HARVARD BUSINESS SCHOOL CLUB

Chicago, Illinois
April 11, 1996

I. **Like to thank the Harvard Business School Club of Chicago for invitation.**

A. Distinguished group.

B. Club's overseers include my immediate predecessor as Chicago Fed president, Silas Keehn.

C. As well as one of the Bank's current directors, Arthur Martinez of Sears, Roebuck.

II. **Today, like to take a few minutes to provide some background about the Federal Reserve.**

A. Specifically, like to discuss how Fed's unusual structure facilitates effective, long term policy.

B. Why should we care? Structure important because it facilitates effective, long-term policy.

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

A. 12 Reserve Banks—regional design.

B. Overseen by Federal Reserve Board in Washington.

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

- Academic research center.
- Government regulator.
- Private business.

D. Different responsibilities make for interesting group of employees.

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

F. A lot of people think I'm a government employee. Technically that's incorrect.

1. Not subject to Civil Service.

2. We can hire and fire people.

IV. We're unique organization with a unique structure.

A. Decentralized, regional design.

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

C. Somewhat quirky, but it's a structure that works.

V. Key word to understand Fed structure—compromise.

A. An institution built on compromise—very much American version of central bank.

B. U.S. had two previous central banks—both failed.

C. First 20 year charter 1791-1811.

1. Second, 20 year charter 1816-1836.
2. Then, 77 year period with no central bank.

D. Most other industrialized nation had central banks.

1. We were behind the times.

VI. Consensus in early 1900s, U.S. needed central bank.

A. Question how to structure.

B. Political battle developed.

C. Would it be bankers with control?

D. Would it be government?

E. Result is a compromise.

  1. 12 regional reserve banks, with mixture of public/private features.

  2. Governing board in Washington, D.C., consisting of public officials appointed by President and approved by Senate.

VII. An example of this compromise is Federal Open Market Committee.

A. As you know, in charge of formulating national monetary policy.

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.

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

D. Seemingly unwieldy system.

  1. But it works.

VIII. FOMC meeting

A. Decision by consensus.

  1. Rarely a close vote.

B. Regional input is crucial.

C. Policy process is ongoing.

D. We analyze data from all sectors of the Seventh Federal Reserve District.

E. Reserve Banks add regional perspective and a broad array of information, input, and ideas from beyond the Beltway.

F. Each Bank develops expertise in different areas—for example, St. Louis Fed an early advocate of monetarism.

IX. Regional, independent structure key to effective policy.

A. Insulation from day-to-day political pressures provided by our structure important—facilitates Fed ability to take long-term outlook.

B. Reflected in Fed structure.

   1. 7 governors serving 14-year terms.

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

   3. 19 members total.

C. I'm not appointed by Congress, by the way. Appointed by my board of directors with the approval of the Board of Governors in Washington.

   1. Again, checks and balances.

D. Our budget does not go to Congress for approval.

E. We don't report to the President.

F. Congress doesn't have to approve our monetary policy actions.

G. But accountable to the government.

X. Why need insulation? Generally acknowledged that it can be difficult for an elected representative to resist temptation to "gun" the economy periodically.

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

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

C. That's the conclusion of many students of central banking, including Congress.

   1. Nobody's more aware of short term political pressures than those who experience it.

   2. Nothing new—back in 1830 House Ways and Means Committee stated its reluctance to have the government directly involved in issuing money, stating, (quote)

   "…the temptation to supply the Federal Treasury by the easy process of bank issues, rather than resorting to the unpopular process of internal taxation, would be too fascinating to resist."

D. Insulation also essential because of lags in policy.

   1. Monetary policy like a time release capsule, takes several months or a year to cure the economy.

   2. Thus, need to stay ahead of the curve.

   3. If don't react until serious problem shows up then already too late.

4. Insulation from day-to-day pressures enhances our ability to take a policy action that will help the economy in the long run although it may be unpopular in the short term.

XI. Think our economy today is in solid shape due in part to Fed's ability to focus on price stability and take the longer term view.

A. Last year, the economy performed reasonably well, although it was sometimes sluggish.

1. A bright spot was the combination of low inflation and low unemployment rates.

2. 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.

B. What do we see for 1996?

1. 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.

C. But I'll take just a minute to break those rules.

1. We anticipate that we'll have real GDP growth of two percent or slightly higher during 1996.

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

3. 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.

D. I guess you could say I'm guardedly optimistic about the economic outlook.

1. 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.

2. We should experience average growth during 1996.

3. That isn't bad, although I'll admit most people aren't excited about the prospect of an uneventful economy.

4. You might call it a Rodney Dangerfield economy—it's not likely to get a lot of respect.

5. But an economy that's a bit of a plodder can achieve better results over the long haul.

6. 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.

XII. A very important long-term economic issue I'd like to mention is the budget deficit.

A. In the midst of a contentious debate.

1. Some progress in recent years. Federal deficit 5 percent of GDP in '92. Expected to be roughly 2 to 2½ percent of GDP in '96.

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

B. Serious commitment to balanced budget within the next several years necessary first step.

1. But that's only a down payment—the first step in addressing the problems.

2. Long run demographic changes heighten the urgency.

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

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

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

2. Require enormous revenue.

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

1. Deal with problems now when we're better able to develop thoughtful policy.

XIII. To sum up, I'd like to restate the importance of the Fed taking the long term view.

A. The Fed's structure facilitates our ability to do this.

B. Certainly we can't be so insulated that we turn a deaf ear to the opinions and ideas of others.

C. In ancient Rome, when a victorious general returned home to the cheers of the crowd, a man was assigned to whisper in his ear, "You're mortal; You're mortal."

D. Don't need this particular form of checks and balances at the Fed.

1. Don't recall any cheering crowds when I returned from Washington after a FOMC meeting although my family seemed happy to see me.

E. But the Federal Reserve has an important public responsibility and we need to be as open as possible so we can encourage a healthy debate.

F. At same time though, can't twist and turn in response to gusts and flurries of public opinion.

G. We need to keep our mission in mind and proceed accordingly.

XIV. The best way to accomplish our mission is to keep inflation in check.

A. As we saw in the 1970s, the end result of runaway inflation is low employment and stagnant growth.

B. And the cure is a painful one that's best avoided—prevention is the best medicine.

C. The central issue is balancing short-term gains against long-term considerations.

1. Ignoring inflation may seem to be an easy way to boost growth.

2. But overstimulating the economy is an macroeconomic Ponzi scheme.

3. In the long run you need a foundation of stable prices to achieve sustainable growth.

D. Price stability is a goal we should all share.

1. Working together toward this objective is the best way we can assure a healthy, vibrant economy.