I. Intro:

Thank you. Happy to be here.

Greatly appreciate your taking the time to attend this session. Before I begin, I'd like to acknowledge ______.

I'm pleased we have such a good turnout today.

As Scott (Peoria)/Rich (Quad cities) mentioned, I'm an economist. And sometimes people are scared off by the prospect of hearing an economist. You may have heard the jokes.

If all the nation's economists were laid end-to-end, they still wouldn't reach a conclusion.

And the follow-up— that laying all the economists end-to-end would be a good idea.

You'll probably be glad to know that I won't be giving a heavy-duty talk on economic theory. Instead, I'd like to take a more informal approach and give a general overview of the regional and national economies. First, though, I'd like to take a few minutes to say a few words about the Fed itself. Because the Fed's structure is a big part of our economic success story.

What I'd like to focus on are 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 central banking system is that it helps us get a first-hand look at what's happening at the regional level. And that's a key goal of my visit.
Quad Cities version:

As part of this effort, I'll be taking a look at some redevelopment efforts here in Moline and visit John Deere's Harvester Works plant in East Moline later today. Tomorrow, I'm in Peoria where I'll see the Southtown Redevelopment Area in Peoria's Riverfront. And, of course, I've had conversations with many people in the area.

Peoria version:

As part of this effort, I visited John Deere's Harvester Works plant in East Moline yesterday, and I was at the Southtown Redevelopment Area here in Peoria this morning. And, of course, I've had conversations with many people in the area.

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 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 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, 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. 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 Western 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 result 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 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. In fact, our next meeting will take place in two weeks.
The Fed’s 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.”

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. 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 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 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 each 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 is 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. And, as I mentioned, the Reserve Banks sell a variety of financial services in the marketplace.

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 through our Advisory Council on Agriculture, Labor, and Small Business. Members of these groups provide important information about what’s happening in the local economy. Another way I get useful information is traveling throughout the District and meeting with people like you. 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.

Sometimes I go out to speak with experts, as I am today with you. And sometimes we bring in experts. A good example of this is when we conducted a comprehensive study of the Midwest economy. We brought in local experts from across the District to join in the study, which focused on the Midwest’s economic turnaround since the early 1980s. We were particularly interested in how to sustain our turnaround well into the future. Copies of the findings are available here today, but I’d like to take a few minutes to highlight a few of the findings for you.

We’ve made a remarkable turnaround since the early 1980s when the Midwest was better known as 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. Lower energy costs. A stronger dollar. And growth in exports, especially capital goods and agricultural commodities.

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.

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.

The strength of the Midwest's comeback is indicated by the region's unemployment rates. The Midwest's unemployment rates averaged 4 percent during 1997—a full percentage point below the nation. Here in Illinois, the employment picture was solid, although unemployment rates were not as low as in some other Midwestern states, averaging ___ percent last year. Unemployment in the Peoria/Quad cities area averaged __ percent.

What we're finding is the Midwest's worker participation rates are hitting very high levels. In other words, the region may be running out of potential workers. The Midwest employs 66.2 percent of its working age population—significantly higher than the nation. Illinois has a worker participation rate of ___ percent. So the strong demand for workers continues, but the available supply is becoming limited. That seems to be a factor in the region's slower job growth compared to the nation during the past two years.

Later, I'd be interested in your take on the local and regional economies. But now let me focus on the national economy. We've just finished off quite a year. It's hard to avoid superlatives when you look back at 1997. It was a remarkable year for the economy; a year that caught almost all forecasters by surprise.

Let me give you a few numbers to back up my superlatives. Real GDP growth was about 3¼ percent over the four quarters of 1997—the largest increase since 1987. The unemployment rate averaged 4½ during the fourth quarter—the best sustained effort since the late 1960s. And the core Consumer Price Index, which excludes food and energy prices, increased only 2¼ percent. That's the lowest inflation rate in over three decades.

From the central banker's point of view, we hit the trifecta—we had strong growth, high employment, and low inflation. What makes this even more impressive is that we've hit the seven-year anniversary of this economic expansion. In fact, we're now in our 84th month of continuous growth. 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.

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.

Will consumers keep on spending at a rapid rate?
Second—Will the tight job market trigger inflationary pressures?

And third—How will developments overseas affect the economy?

Let's look at consumer spending first. Consumers continued to purchase goods and services at a healthy clip last year. Spending growth was a bit uneven from quarter to quarter, but it averaged about 3 1/2 percent for the four quarters of 1997. We don't expect growth in this area to be quite that strong this year, although it should continue at a very respectable pace.

Why do we think we'll see continued growth in consumer spending? Two of the key factors are a strong employment picture and a positive outlook for disposable income. In other words, consumers should have more money to spend. And with consumer confidence at a high level, we expect that they'll be inclined to spend it. The overall strong performance of the stock market last year may also increase people's comfort level in making purchases.

There are some factors that will tend to dampen spending growth. Let me briefly mention three. First, some consumers have accumulated quite a bit of debt and there are concerns about the level of delinquencies and bankruptcies. Consumer debt levels are high relative to income. So are monthly payments to service that debt. But consumer debt and monthly payment levels are no longer increasing more rapidly than income— that's an encouraging sign (will update with any new figures).

Second, banks have indicated that they've adopted somewhat tighter standards for extending credit to consumers. In general, I think this is an appropriate trend, given the relatively high level of delinquencies and bankruptcies. But it could have a dampening effect on consumer spending.

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. It does look like we'll continue to see fairly strong demand for cars and light trucks, though. The auto industry sold roughly 15 million units last year and most analysts expect we'll have similar numbers at the end of '98. In addition, with home sales at high levels, we expect relatively strong demand for appliances and other household items. So we're likely to see some continued strength in these sectors, but not large increases from 1997.

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.

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

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.

One of the temporary factors is the strong dollar, which has contributed to a fall in import prices. That's helped to keep inflation down. But of course, we can't count on import prices reducing our inflation rate forever.
Another temporary factor is slower growth in benefits costs for many businesses, particularly health care costs. 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. For example, one report indicated that firms will face HMO rate increases that are twice what they were in ‘s another factor that may not be temporary. 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. Such investments have increased 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 essential because it’s one of the key elements that determines how fast our economy can grow without triggering inflation. Has trend productivity growth increased? We have seen a higher growth rate of productivity in recent years. Productivity growth was 1.7 percent last year and 1.9 percent during 1996. That’s almost double the average growth rate of about 1 percent that the U.S. experienced from 1974 to 1995.

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

That brings me to the third issue—

How will events overseas affect our economy? Of course, recent events in Asian markets have complicated the answer to this question. 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. For example, the International Monetary Fund lowered its 1998 growth forecast for the world economy from 4.3 percent to 3.5 percent.

As has been widely discussed, the Asian situation will affect the U.S. economy on both the export side and the import side. On the export side, there will be less demand for U.S. products in Asian countries because of the slowdown in their economies. 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. 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. For the Midwest, Asia is a comparatively small market, at least when it comes to manufactured goods. However, the situation is much different for the region’s agricultural exports. For example, 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.

On the import side, there are some positive effects. With Asian currencies weaker relative to the dollar, imports from Asia will be less expensive. This will benefit U.S. consumers and U.S. producers who use foreign components because it will help dampen inflationary pressures. Asia already accounts for 39 percent of goods imported to the U.S. and we expect Asian imports to the U.S. will increase during ’98. This will put pressure on U.S. industries competing with certain imports, such as autos and steel. That’s a trend that will be felt in the Midwest because the auto and steel industries are so heavily represented here.
So how will all this affect the U.S. economy during 1998? 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.

Despite the effect of the international sector, however, we expect solid growth for the U.S. during 1998. We anticipate that real GDP will grow between 2 and 2½ percent. The Consumer Price Index should increase between 2 and 2½ percent. And the unemployment rate should come in at about the current level. 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.

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.

Thank you.