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Sustaining Economic Growth

I'd like to discuss some of the specific elements I see as critical in continuing sustainable economic growth into the next century. These four elements—improved efficiency, increased trade, a skilled workforce, and low inflation—are key to long-term U.S. economic prosperity. A point I want to emphasize is the importance of taking the long view in developing policy.

I speak, of course, from the perspective of the Federal Reserve System and the Chicago Fed in particular. And if you will permit me some professorial comments, I want to begin with a few words about the Fed itself. Because the Fed's structure is a big part of our economic success story.

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

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, Indianapolis, Milwaukee, and a facility in Peoria.

The Fed has 12 regional Reserve Banks and a Board of Governors in Washington, D.C., which provides oversight for the System. In other words, we're decentralized. That's unusual for a central bank—and a bit of an oxymoron — a decentralized central bank. In fact, the design is a work of American genius, balancing the public and the private, the central and the decentralized.

To help the Fed focus on the long-term, Congress provided 14-year terms for the Board of Governors. Likewise, the System doesn't rely on Congressional appropriations to meet expenses. Our budget is reviewed by Congress, however, so we're still accountable. And the Fed System turns over more than 95 percent of its earnings to the U.S. Treasury—some $20 billion last year.

In short, we're insulated from political pressures, but we answer to Congress and the American people.

Why did Congress insulate the Fed from day-to-day political pressures? Because they knew the political temptations to stimulate the economy. That may be appropriate at times. But it should be done in response to the business cycle, not the election cycle.

While the Fed is a public institution, the 12 Federal Reserve Banks have private-sector characteristics. For example, each Reserve Bank has a board of directors consisting of private citizens from its district. The directors appoint the Reserve Bank's president, with approval of the Federal Reserve Board in Washington. As I mentioned, the Fed provides a variety of financial services. Some like cash processing are free of charge. But we also compete in the marketplace, selling financial services such as check processing and electronic funds transfers for a fee.

The Federal Open Market Committee is the best example of the Fed's intricate checks and balances. It performs the Fed's most important responsibility—formulating monetary policy. The FOMC is made up of the seven members of the Board of Governors and five of the 12 Federal Reserve Bank presidents. The Presidents serve as members on a rotating basis. However, all 12 Presidents attend the meetings and take part in the discussions. I serve as a voting member every other year—alternating with the president of the Cleveland Fed. This year, I'm the voting member from the Midwest. In fact, our next meeting is September 30.

This regional structure means that the System receives a constant flow of economic intelligence from the districts. Our perspective isn't limited to the Washington "Beltway."

So the Fed's regional, independent structure has two major advantages. First, it insulates us from narrow influences. And, second, it helps us gather information and ideas from all over the country. The Fed's structure is vital for developing effective policy. It helps us maintain a delicate balance…to focus on policy, not politics.

Now that you have an idea, as my kids say, where I'm coming from, I'd like to turn to four key issues that are fundamental to the prosperity of our region and the entire economy. Of course, there are other issues of great importance. But today I'd like to focus on these four. These are issues that should be addressed not only by policymakers but by business people as well.

The first relates to the efficiency of our economy. It's important to use our resources productively—that's basic economics. It's important to invest in the future. The productive use of resources is one of the key ingredients in a steadily rising standard of living, as I'll discuss a bit later.

I'd like to focus on one example of improving productivity — something that's directly related to my job at the Chicago Fed…that's increasing efficiency in the use of financial services. More specifically, I'd like to discuss paper checks. Americans write 65 billion checks every year. The Federal Reserve Banks process about 16 billion checks each year—acting as middlemen between commercial banks. If the checks we process at the Chicago Fed on a typical day were laid end to end, they would stretch to St. Louis and halfway back again.

But checks are an anachronism—especially when we have an electronic alternative. Checks are labor-intensive. They involve moving a piece of paper from one place to another — sometimes across the country. On average, 12 people handle one check from the time it's written until it gets back to the writer at the end of the month. So it's not surprising that a check transaction is two-to-three times more expensive to process than an electronic transaction. Analysts estimate the U.S. could save billions of dollars a year by eliminating checks. The money we spend on check processing could be used in much more productive ways.

We're making progress. But consumers and businesses are reluctant to change. As a result, Americans use electronic payments for only 22 percent of non-cash transactions. The story is much different in Europe. The French average 47 percent…the Germans 78 percent…and the Dutch 91 percent! Closing this gap is a major opportunity for improving the efficiency of our economy.

That's why I'd like to see everyone using electronics. I say this even though check processing generates most of the Fed's service revenues. Nevertheless, reducing the paper flow is a major goal for us. We want to encourage a more efficient payments system. In fact, I encourage you to look at your own operations to see if there are any opportunities to take advantage of electronic payments. We have a major opportunity to reduce our dependence on checks. That's something that will benefit consumers, businesses, and the economy as a whole.

The second item on my list is the need to continue lowering trade barriers. Expanded trade means new opportunities for exports, as well as lower prices and greater choices for consumers, as well as businesses.

Of course, many people around the world say they favor free trade. But talk is cheap. And no one wants to be first. That's why trade negotiations tend to proceed at the pace and warmth of a glacier. I know—I've been involved in a number of them.

Yet we've made significant progress in reducing tariffs and non-tariff barriers. 130 countries participated in the Uruguay Round of the GATT negotiations. A technology agreement has been completed covering 90 percent of world trade and lowering tariffs on computer software, semi-conductors, and fax machines. A telecommunication agreement has been finished. And work proceeds on financial services.

The North American Free Trade Agreement, despite its critics, has been a step forward for Canada, Mexico, and the U.S. A study done by a Chicago Fed economist indicates that NAFTA will have a positive impact on Canada, Mexico, and the U.S. The study uses a new dynamic model, which takes into account changes in capital investment. The study suggests that NAFTA will generate more real economic output and a higher level of trade—twice as much as suggested by other studies that use a static model. Now we need to take steps to extend NAFTA to other Latin American countries, with Chile most likely to be the next new member.

The United States has another major opportunity to increase trade and investment through APEC, the Asian Pacific Economic Conference, which encompasses all of the economic powers of the Pacific Rim. APEC's goal is free trade in the region by the year 2010 — from the U.S. to China and Japan, from Australia to Canada. Keep in mind that many developing countries in this area are among the fastest growing in the world. In fact, some estimate that the world market will grow as much as 40 percent faster than the U.S. market during the next few years. Despite some recent currency fluctuations, these fast-growing developing countries will be excellent markets for our products and services over the long term.

Progress in APEC, NAFTA, and the Uruguay Round is encouraging. But even more is needed to bring the benefits of free trade to people all over the world. These efforts bring real benefits to the U.S. economy. Since 1987 about one-third of our economic growth has come from exports.

Having said that, let me add that some Americans will be challenged—even threatened—by global competition. And we have an obligation to help these people adjust to the new global economy. But we can't stop progress. We must continue moving forward aggressively in lowering trade barriers—the end result will be more choices and lower prices for more people.

This leads me to my third issue—the need to ensure equal economic opportunity for all Americans, especially in education and training.

This subject was paramount in a study we did on the Midwest economy. Our study focused on the dramatic changes in the regional economy—changes that are driving the need for education and training. Our study looked at the Midwest, but I think many of the issues in that study are true for the nation as well.

You'll recall that a number of years ago people talked about the Midwest "Rust Belt." Many of the experts thought that progress had passed us by…that our economic base was declining…and that the future here was bleak.

That may have seemed obvious 15 or 20 years ago — when oil prices were doubling…family farms were being foreclosed…imports were stealing Detroit's market…and people were leaving the Midwest for places like Houston and Phoenix.

But the reports of the Midwest's demise, like the reports of Mark Twain's death, were grossly exaggerated. How did we turn it around? Was it because of external factors that the region couldn't control, like a stronger dollar? Or was it due to internal factors, such as productivity improvements? In other words, were we lucky…or were we good?

Well, luck did play a role. The Midwest was helped by developments outside the region. Like lower energy costs. And growth in exports, especially capital goods and agricultural commodities. And there was the new geography of auto production — which looks a lot like the old geography of auto production, with a concentration of activity in our region. Back in 1979 we had 27 auto production plants in the Midwest. Nine of those plants closed. But 13 new plants opened. Today, the Midwest has 31 auto plants—more than it did before imports became a real factor.

Interestingly, the resiliency of the Midwest is due in part to distribution costs. The Midwest, of course, had a head start since the auto industry originated in Detroit. During World War One, 80 percent of cars were produced in Michigan and shipped out across the nation. But then Henry Ford realized that it was cheaper to ship auto parts to assembly plants located throughout the country. Ford pioneered the use of branch assembly plants outside the Midwest, all producing identical Model T's. Michigan's share of car production plummeted from 80 percent to 40 percent.

That strategy became obsolete as consumers demanded more choice. The number of car and truck models has increased by 800 percent since 1955. At the same time, car and truck sales have only doubled. The end result? Manufacturers produced a smaller number of each model. That changed the strategy. Car manufacturers no longer could afford several regional plants all producing the same model. Instead one plant specialized in one or two models, which were shipped throughout the country. As a result, car producers have reconcentrated their production in the interior of the country during the last sixteen years, having closed plants on the East and West coasts and opening plants in the Midwest and Southeast.

So the Midwest had some luck. But, more importantly, we helped ourselves. We reduced the costs of doing business in the region…we developed sensible fiscal policies at state and local levels…and we increased our use of modern technology, especially in manufacturing.

Research done by Chicago Fed economists highlights the competitiveness of the Midwest economy. According to common wisdom, the Midwest benefitted quite a bit from the declining dollar, which made its exports cheaper for overseas buyers. This is a logical conclusion, given the results of studies that have looked at the value of the dollar and the nation's major trading partners.

Our economists took a different approach—a regional approach—and looked at the value of the dollar and its effect on the Midwest's major trading partners. They found that the dollar did not decline against the currencies of those countries. In other words, the Midwest did not have a built-in price advantage from the weaker dollar. It appears that the Midwest succeeded because of better products and prices, not just because of external factors such as the performance of the dollar.

One key reason for the region's increased competitiveness is the emergence of lean manufacturing, a comprehensive effort to increase quality and reduce costs of production. Among other things, it focuses on controlling inventory levels, and forming closer relationships with suppliers. A survey by the U.S. Census Bureau in 1994 indicates that the application of advanced manufacturing technology is widespread across the nation. For example, 47 percent of larger plants reported using computer network technology to provide a link with suppliers,subcontractors, and customers.

The introduction of lean manufacturing techniques can lead to dramatic changes. There's quite a bit of anecdotal evidence along these lines. In one case study, a leather processing plant cut its production lead time from two months to 9 days and reduced its required inventory by one-fourth.

These types of changes are reflected in manufacturers' inventory-to-sales ratios, which have been trending downward. We haven't seen the same changes in the retail ratio. In some cases, retailers are taking on additional responsibility for distribution, which may be affecting the ratios. In addition, customer demand for more choices may be forcing retailers to keep a larger selection of products. In the wholesale sector, we have seen some reduction in the ratio since 1995. A big question is whether this reduction is a permanent change or a temporary phenomenon. I'd be interested to hear your thoughts during the question and answer session on this issue.

All of these changes indicate that the Midwest wasn't just lucky—it was good, too. That indicates we can influence our own destiny by continuing to improve our competitiveness.

What's the key for the future? We concluded that productivity and work skills were critical for the Midwest's future success. In other words, it's absolutely essential that workers receive the education and training they need to prosper in our fast changing economy. The issue isn't simply one of fairness; it shapes our nation's ability to compete successfully in a global economy.

I don't pretend to have the answers on this issue. But the changes I've just discussed make it absolutely essential to find a way to provide all citizens with the skills and opportunities to participate fully in Economic America.

My fourth issue is the importance of price stability. This, of course, is hardly a surprising goal for a central banker. Low inflation is the surest way to achieve a higher standard of living over the long run.

Some people see a trade-off. They're willing to accept higher inflation in exchange for faster economic growth. I wish it were that easy. In the long run, there is no trade-off. High inflation leads to lower growth.

We need to keep in mind that the economy's real potential is determined by two factors:

Population growth, and Productivity improvements.

These two factors determine how fast the economy can grow. They are the nutrients of our economic diet.

Inflation, on the other hand, is junk food. It's a sugar high. Once people anticipate inflation, they act to protect themselves from higher prices. With prices rising, they make fewer long-term investments, and — instead of saving — they spend more on consumer goods today to beat higher prices tomorrow. Sure, some people profit when inflation skyrockets. But many others are hurt, especially those on the lowest rungs of the economic ladder.

An economy that grows at a solid, sustainable pace may not be exciting. But a roller-coaster economy is a losing proposition in the long run. 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 I want to see—the same, old boring winners.

What have we seen this year? The economy has been doing well. Growth has been very strong, inflation remarkably low, and the unemployment rate coming down. We expect the rapid pace of GDP growth to moderate in the second half of the year and come in between 3 and 3½ percent for the year as a whole. The consumer price index should increase about 2 to 2¼ percent. And the unemployment rate should end the year close to its current level.

I guess you could say I'm guardedly optimistic about the economic outlook. I have to admit that I find myself using phrases like "guardedly optimistic" ever since I took my oath as a central banker. I suppose that's why we're called the Federal Reserve.

So there you have it: Four concrete suggestions to help ensure future prosperity:

- Improved efficiency.
- Increased trade.
- A skilled work force.
- And low inflation.

As I've indicated, some of these issues are being addressed by the Fed. Others are the domain of Congress and the Administration. The private sector, too, must continue its efforts in these areas.

If we each do our part and work together, we can achieve our common goal — a vital and growing economy that ensures a steadily rising standard of living for our communities and families.

Economics may indeed be the dismal science. But in 21st Century America, few subjects will be more pivotal for the continuing health of our nation and the continuing prosperity of our people.