INDUSTRIAL RELATIONS RESEARCH ASSOCIATION

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Thank you. I'm glad to be here and appreciate each of you coining here today. Labor relations has been a life-long interest for me, especially the collective bargaining process. My background includes research in labor economies and serving as Under Secretary of Labor at the U.S. Department of Labor. And, as noted in the program, I previously served as national president of IRRA.

I would like to discuss an important issue today. It's a fundamental issue that has to do with jobs and the growth of the economy. It goes to the heart of what the Fed does and how it does it. How can the Fed help the economy grow? How do we encourage job creation and fight inflation at the same time? That's an issue that the Fed has struggled with for decades. Today I'd like to take a quick look back and trace how the Fed has dealt with this issue over the years.

Fed System

First, I'd like to take a few minutes to give you some background about the Federal Reserve and its regional structure. This is in keeping with the general theme of my remarks and is important in understanding Fed policymaking. The Fed's decentralized, regional design makes it an unusual central bank. Why should anyone care? Because it helps us develop effective, longterm monetary policy.

The Fed's mission is to foster a safe and sound financial system and a healthy, growing economy. Specifically, we formulate monetary policy…supervise and regulate banks…and provide financial services to the U.S. government and depository institutions.

The Fed System is made up of 12 Reserve Banks across the country and the Board of Governors in Washington. The Chicago Fed is one of the 12. We operate in a five-state region that's made up of most of Indiana, Illinois, Michigan, and Wisconsin, and all of Iowa. Our head office is, of course, here in Chicago, and we have offices in Detroit, Des Moines, Indianapolis, Milwaukee, and a facility in Peoria.

The Fed was not the first attempt at a central bank. The United States tried two previous experiments. Both failed to make it past their original 20-year charter. Ultimately they were doomed by a typically American fear of too much power in the hands of too few. A fear that is even greater when the power is money power.

So the U.S. went through most of the 1800s without a central bank. We were behind the times…the only Western industrialized nation without a central bank.

By the early 1900s we knew we 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.

Congress decided to compromise. The Fed was structured with a balance between the public and the private…the central and the decentralized. This system of checks and balances 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.

Congress insulated the Fed from day-to-day political pressures. Why? There's always a temptation for elected representatives to "gun" the economy periodically. Stimulating the economy is, of course, appropriate at times. But you need to do it in response to the business cycle — not the election cycle. The key is balancing short-term gains against long-term benefits. This is an issue I'll return to in a little while.

Congress structured the Fed to help it focus on the long term. It gave the members of the Board of Governors fourteen-year terms. And it freed the Fed from depending on appropriations from Congress to meet its expenses. I should add, though. that Congress does review the Fed's budget. And we turn over more than 90 percent of our earnings to the Treasury every year. Funding our own operations is a public trust. And we take it very seriously. We're insulated from short-term political pressures; but we're ultimately accountable to Congress and the American people.

The Reserve Banks have characteristics of the private sector. A lot of people think I'm a government worker. I'm not. No one at the Bank is. No one is subject to civil service. Each Bank and branch has a board of directors made up of private citizens from the region. And, as I mentioned, we sell financial services in the marketplace to bankers, competing with other firms providing the same services.

The Federal Open Market Committee, or FOMC. is the best example of the Fed's checks and balances. The FOMC is responsible for the Fed's most important function, formulating monetary policy. It's made up of the seven members of the Board of Governors and the 12 Reserve Bank presidents, five of whom vote on a rotating basis. I vote every other year, alternating with the president of the Cleveland Fed. The president of the New York Fed always votes — open market operations are conducted there. The other nine presidents vote every three years. It's a complex system. But the bottom line is, it works.

What do the Reserve Bank presidents bring to the table at FOMC meetings? One obvious difference is the fact that we're not located in Washington. The presidents get a constant flow of input from beyond the Washington "beltway" because of our regional structure. Our regional structure also helps us gather up-to-the-minute, grass-roots information on the emerging developments in the region. You may be familiar with the beige book, the compilation of regional economic conditions prepared by the Reserve Banks. We rely on input from people throughout the District to obtain this kind of information. One of our sources at the Chicago Fed is an advisory group that includes representatives from agriculture, small business, and labor.

So the Fed's regional structure has two major advantages. It insulates us from narrow influences. And it helps us gather information and ideas from all over the country.

Our structure helps us accomplish our mission…to focus on policy — not politics.

This brings me to my earlier point about the Fed's mission and how to achieve it. As I said, the Fed's a relative newcomer as far as central banks go. We're only 83 years old, and still learning. I'd like to take a quick look back at the past-war economy, starting with the Employment Act of 1946. That Act in a sense kicked off the modem era of managing the economy with fiscal and monetary policy. I think the developments over the years tell us a lot about how to foster a healthy, growing economy.

A look back

1946 was quite a year. The war was over. It was an exciting, but anxious, time for the nation.

The U.S. was shifting from a wartime economy. We had 12 million GIs in service on VJ day. We had only 3 million by August 1946. To put that number in perspective, we had total civilian employment of only 55 million in 1946.

Many people were afraid we'd fall back into a depression. There was no more war production. And millions of ex-GIs were looking for work. Recession seemed inevitable.

Congress responded by passing the Employment Act of 1946. It established the four goals of economic policy: Economic growth, low inflation, high employment, and a reasonable balance in foreign trade. All admirable goals. The problem was trying to achieve them all at the same time. The Fed would struggle with how to sustain healthy economic growth for the next 50 years.

The end of the war also triggered a bit of an early mid-life crisis for the Fed. We played a key role financing the war, buying bonds from the Treasury at a pre-determined price. This helped us win the war. But basically it eliminated monetary policy. The only thing affecting the economy was fiscal policy — actions by Congress and the President.

That left us with a basic question: what's the proper role of the Fed? Should monetary policy be used to help the economy? The Employment Act of 1946 didn't really answer the question. It established policy goals, hut it said nothing about how to reach them.

The Fed's role was debated for years. It was finally settled in 1951. The Treasury and the Fed reached what is known as the "Accord." The Treasury agreed that fiscal policy and monetary policy would have a role. And the Fed would be responsible for monetary policy.

After that, the Fed focused on moderating the swings in the economy… smoothing the effects of the business cycle. Fed Chairman William McChesney Martin called this policy "leaning against the wind."

As it turned out, we shouldn't have been so worried in 1946. During the next ten years, we had prosperity and growth. Looking back now, it was the beginning of a golden age for the economy…and for monetary policy.

The nation prospered during the next decade — 1956 to 1965. Looking back, it was a decade of prosperity and stability. The Fed continued learning the relatively new art of monetary policy.

Everything was not smooth. There were mild recessions in 1957 and 1960. But then, we went eight years without a recession. Interest rates were remarkably stable and inflation was moderate.

By 1965, though, the U.S. was cranking up a war machine in Vietnam. And this started to put pressure on our resources. It was the beginning of a hard lesson we'd learn in the next decade. The golden age was coming to an end.

Into the next decade, 1966 through 1975, a difficult time for the nation and the economy.

We saw the beginnings of a high and persistent inflation. The Chicago Fed noted in its 1967 Annual Report that a "greatly expanded military effort is being superimposed on a booming private economy." By 1968, the Chicago Fed reported "interest rates were at a new high in the experience of today's generation." As it turned out, we hadn't seen anything yet.

OPEC announced an oil embargo in 1973. Another severe blow to the economy. We were hit with a double whammy of high inflation and slow economic growth. Stagflation, we called it. The old idea of trading off some inflation for more jobs wasn't working. It was the worst of both worlds. Actually the trade off never worked. And now it was catching up to us.

Nothing seemed to be able to turn the tide. Not monetary policy; Not fiscal policy. Remember the freeze on wages and prices in 1970? I remember. I just started working in government after teaching in college and was involved in some of the early attempts to contain inflation. My job as director of the Council on Wage and Price Stability was to monitor wages and prices after the controls were lifted.

The controls were a dismal failure. I always wanted to play some role in carrying out policy, but this wasn't exactly what I had in mind. Containing inflation was like trying to tape gravy to a wall. Despite our best intentions to seal and patch, it still oozed out.

That experience reinforced to me how complex our economy is. And how futile it is to rely on gimmicks to stop inflation. And how important it is to stop inflation before it gets out of hand.

This brings us to the next decade—1976 through 1985. The economy continued to struggle. There was another oil embargo in 1979. Inflation hit 13 percent. It was feeding on itself. I was in the private sector at that time. I saw first-hand how inflation distorted judgments. Discipline in cutting costs flew out the window. It was easier to recover costs by raising prices. I guess we reached the high point, or low point, when the price of silver went over $50 an ounce.

We needed a dramatic move. And we got it. Paul Volcker was appointed Fed chairman in July 1979. He called an emergency meeting of the FOMC on October 6, 1979. Members gathered in Washington. They stayed in different hotels around the city to avoid publicity.

The Fed announced a dramatic change in its procedures after the meeting. The Federal Reserve was determined to squeeze inflation out of the economy once and for all. The markets responded. There was an immediate and sharp increase in virtually all interest rates.

The economy slowed down. And eventually slipped into a sharp recession. One that was particularly painful for the Midwest. But inflation did begin to slow.

The economy recovered. By 1983, Volcker reported to Congress that the "inflation tide has turned in a fundamental way."

The Fed broke the back of inflation. The economy went on to grow for 8 years without a recession—the longest peace-time expansion in history.

The Fed was always aware of the problems of inflation. But our experience in the late 1970s reinforced the dangers of allowing inflation to get out of hand. We learned a hard lesson.

That brings us to 1986. We were in the middle of the 8-year expansion. We had moderate inflation and healthy growth. But all was not well. Consumers, businesses, and government…all were piling up record levels of debt. And the bill came due. The war in Kuwait triggered a relatively mild hut lengthy recession in 1990 and '91. The economy slowed when people and businesses cut back on their spending.

The Fed eased monetary policy aggressively. The economy recovered. Then it began to build steam. By 1994 we were growing too fast. It wasn't sustainable. We were like a sprinter finishing a 400-meter race. We needed to catch our breath. Our resources were stretched. We couldn't keep up that pace for the long haul. So the Fed tightened policy in 1994 to eliminate inflationary pressures that were building.

It was a controversial move at the time. A new approach. I wasn't at the Fed then, but I think it was absolutely the right move. The Fed acted to head off inflationary pressures before they became a problem. It slowly deflated these pressures instead of waiting and bursting the balloon after the fact. We learned in the late 1970s that waiting is too painful.

This forward-looking approach is necessary because of the lags in monetary policy. Monetary policy is like a time release capsule. It takes several months or a year after any action to cure the economy. So its necessary to stay ahead of the curve. If we don't react until a serious problem shows up, we're too late.

Why is it so important to make sure inflation doesn't emerge? Wouldn't a little inflation be ok if it would help put people to work? I wish it were that easy. There's no trade off in the long run. High inflation inevitably leads to fewer jobs.

Why? The three things that ultimately determine how fast the economy can grow are population growth, technological advances, and productivity improvements. What if the Fed opened up the spigot to encourage faster growth? We wouldn't see the desired increase in the flow of new jobs; we would see a pickup in prices. And what starts as a trickle can quickly turn into a flood.

Closing the floodgate isn't easy. We learned that from the stagflation of the 1970s. People start to expect inflation. They focus on protecting themselves from higher prices. They make fewer long-term investments because they expect prices to go up. And they spend more on consumer goods instead of saving because they want to buy before prices increase. Some people profit when inflation skyrockets. But many others are hurt, especially those on the lowest rung of the economic ladder.

Conclusion

So, it seems to me that's one important lesson we learned from the past five decades —There's no trade off between inflation and growth in the long run.

An economy that grows at a solid, sustainable pace isn't necessarily exciting. But a roller coaster economy is a losing proposition. As the great tennis instructor Vic Braden once said, "Losers hit a wide variety of shots, but champions keep hitting the same old boring winners." That's what 1 like to see — the same old boring winners.

The Fed's ultimate goal is to foster a higher standard of living for the American people. The Fed is all about growth—we want the highest possible level of growth and jobs that can be sustained. The only effective way for a central bank to do that in the long run is to foster price stability. That's the best way we can assure a healthy, vibrant economy for decades to come.

Thank you.