Commencement address by Vice Chairman Roger W. Ferguson, Jr.

Expectations

At the Olin School of Business, Washington University in St. Louis, St. Louis, Missouri
May 16, 2003

Dean Greenbaum, distinguished trustees and faculty, and honored guests, I am pleased to be at the Olin School today to congratulate this accomplished group of graduates. I hope today represents but one among many successful milestones to come. And my advice to the graduates is that they look back, not just forward, and thank the family and friends who supported them in school and helped to make today's achievement possible.

I intend to do more than just wish the graduates success this afternoon. In fact, I will take a few minutes on this happy occasion for a discussion of economic conditions and policy. I will first explain what the Federal Reserve will be doing to ensure the best possible performance of the economic system that you are about to enter. Then, I will discuss some steps that you can take to navigate better in that wider world. Before I proceed, I should note that the views I will be expressing are my own and do not necessarily represent the views of other members of the Federal Open Market Committee or the Federal Reserve Board.

What to Expect from the Central Bank

Let me first explain what you, and others graduating during this season, can expect from the central bank. To my mind, the most important potential contribution of monetary policymakers is to anchor inflation expectations so that private-sector decisions can be made as efficiently as possible. We can do this because, as with any central bank, our control over the size of our balance sheet determines the value of our country's money and the general price level in the long run. We must do it because our enabling legislation directs the Federal Reserve to seek monetary conditions fostering "maximum employment, stable prices, and moderate long-term interest rates." The economics profession has learned, in part from the bitter experience of the 1970s, that those three objectives collapse into one in the long run. That is, only in an environment of stable prices will households and firms be able to direct their complete attention to producing, investing, and saving so that employment will be at its maximum over the long run. And at the same time, when investors are not concerned about a generally rising level of prices for goods and services, inflation premiums will be compressed and long-term interest rates will be moderate.

However, an environment of price stability is not one in which measured price indexes do not change. In fact, price indexes of consumer goods and services suffer from a variety of statistical biases that imply that the indexes overstate actual inflation. That is why, following Federal Reserve tradition, I speak of an environment of price stability, or a situation in which concerns about variations in the general price level do not materially influence the decisions of households and firms. In my view, we are in such an environment. The four-quarter growth in the core personal consumption deflator is currently running at a 1-1/2 percent rate, the slowest sustained pace in thirty years and 8 percentage points below its

peak recorded in 1980. Think of it: Inflation has declined over the years--that is, we have experienced disinflation--to the point that increases in prices are now at a rate not seen on a sustained basis in the lifetimes of most of today's graduates.

This disinflation represents an impressive victory for the disciplined monetary policy of the Federal Reserve under the guidance first of Paul Volcker and then Alan Greenspan. But having won the war, we at the Federal Reserve also have to win the peace. We will do that by always remembering that our mandate to foster price stability imposes a symmetric responsibility. Because resources are misused whenever the economy operates outside the zone of price stability, measured inflation can be too low at times as well as too high.

In the quarters ahead and as noted at the conclusion of our policy meeting earlier this month, the Federal Reserve has to guard against further declines from the already low prevailing level of inflation. And we shall be on guard against such a development. Nonetheless, the possibility that the process of disinflation will cumulate to the point that price levels actually decline for a sustained stretch of time--that is, we enter into deflation--remains quite remote. Quite simply, the United States has too many good things going for it to make a forecast of deflation credible, including the stimulus imparted by prior monetary policy easings, the marked decline in oil prices associated with decisive victory in the war against Iraq, the progress many households and firms have made in repairing their balance sheets, and the fact that inflation expectations remain well anchored.

In discussing the fundamentals supporting economic expansion, I particularly want to single out the impressive growth of labor productivity. These increases in output per hour worked have been made possible by the harnessing of advances in technology in every aspect of business life. The lessons learned at institutions such as the Olin School are being applied everywhere to trim inventories, shorten supply chains, and enhance firms' responsiveness to their customers' needs. Faster productivity growth implies that workers can look forward to more rapidly rising real wages over time. Because the economic pie will be getting larger, those wage gains will not come at the expense of profits.

But we must also remember the unpleasant arithmetic attached to those gains in productivity of late. Thus far in the economic recovery and expansion, firms have been able to meet increased demand for their products without adding workers. I would not be credible before this audience if I did not recognize that some may have had trouble finding employment and a few may still be uncertain of their next job opportunity. Indeed, over the past year, about one-half million private payroll jobs in the nonfarm sector have been lost. Because aggregate supply can increase rapidly, aggregate demand also has to grow faster than its recent pace to ensure that economic slack does not build up. Indeed, given the existing level of slack in labor and product markets, the economy should be able to enjoy above-trend growth for some time without putting undue pressure on resources. Recognizing that the economy is experiencing price stability, I also accept that the central bank should work to create conditions conducive to closing the gap between output and the ability of our economy to produce, thereby fostering utilization of resources, including labor.

With the sound fundamentals that are now in place, I believe that such an outcome will be achieved. That said, an economic system such as ours that relies on the separate decisions of millions of people working to further their self-interest will be sensitive to expectations and sentiment. As a result, economic outcomes can change quickly and are thus difficult to predict. The difficulties of prediction pose a challenge to monetary policymakers: We prefer to act in advance of, rather than in reaction to, economic developments so as to minimize

disruptions to economic activity. We cope with the challenge of prediction as best we can by devoting substantial resources to economic forecasting, by monitoring developments in financial markets, by speaking regularly with an extensive network of business contacts, and by being flexible with our policy actions. But the reality is that the private sector cannot look to the central bank to eliminate all risk. Real decisions have uncertain outcomes, and sometimes the result is adverse. But businesses and households must be prepared to take the reasonable risks associated with modern economies. And I am certain that businesses will return to a more normal pace of investment, although I am less certain of the timing.

What to Expect of Yourselves

Let me now offer a few thoughts about the world you are entering and the key professional challenges you face. Frankly, you will join the business world at a time when many have lost confidence in the integrity and ethics of our institutional leadership. Questions have been raised in the corporate and nonprofit sectors about the quality and reliability of information that is made available and about the personal ethics of those who had responsibility for managing the business risks that all organizations face.

A disregard for ethics, vague accountability, and weak systems of internal control have resulted in unexpected levels of risk in credit or market exposures, in legal liability, and in tarnished reputations and careers. But the damage is not necessarily limited to those situations in which wrongdoing was discovered. The threat is more fundamental: Capital cannot be allocated efficiently if market participants do not have reliable information with which to make reasoned judgments.

Many investors, businesspeople, policymakers and regulators understand this and have successfully promoted a needed emphasis on independence, oversight, and accountability. Corporate governance is now properly understood to be the keystone in risk management. Reputation is a critical competitive necessity, as you know, because reputation certainly weighed heavily in your educational selection process. Reputation risk should not be underestimated; I believe, for example, that Enron ceased to be a viable business because the value of its name was severely reduced well before any liability had been found in any court of law.

How can the organizations you will soon join manage legal risks and protect their reputations? It is here that I believe a well-crafted ethics policy and the means to monitor compliance can serve as a foundation. A solid program in support of ethical behavior, along with sound corporate governance, can act as an early warning system that raises concerns to senior managers and directors before they ripen into legal liability. A rigorous compliance program can also identify behavior that, while within the law, could tarnish the company's reputation with very tangible consequences on equity value.

It would please me thoroughly to say that with your entry into the profession of management the need for these kinds of programs will be reduced. And your educational experience has no doubt included some thoughtful and perhaps heartfelt discussions of business ethics. But one of the constants of human commerce is that a certain proportion of those involved will succumb to the urge to subordinate ethics to the desire for personal gain, however fleeting. I believe that most of you will live up to the highest ethical standards. Some of you will be able to profoundly influence your communities and businesses for the good. I will celebrate that kind of outcome, but my more modest hope is that as a group you will enter the business world as energetic advocates for the careful management of reputation risk and that throughout your careers you will use the lessons of our current experience.

My final thought on managing the challenges ahead is one that will be familiar to you. As a person who was privileged, as you are, to attend some of the world's finest educational institutions, and as someone who currently serves in an institution that is heavily dependent on analysis, I know that knowledge matters. Knowing a business plan or an issue or an analytical technique is an absolute requirement. Recognizing that knowledge is fleeting is the beginning of deeper understanding.

Thus, my hope for you is a continuing commitment to working through difficult problems, a professional life characterized by the highest commitment to ethical behavior, a lifelong love of learning, and a few moments--days like today--for celebration of your success. Congratulations and good luck. We are rooting for you.