressive restructuring, and, as a result, prospered in the next decade. With an entrepreneurial culture, market-based principles, and a drive to develop new technology, both the nation and the Midwest have the ability to handle their current challenges, and the foundation to enjoy solid growth and price stability in the years ahead.