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The Midwest in the new millennium

With the economy entering the longest expansion of our nation's history, the Federal Reserve Bank of Chicago invited economists from business, academia, and government to attend an Economist Roundtable on February 11, 2000, focusing on the outlook for the Midwest economy in 2000 and beyond. This *Chicago Fed Letter* summarizes the workshop presentations on the economic outlook for the region and its states in 2000.

The Midwest economy in the year ahead

The Midwest economy finished 1999 at a slightly slower growth pace than it had shown earlier in the year. Midwest employment had been rising by nearly 1.5% in the first half, then increased at a slower 1.1% rate in the second half. For the year, Midwest employment grew by 1.3%, 0.7 percentage points slower than in 1998, and lagged the nation's employment growth (2.2%) for the fourth consecutive year. The marked slowdown in the region's employment growth four years ago coincided with its unemployment rate falling to 4.6% in early 1996. By January 1998, Midwest unemployment had broken the 4% barrier; and it has remained below 4% for the past two years. In December 1999 the unemployment rate in the Midwest was 3.4%.

While jobs in manufacturing continue to disappear, the region's share of national manufacturing jobs has continued to rise, increasing by 0.3 percentage points during 1999. Some manufacturing industries continued to struggle, while others began to recover from challenges they have faced over the past several years. The Asian crisis had put pressure on electronic equipment manufacturers, as computer chip prices fell sharply, and on steel producers, as foreign imports began to flood the U.S. market. During 1999 both of these industries began to recover. Low commodity prices continued to hamper agricultural machinery manufacturers.

Consumer spending, which has supported the national economy, has also been quite strong in the Midwest. High consumer confidence—supported by relatively low interest rates, a strong stock market, and good home value appreciation—has generated a spectacular housing market and a record sales pace for light vehicles. One challenge to continued growth the region faces is an increasingly tight labor market.

Housing market activity is expected to slow in the coming year as the rising mortgage rates during 1999 finally have an impact. These higher rates have also caused refinancing activity to virtually come to a standstill. With growth in real disposable personal income moderating, stock price gains abating, and interest rates not expected to ease, the stage is set for a breather in the pace of consumer spending during 2000. The auto industry is expected to do quite well in 2000, although light vehicle sales are forecast to be below the record 16.8 million level of last year. Midwest employment growth for 1999 was forecast at 1.3%, and that is exactly what it averaged. The forecast for 2000 is for Seventh District employment growth to continue to moderate, increasing by only 0.9% (see figure 1). This is likely to be below the national level again, due to a shortage of labor in the region.

1. Midwest non-farm employment

	1998	1999[a]	2000[b]
	year over year % change		
Illinois	2.1	1.2	1.1
Indiana	2.1	1.2	0.5
Iowa	2.8	2.5	1.0
Michigan	1.5	1.1	0.9
Wisconsin	2.1	1.1	1.0
Seventh District	2.0	1.3	0.9

[a]Preliminary data from Bureau of Labor Statistics (BLS).
[b]Forecast from Midwest Economist Roundtable participants.
Sources: BLS and Midwest Economist Roundtable participants.

The outlook for Illinois

Four economists from Illinois discussed state tax revenues and labor markets, while another discussed the strength of the Chicago real estate market. The economists noted that the state was sound fiscally, with sales and individual income tax revenue growing and corporate tax revenue falling from a year ago. Labor markets were tight, though there were some indications entering 2000 that they might loosen.

A state government economist and a university economist examined the state budget. Nominal sales tax revenue has been growing strongly and above state projections, up 7% year-over-year in the first six months of fiscal year 2000. A university economist pointed out that was "as good as it has been for a while." Additionally, the government economist noted that generally there has been no great impact from Internet commerce on sales tax revenues. Individual income tax revenue has been growing, but that growth has slowed. Nominal revenue was up 4% year-over-year in the first six months of fiscal year 2000, compared with 12% growth a year and a half earlier. The university economist said that although much of the slowdown was related to exceptional capital gains in the earlier period, it was still a cause for concern. Corporate tax revenue was down sharply from a year earlier, but both economists agreed that the decline reflected a change in the corporate tax rate on multi-state corporations from a weighted formula involving property values, wages, and sales to a flat rate based on sales.

A labor economist from the state government reviewed the state labor markets. The unemployment rate stood at 4.5% in the fourth quarter of 1999, and in January 2000, the unemployment rate dipped to 4.1%, with many people moving into full time jobs. The economist viewed January as an aberration and expected the rate to return to higher levels before long. Jobs in manufacturing continued to decline in 1999 and job growth in construction was solid, but the economist did not see that growth in construction employment continuing for very much longer. Overall employment growth for 2000 was forecast to be 1.1%, but the economist noted that figure could be on the high side. He said that many employers were beginning to report weaker demand and may have to adjust their labor forces accordingly.

A real estate economist from a large university in the District referred to the Chicago real estate market as the best in the country. Chicago, with office vacancy rates in the 2% to 3% range and a rising core city population, was the one city with evidence of a back-to-the-city trend in 1999. This represents a tremendous turnaround from six years ago when owners were renting space in the Loop at cost. The retail market was strong, particularly the North Michigan Avenue area, where a 25% increase in rents translated into only a small increase in vacancies. The market for condominiums has been strong as well. The economist expressed some concern about the way some private firms were underwriting large mortgages across the country, noting that their methods could lead to problems if there is a downturn in house prices.

The outlook for Michigan

Four representatives from Michigan discussed the outlook for the state, including economists from a state agency, a retail trade association, a research group, and an industrial supplier with operations in the state. Like the other states in the region, Michigan had very tight labor markets during 1999, causing concerns for some employers. The strong economy contributed to a good year for businesses, notably retailers.

All of the representatives from Michigan agreed that the tight labor markets would constrict employment and overall growth for Michigan in 2000 and 2001. Employment grew by 1.1% in 1999 and was forecast to grow by 0.9% in 2000 and 2001. Labor force growth for the state was forecast to be 0.9% in 2000 and 1.0% in 2001, implying relatively flat unemployment rates for the next two years. Employment growth in 1999 was stronger in some areas. For example, a strong year for auto-related industries pushed employment in west Michigan up 2.4%. But, the area's future dependence on the auto industry is less certain, as many of the companies that announced expansions or development plans in the area in 1999 are not in the auto sector.

Tight labor markets affected the Michigan economy in several ways. The retail trade association representative presented anecdotal evidence that retailers raised wages up to the \$7 to \$10 per hour range in order to compete for workers, which squeezed some profit margins. Some employers added other benefits to attract workers, including money for college textbooks, rides to and from work for opening and closing shift workers, and flexible work hours. One economist mentioned that some of his industry contacts started to report quality control problems as a result of increased use of temporary workers. This issue could be especially serious for manufacturers working in a just-in-time environment. Representatives reported that some companies had to turn away potential business because they did not have the workers to get the job done. However, the representative from the industrial supplier noted that his company decided to increase employee hours rather than turn away work, and as a result earnings were up 20% to 30% in 1999.

The retail sector of Michigan's economy had a strong year in 1999. Retailers reported strong holiday season sales and very strong January sales, which were probably boosted by the announcement of record bonuses for autoworkers. The retail sector continued to expand, with many of the "big box" stores (such as Home Depot or Menard's) moving into smaller markets and many of the national pharmacy chains expanding their presence. Retailers are concerned about the timing of a possible downturn in the economy, as well as the availability of labor.

The outlook for Indiana

A university economist from the state of Indiana discussed the outlook for Indiana. In 1999, Indiana employers continued to report labor shortages, and the tight labor markets should slow employment growth in the coming year. However, Indiana is one of the few areas in the country where manufacturing employment expanded. Two of the concerns that the economist raised were petroleum cost increases and the differentials in productivity gains between large and small companies.

The economist said that for the past five years, employers have reported labor shortages. The unemployment rate in Indiana fell to 2.4% in 1999, with some counties reporting rates below 2.0%. The data showed that the unemployment rate decline was a result of a declining labor force, but the economist raised questions about the data, saying that some of Indiana's benefits from migration were not reflected. The apparent effects of the labor shortage were limited, however, with few, if any, reports of upward wage pressure. No businesses reported turning away work, because strong productivity gains had offset labor shortages. Manufacturing employment expanded in Indiana, due largely to growth in automotive industry jobs. Notably, Toyota expanded and announced additional expansions of facilities in Indiana. Overall employment growth in Indiana was forecast to fall to 0.5% in 2000.

The economist reported several other issues important to Indiana's economic outlook. Petroleum costs were rising, which would increase the cost of moving goods and affect the financial performance of Indiana's trucking companies; the boom in e-commerce would only exacerbate those problems. Finally, productivity gains seemed to be taking place in only large companies. If the smaller firms fail to match these productivity gains, they could face problems competing.

The outlook for Wisconsin

Discussion about Wisconsin focused mostly on labor markets issues. Representatives reported that employment growth in Wisconsin was equal to or slightly slower than the rest of the nation. Labor shortages largely caused the slower growth; however, representatives from Milwaukee did report some pockets of excess labor supply.

A university economist noted that after 1998 the trend of Wisconsin's employment growth fell below that of the rest of the nation. One reason for the slowdown was a shortage of workers, but another economist pointed to a change in Wisconsin's migration patterns. In the early 1990s, population growth in Wisconsin was strong because the state's below-average unemployment rates attracted workers, but that dynamic evaporated in the last half of the decade as the unemployment rate differential shrank.

The unemployment rate in Wisconsin was around 2% for much of 1999, resulting in hiring difficulties for most industries. Hiring problems were made more severe by the fact that Wisconsin had one of the highest labor force participation rates in the nation. Growth in service sector jobs in Wisconsin was slower than the growth on the national level, and shortages were more pronounced for low-wage service jobs. However, the economist wondered if the data exaggerated the shortages for low-wage jobs. In particular, were workers who were joining the low-wage work force as part of Wisconsin's widely successful welfare-to-work program counted as social service workers because they were contracted out through social agencies? Manufacturing employment in Wisconsin contracted less than it did on the national level. The economist noted that the recovery abroad has helped manufacturing activity in the state and that the contraction in manufacturing employment should stop in the coming year.

Two representatives from the city of Milwaukee pointed out that the city's economy was not performing as well as the rest of the state. Surveys of people in the city revealed that large numbers of people from inner-city Milwaukee were looking for jobs but could not find them, leading one representative to conclude that in some areas of the city the unemployment rate could be as high as 20%. However, many of the problems associated with helping those workers to find jobs require long-term solutions. Representatives cited transportation as one of the largest problems in getting those people to jobs in the suburbs, and initiatives to improve transportation out to the suburbs have failed thus far. City officials are working to improve the city's schools in order to improve the skill sets of those who live in the city. City officials have also tried to lure businesses to the downtown area. While their efforts have yet to bear fruit, they continue to talk about prospective developments for the area. One positive note about the city's economy is that property values increased strongly over the past two years.

The outlook for Iowa

A government economist from Iowa noted that the most important factor in Iowa last year was the tight labor market. While the lack of available labor affected employment growth, it was not necessarily leading to wage pressure. Elsewhere in the Iowa economy in 1999, the housing market set another new record and farmland values stabilized somewhat.

For the whole state, the unemployment rate was 2.6% in 1999 and the monthly, seasonally unadjusted jobless rate dropped as low as 1.6%. Additionally, 90% of the working age population (persons between 18 and 65 years old) was employed in 1999. Tight labor markets led employment growth to slow, and the economist forecast that employment would increase 1.0% in 2000, compared with 2.5% in 1999. However, he noted that the forecast might be high because he did not think that there would be enough workers to fill jobs. These tight labor markets created a "crisis of hiring" for employers in Iowa. The economist spoke of fast food restaurants offering employees $7.50 per hour with health and 401k benefits. One firm was offering signing bonuses as large as $25,000 to attract high-skilled workers to fill some information technology positions. Employers were also offering more promotions to retain employees.

The tight labor markets led to higher wages for low-wage workers, but did not lead to higher wages on the high end of the pay scale. In 1999, average weekly earnings for wholesale workers and service sector workers—traditionally low-wage jobs—increased 4.5% and

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6.5%, respectively. Overall average weekly earnings, however, only increased 1.5%, which the economist said gave "virtually no indication of inflation." However, growth of wage-based personal income was stronger than weekly earnings growth, a sign that workers were moving upward to higher paying positions, while wages for each position were relatively flat. The economist forecast that wage-based income would grow 7.5% in 2000 and 7.7% in 2001.

Indications from other economic activity in Iowa were mixed in 1999. Net farm income was about $2.9 billion in 1999, down from $3.4 billion in 1998. Emergency federal assistance added about $610 million to income in 1999. Farmland values were down only about 1% from 1998, as the emergency federal money caused renegotiations on rent payments to stop and land values to stabilize somewhat. The housing market set a record for the second year in a row; housing permit values were up 0.1% from 1998. The economist suspected that the housing market would start to show the effects of higher mortgage rates early in 2000.

The same old story

The Midwest's major challenge during 1999 was the tight labor market, an issue that the region has been struggling with for a number of years. It appears that a tight labor market will continue to be the key issue during the coming year. How an economy expands while facing full employment is one of those good problems that the Midwest will hopefully be able to adjust to.

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