ECONOMIC FORUM
FEDERAL RESERVE BANK OF CHICAGO

Muncie, Indiana
January 17, 1997

What's Ahead for the Economy: A View From the Fed

Before I discuss the outlook for the economy, I'd like to take a few minutes to provide some background about the Federal Reserve…specifically, the important advantages of the Fed's regional structure. That seems appropriate as my visit here is very much in keeping with these advantages. One of the great strengths of our system is that it enhances our ability to get a first- hand look at what's happening at the regional level. And that's a key goal of my visit. As part of this effort, I was at Borg-Warner earlier today, and I'll be visiting Ball State later this afternoon.

Why should we care about the Fed's structure? The Federal Reserve is unusual, perhaps unique, among central banks in its decentralized, regional design. That's important because our structure helps us develop effective, long-term monetary 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 Indiana, Illinois, Michigan, and Wisconsin, and all of Iowa. In addition to our head office in Chicago, we have offices in Detroit, Des Moines, Milwaukee, and a facility in Peoria. And, of course, we have an office in Indianapolis.

To understand the Fed's unique structure, the key word is compromise. The United States tried two previous experiments in central banking—both failed. Each bank was allowed to expire after 20 years. The early banks were doomed by a typically American suspicion of concentrated power, especially money power.

So the U.S. went through most of the 1800s without a central bank, unlike most other industrialized nations. 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. Some favored a centralized institution with a strong private-sector orientation. Others preferred a regional structure dominated by the government.

The organization that resulted was a compromise. The Fed was created with an intricately structured balance between the public and the private, the central and the decentralized. It's a balance that still exists. The 12 regional Reserve Banks have a mix of public and private features. And the governing board in Washington, D.C., consists of seven public officials appointed by the President and approved by the Senate.

One of the Congress' goals was to insulate the central bank from day-to-day political pressures. That's a key aspect of the Fed—it's about policy, not politics. 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. But doing so in response to the election year cycle—rather than the business cycle—isn't likely to result in effective policy. The central issue is balancing short-term gains against long-term considerations.

To help the Fed focus on the long term, Congress provided fourteen-year terms for the Board of Governors. Additionally, the Federal Reserve doesn't depend on the appropriations process to meet its expenses. I should add, though, that Congress does review the Fed's budget. And the vast majority of our earnings is turned over to the U.S. Treasury. Our ability to fund our own operations is a public trust…it's a responsibility we take very seriously. The Federal Reserve is insulated from short-term political pressures, but we're ultimately accountable to Congress and the American people.

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…people such as Steve Anderson and Charlene Sullivan. And, as I mentioned, the Reserve Banks sell a variety of financial services in the marketplace.

The Federal Open Market Committee, or FOMC, is the most intricate example of the Fed's checks and balances. It's the Fed's most important policymaking body, which decides on the course of monetary policy. Any particular FOMC meeting combines the seven members of the Board of Governors and the 12 Reserve Bank presidents, five of whom 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. 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. 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 information and ideas from people living and working throughout the country. That's why it's so useful for me to spend time travelling throughout the District. And I'm very interested in hearing your questions or comments regarding the economy, especially regarding the local economy. You are truly the experts on that subject.

To set the stage, I'd like to discuss the outlook for the national economy. How do I see the current situation? Well, I'd put it this way: the economy did well last year and we can expect more of the same in '97. Or, to put it in Yogi Berra's well-known words, "It's deja vu all over again."

Fortunately, more of the same is positive news…1996 was a good year for the economy. We had very respectable growth, with real GDP growth expected to come in at about 2¾ percent. A particular bright spot throughout the year was the combination of low inflation and low unemployment rates. Inflation as measured by the Consumer Price Index was up a bit in '96 as compared to '95. But the growth of core CPI—which excludes food and energy prices—slowed down in '96…to its lowest level in more than thirty years. And the unemployment rate remained low, averaging 5.4 percent.

Some observers have described it as the "Goldilocks economy—not too hot, not too cold but just right." That's not a bad description, although some might say the porridge had some lumps in it as growth was a bit uneven from quarter to quarter. We started out of the gate last year at a moderate pace in the first quarter, picked up quite a bit of momentum in the second, and then settled into a somewhat more comfortable speed during the last half of the year. Despite a bit of unevenness, though, 1996 was a good year by historical standards, especially for the sixth year of expansion.

Given this background, what do I see for '97? 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 1997. These are just a few of the many issues that are worth watching.

The first issue—Are consumers tapped out?

Number two—Will developments overseas provide a boost to the economy?

And number three—Will tight job markets eventually increase pressure on wages?

Regarding the first question, growth in consumer spending was generally solid last year. We don't have the final numbers yet but it looks as though spending increased about 2½ percent. In general, consumer spending growth was roughly in line with the overall economy…it didn't act as a drag on the economy or pull it along too fast.

It looks as though we'll see more of the same in '97. One positive sign is income growth. Last year, growth in consumers' disposable income kept pace with spending. We expect incomes to continue increasing at a healthy pace during '97, which bodes well for spending.

There are some potential hurdles, however. We're now in the sixth year of expansion…and we're close to beginning a seventh. At this point in the expansion, consumers have already made the major purchases that they deferred during the 1990-91 recession. In other words, there probably isn't much pent-up demand. So we probably won't see a spurt in the sale of big-ticket items in '97.

The consumer debt situation is another factor. It's a well-publicized fact that consumers have accumulated a lot of debt. In general, people are using a relatively high percentage of their disposable income to service their debt. But things have been improving. The growth in consumer credit slowed last year from the double-digit pace of '94 and '95. And the debt service payments of consumers relative to their income have stabilized, although they're still at a high level. Overall, we don't think consumer debt will be a major constraint on spending.

So, on balance, we at the Chicago Fed don't think consumers arc tapped out. Given the healthy income picture, high consumer confidence levels, and other factors, we expect that spending growth will continue along at a respectable pace in '97, roughly the same as in '96.

Second question—How will developments overseas affect the U.S. economy?

There was somewhat of a mixed picture for the U.S. last year We had strong growth in imports, thanks in part to the healthy increase in our GDP. Americans had more to spend and we spent it…including a fair amount on foreign goods and services. Export growth, on the other hand, was somewhat disappointing. In general, our major trading partners experienced fairly sluggish economic growth, which affected the demand for U.S. exports. Overall, U.S. imports exceeded exports by a wider margin than in '95. As a result, the international sector was a bit of a drag on the U.S. economy in '96.

The outlook for the international sector is a tough call at this point. Eventually our major trading partners should see their economies pick up. This should provide a boost for U.S. exports. But I don't think we can count on a strong rebound for exports in '97, Our best guess right now is the international sector will have a neutral effect on the U.S. economy.

Finally, the third question—Will tight labor markets spark inflationary pressures?

As I mentioned earlier, unemployment rates have been low across the country, averaging 5.4 percent in 1996. Unemployment rates have been even lower in the Midwest. That's certainly true in Indiana where unemployment was 3.6 percent in November. And Muncie also did better than the nation, with an unemployment rate of 3.8 percent in November.

That's not an isolated example, by the way. The Midwest's unemployment rates have been consistently lower than the nation in recent years…an indication of the strength of our regional economy. The Rustbelt has become robust. As a regional institution, the Chicago Fed has a strong interest in this trend. In fact, we've nearly completed a major study of the Midwest economy, which examines the region's turnaround and what we need to do to keep it going. That's another advantage of our regional system—the ability to do such specialized research projects. Our study has revealed some very interesting trends. But, that's the subject of another talk.

As I said, unemployment rates have been quite low, in the Midwest and nationwide. It's interesting that there hasn't been more pressure for higher wages. When unemployment was this low in the past, businesses had to increase wages more aggressively to attract workers.

We did see a slight acceleration in wage gains last year, but that was offset by a slower rise in benefit costs. So, overall compensation costs did not accelerate very much.

Don't get me wrong. Higher wages are all to the good....as long as productivity is increasing and we don't get a corresponding hike in inflation. Workers obviously can't improve their living standards if their raises are eaten up by higher prices.

Frankly, many economists have been somewhat surprised that workers haven't been more aggressive in seeking higher wages. Why haven't they? There's probably a number of factors at play. It seems safe to say that one reason is a lingering sense of insecurity in the workforce. Workers seem to be more concerned about job security than wage increases. For instance, we've seen labor unions focusing on job security issues during negotiations. Longer-term labor contracts have been negotiated as part of this trend, some extending as long as five or six years. At some point, though, workers may begin feeling more secure and become more aggressive in seeking wage increases.

Given past trends, the Federal Reserve will certainly continue to pay close attention to the labor markets. We're watching carefully for any signs that wage pressures are mounting more than can be justified by productivity gains. We haven't seen that yet. But it's a key issue to keep in mind during '97.

What's the overall outlook for the nation? We anticipate that real GDP will grow between 2 and 2½ percent this year. The Consumer Price Index should come in at about 3 percent. And the unemployment rate should fluctuate around 5½ percent.

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.

So, it looks as though we'll see more of the same in '97. The deja vu economy, if you will. We should have another year of respectable growth, with low inflation and low unemployment rates. In other words, a year that would be consistent with the Fed's goal of a healthy, growing economy with price stability.

To sum up, I'd like to restate the importance of the Fed's structure in the development of effective policy. I think our economy today is in solid shape due in part to the Fed's ability to focus on price stability and take the longer term view. Our structure helps us maintain that delicate balance. It allows us to focus on policy, not politics.

Ignoring inflation may seem to be an easy way to boost growth...but it's a macroeconomic Ponzi scheme. As we saw in the 1970s, the end result of runaway inflation is low employment and stagnant growth. The cure is a painful one that's best avoided...prevention is the best medicine. In the long run you need a foundation of stable prices to achieve sustainable growth...that's the best way we can assure a healthy, vibrant economy for many decades to come.

Thank you.