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Back to Basics: Savings, Stability and Our Economic Future

Good morning. It's truly a pleasure to be with you today. I think it's quite appropriate that your annual conference is taking place today, April 30th. Today is the 193rd anniversary of the Louisiana purchase, which nearly doubled the size of the United States at a cost of just three cents an acre. Not only was Thomas Jefferson our third president and the author of the Declaration of Independence, he was a pretty shrewd purchasing manager.

It is also quite appropriate that you meet here in the Midwest. In the early 1980s, the Midwest was known as the "rust belt." The region was hit harder by recessions than other regions. Today our rust belt image has given way to a new metaphor. As the region's economy has become increasingly diversified, the Midwest is now viewed as a well-oiled machine.

Chicago holds a particularly special place in the Midwest. Carl Sandburg characterized Chicago as "stormy, husky, brawly; the city of big shoulders." Given the city's strength in manufacturing, the flow of air passengers through O'Hare, the vitality of its downtown and neighborhoods, and the enormous trading activity supported by its financial markets, I believe that Chicago is truly a grand site for your meeting. It is my pleasure to welcome you to our city this morning and to talk about our national economic prospects going forward.

Our business at the Federal Reserve, of course, is monetary policy and the long-term health of the U.S. economy. Obviously, the long-term is made up of a number of short-terms. Any winning effort is. Just look at the Bull's record-setting season. It was built one game at a time. In this vein, I'd like to set the stage with the short-term outlook for this year and follow-up with some ways to foster long-term growth.

Let's start with a quick look back. In April 1991, we were just coming out of a recession. Households, businesses and government had cut back on spending after an extended period of accumulating debt.

The Fed had responded and eased monetary policy, and the economy recovered.

By 1994, we faced a different problem. We were growing too fast. In response, the Fed tightened policy during 1994 to suppress inflationary pressures and to put us back on a trajectory more in line with a rate of sustainable growth.

Inflationary pressures did subside in 1995. The Consumer Price Index rose by less than 3 percent, for the fourth straight year and the unemployment rate was 5.6 percent, its lowest sustained level in five years. At the end of 1995, we had an economy that was occasionally sputtering, but basically sound. Against this backdrop, we made two monetary policy moves. In December and, again, in January, we decided to ease the federal funds rate — one-quarter of a percentage point each time. The December decision was based on the positive outlook for inflation. The January decision was a tougher one.

Because of the government shutdown, we were short on statistics. Harsh weather had disrupted normal economic patterns. The economy seemed to be softening, but that appeared to be due to temporary factors — like the weather. In fact, a number of fundamental factors indicated that the economy was basically on track for sustained growth. Still, the FOMC decided it was appropriate to ease monetary policy slightly as a form of insurance against the risk of below potential economic performance. And, it didn't seem that this move would boost inflationary pressures. This decision exemplifies our biggest challenge: anticipating economic developments. Hockey great Wayne Gretzky once explained his success by noting that, "I move to where the puck is going to be, not where it is." Dennis Rodman explains his rebounding success the same way.

In anticipating developments, the Fed does many of the same things you do. You have to anticipate the needs of your companies and customers; we have to anticipate economic developments. Then we both decide on the actions to take. If you buy or produce and demand never develops, there are problems. If you fail to buy or produce and you're not ready when demand explodes, there are problems. If you wait for all the data to be in, it's clearly too late to act effectively. So too for the Fed.

With this as background, what do we see for the rest of this year? There are two fundamental issues that I think will have a lot to do with how things shape up. Are consumers tapped out? And, will a tight job market eventually increase pressures on wages?

First, consumer spending. Consumer spending accounts for about two-thirds of GDP so it's an area we watch closely. Consumer spending growth was moderate during 1995, at about 2 percent on a fourth-quarter to fourth-quarter basis. But overall economic growth was slower — 1.3 percent. The basic reason for the difference was an inventory correction. All of you know this scenario well. Businesses found they had too much inventory and reduced orders for goods. This slowed production and put a damper on near-term growth. As a result, businesses made good progress in clearing their shelves and that is a good sign for the economy this year.

Here are a couple of considerations in looking at consumer spending for 1996. There's some concern that consumers may cut back on their spending because they've accumulated too much debt. We do not think that will happen. Debt numbers are up because credit cards are easier to obtain and use. More people are now able to sign up for credit cards. They've become increasingly available to those at lower income levels, including young people. This increased access to credit is a very important change for the economy. I'm sure anyone with a son or daughter in college has been surprised by the number of

credit card applications sent to college students. Furthermore, people have become much more likely to use credit to buy things like gas and groceries. Such convenience credit is typically repaid within the next billing cycle, so it shouldn't put a crimp in consumer spending. In fact, lower interest rates and better terms have made it easier for consumers to service their debt; nevertheless, some of this gain has been offset by recent increases in interest rates. This could affect consumers' ability to service their debt. But interest rates continue to be lower than they were a year ago. So we don't think the relatively high debt load will cause consumers to cut back.

Some also have suggested that there's likely to be less demand for consumer goods because we're five years into the current economic expansion. Durable goods purchases tend to rise more sharply in earlier stages of expansions. Yet current indicators do not tend to support this completely. For instance, auto and light truck sales have been stronger than expected in the first quarter at 1 5.2 million units. Furthermore, existing home sales were up 6.9 percent in March. New home sales declined 7.6 percent in March, but that followed relatively strong sales in January and February. So, 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 about the same or slightly faster in 1996 than it did last year.

Finally, the labor situation. It is clear that labor markets are tight. The national unemployment rate averaged 5.6 percent during 1995, the lowest sustained level in five years. Here in the Midwest, our unemployment rates have been lower than the national figures. Despite this, we haven't seen much systematic pressure for larger wage gains in the Midwest or nationwide. When unemployment was this low in the past, businesses had to increase wages more aggressively to attract workers. These wage pressures are of interest to the Fed because they could trigger inflationary pressures. Don't get me wrong. Wage increases are good... as long as they are accompanied by increases in productivity. If they're not, then we're likely to see price inflation rise.

Nobody is helped by higher wages when prices are increasing. Many have noted that subdued pressure for wage increases may be due in part to job insecurity. Presumably this results, in part, from the jarring changes taking place in many industries — particularly highly publicized downsizing at many large corporations and perhaps a greater move to outsourcing and the use of temporary workers. Labor unions seem to be also increasingly focusing on job security in contract negotiations, and we've seen an unusually low level of strikes. In 1995, work stoppages were at a fifty-year low. Will this trend continue? It seems unlikely that job insecurity can suppress wages indefinitely.

Now what do I see for the economy in 1996 overall? I guess you could say I'm guardedly optimistic. 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. I anticipate that we'll have growth of 2 percent or slightly higher for the year. That's approximately the growth our economy can sustain without sparking an increase in inflation. The consumer price index should come in below 3 percent, and the unemployment rate should end the year at close to its current levels.

As with any forecast, there are both upside and downside risks. Back in December and January, many felt that the downside risks dominated. More recently, however, I think the risks have become more balanced — that it's just as likely that any forecast error will be positive as it will be negative.

Some commentators have expressed concern about the recent increases in prices of certain basic commodities such as corn, wheat, and crude oil. Supply and demand factors seem to have contributed to

these dramatic increases. Thus far these price changes do not appear to have had a significant impact on underlying inflation trends, but we are continuing to monitor such developments.

Another area of potential concern is the increase in longer-term interest rates we've seen over the past few months and the potential impact on industries such as housing. In part, this increase reflects the stronger economy in the first quarter as well as expectations of higher inflation. In my view, the slowdown in balanced budget negotiations between the Congress and the Administration also contributed to the rise in interest rates. My forecast of a 2 percent real GDP growth rate isn't exciting, but it sure isn't bad. An economy that grows consistently at that rate can achieve excellent results over the long haul. As far as we at the Fed are concerned, steady, healthy growth is the ideal. Those slam dunks look great, but you'll have trouble winning if you've neglected to practice free throws and defense. It's attention to the basics that set you up for steady, sustained progress over time.

And that brings me to the last area I want to touch on: how to foster sustainable economic growth and a better standard of living for the long run. This, after all, is the Fed's basic goal. And that's where the genius of the Fed's structure shows itself: we're set up to focus on the long run. More specifically, the Fed has the independence necessary to control inflation. Through the structure which Congress so carefully crafted, the Fed is able to look beyond the next several months and beyond the next election. While Congress carefully provided for the Fed's independence from potentially transitory political agendas, it also built in the accountability that any policy-making body must have.

Given this background, there are two key factors when it comes to achieving sustainable economic growth. The first is price stability and the second is an adequate savings rate. They reinforce one another. Over the last fifteen years, we've made significant progress keeping inflation in check. However, I believe the savings rate must be higher than it is if we want to grow at faster rates.

As I noted earlier, growing at our long-term potential rate is not exciting. Many people would like to see the economy grow faster — even if it means higher inflation. They ask, "Wouldn't it be worth a few points on the consumer price index to put thousands of people back to work?" Unfortunately, it's not that simple. Economic growth is determined by labor force growth and productivity growth. The best way to improve our standard of living is to increase productivity. That allows for higher incomes that will not be eaten away by rising prices. The best way to lower our standard of living is to try to grow faster than our labor force and productivity, triggering a wage-price spiral and adding even more points to the CPI. The end result is high inflation and slow growth.

So, how can we increase national productivity? We need higher levels of investment. And to increase investment, we need a higher level of savings, since savings is the source of investment funds. During the 1980s, net savings — which includes household, business and government savings — fell to an average of 3 percent of GNP, well below net fixed investment of about 5 percent. This was occurring at the same time that Germany and Japan had much higher savings and investment rates. And U.S. government savings were actually negative 2½ percent. In other words, our federal government budget deficit is dissavings.

It is important to note that we have been running large deficits in all phases of the economic cycle, including the last five years of sustained economic growth. The gap between savings and investment in the U.S. has been filled by foreign capital. Between 1980 and 1994, net foreign capital inflows averaged about \$80 billion a year. In the long term, this is a problem.

A healthy economy's investment level is ultimately determined by domestic savings. Depending on foreign capital is not a long-term solution for a highly developed economy like ours. Again, to increase productivity we have to increase domestic savings. And the best way to do that is to eliminate our biggest source of "dissaving"... the federal budget deficit.

The contentious debate on balancing the budget is all over the papers in this political year. Everyone seems to agree that a balanced budget is a must but they can't agree on how to get there. Fortunately, there has been some progress in recent years. The deficit has fallen from 5 percent of GDP in 1992 to a projected 2½ percent by the end of this year. But we're still well above the pre-1980 average of 1½ percent. And the goal must be to have surpluses in periods of sustained economic expansion that would begin to trim the national debt and its interest burden. The President and Congress must resolve this issue. Their action, or lack of it, could have an impact on the economy for years — even decades— to come. Yogi Berra said, "When you're at a fork in the road, take it." We're at a fork and — while I realize it's a difficult political process — setting a program and carrying it out is absolutely essential.

Adding another dimension, and urgency, to the situation is long-term demographics — and particularly the aging of the baby boomers. Beginning in the next ten years or so, our society will be facing significant cost pressures as the boomers, in all their numbers, start retiring. They'll begin paying less in taxes and receiving more in benefits. Yet, we'll be more poorly equipped to take care of them. In 1945, when social security was still young, there were 42 workers paying into the system for each beneficiary. This is, of course, a bit misleading since there were a good number of retirees back then who weren't beneficiaries. Still, by 1960, the ratio was about 5 to 1, at the end of last year it was 3.3 to 1 and in 2030, when the last of the Baby Boom generation reaches retirement age, it will be around 2 to 1. Unless we change the Social Security program requirements, supporting these retirees will require enormous revenue. Investment in productivity aside, we need to build a surplus now so we'll be in a position to handle these increased costs we know are down the road.

Given the importance of savings and investment, it's easy to see why ensuring price stability is the best way to foster maximum sustainable growth. It is important to use sound policy to stop inflation before it gets out of hand. High inflation distorts decisions. People expend too much of their resources to protect themselves from price increases. They make fewer long-term investments because they expect their return will be eaten away by inflation. They spend more on consumer goods short-term because inflation will reduce the value of their dollars. This inflation mentality creeps in and affects decisions. We've seen that happen. Stable and low inflation leads to sound decisions and more efficient allocation of resources. It encourages savings and investment which, in turn, foster productivity increases. And this achieves the Federal Reserve's mission — a goal that we all share: healthy sustainable growth and a higher standard of living for us all.

Thank you.