THE ROTARY CLUB OF DES MOINES AND THE GREATER DES MOINES CHAMBER OF COMMERCE

Des Moines, Iowa
March 2, 1995

Economic Outlook — Where To From Here?

Thank you for inviting me to be here for this joint meeting of the Rotary and the Chamber of Commerce. I'm told this is the oldest Rotary in the nation; it's a pleasure to be here.

Today I'd like to talk about my outlook for the national and regional economies and share some thoughts on monetary policy. Fortunately, the news on the economy is good. In a way, I'm here bringing coals to Newcastle as Iowa has certainly been a source of a lot of positive economic news lately. Following a tumultuous 1993 marked by the Great Flood, Iowa's come back stronger than ever. I know the employees at our Des Moines Office showed how resilient and hard working they were by keeping our operations going nonstop during the flood. Those characteristics seem to be commonplace in Des Moines and Iowa.

The Fed, of course, is very much focussed on the state of the economy. Our mission is to foster a healthy, growing economy and a safe and efficient financial system. More specifically, the Fed formulates monetary policy; supervises and regulates banks; and provides financial services to depository institutions and the U.S. government. The Chicago Reserve Bank serves a five-state region, which consists of all of Iowa and most of Illinois, Indiana, Michigan, and Wisconsin. To carry out these activities, we have a head office in Chicago, a branch in Detroit, and offices in Milwaukee, Indianapolis, and, of course, here in Des Moines. This past year, we've had strong economic growth and moderate inflation, perhaps the best year since the early 1970s. That period strikes a chord with me as I first became involved in economic policy at the national level at that time. In fact, it was about twenty-five years ago that I was involved in what might be one of the more misguided economic experiments in recent times—the wage and price controls of the early 1970s. It was one of the experiences that helped to shape my views on monetary policy and, in particular, the importance of containing inflation. I'll come back to that in a few minutes, but first I'd like to briefly sketch what I think is a very promising economic outlook.

A Tough Act to Follow

Clearly, 1994 was a year of robust growth — a very tough act to follow! Connoisseurs of GDP will note that 1994 was a vintage year; the economy yielded one of its best performances. It was possibly the most favorable mix of real growth, low unemployment, and moderate inflation in the last twenty years.

As a reminder, here are the numbers for 1994. A 4 percent increase in real gross domestic product. 3 and one-half million new jobs and unemployment down to 5 and one-half percent at year end, more than a percentage point below the 1993 level. And, importantly, only a 2.7 percent increase in inflation as measured by the Consumer Price Index, the same as in 1993. This means that inflation increased less than three percent at the retail level for the third consecutive year. That's the first time that's occurred since the early 1960s. That's a significant accomplishment.

The Seventh Federal Reserve District was at the center of the economic surge. In terms of employment, our Midwestern District led the nation out of the recession. In fact, each of our five District states now has an unemployment rate that is lower than the national average. And Iowa's 3.2 percent unemployment rate is the lowest of the District states and the fourth lowest in the nation.

Manufacturing employment has led the charge in the District, with an increase of 2.5 percent in 1994. Just how well the region's manufacturing sector performed is indicated by the manufacturing activity index developed by the Chicago Fed. This index showed an 11 percent increase for the Seventh District compared with six percent for the nation, as measured by the Federal Reserve Board's index of industrial output.

The recent performance of the Seventh District is particularly exciting considering the region's past reputation. As you may recall, the District was not-so-affectionately referred to as “The Rustbelt” in the 1980s. Today, the region is much more productive and competitive. Following a painful adjustment period, the Rustbelt has become a well-oiled machine.

Iowa's traditionally been one of the District's strongest performers. Iowa's created jobs at a substantially faster pace than the nation since 1986—and the gap has widened in the 1990s. While the state faced some difficulties early in the decade due to its dependence on agriculture, it's diversified to a degree and has since been in the forefront of the region. Agriculture still dominates the state economy, but manufacturing has become increasingly important. It's interesting to note that jobs producing durable goods such as industrial machinery have grown in Iowa since 1992, even as they've decreased in the nation as a whole.

Like the District, Iowa performed quite well in 1994. As I mentioned, employment has been outstanding. Agriculture, always a mainstay in Iowa, recovered from the flood-related problems of 1993 with a record harvest last fall. Conditions aren't as favorable for livestock producers, and the debate about a new farm bill will cause some uncertainty. But the state's ag sector should hold up fairly well in 1995.

A Bright Outlook

As I said, 1994 is a hard act to follow. The economy will benefit from some substantial momentum that has carried over from 1994, especially in terms of employment. Yet growth will slow in 1995, which is a welcome development as the pace of growth in 1994 was not sustainable. Past monetary policy actions will affect the economy in 1995. The surge in the sale of durable goods such as machinery and large appliances will inevitably moderate during the course of the year, although the most recent data has revealed surprising continued strength in this area. However, other statistics for early 1995 indicate slower job growth and more moderate retail sales and housing activity.

I still expect healthy growth in 1995, but in the realm of 2 to 2.5 percent GDP, which is more in keeping with the long-term potential of the economy. I would expect inflation pressures to increase somewhat, given the rising prices for a variety of raw materials such as steel and paper products and the signs of tightening labor markets. However, the expected cooling of the economy should prevent a strong resurgence of inflation. Overall, I expect inflation as measured by the Consumer Price Index to average 3.5 percent during 1995. Given the likelihood of slower but still healthy growth, I'd anticipate a year-end unemployment rate of about 5.6 percent.

The outlook for the Seventh District is also quite favorable. Historically, the combination of interest rate increases and higher inflation has slowed the Midwest economy, given its traditional emphasis on the manufacture of durable goods. Sales of goods such as tractors and refrigerators tend to flatten as the economy slows. However, the Midwest today is much more competitive, more diversified, and less susceptible to the swings of the business cycle.

Exports should continue to provide a boost to the Midwest economy, although the recent events in Mexico will have a dampening effect. Iowa, which exceeds the national average in exports, will also benefit from this trend. For example, 1995 is expected to be a record year for agricultural shipments, thanks in part to the emergence of China as a major grain importer.

To sum up, there's a bright outlook for the nation and the region. We won't repeat the rapid growth of 1994. Such growth was not sustainable. We're like a runner that's just completed a 4-minute mile. Our resources are stretched. It's time to slow down and continue at a steady clip that we can sustain over the long term. I expect we'll do exactly that in 1995. We should experience very respectable growth with moderate inflation, which should leave us well-positioned for a period of solid, sustainable expansion.

Mistakes of the Past

Now I'd like to briefly discuss my views on monetary policy. The point I'd like to emphasize is the importance of keeping inflation in check in order to foster healthy, sustainable growth. Now that's not a startling statement from a central banker. But it's one that can't be overemphasized. Why is inflation so dangerous? It leads to a subtle distortion in the decisions of businesses and consumers. With excessive inflation we devote too much of our resources to protecting ourselves from price increases. With a stable and low inflation rate, we're more likely to invest and save.

I think a look back to the 1970s makes it clear. There seems to be an intense interest in the '70s now. We're seeing '70s fashions, hearing '70s songs, and even have an opportunity to see the Brady Bunch in the movie theaters. I can't claim to understand this fad but I won't buck the trend.

It's interesting that 1994 was perhaps our best year since the early 1970s. But that performance in 1972 was misleading. As we all know, a persistent inflation built up during the decade, with devastating effects on our economy and society. Not that people weren't concerned about inflation. As I mentioned earlier, I was involved in some of the early attempts to contain inflation as director of the Council on Wage and Price

Stability. Following the implementation of the wage and price controls, I had an opportunity to see first hand the difficulties involved in monitoring wages and prices after the controls were lifted.

Needless to say, the experiment was an abject failure and provided a real-life verification of my academic training. One always hopes to play some role in an important event but this wasn't exactly what I had in mind when I moved to government. It was somewhat like trying to tape gravy to a wall. Despite our best intentions to seal and patch, inflation inevitably oozed out. It highlighted to me how complex our economy is and how each industry has its own dynamics. It also highlighted the futility of relying on gimmicks to contain inflation. The importance of stopping inflation before it got out of hand was very clear. Once the genie is out of the bottle, it's difficult to squeeze back in.

I joined the private sector in 1977 and gained a different perspective. Inflation had built during the 1970s, peaking at 13.3 percent in 1979. I saw first-hand how inflation distorted the judgement of people and businesses and led to serious mistakes in investment projects.

Discipline in cutting costs flew out the window because it was easier to recoup cost increases by raising product prices. I guess we reached the high point or low point, if you wish, when the price of silver peaked at over $50 an ounce.

Following the long and painful recession of 1981-82, we experienced the longest peacetime expansion in our history. The more moderate inflation of that period provided a foundation for sustained growth. Yet there were areas of concern. Our growth was fueled in part by debt; eventually the bill became due. The events in Kuwait triggered a relatively mild but very persistent recession. The economy's progress was staggered by powerful headwinds—the efforts of households and firms to reduce their debt.

This was entirely appropriate. Certainly, we have to keep a steady eye on the long term. But we also need to remember the long run is made up of a series of short runs. In this case, the Fed helped to alleviate some of the unusual constraints that had build up over the 1980s and allowed the economy to grow again.

But by the beginning of 1994, it became clear that the headwinds had abated. The Fed needed to shift its policy direction. The goal was to eliminate inflationary pressures before they had a chance to build.

There was some controversy at the time as to whether these moves were necessary, whether we were jumping the gun. In retrospect, I think the Federal Reserve was absolutely right. Determining the best policy is always a difficult undertaking, at best. Monetary policy works slowly as it seeps into the economy, affecting the decisions of millions of households and businesses. As a result, policy works on a delayed basis — a time release capsule that may take several months or even more than a year to take effect.

Because the effects of policy are slow and occur with a lag, the Federal Reserve needs to look forward as it acts. In 1994, the Fed moved to head off inflationary pressures even though they weren't evident in the data. The Fed preferred to deflate these pressures with a series of pin pricks rather than wait and burst the inflationary balloon after the fact.

Conclusion

As you know, the Federal Reserve's most recent policy move took place on February 1st when we raised the discount rate and the fed funds rate by half a percentage point. Some have argued that we had reached a turning point, that we no longer needed to act to contain inflation. However, based on the data available at that time, I think it was very clear that the economy was continuing to expand and that inflationary pressures were building up at the producer level. These increases will likely be passed on to the consumer. Our actions were intended to forestall these inflationary pressures and keep the economy on an even keel.

Will we need to take further action? No one can answer that question with certainty. Some signs are beginning to appear that economic growth is moderating, particularly in areas sensitive to interest rates, such as autos and housing. The signs are tentative, however. It's still too early to know whether the pace of the expansion has abated sufficiently to put the economy on a sustainable, noninflationary growth path.

As we assess the need for further policy action, we'll need to remain especially vigilant for signs of increasing wage and price pressures. There are signs that labor markets have tightened perceptibly in the past few months. Typically this would increase pressures to raise wages and labor costs would accelerate. But it appears that a lingering sense of insecurity among workers has been a factor in discouraging rapid wage growth thus far. We'll continue to maintain a close watch on labor market data and keep in touch with those living and working in the region to ensure that we have the best possible understanding of emerging developments. This is one of the advantages of a regional Federal Reserve System. The twelve Fed Bank presidents are located throughout the country and have an opportunity to get a first hand view of regional developments.

Whatever our actions, we'll need to keep in mind our long term objective. To some degree we're still paying the price for our mistakes of the past. For example, long term rates have included a relatively high premium for expected inflation, despite the significant improvement in inflation during the past fifteen years.

I think we've made progress in this area. Since the Federal Reserve increased the federal funds rate and discount rate by three quarters of a percentage point last November, the interest rates on long-term Treasury securities have dropped more than one-half of a percentage point. Rates for fixed-rate mortgages have also decreased by the same amount. This decrease was the result of moderating demand combined with a renewed faith on the part of the market that inflation would be contained. If we had not moved aggressively to tighten policy, these longterm rates might have been higher than they are today.

To conclude, I'd like to emphasize that the outlook is positive for the nation and the region. The best way to foster this positive outlook over the long term is to ensure price stability. A low, stable inflation rate allows households and firms to make their saving and investment decisions most efficiently. High and unpredictable inflation distorts the incentives to save and invest, which are so important to the economy's long-term growth.

Allowing inflation to increase might seem like a painless way to boost employment in the short run. But it's a macro-economic Ponzi scheme. There's no foundation. Any gains are fleeting and illusory, and come at the cost of forgone future growth. As we saw in the 1970s, the end result is high inflation, low employment, and stagnant growth. And the cure is a painful one that's best avoided—prevention is the best medicine. In the long run, price stability is the surest way to achieve the goal that we all share—a healthy, growing economy.

Thank you.