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What's ahead for the economy: A view from the Fed

Good afternoon. It's a pleasure to be here for the University of Arizona's annual conference on labor and management issues. I think it's a terrific idea to bring together labor and management representatives to discuss issues of mutual concern. It looks like you have an exceptional program.

As advertised, I plan to discuss my view on where the economy is headed. First, though, I'd like to take a few minutes to provide some background about the Federal Reserve. Specifically, I'd like to discuss the important advantages of the Fed's regional structure.

Why should we care about the Fed's structure? The Federal Reserve is unusual, perhaps unique, among central banks in its decentralized, regional design with a mixture of public and private attributes. To my mind, this is important because this structure fosters effective, **long-term** monetary policy.

People usually think of Fed policymaking as taking place in Washington—and that's true. But only in the sense that the decisions are made at meetings that are held there. The decision making process does not emanate from within the Beltway—from the inside looking out; instead, ideas and opinions flow to the Fed and are distilled into policy.

The Fed's mission, of course, is to foster a safe and sound financial system and a healthy, growing economy with price stability. More specifically, the Fed formulates monetary policy; supervises and regulates banks and bank holding companies; and provides financial services to depository institutions and the U.S. government. The Chicago Fed carries out these activities in a five-state region consisting of most of Illinois, Indiana, Michigan, and Wisconsin, and all of Iowa. Arizona is in the twelfth Federal Reserve District, which is serviced by the Federal Reserve Bank of San Francisco.

Given the Chicago Fed's involvement in all of these areas, we have a fairly complex and diverse organization. We study the economy; we examine banks; and we sell financial services. We're an academic research center, a government regulator, and a private business— all rolled into one. This wide range of responsibilities makes for quite a challenge for our staff. And I have to say we have an exceptionally talented group of people working at the Bank.

How did the Federal Reserve end up with its unique structure? The key word is compromise. The United States tried two previous experiments in central banking—both failed. In each case, the central bank was allowed to expire after its 20-year charter ran out. The early banks were doomed by a typically American suspicion of concentrated power, especially money power.

As a result, the U.S., unlike most other industrialized nations, went through most of the 1800s without a central bank. We were very much behind the times. By the early 1900s, however, there was a consensus—the U.S. needed a central bank. The crucial question was how to structure it. On one side were those who favored a centralized institution with a strong private-sector orientation. On the other side were those who wanted a regional structure dominated by the government.

The organization that resulted was a compromise, an intricately structured balance between the public and the private, the central and the decentralized. The 12 regional Reserve Banks would have a mix of public and private features. The governing board in Washington, D.C., would consist of seven public officials appointed by the President and approved by the Senate.

One of the keys was to insulate the central bank from day-to-day political pressures. It's generally acknowledged that it's difficult for an elected representative to resist the temptation to "gun" the economy periodically. Stimulating the economy is, of course, appropriate at times. However, doing so in response to the election year cycle is not likely to make for effective policy. The central issue is balancing short-term gains against long-term considerations. Ignoring inflation may seem to be an easy way to boost growth. But overstimulating the economy is a macroeconomic Ponzi scheme. In the long run, you need a foundation of stable prices to achieve sustainable growth.

To help the Fed focus on the long term, Congress provided fourteen-year terms for the Board of Governors. Additionally, the Federal Reserve does not have to depend on the appropriations process to meet its expenses. I should add, though, that Congress does review the Fed's budget and that the vast majority of our earnings is turned over to the U.S. Treasury. While the Federal Reserve is insulated from short-term political pressures, we're ultimately accountable to Congress and the electorate.

The Reserve Banks are an integral component of this system of checks and balances. Because I'm an employee of the Chicago Fed a lot of people think I'm a government worker. Technically that's not correct. The staff at the Reserve Banks are not subject to civil service.

The Reserve Banks are similar to the private sector in other ways. For example, each Reserve Bank and branch has a board of directors consisting of leading private citizens from the region. In addition, member commercial banks hold shares of stock in the Reserve Banks. And, as I mentioned, the Reserve Banks sell a variety of financial services in the marketplace.

The Federal Open Market Committee is the Fed's most important policymaking body and perhaps its most intricate example of checks and balances. The voters at any particular FOMC meeting consist of the seven members of the Board of Governors and 5 of the 12 Reserve Bank presidents, who vote on a rotating basis. It's admittedly a complex system. As president of the Chicago Fed, I'm a voting member every other year, alternating with Jerry Jordan, president of the Cleveland Fed. The president of the New York Fed always votes, as open market operations are conducted at New York. The remaining nine presidents vote once every three years. I know it seems unwieldy. But the bottom line is it works.

An important advantage of our regional structure is that we're better able to obtain input from all over the country. Because we're located throughout the nation, the Reserve Bank presidents help to ensure a constant flow of information and ideas from beyond the Washington "beltway." So our regional structure not only insulates us from narrow influences, it also helps us obtain a broad range of input, information, and ideas.

So much for the Fed's structure. Now I'd like to provide my perspective on the economic outlook. Let's take a brief look back. It was just five years ago that we were experiencing a downturn in the economy. Households, businesses, and government were all cutting back on their spending after an extended period of accumulating debt. During this retrenching period, the economy was staggered by powerful headwinds—namely, the desire of consumers and businesses to put their economic houses in order. The Fed responded aggressively and eased monetary policy. The economy recovered over time and began to build a head of steam. By 1994 we faced a different problem. We were growing too fast—our growth wasn't sustainable. We were like a runner who had just finished a long sprint. Our resources were stretched. It was time to catch our breath and grow at a pace that we could sustain over the long haul. So the Fed tightened policy during 1994 to eliminate inflationary pressures that were building up in the economy.

These policy moves set the stage for 1995. Inflationary pressures did subside and the economy performed reasonably well, although it was sometimes sluggish. A bright spot was the combination of low inflation and low unemployment rates. The Consumer Price Index was 3 percent or below for the fourth year in a row and unemployment was at its lowest sustained level in five years.

What we had at the end of last year was an economy that was occasionally sputtering even though unemployment and inflation rates remained low. Given this backdrop, we made two monetary policy moves. In December we allowed the federal funds rate to decline about ¼ of a percentage point, from 5¾ to 5½ percent. Given the positive outlook for inflation and some concerns about the risks of prolonged sluggishness, we decided that a slight reduction in the funds rate was appropriate.

At our next FOMC meeting at the end of January, we decided to allow the federal funds rate to decline by another one-quarter of a percentage point, from 5½ to 5¼ percent. And we lowered the discount rate from 5¼ to 5 percent. That was a tough decision. There was a lack of statistics mainly due to the government shutdown. The harsh weather in much of the country also threw us a curve as it disrupted the normal economic patterns. The economy seemed to be softening but that appeared to be due to temporary factors such as the weather. In fact, a number of fundamental factors indicated that the economy was basically on track for sustained growth. Nevertheless, given the positive outlook for inflation, we felt it was appropriate to ease monetary policy slightly. It didn't appear that this modest move would boost inflationary pressure. The action was a form of monetary policy insurance against the risk of a subpar economic performance.

Given this background, what do we see for 1996? It's always difficult to forecast. There's three rules of thumb for a forecaster. One, never give a forecast unless you have to. Two, if you have to forecast do it often. And three, give either a number or a date but never both. I'm going to break those rules 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. The first issue—Are consumers tapped out? Number 2—Will developments overseas provide us with a boost or a drag? And number 3—Will a tight job market eventually increase pressures on wages?

The first question—are consumers tapped out? Consumer spending accounts for about two-thirds of GDP so it's an area we watch closely. Last year, consumer spending growth was generally solid if not spectacular. Yet the economy was sometimes sluggish during 1995. What slowed the economy was an inventory correction. Businesses found they had too much inventory on hand and reduced orders for goods. This affected production and put a damper on growth. Businesses made good progress in clearing their shelves during 1995, especially during the fourth quarter. That's a good sign for the economy in 1996.

There's some concern that consumers may cut back on their spending this year because they've accumulated too much debt, especially credit card debt. In part, consumers have taken on more debt because credit cards are easier to obtain and to use. Many of us are much more likely to use credit to buy things like gas and groceries. Since such convenience credit is typically repaid within the next billing cycle, it shouldn't put a crimp in spending. Also, consumers are in a better position to service their debt because of lower interest rates and better terms. This is an issue we'll continue to track closely, but at this point we don't view these debt burdens as a major concern.

Other factors to consider are developments in the bond and stock markets, which have put consumers in a better position to spend. Although they've been volatile lately, the rise in stock prices has been a boon for the increasing number of consumers with mutual fund investments. The reduction in long-term interest rates during the past year has also helped consumers, especially those looking to buy a home or refinance their mortgage. However, long-term rates have moved up since early March so we'll be monitoring developments to see how that will affect spending in areas such as housing.

Overall, we don't think consumers are tapped out. Given a healthy income picture and fairly steady employment growth, we expect consumer spending to increase somewhat faster than last year.

The second question is whether developments overseas will provide a boost or a drag on the economy.

International trade, of course, has a significant effect on our economy. There's been increasing interest in this area because of NAFTA and the latest round of GATT trade negotiations. In past years, the U.S. has benefitted from strong export growth. During the late 1980s, for example, exports provided a shot of adrenaline to the economy. That wasn't the case during 1995. We experienced relatively healthy growth in exports but import growth was also strong. The result was that net exports provided only a small boost to the economy.

Looking to 1996, the economic prospects for our major trading partners, such as Canada, Mexico, and Japan, are looking somewhat brighter, which will help export growth. At the same time, it appears that import growth will continue to increase at a moderate pace. Overall, it looks as though the international sector will have roughly the same effect on GDP this year as it did last year.

Finally, the third question I mentioned—will tight labor markets spark inflationary pressures?

Unemployment rates have been low across the country, averaging 5.6 percent during 1995. As I mentioned, rates were at the lowest sustained level in five years. This statistical evidence is backed by continued anecdotal reports that labor markets are tight in many sections of the country.

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

Of course, higher wages for workers are beneficial as long as we don't get a corresponding hike in inflation. Workers obviously won't improve their living standards if their wage increases are eaten away by higher prices. The principal way to improve the standard of living is to increase productivity, which will allow for higher incomes that won't be offset by rising prices.

With labor markets tighter, why haven't we seen more pressures on wages? In part, the muted calls for wage increases are due to job insecurity. This insecurity is presumably the result of all the jarring changes that are taking place, including the highly publicized layoffs at many large corporations.

Certainly, layoffs are very painful for the workers who are displaced. One study conducted by the Federal Reserve Bank of Chicago found that high seniority, displaced workers experienced significant income losses even though they eventually found another job or were rehired at the same firm. In short, these displaced workers were never able to "catch up" and recover their lost income through future wages.

The general sense of unease among workers may be reflected in the unusually low level of strikes. Last year, work stoppages were at a fifty-year low. We've all seen labor unions increasingly focus on job security issues during negotiations. As part of this trend, there have been more and more long-term labor contracts, some extending as long as five or six years. This insecurity may be affecting labor costs. The employment cost index, which includes both wages and benefits, increased by only 2 and three-fourths percent last year. That's the lowest increase in the fourteen-year history of the index.

Will this trend continue? If you believe in market forces, it seems unlikely that job insecurity will suppress wages indefinitely. At some point, workers will be less willing to accept low wage growth in exchange for a perceived increase in job security. It's possible we've seen some initial signs of unrest in recent months. The employment cost index did register more significant increases during the fourth quarter of last year, although this was mainly due to a rise in benefits. The strike at GM last month might also be an early indication that workers are becoming more demanding. Certainly, such developments in the auto industry are of interest because of the sheer size of the work force.

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

So, what do we see for 1996 overall? We anticipate that we'll have growth of two percent or slightly higher during 1996. That's approximately the growth we can sustain without sparking an increase in inflation. The Consumer Price Index should come in at about two and three-fourths percent, and the unemployment rate should end the year at close to its current levels.

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.

We should experience average growth during 1996. That isn't bad, although I'll admit most people aren't excited about the prospect of an uneventful economy. You might call it a Rodney Dangerfield economy—it's not likely to get a lot of respect. But an economy that's a bit of a plodder can achieve better results over the long haul. Steady, healthy growth is the ideal. Quick sprints to the finish line may look good, but if you're running a marathon you want to concentrate on steady, sustained progress.

A few years ago, our economy was facing strong headwinds that were slowing its progress. Now we have the wind at our back, a steady breeze that may occasionally falter or pick up but should make for fairly smooth sailing during 1996. It's always difficult to predict what lies ahead but I feel confident that we're well positioned to make continued progress toward sustainable growth with price stability.