PRAIRIE STATE COLLEGE FOUNDATION
ECONOMIC FORECAST BREAKFAST

Country Club Hills, Illinois
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I. Thank you Manny. Pleasure to be here. As Manny mentioned, former professor at Northwestern. Always good to be back on campus.

A. Recently attended the Federal Open Market Committee meeting. Typically a lot of press about what we do at those meetings — or don't do.

B. Tends to leave public with impression that Fed's primary activity is meeting in Washington periodically to make short-term decisions on policy.

C. Federal Reserve much more complicated than that.

D. Decision-making process actually begins at the regional level with the 12 Federal Reserve Banks.

E. And while press accounts tend to focus on the latest policy changes, the Fed's most important job is to focus on the long-term health of the economy.

F. Today, I'd like to discuss three things, all related to Fed's ability to conduct effective monetary policy.

1. First, how the Fed's unusual structure facilitates effective, long-term policy.

2. Second, the economic outlook for this year.

3. Third, how to foster stable growth and a better standard of living over the long run.

II. As I thought about the first point, our unusual structure, I came to an unexpected conclusion — I come today to praise Congress.

A. Congress, and government in general, have taken a lot of heat lately.

B. Nevertheless, entirely appropriate to praise Congress. Or to be more precise, I'm here to praise Congress' wisdom over the years in endowing the Fed with its current structure.

C. Fed is a unique organization with unique structure—mix of public/private and centralized/decentralized features.

D. 12 Reserve Banks — regional design.

E. Overseen by Federal Reserve Board in Washington.

F. Each Bank has three major functions. Three major cultures.

1. Academic research center.

2. Government regulator.

3. Private business.

G. Carried out in five-state region. Head office here in Chicago, a branch in Detroit, and offices in Des Moines, Indianapolis, Milwaukee, and Peoria.

H. We're not a government agency, but we're accountable to the government.

I. All of these activities allow Fed to accomplish its mission of fostering a stable banking system and a healthy, growing economy.

III. Structure sort of quirky, but it works well.

A. Policy comes out of Washington, but is based on information and views that flow from the regional banks around the country to Washington.

IV. I mentioned the Federal Open Market Committee.

A. Headed by Alan Greenspan. In charge of formulating national monetary policy.

1. 7 governors serving 14-year terms.

2. 12 regional Bank presidents, of which I am one.

3. 19 members total.

B. 12 people vote at each FOMC meeting.

1. The 7 governors. We always let Alan Greenspan vote.

2. Five of the 12 presidents on a rotating basis.

C. A dollar to the person who can explain the rotation process.

D. Of the 12 presidents, New York all the time. Chicago switches off with Cleveland each year, and each of the others vote every other three years.

1. This year, I do not vote. Regardless of who votes, everyone provides input and participates at the meetings.

V. Regional, independent structure key to effective policy.

A. Insulation from day-to-day political pressures provided by features like our governors' 14-year terms and the fact that presidents are not political appointments.

1. I'm appointed by the Chicago Fed's Board of Directors and approved by the Federal Reserve Board in Washington.

a. That insulation is important because it facilitates Fed's ability to take a long-term outlook.

B. Generally acknowledged that it can be difficult for an elected representative to resist temptation to "gun" the economy periodically.

C. Stimulating economy, of course, appropriate at times.

D. But policy based on election-year cycles rather than business cycles is not likely to be effective.

VI. Insulation also essential because of lags in policy.

A. Hockey star Wayne Gretzky once explained his success by noting, "I move to where the puck is going to be, not where it is."

1. Fed faces same challenge to anticipate events.

B. Monetary policy like a time-release capsule, takes months or a year to address the ills of the economy.

C. We must forecast the economy, and then determine the appropriate monetary policy based on that forecast.

D. If don't react until serious problem shows up, it's already too late.

E. Fed's insulation better enables it to take an action that's potentially unpopular in the short run but best for the state of the economy in the long run.

VII. That gives you a quick overview of how we are structured. Now let me turn to my second point, the state of the national economy and our outlook.

A. After very strong — but unsustainable — growth in 1994, the economy slowed considerably in the first half of 1995.

B. Growth picked up markedly in last year's third quarter, but it doesn't look as though we kept up that pace in the fourth quarter, though we're not going to have final numbers until later this month.

C. For 1995 as a whole, the economy continued to grow —roughly half as fast as we did in 1994.

D. A particular bright spot as we moved through the year was the combination of relatively low inflation and low unemployment rates.

1. After accelerating in the first four months of 1995 at a rate of 4.2%, inflation grew at only 2.3% in the last 8 months of the year. (core CPI)

VIII. What do we see for 1996?

A. It's always difficult to prognosticate. The rule of thumb for an economist making a forecast is to give either a number or a date but never both.

1. I'm going to break that rule, but first I'd like to briefly cover three issues that I think will have a lot to do with how things shape up during 1996. These are just a few of the many issues that are worth watching.

B. The first issue — Are consumers tapped out?

Number 2 — Will a tight job market eventually increase pressures on wages and labor costs?

And number 3 — Will developments overseas provide us with a boost or a drag?

IX. Regarding the first question, we had moderate, although not spectacular, consumer spending growth last year.

A. We did end up on a bit of a mixed note with a holiday season that wasn't up to the expectations of retailers.

1. However, auto sales moved up considerably in December.

2. What's important to note is that growth in consumers' incomes generally increased at about the same pace as growth in spending.

   a. Or in other words, consumers weren't spending more than they were taking in.

B. So why did we experience some unevenness in growth during the course of the year?

1. One important factor was that businesses were adjusting their inventories.

2. On balance, consumer spending was up in 1995, but the increase was smaller than in 1994.

3. With the slower sales pace in 1995, businesses found they had too much inventory on hand and reduced orders for goods.

C. This affected production and slowed the economy. Businesses made progress in clearing their shelves during 1995.

However, we may face some additional inventory correction in 1996 though it'll be on a smaller scale than last year.

D. The extent of the correction will depend in part on consumer spending.

1. Some worry that consumers may cut back on their spending because they've accumulated too much debt, especially credit card debt.

2. In part, consumers have taken on more debt because credit cards are easier to obtain and easier to use.

3. For example, it's much easier to use credit to buy things like gas and groceries.

4. Since such convenience credit is typically repaid within the next billing cycle, it's less likely to put a crimp in spending.

E. Also, consumers are in a better position to service their debt because of lower interest rates and better terms.

1. At this point, we don't view these debt burdens as a major concern, but we'll continue to keep a close watch.

F. Overall, we don't think consumers are tapped out. Given continued income gains and other factors, we expect consumer spending to pick up a bit, with increases similar to or slightly larger than they were in 1995.

X. The second question is whether tight labor markets will spark inflationary pressures.

A. Unemployment rates have been low across the country, averaging 5.6 percent for the year. Here in the Midwest, unemployment rates have been even lower, reaching 20-year lows.

1. Our sources also tell us that temporary help agencies are having trouble filling positions and that some businesses are increasing wages for entry-level positions.

2. Anecdotal reports also indicate that labor markets in some parts of the country are tight for certain skilled and unskilled workers.

B. Of course, higher wages are all to the good as long as productivity is increasing and we don't get a corresponding hike in inflation.

1. Workers obviously won't improve their living standards if their wage increases are eaten away by higher prices.

C. Given our low unemployment rates, it's interesting that we haven't seen more pressure for higher wages. In the past when unemployment was this low, businesses had to increase wages more aggressively to attract workers.

1. Such a development is always of special interest to the Fed because it could trigger inflation problems.

D. As Federal Reserve Chairman Greenspan has pointed out, the muted calls for wage increases may be due in part to job insecurity.

1.This insecurity is probably the result of all the changes that are taking place, including the highly publicized downsizing at many large corporations. We all read about the downsizing at AT&T, for example.

E. At some point, workers may begin feeling more secure and become more aggressive in seeking wage increases. This is an issue we'll be watching closely.

Xl. Finally, the third question that I mentioned — Will developments overseas provide a boost or a drag on the economy?

A. International trade, of course, has a significant effect on our economy, especially here in the Midwest.

1. The U.S. has benefitted from strong export growth in past years. During the late 1980s, for example, exports provided a shot of adrenaline to the economy. Unfortunately, that wasn't the case during 1995.

2. We don't have complete data but it appears that the international sector may have stunted our growth a bit last year.

3. We experienced relatively healthy growth in exports but import growth was even stronger, resulting in an overall drag on the economy.

B. Looking to 1996, the economic prospects for our major trading partners (Canada, Mexico, Japan) are uncertain, which will, of course, affect export growth.

1. At this point, it looks as though net exports will have a neutral effect — they won't appreciably slow down our growth but they won't provide a boost to the economy either.

XII. So, what do we see for 1996 overall?

A. We anticipate that we'll have growth of about two percent during 1996, as measured by the "new" chain-weighted measure of real GDP.

1. That's approximately the growth we can sustain without sparking an increase in inflation.

B. The Consumer Price Index should come in at about 2¾ percent, similar to what we had last year.

C. Unemployment should hover within 1995's range of 5.4 to 5.8 percent.

D. I guess you could say 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 suppose that's why we're called the Federal Reserve.

E. We don't expect the economy to exhibit a lot of flash and dash. But that's not bad. To put it in football terms, we prefer an economy that performs more like the steady, straightforward running of Walter Payton than the flashy end-arounds of Deion Sanders.

1. An economy that's consistent can achieve better results over the long haul. Steady, healthy growth is the ideal. A "Hail Mary" pass is always exciting, but if you're playing to win, it's usually better to concentrate on steady, sustained progress toward the goal line.

XIII. Turning now to the final area I promised I'd touch on, and that's how to foster stable growth and a better standard of living over the long-run. Keeping in mind as always that our goal is to foster the maximum level of output without inflation rising.

A. We've made significant progress in last 15 years in keeping inflation in check.

B. But many people would like to see the economy grow even faster — even if it meant higher inflation.

C. Wouldn't it be worth a few points of CPI to put thousands of people back to work? Unfortunately, it's not that simple.

D. Growth is determined by labor force growth and productivity growth.

E. If you try to grow faster than your labor force and productivity, you end up with accelerating inflation.

F. Result is a boom-and-bust cycle like the ones we experienced in the 1970's and 1980s.

1. Productivity growth is important because it's the only source of lasting increases in real incomes.
2. Even small differences in productivity growth can accumulate over time to large differences in living standards.

G. We've made enormous progress in some areas.

H. Increasing manufacturing productivity in recent years, for example.

1. Wake up call from Japanese.
2. Lean manufacturing.
3. Improved logistics.

I. U.S. firms much more competitive today.

J. However, improvement in manufacturing sector has not significantly affected overall productivity numbers.

1. There may be some mis-measurement.

2. But difference would be slight.

XIV. How can we increase productivity?

A. The key is higher levels of investment and lower consumption.

B. To increase investment we need a higher level of savings.

C. Rate of savings has declined since 1960s and 1970s.

D. Since 1981, saving rate, net of depreciation, averaged only 3 percent of GDP compared with 7½ percent between 1961 and 1981.

1. During 1994, net savings was 3.0 percent. Private savings — 5.0 percent; government savings — negative 2.0 percent.

2. By the way, the government recently revised the way it measures savings and investments to account for the fact that some government expenditures are classified as investment rather than consumption.

a. The figures I've given are the so-called old figures. But both the old and new figures tell the same story — the savings rate in the U.S. has declined in the 1980s and particularly in the 1990s.

E. We've made up that gap by attracting foreign investment.

1. Between 1980 and 1994, net foreign capital inflows averaged about $80 billion a year.

F. The concern is that over the long-term, the economy's investment level is determined by its domestic savings.

1. For example, Mexico in 1994 — paper versus brick and mortar.

XV. Best way to increase savings is to reduce deficit.

A. We're in the midst of a contentious debate on a seven-year balanced budget.

B. Have already made some progress in recent years.

1. Federal deficit expected to fall over the next few years from 5 percent of GDP in '92 to roughly 2 to 2½ percent of GDP by 1996.

2. But this far above pre-1980 average of 1⅓ percent.

C. Serious commitment to balance budget within the next several years necessary first step.

D. But that budget is really only a down payment — the first step in addressing the problem.

E. Long-run demographic changes heighten the urgency.

F. In the next 20 to 30 years, we'll be facing significant cost pressures again because of impact of an aging America.

1. When Baby Boomers start to retire, they'll pay less in taxes and receive more benefits.

2. In 1990, ratio of workers to retirees was 5½ to one. In 2030, the ratio will be 3¼ to one.

3. Require enormous revenue.

G. Need to build surplus now so that we'll be in a position to handle increased costs we know are down the road.

H. Deal with problem now when we're better able to develop thoughtful policy.

XVI. Role of price stability.

A. Given this background, clear that best way to foster maximum sustainable growth is to ensure price stability —it's the key to long-term growth because price stability encourages savings and investment.

B. Important to use sound policy to stop inflation before it gets out of hand.

C. High inflation distorts decisions. We expend too much of our resources to protect ourselves from price increases. We make fewer long-term investments because of inflation.

D. An inflation mentality creeps in, and we're more likely to spend now before prices go up.

E. Stable and low inflation leads to sound decisions and more efficient allocation of resources.

F. Savings and investments, in turn, foster productivity increases.

G. Achieve Federal Reserve mission — healthy sustainable growth.