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**The Federal Reserve System: Form Serving Function**

Thank you. I'm very happy to be here today although it seems a little funny to be in a town where not everyone claims to be a Northwestern alum. I taught at Northwestern, and I'm excited about the Rose Bowl, like everyone else in Chicago.

I'm very pleased to be speaking as part of the Commodity Club of Indiana Lecture Series. I had a chance to review the list of distinguished speakers in the series and am honored to be included.

Recent speakers have focused on the farm bill being debated in Congress, and I suspect they gave you a political perspective. My focus is different. As a representative of the Federal Reserve, I don't come with a political perspective. The System is structured to insulate us from political pressures, and we're very conscious about maintaining our distance from partisan politics.

That's one of the strengths of the Federal Reserve — our structure allows us to maintain that distance. What I'd like to focus on this afternoon is how our unique structure helps us to achieve our mission of fostering a healthy, growing economy with price stability. The Federal Reserve is certainly different from central banks in other countries. It has a decentralized, regional design with a mixture of public and private features.

To my mind, this is important because the structure is a key element that enables the Fed to focus on effective, long-term monetary policy.

I realize that you might feel shortchanged if I didn't discuss the state of the economy from my perspective at the Fed. So I'll include my thoughts on the outlook. Also I'd welcome any questions you may have.

## Overview of Fed with Focus on Regional Structure

First, let me start with a brief overview of the structure of the Fed. It's complex, but it's important in better understanding how we formulate monetary policy.

There are 12 Reserve Banks across the country. The Federal Reserve Bank of Chicago serves the Seventh Federal Reserve District, which consists of most of Illinois, Indiana, Wisconsin, and Michigan, and all of Iowa. The Bank has a Branch in Detroit, and offices in Des Moines, Milwaukee, Peoria, and one in Indianapolis, just a couple of miles from here. The twelve Banks are overseen by the Federal Reserve Board in Washington, and together they form the Federal Reserve System.

Each Bank performs 3 major functions. We supervise and regulate banks; we sell financial services to banks, and we study the national economy as well as monitor the economic conditions in our region. As a result of these three functions, each Reserve Bank incorporates three distinct groups of staff members. We're a government regulator, a private business, and an academic research center. I've spent a number of years in government, academia, and the private sector, so I've found working at the Federal Reserve to be an especially interesting experience.

Many people think I'm a government employee. Technically that's not correct. I'm not appointed by the President or Congress. I'm appointed by the Chicago Fed's board of directors with approval of the Board of Governors in Washington. We don't report to the President, and Congress doesn't have to approve our monetary policy actions. We're not subject to Civil Service. We can hire and fire people, and our budget doesn't go to Congress for approval. We fund our operations through our income and turn over the rest to the U.S. Treasury. In fact, we turn over billions of dollars each year, about 98 percent of our income.

Nevertheless, we certainly are accountable to the American people, and this is very appropriate given our public responsibilities. We report regularly to Congress on our monetary policy goals and many other issues. The seven members of our Board of Governors, including Alan Greenspan, are appointed by the President and confirmed by the Senate. The Governors serve staggered 14-year terms, with one Governor's term expiring every two years. In this way, the Board of Governors is insulated from short-term political pressure, but still ultimately accountable to Congress and the electorate.

As you can see, we're a unique organization for a central bank. This blend of public and private, centralization and decentralization is reflected in the Federal Open Market Committee, the Fed's main monetary policymaking body. The Committee, referred to as the FOMC, meets 8 times a year. The 7 Governors and all 12 Reserve Bank presidents participate in the discussions. However, only 12 vote at each meeting: the 7 Governors — we always let Chairman Greenspan vote — and 5 Reserve Bank presidents. The president of the New York Fed serves as vice chairman of the FOMC and votes every year. Four of the other Bank presidents vote on a rotating basis. I'm a voting member this year and every other year. This may seem unwieldy, but it works.

Policy comes out of Washington, but it's based on information and views that flow from the regions through the Reserve Banks to Washington. I should emphasize though that we develop one policy for the whole economy, based on input from all regions of the country. Our arsenal of monetary policy tools doesn't include any "smart bombs" that can attack a problem in any region of the economy with surgical precision. Our tools are sometimes called blunt instruments since they tend to affect the whole economy. For exam-

ple, even if we agreed that agriculture in Indiana needed a boost, there is no monetary policy action we could take that would help just that sector.

We can insure, however, that we have input from all regions and all economic sectors when we formulate our policy. In this way, we develop a policy to foster a healthy, growing economy with price stability, and a stable financial system. When we achieve this goal, the whole economy benefits — all states, including Indiana, and all sectors, including agriculture.

### Seventh Federal Reserve District Focus

As President of the Chicago Fed, I report on economic conditions in the Seventh Federal Reserve District at the FOMC meetings. The research performed at the Bank is a valuable source of information on the economy and mirrors the make-up of our diverse District. Our economists conduct high-quality research on a variety of macroeconomic, financial, and regional topics. Agriculture has been a long-time speciality of the Chicago Fed, mainly because of its importance in the region. Some of you here may know Gary Benjamin, one of our economists specializing in agricultural issues. Some of you may receive our newsletter, *Ag Letter*, and some have probably participated in our quarterly surveys of agricultural credit and farmland values.

An important part of our economic research efforts is gathering grass-roots, anecdotal information. This up-to-the minute material is very important because it comes to us without the lags that are an inevitable part of published statistics, which, by their nature, report what's happened in the past. In addition to this information lag, monetary policy affects the economy with a lag — like a time-release capsule that takes several months or even a year to have an effect. So it's important to know as soon as possible what's going on in the economy. To do this, we need to get out and talk to those living and working in the region.

Where do we get this grass-roots information? Our boards of directors in Chicago and at our Detroit Branch are two important sources out of many different contacts. Typically we have a farmer or agribusiness representative on our board. Currently that member is Tom Dorr, who owns a farm in Marcus, Iowa. We also include representatives from throughout the District, people who are involved in important sectors of the economy so that they can provide advice on the state of the economy.

The two Indiana members on our board are Steve Anderson, head of First Merchants Corporation in Muncie, and Charlene Sullivan, a professor at the Krannert Graduate School of Management at Purdue University, and a nationally known expert on consumer credit issues. At every board meeting, each provides valuable insights into developments taking place in Indiana.

In addition to our boards of directors, we have two advisory councils — one on small business and one on agriculture. Members of these councils provide valuable economic intelligence in these important sectors. The members of our current agricultural advisory council from Indiana are George Crosby, from Greensburg; Richard Ward, from Crawfordsville; and Kaye Whitehead, from Muncie. Here today are two former agriculture advisory council members from Indiana — Don Villwock [Vill-walk] and George Morton.

Indiana members of our small business advisory council are Charles Garcia, president of G. M. Construction in Carmel; David Goodrich, executive vice president and treasurer of F. C. Tucker Company

in Indianapolis; and P. Eric Turner, president and CEO of T-3 Investments in Gas City. These people provide information that is important to the monetary policy process.

There's another important source that I'd like to elaborate on this afternoon — traveling throughout the District and visiting with people, as I'm doing here with you today. As part of this effort, we periodically hold directors' meetings off-site, that is, outside Chicago or Detroit. Just last September, the Chicago board went to Ames, Iowa. These so-called "field trips" are very helpful, and, I must admit, a particularly enjoyable way for me to get information.

During our Ames visit we focused on the "structural changes" that have been transforming agriculture throughout much of this decade. Visiting people who are experiencing these changes first-hand certainly helped me put a human face on the economic realities. While in Ames, we saw some very positive responses to these structural changes but also learned about some of the difficulties and dislocations these changes will inevitably bring.

### Experiences in Ames, Iowa

During our visit, we had an opportunity to tour the Center for Crops Utilization Research at Iowa State University. It's a fascinating place, designed to expand markets for Midwestern crops by developing new products and refining industrial applications. The type of research done at this state-of-the-art facility is important in helping to make U.S. agriculture more efficient and more productive.

We also learned about the structural changes occurring in hog production, brought about by the rapid increase of the so-called "mega-hog farms." We saw first-hand how some of the tough environmental issues related to these mega farms are eroding the Midwest's long-held dominance in hog production.

On a more upbeat note for Midwestern agriculture, we enjoyed visiting a large working farm near Ames. We saw how computers and other modern technology are helping to automate the record keeping, feeding, and milking of a 350-cow dairy herd. On the same farm, we also saw the process and the facilities for raising over 200,000 turkeys annually. I suspect that some of the turkeys we saw may be the "left-overs" that we've been eating for the last two weeks.

These and other visits I make throughout the District provide an opportunity to see and hear first-hand what's going on in the economy. This is very helpful in evaluating conditions in the District and prepares me for the FOMC meetings and monetary policy decisions to be made.

### Economic Outlook

As I said at the beginning, the regional structure of the Fed System contributes to the development of effective monetary policy and helps us do our part in fostering a healthy, growing economy with price stability.

And this brings us to the second part of my comments. I'd like to discuss the state of the economy and give some indication of what we can expect in the near future.

First, let's take a quick look at where we've been. We're going through an interesting period. We experienced very strong growth late last year, with real GDP increasing at a robust 5.1 percent annual rate during the last quarter of 1994. We expected that the economy would slow during 1995 and it did—growth was down to 2.7 percent in the first quarter and 1.3 percent in the second. In the third quarter, the economy took off again. GDP rose 4.2 percent, which was much stronger than most economists had anticipated. If growth continues at that rate, the economy could overheat and reignite inflationary pressures. But we don't expect that pace to continue.

Indeed, inflationary pressures have subsided since the early months of this year. To gauge inflationary pressures, it's useful to look at the core Consumer Price Index, which is the CPI minus food and energy prices. After rising by a worrisome 4.2 percent during the first four months of 1995, the core CPI increased at only 2.8 percent annual rate from April to October. That's more in line with inflation's good performance in 1994.

Another sign of reduced inflationary pressures is the downward trend in capacity utilization rates. These rates measure how intensely we are using our industrial production facilities. While still high from a historical perspective, capacity utilization in October was down nearly two percentage points from its recent peak in January.

The unemployment rate recently has fluctuated within a range close to where you typically see little upward or downward pressure on wages or prices — between 5.4 percent and 5.8 percent so far this year. The most recent figure was 5.5 percent in October. These rates are worth careful attention. We're aware that we have tight labor markets in the Midwest and especially in Indiana, where the unemployment rate was only 4.2 percent in October. Typically such tight markets would increase pressures to raise wages, leading to an acceleration in labor costs. 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 what's happening.

So, in summary, our current situation is fairly positive. Importantly, inflationary pressures have subsided. We experienced a surge in growth during the third quarter and employment has been strong, but we don't expect the third quarter pace to continue. And it doesn't appear that our relatively tight labor markets have affected labor costs thus far.

To look ahead, let me highlight what I expect to develop in the key areas of our economy namely the consumer and business sectors, the international arena, and the government sector. We expect consumer spending to continue to show modest gains through the remainder of 1995 and into 1996. On average, both consumer spending and personal income growth so far this year have been relatively healthy, but less rapid than in 1994. Similarly, employment has continued to rise, albeit at a more moderate pace than in 1994, and consumer confidence is at high levels. Higher employment incomes and confidence should support further spending growth by consumers.

Of course, what happens during this critical holiday shopping season is important for our overall economic outlook. Reports so far indicate that consumer spending was rather weak in October, but picked up somewhat in November. Post-Thanksgiving sales reports have been mixed, but generally suggest that consumers are willing to buy if they feel they're getting a good price. Retailers tell us that holiday promotions started earlier and will be more intense than we've seen in some time, a factor that may encourage spending.

For most of us, our biggest purchases involve autos and housing. As you might expect, these purchases have a significant effect on the economy, and we track developments in these areas very closely.

In the auto industry, sales have been running below industry expectations virtually all year. It now appears that sales in 1995 will come in around 14¾ million units. We expect sales will be near this level again next year.

As for the housing sector, residential investment, which includes home building and renovation, declined sharply in the first half of 1995, but rebounded in the third quarter. For 1995 as a whole, residential investment is expected to be about even with 1994, with some modest gains anticipated in 1996.

In addition to tracking consumer spending, we also closely watch spending by business, or as economists put it, capital spending. Growth in business spending for plant and equipment was very brisk during 1994 and the first half of 1995. It slowed to a high single-digits pace during the third quarter, and we expect it will continue to moderate through 1996.

The second major area I mentioned is the international arena. Overall, trade has been a significant drag on our economic growth for several years, with import growth exceeding export growth. In this year's third quarter, we saw some reversal in this trend. Looking to the future, however, prospects for our major trading partners remain uncertain. Japan, Canada, and Germany all are experiencing slower growth than we anticipated earlier this year, and Mexico's economy is still struggling. At best, it looks as though net exports will have a neutral effect on real GDP growth during the fourth quarter and much of 1996.

The last area I'd like to review is government. Fiscal restraint is a common theme across all levels of government. So it was somewhat surprising that government purchases at the federal level increased during the third quarter. We see this increase as an anomaly rather than a new trend. We don't expect the total government sector to contribute to GDP growth in 1996. Declines in federal government purchases should offset moderate increases in state and local government purchases.

These reduced federal purchases reflect the growing momentum for deficit reduction. It's clear that the President and Congress are moving toward reducing the deficit, and I find those efforts encouraging. Meaningful deficit reduction will have a positive impact on the economy overall.

A key point to emphasize is that deficit reduction must be sustained over a number of years to be truly effective. Commitment is crucial. Commitment by Congress and the executive branch over a long period of time is essential to the success of any deficit-reduction plan.

And we're going to have to come to grips with more than just deficit reduction. The impact of an aging America is also a major concern. Americans are growing older at a startling pace. That's great from a personal perspective — we all want to live longer. But we have to keep in mind that when Baby Boomers start retiring, they'll be paying less in taxes and receiving more in retirement benefits for a longer time than was true for previous generations. At the same time, relatively fewer younger workers will be contributing to the Social Security fund.

If the formulas used to distribute benefits stay the same, the revenue that will be needed to pay for Social Security and health care for retired Baby Boomers is going to be enormous. We should begin deal-

ing with the problem now rather than later when our options will be much more limited. The U.S. is not the only nation facing this challenge. It will be a problem of worldwide dimensions. Other developed countries such as Japan, Germany, and Canada face even more severe problems in this area.

Returning now to the shorter-term outlook, where does all this leave us for a forecast? As you can tell, we have a bit of a mixed bag. Growth in both consumer spending and capital spending is expected to slow somewhat during 1996. At the same time, the international sector should not act as a drag on economic growth during 1996, the way it has in 1995. The key difference between 1995 and 1996 though is inventory correction. For most of this year, businesses have strived to bring inventories into better alignment with slower growth in final sales. Basically, businesses had too much inventory on the shelves, and, as a result, reduced orders for goods. This affected production and slowed the economy. We expect the inventory correction process to be completed soon, so that real GDP growth next year should more nearly match growth in final sales.

Given all these factors, we don't see the 4.2 percent GDP growth reported for the third quarter as being indicative of a permanent surge in economic growth, a surge that might trigger inflationary pressures. Rather, our expectation is that growth next year will be about 2½ percent, which is approximately the growth rate that we can sustain without sparking an increase in inflation.

With this expected growth, inflation as measured by the CPI should come in around 3 percent this year and next, and the unemployment rate probably will remain in the same range we've experienced so far in 1995.

In conclusion, I'm guardedly optimistic about the economic outlook. I have to admit that ever since I took my oath as a central banker, I find myself using phrases like "guardedly optimistic." I guess that's why we're called the Federal Reserve. Seriously, it's always hard to predict what lies ahead beyond the next curve. But I don't anticipate any major roadblocks in the near future. I think we're well-positioned to make continued progress toward our objective of healthy, sustainable growth with price stability.

Thank you very much.