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BUSINESS BREAKFAST

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Economic Overview and Outlook

I'd like to give a general overview of the economy and review some of the key developments we've seen recently. First, though, I'd like to take a few minutes to say a word about the Fed itself. Because the Fed's structure is a big part of our economic success story.

I'd like to focus on the important advantages of the Fed's regional structure. One of the great strengths of our central banking system is that it helps us get a first-hand look at what's happening at the regional level.

The Fed's mission, of course, 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 Fed consists of 12 regional Reserve Banks, which are overseen by the Board of Governors in Washington, D.C. The Chicago Fed serves a five-state region consisting of most of Michigan, Indiana, Illinois, and Wisconsin, and all of Iowa. Our head office is in Chicago. We have a Branch in Detroit, and offices in Des Moines, Indianapolis, Peoria, and Milwaukee.

The Fed's structure is 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.

Why should we care about the Fed's structure? It's important because it helps us develop effective, long-term monetary policy. To understand the Fed's unique structure, the key word is compromise. Congress created the Fed in 1913 with an intricately structured balance between the public and the private, the central and the decentralized. It's a balance that still exists. The Reserve Banks have a mix of public and private features. And the governing board in Washington consists of seven public officials appointed by the President and approved by the Senate.

The Federal Open Market Committee, or FOMC, is the best example of the advantages of the Fed's regional structure. 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 Reserve Bank presidents, who vote on a rotating basis. However, all of the presidents attend the meetings and take part in the discussions. This year, I'm the voting member from the Midwest. At our next meeting on November 12, each of us will discuss economic conditions in our region.

In this way the System receives a constant flow of economic intelligence from the districts. Our perspective isn't limited to the Washington "beltway."

The Fed's independence is another hallmark of its structure. One of Congress' goals was to insulate the central bank from day-to-day political pressures. Why? It's generally acknowledged that it's difficult for an elected representative to resist the temptation to "gun" the economy. Stimulating the economy may be appropriate at times, of course. But it should be done in response to the business cycle — not the election cycle. The central issue is balancing short-term considerations against long-term gains.

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 Congressional appropriations to meet its 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. 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 answer 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. As I mentioned, the Reserve Banks sell a variety of financial services in the marketplace. Each Reserve Bank and Branch also has a board of directors consisting of leading private citizens from the region.

So the Fed's regional, independent structure has two major advantages. First, it insulates us from narrow influences. And, second, it helps us obtain a broad range of 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.

As I said, we're looking for ideas and information from each region. One important way we get local information is traveling throughout the District and meeting with people. So I'm very interested in hearing your comments regarding the economy, especially regarding the local economy. You're truly the experts on that subject.

Another way we get information is to bring experts into the Bank. A good example of this is when we conducted a year-long study of the Midwest economy. We brought in local experts from across the District to join in our study. Our focus was the Midwest's economic turnaround since the early 1980s. We were particularly interested in how to sustain our strong economy. I think you may find some of the information quite interesting. The study highlights are available here today. But let me discuss just a few of the findings for you now.

We've made a remarkable turnaround since the early 1980s when the Midwest was called the "Rust Belt." How did we do it? Were we helped by developments outside our control, like favorable exchange rates? Or did we help ourselves by improving productivity? In other words, were we lucky or were we good?

We were helped by developments outside the region. Like lower energy costs. And demand for our goods from abroad, especially capital goods and agricultural commodities.

But, more importantly, we helped ourselves. In fact, we re-invented 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 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 if you look at the value of the dollar relative to currencies of the nation's major trading partners.

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

What's the key for the future? Well, we found a number of keys. But essentially it's productivity and work skills that will be critical for our future success. We found that workers must get the education and training they need to keep their skills current so that they can continue to be highly productive. That's what will distinguish the Midwest from other regions of the U.S.

I'd like now to look at the local and national economies. First, a quick look at the local economy and then I'd like to move to the national economy and a forecast.

Both Illinois and Lake County are doing well. In Illinois, the unemployment rate is 4.4 percent, the lowest it's been in the last two decades. In Lake County the unemployment rate is even better, at just over 3 percent (3.1%).

The County now has almost 7 percent (6.8%) of the total number of jobs in the Chicago area and more than 8 percent (8½%) of the area's manufacturing jobs. As I said, you're the experts, and I'd be interested in what you have to say about the local economy.

Turning to the national economy and our outlook, we expect that real GDP growth will come in between 3 and 3½ percent this year. The Consumer Price Index should come in at 2 to 2¼ percent. And the unemployment rate should end the year close to its current level — just under 5 percent.

Standard economic thinking says that sustainable economic growth is in the 2 to 2½ percent range and that faster growth would lead to higher inflation and negatively affect our standard of living.

Well, so far this year, we haven't seen that. Real GDP increased at an annual rate of more than 4 percent in the first half of the year. The unemployment rate fell to 4.9 percent in April, its lowest level in 24 years, and it's been hovering around that level ever since. The core CPI, which excludes food and energy prices, is up only

2¼ percent from a year ago, the lowest inflation rate in over three decades (31 years). And it looks like the fiscal 1997 federal budget deficit was less than one-half of one percent of GDP for the first time since 1974.

This is a remarkable performance, especially since we're in the seventh year of expansion. The economy keeps marching forward, surpassing everyone's expectations. In the past, inflation usually started to accelerate when growth was so strong and unemployment fell to such a low level. Instead, we've seen inflation move lower.

How long will this continue? Based on the past performance of the economy, we'd expect inflation to pick up, particularly since labor markets are so tight. Why isn't history repeating itself?

I don't have the complete answer, and I'm sure no one else does either. But I can identify some factors that seem to have played a role. A few are temporary; some may be more permanent. Also, there are some technical reasons why inflation hasn't risen as much as many expected.

One of the temporary factors is the strong dollar, which has led to a fall in import prices. That helped to keep our inflation rate down. But of course, currencies move in both directions. So we can't count on import prices reducing our inflation rate on an ongoing basis.

Another temporary factor is slower growth in benefits costs for many businesses, particularly health care costs. Again, this trend may continue for a while. But we're beginning to see reports that employer costs for health benefits may rise more rapidly next year. For example, one report indicated that firms face HMO rate increases that are twice what they were in 1997. If benefits costs do rise more rapidly, that could put upward pressure on inflation.

There's another possible factor that may not be temporary—that trend productivity growth has risen to a higher level as a result of strong investment in computers and other high-tech equipment. Such investment has risen at double-digit rates for the past five years. The U.S. may finally be getting the return on that investment in the form of higher productivity growth.

Productivity growth, of course, is one of the factors determining how fast our economy can grow without triggering inflation. The evidence on whether there's been an increase in productivity growth is mixed. The strong business profits in recent years are certainly consistent with higher productivity. The official statistics, however, show productivity up only 1.2 percent over the past year. That's only slightly higher than the 1.1 percent average annual increase we've observed over the past quarter century. But many economists argue that the official statistics understate productivity.

As I mentioned, there are also some technical factors to take into account. Many economists have argued that the Consumer Price Index (CPI) overstates inflation. But it's important to recognize that the Bureau of Labor Statistics (BLS) has been making changes to the CPI to improve its accuracy. These technical changes are another reason that the inflation numbers are lower this year. The changes made by BLS reduced reported CPI inflation by about one-tenth of a percentage point in each of the past two years. Similar reductions are expected for this year and next. Historical CPI data, however, haven't changed. So we need to remember that the recent good news on inflation is due in part to a changing yardstick.

These are some of the reasons why inflation has been lower than many expected. Import prices and benefits costs will only have a temporary effect. Computer and high-tech investment may be having a more perma-

ment impact on productivity. But we don't know how big that impact is or if it's really permanent. In fact, we won't know for some time if trend productivity growth has increased.

Where does this leave us? Are we entering a new era, or just experiencing a short-term anomaly? The answer, of course, is we don't know. So what course of action should the Fed take?

In the face of all this uncertainty, there is really only one course for the Fed — focus on price stability. This conclusion is hardly surprising coming from a central banker. But I firmly believe that 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's 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 growth.

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.

To sum up, I'd like to re-emphasize that the Fed's regional structure and its independence from day-to-day political pressure are very important for the development of effective policy. Our structure and independence help us take the longer term view and focus on price stability. I think our economy today is in solid shape due in part to this focus.

Ignoring inflation may seem to be an easy way to boost growth — in the short term. But in the long term, it's a prescription for low employment and stagnant growth. The cure is painful and is best avoided — prevention is the best medicine. In the long run you need a foundation of stable prices to achieve maximum sustainable growth — that's the best way we can assure a healthy, vibrant economy for many decades to come.

Thank you.