Economic Assessment and Outlook

Richard H. Bard, Peter J. Widmer

Richard H. Bard  In 2001, Bard was elected to the board of directors of the Federal Reserve Bank of Kansas City and serves as deputy chairman. He is the founder and manager of IdeaSpring which invests in and supports early stage companies. He also has founded and been part of the senior management of three former NYSE-traded companies and is the founder and former CEO of NASDAQ-based Optical Security Group, now merged with Applied Optical. In 1987, he established the Irene and Irving Bard Professorship in Marketing at Pennsylvania State University; and in 1997, the Bards endowed the Center for Entrepreneurship Development at the University of Colorado at Denver. In 2001, he was a recipient of the Ellis Island Medal of Honor, awarded for encouraging cultural unity and engaging in humanitarian efforts that benefit the country.

Peter J. Widmer  As an investment banker with Zurich-based Julius Baer, one of the largest private banks in the world, Widmer has been able to acquire firsthand knowledge of the euro and its global impacts. During his long and successful career, from which he is now retired, Widmer founded Baer's investment management business and was responsible for all institutional investment activities outside of Switzerland. He chaired the boards of Julius Baer Investment Management, Inc. (New York, London), Julius Baer Investments Limited (London) and Julius Baer Kapitalanlage AG (Frankfurt). Widmer was born and educated in Zurich, followed by a three-year banking apprenticeship. He subsequently received the Commercial Diploma from the Swiss Business Association.

Opinions on the outlook for the economy range from one extreme to the other. The economy is either recovering from a recession or never was in a recession. It's either going to grow moderately this year or it's going to double dip back into recession, provided we had one in the first place. To make sense of it all, the Forum invited two experts to address the key issues. Richard H. Bard discussed the U.S. economy and the role of the Federal Reserve Board; Peter J. Widmer focused on economic conditions in Europe and the status of the euro.

The U.S. economy

As a member of the board of directors of the Federal Reserve Bank of Kansas City, Richard Bard tries to look beyond charts and numbers and "get into the minds of CEOs" to learn firsthand how business is shaping up on the ground. His information gathering is usually done on an informal basis, at breakfast and lunch meetings in Denver. He then reports his findings to the board at regular meetings in Kansas City.

Despite optimism at the Fed, "the CEOs see things differently," Bard said. "They're worried that this recovery isn't sustainable even though interest rates are low, there's been some tax relief, and inventories are getting to a point where they need to be replenished."

The problem?

"We CEOs don't see sales opportunities to invest in and we don't see underlying growth. We don't see inflation either. What this means is that you can't really manage your business from a price standpoint; you can't impose price increases and you can't manage your cost structure, other than perhaps investing in supply chains and some of the other programmables." A double dip occurs when the recovery starts, sputters and runs out of steam. "The attitude around the Fed is that this is not a double dip," said Bard. "They think that we're going to pull out and recover, though it may be slow." There are signs to support the Fed's position. "Consumer confidence is increasing and there are improvements in the manufacturing and non-manufacturing sectors almost across the board. The inventory-to-sales ratio is on a steady decline and in March job creation was good."
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Also...

- Consumer spending. When a recovery starts, there is a pent-up demand and consumers start spending again. "But the anomaly here is that, excluding the second week of September when stores were almost deserted, consumer spending never really went away."
- Housing market. Low interest rates are pushing housing. "But I don't think it's sustainable. Eventually, people who are out of work don't buy houses and can't refinance."
- Inflation. "Another anomaly is that inflation has been steady at about 2.3 percent, with 1 percent deflation in goods and almost 4 percent inflation in services."
- Capital spending. "Starting about mid-January, there has been an upturn in capital spending, particularly in the IT sector."

With these positive signs, why aren't all CEOs more upbeat about the recovery?

"Some feel that it's a recovery without earnings," said Bard, adding that business investment is lacking. Speaking for himself, he said, "My health care costs are going through the roof, my insurance costs are going through the roof, costs in the service side of my business are going up at a high clip, and I don't have anybody to pass the costs onto."

Geopolitical events also factor into the thinking of CEOs who are less likely to make growth-related investments in their business when the Middle East is on the verge of blowing up. "And the dollar has been too high, making it difficult to sell U.S. goods in other markets. If there are currency devaluations abroad, that could make the problem worse."

All things considered, Bard believes the recession is over but that the recovery will be a lot slower than early predictions. "Whatever happens in the United States will have some effect on the global economy."

The nation's banking system

The Federal Reserve is a national banking system that has at the top of its structure the Board of Governors, chaired by Alan Greenspan. When the board makes decisions for the U.S., the impact of those decisions affects the world's economy, said Bard, explaining that the Fed is responsible for setting the nation's monetary policy; supervising and regulating banking institutions; protecting the credit rights of consumers; maintaining the stability of the financial system; and providing certain financial services to the U.S. government, the public, financial institutions, and foreign official institutions. All checks written by the federal government get processed through the system, headquartered in Washington, D.C..

In making its decisions, the board is counseled by the Federal Open Market Committee (FOMC), the most important monetary policymaking body of the Federal Reserve System. "It's the one that gets most of the media attention," said Bard. The FOMC is responsible for formulation of a policy designed to promote economic growth, full employment, stable prices, and a sustainable pattern of international trade and payments.

There are 12 reserve banks in the reserve system. Only one state, Missouri, has two banks (St. Louis and Kansas City federal banks). The banks are located in major cities across the country: Boston, New York, Philadelphia, Richmond, Atlanta, Cleveland, Chicago, St. Louis, Minneapolis, Kansas City, Dallas, San Francisco. Bard is on the board of the Federal Reserve Bank of Kansas City, District 10, which covers 1000 banks in Kansas, Colorado, Nebraska, Wyoming, New Mexico and Oklahoma.
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Supervised by the Board of Governors in Washington, the Federal Reserve banks are the operating arms of the reserve system. "They oversee the banks in their district and make reports to the board on local business conditions, among other duties," said Bard. One representative from each of the 12 districts makes up the Federal Advisory Council. "The Board of Governors by statute must take the advice of this council because its members provide the states with representation at the national level."

The European economy

Peter Widmer agreed with Richard Bard that to a large extent the health of the global economy depends on the U.S.

Said Widmer, "We look for a slow recovery in the European economy in 2002 with projected growth rates of 1.1 percent real growth this year and 2.5 percent next year. This is below U.S. figures, but our decline was less significant as well."

Inflation is under control, "which explains why the European Central Bank did not move as aggressively as the Federal Reserve to bring down interest rates to fight this so-called recession." Widmer added that the ECB has only one mandate and that's price stability. "We do not expect the ECB to raise interest rates any time soon, certainly not before the Fed would move."

The stock market is anemic. "We have the same earnings disappointments in Europe that you have here," said Widmer. "So I think the best we can hope for is single digit returns this year. Our bonds are expensive, not as expensive as yours, so when the rates go up, you won't be able to make much money there."

The corporate environment in Europe is moving closer to the American model due to stricter regulations. "Companies are now allowed to go out of business, especially in Germany, because the banks have stopped supporting poorly conceived deals."

The fallout from Andersen/Enron is also being felt in Europe, as are U.S. politics in general. Asked if Europe's sentiments are with Palestine and not Israel, Widmer said, "I don't think that is the case. There is an awful lot of sympathy for Israel, but there is growing sympathy for the Palestine side. And maybe Europe should play a more active role in trying to broker a deal because they're not considered to be biased towards one side."

The euro and European Union

The introduction of the euro on January 1, 2002 was "unbelievably smooth," said Widmer. "In the two-month transition period where two currencies ran parallel, people paid for purchases with their national currency and received change in euros. This made it possible to replace the old with the new and take a lot of the old money out of circulation."

Only 12 of the 15 European Union countries have joined the euro: Finland, Austria, Portugal, Netherlands, Luxembourg, Italy, Ireland, France, Spain, Greece, Germany and Belgium. The UK, Denmark and Sweden have chosen to stay out. But now that the euro has debuted so successfully, Sweden is thinking more seriously about joining and there is pressure on the UK to join. "My prediction is that the UK will join eventually."

In 2004, the European Union will expand its membership from 15 to 27. The 12 new candidate countries, most of them once part of the former Soviet Union, include Bulgaria, Cyprus, Czech Republic, Estonia,
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Hungary, Latvia, Lithuania, Malta, Poland, Romania, Slovak Republic and Slovenia. EU membership does not automatically ensure participation in the euro although these countries may be able to join the euro at a later time.

Expansions by their very nature create problems and the EU expansion is no exception. Subsidies and the matter of who gets what is a big issue. The new candidates add only 5 percent to the GDP of the EU while adding one-third to the total population. Some of the existing members fear that the new and weaker members will lower the bar and siphon off the subsidies they now enjoy.

Poland is another issue, only because Germany is threatening to veto any new member in 2004 if Poland is not allowed in. This isn't altruism on the part of Germany, but a desire to solve the historic problems between the two countries. Considering that the EU was formed to weld Europe together in an effort to eradicate wars, Germany's position is easily understood.

But according to Widmer, the Poles' attitude needs work. With Germany championing their cause, the Poles have expressed the feeling that maybe they don't have to work so hard to measure up to the requirements as the EU will make allowances for them. "Of course this got other people a little excited," said Widmer.

It would be easier to expand the EU one or two countries at a time, but that would cause negotiations to go on for 10 or more years, said Widmer. "The theory is to bring in all 12 at one time and then address the other issues. And that's going to be very, very difficult, not just because of the different nature of these countries, but because of the internal EU structure which is not flexible enough at this point to accommodate 27 members."

Switzerland is not a member of the European Union but it has forged six bilateral agreements with the EU "that cover the most important segments of the Swiss economy and more or less put us on the same footing as if we were a member," said Widmer. This gives the Swiss the economic advantages without the political commitment. "Because our problem with the EU is only political. We are a direct democracy and we are not sanctioned to take instructions from another government body."

Where the money is

The Federal Reserve, the central bank of the United States, was founded by Congress in 1913 to provide the nation with a safer, more flexible, more stable monetary and financial system. "The Fed is the bankers' bank. The Kansas City Fed handles cash and coin management for over 1000 banks in the 10th District," said Bard. "There's plenty of money in the Federal Reserve banks and the New York Fed is where all our gold is."