

HARVARD BUSINESS SCHOOL CLUB OF DETROIT

Detroit, Michigan  
April 26, 1995



**Monetary Policy: From Where I Sit**

I'd like to thank you for inviting me to speak tonight. I know a lot of you enjoy this evening because you have a chance to renew old friendships, some going as far back as the Harvard Business School. Even though I'm a product of Wharton and I taught at Kellogg, it's a pleasure for me to be here also.

I hope you were able to take a quick tour of our facility to get a feel for what we can accomplish with electronic payments technology. A couple of our Detroit directors are here tonight, and I'd like to recognize them ...thank you for taking the time to be here.

I enjoyed listening to Dave Allardice talk about our regional economy. I've been trying to get him to put together some numbers on the economic impact of Michael Jordan's return to the Chicago area. Increased hotel occupancy and restaurant use on game nights, things like that. Dave says he's excited about the assignment, but wants to hold off a couple months. He thinks the figures will be much more complete after the Bulls win the NBA championship.

Dave's thoughts about the impact of the Midwest auto industry on our total economic output always capture my attention. Forty-five percent of the nation's auto production takes place here in the Seventh Federal Reserve District. It's an industry of crucial importance to the well-being of the regional and national economy, and our staff monitors it very closely.

What am I going to talk about tonight? Monetary policy. Since Dave has painted such an interesting portrait of the Midwestern economy and the auto industry, I'll frame his comments with some of my impressions of the monetary policy process.

To start off, let me give you my impressions of the Federal Reserve. It's a complex, dynamic institution with a variety of different responsibilities. These can be split into three broad areas:

**Number 1** — We're an academic research center. We have an entire floor of economists studying the regional, national and international economy in detail. It's a giant think tank analyzing economic data, from agriculture to the auto industry, from everyday, nuts-and-bolts issues to the highly theoretical.

**Number 2** — We're a government regulatory agency supervising and regulating banks. This gets much less attention in the press than our monetary policy role.

**Number 3** — We're like a private company that plays a significant role in the country's payment system. We compete for market share in the sale of various services, like check processing, to financial institutions. This Detroit Branch of the Chicago Fed is a large-scale provider of these services. In fact, its service volumes are higher than those at many Federal Reserve Banks.

So we have an academic research component, a government regulatory component, and a private-business component. Having worked in academia and the public and private sectors, it was fascinating for me to find elements of all three in one organization. That caught my eye about this position. It's also a unique opportunity for me to stay in the Midwest and take part in formulating national monetary policy.

## Monetary Policy

Each of the areas I just mentioned are different, but all relate to our overall mission, which is to foster a healthy, growing economy and a safe and stable financial system. Monetary policy, of course, is a key part of that. By monetary policy I mean influencing the flow of money and credit in the economy, largely through interest rates, to achieve a sustainable level of economic growth and stable prices. To do this, we need to be careful to look at the long-term effect of our actions. We can't let short-term considerations dictate our policy.

One of the reasons we've been able to do this is the non-partisan nature of the Fed. Our Board of Governors has seven members, led by Chairman Alan Greenspan. They are appointed by the President and approved by the Senate to serve 14-year terms. That's a very long term. I don't get the feeling our Governors are sitting up at night worrying whether they're going to be re-appointed sometime in the next millennium if they make a politically unpopular decision in 1995. Research, logic and economic expertise dictate our actions, not opinion polls, newspaper editorials or talk radio.

Likewise, the decentralized, regional Federal Reserve structure is very important because it guarantees that a variety of viewpoints from across the country are considered. People commonly think of Fed policy as emanating from Washington. That's true, but only in the sense that monetary policy decisions are made there at meetings of the Federal Open Market Committee. The decision-making process is not restricted to the Beltway. It isn't developed from the inside looking out. Instead, ideas and opinions flow to Washington, where they're distilled into policy.

Each of the twelve Fed Banks contributes to this process. The Chicago Fed plays an important role because we have a large and diverse district. Our five-state region consists of most of Illinois, Indiana, Michigan and Wisconsin and all of Iowa. We have a branch here in Detroit and offices in Indianapolis, Milwaukee and Des Moines. This regional make-up allows us to get information from a broad array of sectors, regions and interests here in the Midwest. The other Fed Banks operate the same way. Information flows into our nation's Capitol. Monetary policy flows out.

## FOMC Responsibilities

Turning now to the Federal Open Market Committee, the FOMC, where all that information flows. That's made up of the seven Governors I just mentioned, with Alan Greenspan at the helm, and the twelve Regional Bank Presidents, five of whom vote on a rotating basis. We meet eight times a year in Washington, and hold telephone meetings as well, but the policy process is really ongoing. On a continuous basis, our staff conducts research on a variety of macroeconomic, financial and regional topics. In addition, we have ongoing contact with a variety of people living and working in the Seventh District. Plus we have advisory councils on agriculture and small business and roundtable discussions with economists and industrial leaders. Our economy is so dynamic and complex that we need to examine the regional economies and even specific industries to get a true picture of what's going on — to figure out if the economy needs a shot of adrenaline, or a tranquilizer. All this information flows to Washington and is used at the FOMC gatherings.

During the FOMC meeting, the presidents give a concise, 5-minute briefing of conditions in their Districts. The Governors then report on information they've obtained from their contacts throughout the nation. Because everybody is familiar with the published statistics, our reports tend to include special information about our districts and anecdotal information obtained just before the meeting. All of the participants also give their views of the national economic outlook, emphasizing any areas where there's disagreement with the Board staff outlook, which is distributed prior to the meetings.

The FOMC is a pretty formal affair, and there is a good bit of high-level discussion. Monetary policy is very abstract and it's sometimes hard to describe the economy. To keep things simple, one Governor always refers to the state of the economy in terms of a thermostat, things are heating up or cooling down. Another talks about a balloon inflating and deflating. My analogy is obvious, given our heavy involvement with auto manufacturing in the Seventh District. I can talk about hitting the brakes, or the accelerator, or shifting gears.

Once everyone has had their say, Chairman Greenspan may summarize the views and suggest a possible course of action if there is a clear consensus. Or there may be more discussion until a consensus emerges. Rarely is there a close vote. From my viewpoint, I've been very impressed with the high level of discussion and preparation at these meetings. I've been involved in many high-level policy discussions in government and private industry, and this level of analysis ranks right up there with anything I've encountered.

## Inflation and the Economy

To understand some recent FOMC actions, a quick look back to the 1970's is in order. I mentioned before the importance of long-term objectives. It's interesting that 1994 was our best combination of total economic output, inflation and employment since perhaps 1972. That performance in '72 was misleading though. As we all know, that year featured price and wage controls. But these didn't prevent the persistent inflation that built up during the decade, with devastating effects on our economy and society.

I was involved in some of the early, and, I must add, misguided 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 of 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 gravity 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.

Well, we're still paying the price for letting inflation get out of control in the 70's. That price is a heightened sensitivity in the financial community about the Fed's resolve to keep the U.S. on its stable-growth, low-inflation economic track. It's been a long road back to credibility. Now that we're almost all the way back, the Fed will do all it can to maintain price stability. Because price stability is absolutely necessary if we are to have steady long-term economic growth as well as low unemployment. As I said before, 1994 was a strong year for the economy. Experience told us to be wary, that inflationary pressures should be contained. Past behavior shows that if the U.S. economy grows faster than its potential for some time, inflation accelerates, interest rates jump, and the economy teeters and sometimes falls into a recession. It's very difficult and costly to bring inflation under control. Look back at the inflation of the early 1980's. The cost of getting to 3.8% in 1982 from 12% in 1980 was a double-dip recession and 10 million unemployed people.

There has been controversy as to whether our seven moves on interest rates since the beginning of 1994 were necessary, whether we jumped the gun. It's important to note here that the monetary policy process works on a delayed basis. It's like a time-release capsule that might take months, or even more than a year, to take effect. Monetary policy needs time, sometimes a long time, to be effective. Considering that, I think the actions we took last year were correct. We moved to head off inflationary pressures even though they weren't evident in the data. We slowly decelerated, rather than having to slam on the brakes. See, there's my auto analogy.

And look at the results. Interest rates on long-term Treasury securities have dropped more than three-quarters of a percentage point since November. Thus, by raising short-term rates, the inflation premium in longer-term rates has been reduced. This inflation premium is what helps depress capital formation and productivity.

Fixed-rate mortgages have also declined. The rate for a 30-year, fixed-rate mortgage dipped to 8.2 percent last week, the lowest in roughly a year. That's 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, the long-term rates would be higher.

Where do we go from here? No one can answer that question with certainty. There are definite signs that economic growth is moderating, particularly in areas sensitive to interest rates, such as autos and housing. Hopefully, the pace of the expansion has abated sufficiently to put the economy on a sustainable, non-inflationary growth path.

I'd like to emphasize here that the goal of the Fed has not been to hurt the housing and auto industries. Our goal is to foster sustainable growth, productivity and rising standards of living: an environment in which

industry, and individuals, can thrive. Although economic growth has slowed, we'll need to continue to remain vigilant for signs of increasing wage and price pressures. For example, first-quarter results for 1995 show that despite some of the progress we've made, the core inflation rate, which excludes volatile food and energy prices, is currently tracking at a 3.3% annual rate. There are also indications labor markets are tightening. Typically this would increase pressures to raise wages, and labor costs would accelerate. And in the Midwest, there is some anecdotal evidence that labor shortages may be a growing constraint on employment growth and business expansion. However, it also appears that a lingering sense of job insecurity among workers has been a factor in discouraging rapid wage growth thus far.

## Conclusion

In conclusion, it's important to remember that a low, stable inflation rate allows households and firms to make their saving and investment decisions most efficiently. High and unpredictable inflation distorts the incentive to save and invest, which is so important to the economy's long-term growth. Our goal is to foster productivity increases, higher incomes and better standards of living. 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. Although easy monetary policy can briefly stimulate the economy to grow faster and to lower the unemployment rate, persistent easing results in persistently high and volatile inflation. Output and employment depend on real factors like technology, population growth and productivity. Inflation-induced gains are fleeting and illusory, and come at the cost of future growth. In the long run, price stability is the surest way to achieve the goal that we all share — a healthy economy growing at a rate consistent with its long-run potential.

Thank you.