

ROTARY CLUB AT CHICAGO

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Back to Basics: Savings, Stability and Our Economic Future

Good afternoon. It's a pleasure to be here at the Rotary Club. The Club has a distinguished record of featuring many notable speakers. I'm honored to be asked.

I plan to talk about the economy today, but first I'd like to take a couple of minutes to give some background on the Fed. The Federal Reserve is set up on a regional basis with 12 Reserve Banks across the U.S. The Reserve Banks, together with the Board of Governors in Washington D.C., make up the Fed System.

Our mission as a central bank, of course, is to foster a safe and sound financial system and a healthy, growing economy with stable prices. More specifically, we formulate monetary policy...We supervise and regulate banks and bank holding companies...And we provide financial services to banks and thrifts and the U.S. government. The Chicago Fed carries out these activities in a five-state region that consists of most of Illinois, Indiana, Michigan, and Wisconsin, and all of Iowa.

This regional structure is unusual for a central bank. But it's effective because it allows for input on policy from all over the country. Each of the 12 Reserve Bank presidents take part in determining monetary policy. The structure also helps to insulate the Fed from day-to-day political pressures. The bottom line is the structure helps the Fed formulate effective policy that focuses on the long-term.

The importance of the long-run performance of the economy is one of the topics I'd like to cover today. First, though, I'd like to set the stage by discussing the short-term outlook. Last year 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 at 3 percent or less for the fourth straight year and unemployment was at its lowest sustained level in five years.

So far in '96 we've experienced respectable growth, with GDP up 2.3 percent during the first quarter. And early assessments indicate that second-quarter GDP growth could be well above the first-quarter pace.

What do I see for 1996? Well, one major factor is consumer spending...it accounts for about two-thirds of GDP. Consumer spending increased at a moderate clip last year. We expect spending to be a bit stronger this year but still moderate. Income growth is fairly strong and employment has been solid. People generally have some money to spend and it looks as though they'll be inclined to spend it.

But a number of analysts have expressed some doubts about consumer spending growth. One concern is the level of consumer debt. Some worry that consumers will cut back on their spending because they are carrying too much debt. Consumers have accumulated debt...there's no doubt about that.

But we at the Chicago Fed don't think the debt load is a problem at this point. A key factor is the capacity of consumers to pay off their debts. Consumers during recent years have taken advantage of lower interest rates and better credit terms. So their scheduled payments for paying down their debt isn't as much of a burden as you might think.

The amount consumers spent to service their debt—both principal and interest—was a smaller portion of their personal income in '95 than it was in '89. In other words, consumers were in a better position to pay off their debt last year than they were in '89. So we don't think the relatively high debt load will cause consumers to cut back significantly on their spending.

Another issue is whether consumers will continue to buy durable goods. We've had a number of years of healthy economic growth. Early in an expansion there tends to be a lot of pent-up demand for consumer goods, especially durable goods. Later in an expansion consumers tend to slow down their purchases of durable goods. But that hasn't happened.

People are still buying cars and trucks, for instance. Auto and truck sales were stronger than expected during the first quarter of '96. And sales held up fairly well in April and May.

Of course, the biggest purchase for most people is buying a house. The housing market remains strong despite the recent run-up in mortgage rates. Housing demand should continue to be strong with the economy growing. But higher long-term rates could eventually put a squeeze on housing and related industries.

Overall, as I said, we do expect consumer spending will increase at a moderate pace in '96, a bit faster than last year.

Let's move on to a major issue for any central banker—inflation. GDP growth was 2.3 percent during the first quarter, a bit higher than expected. Are inflationary pressures a problem? Well, there are a couple of concerns. One is the recent increase in food and energy prices; the other is tight labor markets.

First, food and energy prices. Energy prices have shot up. We've all seen that at the gas station. And grain prices have increased dramatically. On the energy side, we've already seen some declines in crude oil prices. That should show up in other energy-related prices. The increase in grain prices will probably lead to higher food prices in the months ahead. The question is whether increases will spillover to other prices. It's too early to judge. But we should see less pressure on food prices if we have a normal harvest this summer.

The important point to stress is that we have not seen significant price increases outside the food and energy areas...yet. The core CPI inflation rate—CPI minus food and energy—is holding at a fairly stable level. We're seeing some mixed signals but haven't detected a consistent pattern of inflationary pressures at this point.

The other issue I mentioned is labor markets. It's clear that labor markets are tight. The national unemployment rate averaged 5.6 percent during the past 12 months. Unemployment rates here in the Midwest have been lower than the national figures, averaging 4.5 percent during the past year.

But even though our labor markets are tight we haven't seen much pressure on wages in the Midwest or nationwide. Businesses in the past had to increase wages more aggressively to attract workers when unemployment was this low. The Fed always monitors wage rates because they could trigger inflation problems. Don't get me wrong. Wage increases are good...as long as they're accompanied by increases in productivity. If they're not, then we're likely to see prices increase. And nobody is helped by higher wages when prices are increasing.

Many have noted that subdued pressures on wages may be due in part to job insecurity. This is probably the result of the jarring changes taking place in many industries. The question is whether wage pressures will remain subdued. It seems unlikely that job insecurity can suppress wages indefinitely. This is something that we're monitoring.

Are inflationary pressures a problem at this point? Not so far. We're always watching inflation closely. Any central banker worth his or her salt would have some concerns right now. The economy is warming up slightly. Pressures may be building up in certain areas like food and energy. But it doesn't look like inflationary pressures for the overall economy are ready to bubble over. The teapot hasn't begun to whistle. And the pace of economic growth should moderate during the second half of the year so any pressures that do build up should subside.

So what do I see for the economy for 1996? We anticipate that we'll have real GDP growth of about two and one-half percent during 1996. That's near the range of growth that we can sustain without sparking an increase in inflation. The Consumer Price Index should come in below three percent. And the unemployment rate should end the year at close to its current level.

As always, there are some cross currents in the economy. There will be some occasional turbulence; there will be some temporary lulls. Overall, though, the economy is rolling along at a reasonably good clip, even though there's been some bumpiness from quarter to quarter.

That brings me to my next topic: 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.

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 15 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.

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 three percent of GNP, well below net fixed investment of about five 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's 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 has been 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 was five percent of GDP in 1992. It's projected to be slightly below 2 percent in the current fiscal year. But we're still well above the pre-1980 average of 1½ percent. And without further action we'll see current figures rise in future years. 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 10 years or so, our society will be fac-

ing 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 five to one, at the end of last year it was 3.3 to one, and in 2030, when the last of the Baby Boom generation reaches retirement age, it will be around two to one. 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.