OUTSTATE BOARD OF DIRECTORS MEETING

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Charting the National Economy — Where to From Here?

Thank you John and good afternoon. I'm glad so many of you were able to join us this afternoon at Michigan State University. It's wonderful to be here on this beautiful campus.

Seeing all the students about reminds me that it's football season. Despite what happened Saturday, I'm hopeful the Spartans are going to have a good year. Personally, I'm on a bit of a college football "high" right now. John mentioned I spent a year teaching at Northwestern University, and I'm going to have get in a plug here today for those victorious Wildcats in light of that big win over Notre Dame. Believe me, you don't get to use the words "victorious" and "Wildcats" very often in the same sentence, so I'm going to take advantage of it while I can.

Speaking of winners, I'd also like to take a moment to recognize Roby Sloan and the fine manner in which he has represented the state of Michigan within the Federal Reserve System. We're going to miss the strong leadership Roby's provided over the last 11 years as head of the Detroit branch. In all, Roby's given 33 years of service to the Fed, and we're certainly indebted to him. Dave Allardice has some big shoes to fill, but we're more-than-confident that he's up to the challenge.

Today, I'll discuss my view of what's happening with the national economy — where we are now, and where I think we're headed. Our goal at the Federal Reserve, of course, is sustainable economic growth with price stability. The question now seems to be, "Are we on the final approach to achieving that elusive soft landing?" Right now, I'd say it looks like a soft landing, it sounds like a soft landing, but it hasn't necessarily felt like a soft landing. We've experienced some turbulence along the way. In general, though, I'm feeling positive about the economic outlook.

Before going into detail about the outlook, let me touch briefly on the Fed and how we develop national monetary policy. The Fed is a fairly complex and diverse organization, with elements of the private sector, government, and academia. In addition to studying the economy and formulating national monetary policy, we also supervise and regulate banks and provide them with financial services, like check processing.

We strive for an efficient, stable financial system and the highest rate of economic growth we can achieve without igniting inflation. Our decentralized, regional structure helps us accomplish that goal. The Chicago Fed is one of 12 regional Reserve Banks that —along with the Board of Governors in Washington, D.C. — make up the Federal Reserve System.

Our decentralized structure is reflected in how we determine monetary policy. All the governors of the Federal Reserve Board in Washington and all the presidents of the Reserve Banks take part in policy-making. The Fed's main policy-making body is the Federal Open Market Committee, which is chaired by Alan Greenspan. It consists of the seven members of the Federal Reserve Board and five of the 12 Reserve Bank presidents. The president of the New York Fed is a permanent member. The other Bank presidents all participate, but alternate as voting members. I alternate annually with the president of the Cleveland Fed. This year, I'm a voting member.

One of the strengths of our regional structure is that we have access to timely, grass-roots information on the state of the economy. The 12 Reserve Banks gather information, making sure we're getting accurate updates and a variety of perspectives from beyond the Washington Beltway. Information and ideas from the Reserve Banks flow into our nation's Capitol. And this information plays an important part in the monetary policy decisions that then flow out of Washington. The boards of directors at each Reserve bank have an important role. So do our advisory councils on agriculture and small business. They all provide valuable input and ideas.

One of the ways I get a feel for what's happening throughout the Midwest is through meetings like this. Not just to give my point of view, but to get your point of view as well. It's very helpful to know what's going on at the local level — in the bank's branch office, on the production line, in the cashier's aisle — where the nation's business takes place. What's happening out there right now, today. And what your expectations are for the future.

The various economic data series compiled and published by the Fed and other government agencies are extremely useful, but they're often dated and likely to be revised. They capture what's happened in the past. As a result, depending only on statistics is like driving a car using only a rear-view mirror. Supplementing statistics with more current, anecdotal information helps us get a clearer view of an economic landscape that's constantly changing.

I think we're at an interesting juncture right now concerning the economy. Three weeks ago I was in Washington for a meeting of the Federal Open Market Committee. As you may recall, we didn't take any new policy actions at that August meeting. At our July meeting, we did decide that inflationary pressures had receded enough to accommodate a modest easing in monetary conditions. More specifically, we allowed the federal funds rate to decline by 25 basis points, from 6 percent to 5% percent. It was the first policy action to lower short-term interest rates since September 1992. And it came after seven moves between February of last year and February of this year geared toward raising rates. I'd like to bring you up-to-date on how we reached the point we're at today, and let you know how things look for the future.

First, let's look back to the start of 1994. The economy had picked up steam after the doldrums of the early '90s. It was expanding rapidly. We were concerned about an unsustainable pace of expansion and mounting inflationary pressures. The goal at the start of 1994 was to eliminate inflationary pressures before they had a chance to build.

As it turned out, we had unusually strong real GDP growth of 4.1 percent during 1994, despite the policy actions to raise short-term interest rates.

You might ask why we didn't let the economy keep rolling along at that pace. The answer is that 4 percent real growth is not sustainable. The economy's real potential is closer to 2½ percent. Let me compare it to a sailboat. A 2½% percent rate is that point when the boat is cutting through the water at peak efficiency, with just the right amount of wind in its sails, not tipping to one side or the other. If the wind picks up too much, the boat's in danger of tipping over. For the economy, real output growth much above the 2½ percent level really can't be sustained without inflation accelerating.

And keeping inflation in check is absolutely crucial. Central bankers are paid to make statements like that (smile), but it's really true. Once inflation is allowed to rise uncontrollably, the impact on the economy can be devastating. To put it another way, once inflation gets out of hand, it's like trying to tape gravy to the wall. It just oozes out all over (smile).

That's what we learned in the '70s. Remember price controls? I worked in government in Washington at the time, and I directed efforts to monitor wages and prices after the controls were lifted. The controls, of course, were a futile effort.

Our 1994 monetary policy actions to foster sustainable, non-inflationary growth began to have a significant impact on the economy in 1995. We've seen a definite slowdown in output growth, especially in the second quarter. Real GDP grew at a very robust 5.1 percent in the fourth quarter of last year. It slowed to a 2.7 percent pace in the first quarter of 1995, and to only 1.1 percent in the second quarter.

The slowdown in output growth was most noticeable in areas sensitive to interest rates, like autos and housing, where sales growth softened. It eventually spread to other areas such as appliances and other durable goods. As growth in sales moderated, some stores and factories were caught with excessive inventories, particularly in the auto industry.

As a result, we began to see an inventory correction taking place in many industries. In its simplest form, an inventory correction becomes necessary when too many goods and services are produced relative to demand. There were too many products on the shelves, too many vehicles on car lots, all waiting to be sold. It appears that a significant portion of the inventory correction took place in the second quarter.

Factories have been trimming production to bring inventories back in line with sales. Just-in-time inventory management techniques have helped firms respond when production levels moved out of alignment with demand. The major area where production may still be exceeding demand is autos, which I'll come back to later.

The good news is that inflationary pressures appear to be subsiding. It's true that the core Consumer Price Index (CPI) increased at an annual rate of 3.5 percent in the first seven months of 1995, higher than last year's 2.6 percent rate. But there has been a gradual reduction so far this year from month-to-month. Some of the underlying cost structure that was generated last year carried through into early 1995, but it appears that our monetary policy actions have had an impact.

We're not seeing as many signs of an overheated economy, which could spark inflation. For example, capacity utilization rates have declined. At the same time, there's been a speed-up in the delivery of materials to factories, indicating a slowing in demand and possibly less upward pressure on prices. Fewer purchasing managers are reporting increases in what they pay for materials used in production. We're also hearing anecdotal evidence here in the Seventh Federal Reserve District that price pressures are fading.

In addition, the unemployment rate recently has fluctuated within a range close to what many economists estimate to be the so-called natural rate of unemployment, where typically you see no upward or downward pressure on wages or prices. The actual unemployment rate has been between 5.4 percent and 5.8 percent so far this year. The most recent figure was 5.6 percent.

Speaking of labor markets, here in the Midwest our state unemployment rates generally have been below the national average all year. Here in Michigan, for example, the rate was at 5.1 percent in July and August.

Let's take a look now at what's ahead. You may have heard the line, "Economists have forecasted nine out of the last five recessions. (smile)" That pretty much sums up the difficulty of forecasting economic turning points. Right now is no exception. There's still some uncertainty, but in general I'm optimistic about the prospects for stronger growth through the end of the year. And I'm certainly not forecasting a recession.

Let's look at four key areas: the consumer sector, the business sector, government and the international arena.

- Number one — the consumer sector. We expect consumer spending to rise at a moderate pace in the second half of the year. Early indicators of consumer spending in the third quarter have been mixed. However, consumer confidence measures remain at high levels, and recent income gains have been solid.

In terms of the housing sector, we expect a modest rebound during the second half of 1995. That's a result of lower mortgage rates. In fact, we've recently seen a pick-up in housing starts.

As for autos, we keep close tabs on that industry because it has such a spill-over impact on the rest of the economy, especially here in the Seventh Federal Reserve District.

Sales of autos and light trucks this year have been quite volatile on a month-to-month basis. For example, August numbers show an annual sales rate of 15.7 million units, but July's rate was just 13.7 million units.

Last December, the Chicago Fed sponsored an economic outlook symposium. The consensus forecast at that time was for 1995 light vehicle sales in the area of about 15.4 million units. But sales so far this year have been well below those expectations. In fact, the participants at our Auto Outlook Symposium in June scaled back their 1995 sales forecast to 14.9 million units.

It now looks like sales for the year will end up at about 14.7 or 14.8 million. That's about the average of the July and August numbers. The big question right now is whether we're going to see the August rebound sustained for the rest of the year.

Why have sales run so far below what seemed like a pretty reasonable forecast last December? There were a number of one-time occurrences that may have had an impact: Higher tax payments, delayed tax refunds, and reduced fleet sales. But some more fundamental explanations have also surfaced. One is higher rates for auto loans, which have had a significant impact on how much people can afford to pay. Used car sales are also up. Better-built cars are simply lasting longer, and high-quality leased vehicles are also entering the used-car market. Needless to say, that affects new-car sales.

The auto industry's response has been rebates and discount financing. Over the long run, the industry is going to have to deal with the increasing durability of cars and with more and more people buying used cars and autos that were formerly leased. It's a situation we are watching closely.

- So much for the consumer sector, which we see as positive even with some uncertainty about autos. The second key area of the economy is the business sector. Capital spending should continue to be strong, although the pace of growth should slow from the double-digit rates we had last year and during the first half of 1995. Competitive pressures are encouraging firms to continue spending for equipment that enhances productivity — even in the face of moderating demand for their products. With no large build-up in debt and lower long-term interest rates, firms are in a good financial position to undertake additional capital spending.

- Number three — government. Fiscal constraint is a common theme across all levels of government. I'm sure you are well aware of that here, being so close to the state capitol. At the federal level, the momentum for deficit reduction is strong. In the short term, less government spending might mean less stimulus to economic activity, but that shouldn't be a significant problem, nor should it deter us. Meaningful deficit reduction would have a positive impact on the economy overall. Long term, a smaller deficit will be a major plus because the government will be borrowing less. That will tend to lower long-term interest rates and stimulate private investment. And that sets the stage for higher productivity and a better standard of living in the future.

It's clear that the direction of the President and Congress is toward reducing the federal deficit, and I find those efforts encouraging. The impact of possible deficit reduction was the topic of discussion at the Kansas City Fed's annual conference I attended over the Labor Day weekend in Jackson Hole, Wyoming. One key point that emerged from the conference was that deficit reduction would have to be sustained over a period of years for it to be truly effective. A continued commitment by Congress and the executive branch over a number of years is crucial to the success of any deficit-reduction plan.

The impact on the federal budget of an aging America is also a consideration. Demographic trends suggest that retiring Baby Boomers will be paying less in taxes and receiving more in the way of retirement benefits over a longer period of time. At the same time, relatively fewer younger workers will be contributing to the Social Security fund. The impact of this situation must be addressed over the long term when considering the question of deficit reduction.

- Number four — the international arena. At the start of 1995, we were expecting solid growth abroad. The Mexican crisis took some of the wind out of our sails, but that situation has stabilized. However, Japan's economy has stalled, prompting the Bank of Japan on Friday to lower its discount rate to a record low 0.5 percent. That should help promote recovery in the Japanese economy. Economic growth in Canada, another significant trading partner, has also slowed more than expected. In fact it actually declined in the second quarter. In addition, growth in many European countries has been slower than we expected earlier this year. So, in general our forecasts for growth abroad have been scaled back. That means our country's economy will get less of a boost from exports.

In summary, while we've experienced slowing in U.S. economic growth, we're not seeing significant imbalances, such as the high debt service burden problems we had in the late 1980s. We've had some moderation, but coming out of the second quarter there appear to be solid prospects for moderate growth. Consumers are confident. Some businesses seem to have nearly completed the process of adjusting their inventory levels to the desired slower pace of the economy, although the adjustment process throughout the entire economy is not yet completed.

For 1995, we anticipate modest growth in real GDP for the third and fourth quarters. For 1996, we expect real GDP growth of approximately 2½ percent. We see the CPI rising about 3 percent this year and next, and at the end of 1995 and 1996 we expect the unemployment rate to be slightly above its current level.

I'm guardedly optimistic about the economic outlook. Although it may not feel like it, I think it's fair to say that we're headed toward the soft landing I mentioned before. We've certainly experienced some turbulence, but I think we're well-positioned to make continued progress toward our objective of sustainable growth with price stability.

As always, the Federal Reserve will continue to promote price stability over time. High inflation distorts incentives to save and invest. Low inflation allows for efficient savings and investment decisions, and that ultimately means a better standard of living for all. Price stability is a goal we should all share. Working together toward this objective is the best way that we can help ensure a healthy, vibrant economy.

Thank you very much.