I. Intro

A. Pleasure to be here. I appreciate your taking the time to be here tonight.

B. Some people are scared off by the prospect of hearing an economist. You may have heard the jokes.
   1. If all the nation's economists were laid end to end, they still wouldn't reach a conclusion.
   2. And the follow-up — that laying all the economists end-to-end would be a good idea.

C. Given that sentiment, I won't be giving you a heavy-duty talk on economic theory tonight. Instead, I'd like to take a more informal approach.
   1. First, I'd like to briefly discuss the Fed and its structure.
   2. Then, I'll provide some thoughts on the economic outlook for 1998.
   3. And, finally, I'd like to talk about what regulators can do to help prevent a major bank crisis, such as the one that occurred in Asia.
   4. First, some brief background on the Fed.

II. Fed Background

A. The Fed's mission as the nation's central bank, of course, is to foster a safe and sound financial system and a healthy, growing economy:
1. We formulate monetary policy.

2. We supervise and regulate banks.

3. And we provide financial services to the U.S. government and banks and thrifts.

B. The Fed consists of 12 regional Reserve Banks, which are overseen by the Board of Governors in Washington, D.C.

1. This regional setup means we're decentralized.

2. That's unusual for a central bank—and a bit of an oxymoron—a decentralized central bank.

3. In fact, the design is a work of American genius, balancing the public and the private, the central and the decentralized.

C. The Chicago Fed serves a five-state region consisting of most of Illinois, Indiana, Michigan, and Wisconsin, and all of Iowa.

1. Our head office is in Chicago.

2. We have a branch in Detroit and offices in Des Moines, Indianapolis, Milwaukee, and Peoria.

D. The Federal Open Market Committee, or FOMC, is the best example of the value of the Fed's regional structure. It carries out the Fed's most important responsibility—formulating monetary policy.

1. The FOMC is made up of the seven members of the Board of Governors and five of the twelve Reserve Bank Presidents, who vote on a rotating basis.

2. However, all of the presidents attend the meetings and take part in the discussions regardless of their voting status.

3. In fact, I'll be traveling to Washington to attend our next meeting on February 3th and 4th.

E. The Fed's regional structure means that the System receives a constant flow of economic intelligence from all over the country. Our perspective isn't limited to the Washington Beltway.

F. The Fed's independence is another hallmark of its structure.

1. To help the Fed focus on the long-term, Congress provided 14-year terms for the Board of Governors.

2. Likewise, the System doesn't rely on Congressional appropriations to meet expenses.

3. Our budget is reviewed by Congress, however, so we're still accountable.

4. And the Fed System turns over more than 95 percent of its earnings to the U.S. Treasury—roughly $20 billion each year.
5. In short we’re insulated from political pressures, but we answer to Congress and the American people.

G. So the Fed’s regional, independent structure has two major advantages.

1. First, it insulates us from narrow influences.

2. And, second, it helps us gather information and ideas from all over the country.

H. The Fed’s structure is vital for developing effective policy. It helps maintain a delicate balance—to focus on policy, not politics.

III. The U.S. Economy

A. Now that you know, as my kids would say, where I’m coming from, I’d like to discuss the economic outlook.

1. We’ve just finished off quite a year. It’s hard to avoid superlatives when you look back at 1997.

2. It was a remarkable year for the economy—a year that caught almost all forecasters by surprise.

B. The economy’s performance reminds me of Yogi Berra’s comment after Tiger Woods won the Masters Tournament last summer.

1. Yogi was asked if Tiger had exceeded his expectations.

2. Yogi replied,”He's done more than that!”

3. Like Tiger Woods, I think the economy has exceeded our expectations—and then some.

C. Let me give you a few numbers to back up my superlatives.

1. It looks as though real GDP growth will be about 3⅓ percent over the four quarters of 1997—the largest increase since 1987.

2. The unemployment rate fell to 4.6 percent in November—the lowest in 24 years.

3. Finally, the core Consumer Price Index, which excludes food and energy prices, should increase only about 23 percent.

4. That’s the lowest inflation rate in over three decades.

D. From the central banker’s point of view, we hit the trifecta—we had strong growth, high employment, and low inflation.

1. What makes this even more impressive is that we’re approaching the seven-year anniversary of this economic expansion.
2. In fact, we're now in our 82nd month of continuous growth.

3. That makes this expansion the third longest in our nation's history, behind only the 92-month expansion during the 1980s and the 106-month expansion during the 1960s.

E. So what do I see for '98? I'd like to briefly cover three issues that I think will have a lot to do with how things shape up this year.

1. First—Will consumers keep on spending at a rapid rate?
2. Second—Will the tight job market trigger inflationary pressures?
3. And third—How will developments overseas affect the economy?

IV. Consumer Spending

A. Let's look at consumer spending first.

1. Consumers continued to purchase goods and services at a healthy clip last year.

2. Spending growth was a bit uneven from quarter to quarter, but it looks as though it will average about 3.2 percent for the four quarters of 1997.

3. We don't expect growth in this area to be quite that strong this year, although it should continue at a very respectable pace.

B. Why do we think we'll see continued growth in consumer spending?

1. Two of the key factors are a strong employment picture and a positive outlook for disposable income.

2. In other words, consumers should have more money to spend.

3. And with consumer confidence at a high level, we expect that they'll be inclined to spend it.

4. The overall strong performance of the stock market last year may also increase people's comfort level in making purchases.

C. There are some factors that will tend to dampen spending growth. Let me briefly mention three.

1. First, some consumers have accumulated quite a bit of debt and there are concerns about the level of delinquencies and bankruptcies.
   a. Consumer debt levels are high relative to income. So are monthly payments to service that debt.
   b. But consumer debt and monthly payment levels are no longer increasing more rapidly than income—that's an encouraging sign.
2. Second, banks have indicated that they’ve adopted somewhat tighter standards for extending credit to consumers.
   a. In general, I think this is an appropriate trend, given the relatively high level of delinquencies and bankruptcies.
   b. But it could have a dampening effect on consumer spending.

3. Third, most people have already made their major purchases at this point in the expansion, so we probably won’t see a spurt in the sale of big-ticket items.
   a. It does look like we'll continue to see fairly strong demand for cars and light trucks, though.
   b. The auto industry sold roughly 15 million units last year and most analysts are predicting similar numbers for ‘98.
   c. In addition, with home sales at high levels, we expect relatively strong demand for appliances and other household items.
   d. So we're likely to see some continued strength in these sectors, but not large increases from 1997.

D. Overall, I don't think consumers are tapped out. Given the high level of consumer confidence, the healthy outlook for income growth, and the strong employment picture, we expect that spending growth will continue at a respectable pace, although a bit slower than last year.

V. Tight Labor Markets

A. The second issue I'd like to discuss is whether tight labor markets will trigger inflationary pressures.

B. In the past, of course, inflation usually started to accelerate when growth was so strong and the unemployment rate fell to such a low level. Instead, we've seen inflation move lower.

C. Tight labor markets have been especially evident here in the Midwest.

1. We’ve had unemployment rates lower than the nation since 1992. That’s a dramatic change from our ‘Rustbelt’ days back in the early ’80s.

2. The unemployment rate for the Midwest averaged 4 percent during 1997—a full percentage point below the nation.

3. In fact, the Midwest not only enjoys low unemployment rates, but our worker participation rates are hitting very high levels. In other words, the region may be running out of potential workers.

4. The Midwest employs 66.2 percent of its working age population—significantly higher than the nation.

5. Wisconsin has the highest worker participation rate in the country—72.1 percent.

6. So the strong demand for workers continues, but the available supply is becoming limited.
7. That seems to be a factor in the region's slower job growth compared to the nation during the past two years.

D. As I said, such a tight labor market in the Midwest and throughout the nation usually resulted in inflationary pressures in the past.

E. Why haven't we seen history repeating itself? There are a number of factors that seem to have played a role. A few are temporary; some may be more permanent.

1. One of the temporary factors is the strong dollar, which has contributed to a fall in import prices.
   a. That's helped to keep inflation down.
   b. But of course, we can't count on import prices reducing our inflation rate forever.

2. Another temporary factor is slower growth in benefits costs for many businesses, particularly health care costs.
   a. Again, this trend could continue for a while. But we've had reports that employer costs for health benefits may rise more rapidly this year.
   b. One report indicated that firms will face HMO rate increases that are twice what they were in '97.

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

F. Productivity growth, of course, is essential because it's one of the key elements that determines how fast our economy can grow without triggering inflation.

G. Has trend productivity growth increased? The evidence is mixed.

1. The strong business profits in recent years are certainly consistent with higher productivity.

2. But until recently, the official statistics didn't show any change from the 1.1 percent average annual increase we've seen over the past 25 years.

3. However, the latest data indicate that productivity is picking up—it increased at twice the trend rate in the second quarter of 1997 and four times the trend rate in the third quarter.

H. Is this recent pickup a temporary, cyclical phenomenon? Or does it reflect a more permanent increase—an increase that could reduce the potential inflationary pressures generated by tightness in the labor markets?

1. Unfortunately, it will be some time before we'll know the extent of any lasting improvement in productivity and its effect on the economy.
2. In the meantime, the Fed will certainly continue to pay close attention to the labor markets and watch for signs of increasing wage pressures.

VI. Overseas Development

A. That brings me to the third issue—How will events overseas affect our economy?

B. Of course, recent events in Asian markets have complicated the answer to this question.

C. It’s still too early to draw any definite conclusions, but we are starting to get a better idea of the overall impact of the Asian situation.

1. For example, the International Monetary Fund recently lowered its 1998 growth forecast for the world economy from 4.3 percent to 3.5 percent.

2. That dramatic revision took place in just two months, which highlights how quickly the turbulence in Asia changed the outlook for the world economy.

D. The Asian situation will affect the U.S. economy on both the export side and the import side.

E. On the export side, there will be less demand for U.S. products in Asian countries because of the slowdown in their economies.

1. At the same time, the sharp appreciation of the dollar against Asian currencies will make it more difficult for U.S. exporters to compete in those markets.

2. That will certainly have an impact on our overall level of exports. The U.S. shipped nearly 29 percent of its exported goods to Asian markets during 1996.

3. For the Midwest, Asia is a comparatively small market, at least when it comes to manufactured goods.

4. However, the situation is much different for the region’s agricultural exports.

5. We estimate that 55 to 60 percent of the Midwest’s exports of so-called coarse grain such as corn was shipped to Asia last year.

F. On the import side, there are some positive effects. With Asian currencies weaker relative to the dollar, imports from Asia will be less expensive.

1. This will benefit U.S. consumers and U.S. producers who use foreign components because it will help reduce their costs.

2. Asia already accounts for 39 percent of goods imported to the U.S. and we expect that Asian imports to the U.S. will increase during ’98.

3. This will put pressure on U.S. industries competing with certain imports, such as autos and steel.
4. That's a trend that will be felt in the Midwest because the auto and steel industries are so heavily represented here.

VII. 1998 Outlook

A. So how will all this affect the U.S. economy during 1998?

1. The situation is still evolving, but our current estimate is that the recent problems in Asia will reduce our real GDP growth this year by roughly half a percentage point.

2. As a result, we anticipate that the overall effect of the international sector will be to reduce our real GDP growth by about three-quarters of a percentage point.

3. That's essentially the same overall effect we estimate that the international sector had on real GDP growth during 1997.

B. Despite the effect of the international sector, however, we expect solid growth for the U.S. during 1998.

1. We anticipate that real GDP will grow between 2 and 22 percent.

2. The Consumer Price Index should increase between 2 and 22 percent.

3. And the unemployment rate should come in at about the current level.

4. As I said, our economy will grow more slowly than last year, but it will grow at a pace that's more sustainable over the long run—a pace that won't trigger inflationary pressures.

VIII. Longer-Term Perspective

A. I'd like to take a few minutes now to take a step back and give a longer-term perspective on the turbulence in the Asian markets.

B. I think the key question is how can we prevent such a situation from occurring in the future?

C. The problems in Asia clearly highlight the importance of a sound banking and financial system.

1. A nation with a troubled financial system will usually have some problems in its overall economy.

2. And, as we've seen, serious problems in one nation's economy and financial system often have a ripple effect in today's interconnected world.

D. While it's hard to sort out all of the causes and consequences of the Asian situation at this point, there are some lessons from the past that are useful to review.

1. The Chicago Fed co-sponsored a conference with the World Bank last June in which we looked at some of these lessons.
2. We invited leading researchers and regulators from countries that had experienced problems, including participants from Europe, Asia, and Latin America.

E. Participants agreed that in almost all cases a bank crisis can be traced to large credit losses, which are usually triggered by instability in the macro economy.

1. This is true in highly developed countries as well as developing countries with untested supervisory systems.

2. Those taking part in the conference generally agreed on what needs to be done.

F. First, it's essential that banks provide accurate and truthful information on their current condition.

1. A transparent accounting system is perhaps the most basic requirement for efficient financial markets.

2. The rules for preparing financial statements must be clearly specified. These statements communicate vital information to creditors, investors, commercial counterparts, and regulators.

3. This is particularly true of banking where there's a need for better information on hidden reserves, loan loss provisions, non-performing loans, and off-balance sheet commitments.

4. The recent problems in Asia clearly show how important it is to have a consistent set of standards to monitor and control risk-taking.

5. Market values usually don't change overnight. Better, more timely information will help prevent the type of surprise that can trigger a crisis.

G. A second key factor is market discipline.

1. Accurate, timely information fosters market discipline. And market discipline is often more effective than regulation.

2. I should note that using market discipline requires having an appropriate infrastructure, such as laws covering bankruptcy and the rights of creditors in seizing or disposing of assets.

3. But market discipline is invaluable, assuming that the basic infrastructure is in place.

4. The major advantage of market discipline is that it can help to prevent a crisis from happening in the first place.

5. That's obviously preferable to a regulator coming in after the fact to clean up a problem.

H. That brings me to a third issue—in many cases banks have made lending decisions based on politics rather than economics.

1. This was true for state-owned banks as well as private banks.

2. In effect, these banks existed to carry out industrial policy—to allocate credit to sectors favored by the government.
3. You can guess the results. A growing economy can hide poor lending practices for a while. But eventually the economy slows down and loans turn sour.

I. A fourth issue is ensuring that regulations are actually enforced.

1. In a number of cases, rules and regulations were in place, but they were ignored.

2. Typically, regulatory enforcement was lax or non-existent due to political pressures.

3. The inability or unwillingness to enforce necessary regulation has been costly in a number of situations.

J. Finally, if a crisis does occur it's essential for regulators to act in a timely and decisive manner.

1. Regulators have to meet the problem head-on.

2. And the markets must know that the regulators are serious.

3. When a nation is experiencing problems, the government and regulators in that country tend to delay a necessary action that they know will be painful and unpopular.

4. However, the longer the delay, the more serious the problem.

K. It's important that a nation in crisis implement the fundamental reforms I've just discussed. A band-aid approach isn't enough. Without reforms, the same problems will eventually reoccur.

1. The ideal solution, of course, is to implement reforms before a crisis occurs. Prevention is the best cure.

2. That's why it's so important that all nations work to implement fundamental reform before they're forced to do so in response to an emergency.

3. One important step is for regulators in all nations to adopt the core principals for effective supervision developed by the Bank for International Settlements.

L. These periods of financial stress also highlight the importance of maintaining effective monetary policy in conjunction with sound fiscal policy and efficient financial systems. One recurring theme is that a banking crisis usually can be traced to instability in the macro economy.

M. That's where a nation's central bank plays a crucial role.

1. Here in the U.S., the Fed's mission is to foster a stable, growing economy.

2. How can the Fed do this? Focus on price stability.

3. That's the best way to ensure healthy, sustainable growth.

N. 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.
1. 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.”

2. That’s what I want to see—the same old boring winners.

O. We’ve made significant progress in achieving price stability.

1. But I think it’s always important to always keep in mind the importance of a low inflation environment.

2. 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.

P. Thank you.