ECONOMIC FORUM

Saginaw, Michigan
October 20, 1998

I. Introduction

A. Thank you, Jim (Introduction by James Van Tiflin). Good afternoon.

- It looks as though we have an excellent turnout. Thanks to each of you for taking the time to be here today.

- I know we have a number of teachers here today, who are joining us after taking part in a Chicago Fed economic education program.

- (Optional) By the way, that program was led by our economic education director, Tim Schilling, who's a native of Saginaw.

- And we also have a number of people representing business, banking, government, and civic and community organizations. Welcome to all of you.

B. One of the advantages of trips like this is getting a chance to see the local economy at work. Earlier today I visited the GM Powertrain plant…(add any observations regarding visit).

C. My topic today is one that's been in the news quite a bit lately—the economy.

- We've seen a lot of change in the economy in a relatively short period of time. So I'd like to take a few minutes to provide an update on recent developments in the national economy.

- First, though, I'd like to say a few words about the Fed itself.

D. 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 in the economy at the regional level. And that's a key goal of my visit.

E. The Fed's mission, of course, our mission is to foster a safe and sound financial system and a healthy, growing economy. We have three main responsibilities.

- We formulate monetary policy;
- we provide financial services to banks and the U.S. government;
- and we supervise and regulate banks and bank holding companies.

F. The Chicago Fed is one of 12 regional Reserve Banks and serves a five-state area consisting of most of Indiana, Illinois, Michigan, Wisconsin, and all of Iowa.

- We have a head office in Chicago as well as check processing centers in Des Moines, Indianapolis, Milwaukee, and Peoria, and a branch in Detroit.

G. The Fed's structure is unusual for a central bank—and a bit of an oxymoron-a decentralized central bank. 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.

H. So the U.S. went through most of the 1800s without a central bank, unlike most other Western nations. We were behind the times. By the early 1900s, however, there was a consensus—the U.S. needed a central bank. The 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 in 1913 with a careful balance between the public and the private, the central and the decentralized.

I. One the one hand, the Fed is a public institution with a public purpose. The governing board in Washington consists of seven public officials appointed by the President and approved by the Senate.

J. On the other hand, the Reserve Banks have similarities to the private sector. Each Reserve Bank and branch has a board of directors consisting of leading private citizens from the region.

- The staff at the Reserve Banks is not subject to civil service. And, as I mentioned, the Reserve Banks sell a variety of financial services in the marketplace.

K. The Fed's independence is another hallmark of its structure. Congress structured the Fed so it would be insulated from day-to-day political pressures.

- For this reason, Congress provided fourteen-year terms for the Board of Governors. And the Federal Reserve doesn't depend on Congressional appropriations to meet its expenses.

L. 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.

M. The formulation of monetary policy is a good example of the advantages of the Fed's structure.

- Most people tend to think of monetary policy as a process that begins and ends in Washington, D.C.

- But it's also a regional process that includes the presidents of the 12 Fed Banks.

N. The Fed's main policymaking group is the Federal Open Market Committee.

- 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.

- I'm not a voting member this year, but I will be next year.

O. The Fed's main tools for formulating monetary policy are statistical data and econometric models.

- The problem is that even the best data take time to be compiled and are available only on a lagged basis.

- So we need to reach out to people in the regions to supplement statistical data with up-to-the-minute information

P. All Fed Bank presidents have a number of sources for getting this information. One of the most important is the board of directors at each Bank and Branch.

- In the Seventh District, we have two boards of directors - the Chicago Board and the Detroit Branch Board, which is here today.

- Each board has an interesting mix of people who live and work in the Midwest.

Q. Our current boards include representatives from retail, trucking, the auto and steel industries, real estate, publishing, and banking.

- The different backgrounds of the directors help ensure that each one contributes a unique viewpoint.

R. The members of the boards help us understand current conditions and the future outlook.

- Before coming to a board meeting, some directors make their own round of calls within the District.

- Others report in specific terms on the industries in which they participate. In addition, the Chicago board recommends a discount rate to the Federal Reserve Board of Governors every two weeks as required by law.

- By the way, I should note that the members of the board provide a valuable public service. We greatly appreciate their willingness to contribute their time and talents to the Federal Reserve.

S. Other important sources of anecdotal information are the Bank's advisory councils.

- The Advisory Council on Agriculture, Labor and Small Business is one of our best sources on issues affecting rural areas, labor markets, and smaller firms.

- Similarly, our new Community Bank Council gives us the views of community banks and thrifts.

T. I also spend quite a bit of time travelling throughout the District to meet with local business, community, and government leaders at meetings like this.

- These sessions give me a chance to travel and get a first-hand look at what's happening in the region.

- (If don't mention at beginning.) For example, my trip to Michigan will include a visit to the GM Powertrain plant here in Saginaw.

U. So the Fed's regional, independent structure has two major advantages. It insulates us from narrow influences and day-to-day political pressures.

- And it helps us obtain a broad range of information and ideas from all over the country.

- The Fed's structure is admittedly unusual and complex—but it works.

V. As I said, the Fed's structure helps us form an accurate picture of the economy. That's been especially difficult recently, given the changes we've seen in a relatively short period of time.

W. What's the current picture for the regional and national economy from the Chicago Fed's point of view?

II. Midwest Economy

A. First, some brief comments on the regional economy, specifically on Michigan.

- You're the true experts on what's happening in the state economy, and I'm interested in hearing your thoughts on local developments.
- But let me briefly note that the Michigan economy continues to perform at a high level. That's quite a turnaround from the days when the Midwest was better known as the "Rustbelt."
- Back in the early 1980s, unemployment rates in the Midwest were a full percentage point above the nation's.
- Today, the Midwest's unemployment rates are a full percentage point below the nation's.

B. Of course, the GM strikes had an impact on the Midwest and the state of Michigan.

- The Chicago Fed's Midwest Manufacturing Index, which measures manufacturing activity in the region, dropped in June and July when the strikes were having an effect on the economy.
- But manufacturing activity rebounded sharply in August, with the index registering its largest monthly increase in 16 years.

C. Similarly, unemployment rates for Michigan increased a bit in July when the effects of the strike were felt.

- But the unemployment rate for August was 3.6 percent, consistent with Michigan's low rates for most of 1998 and well below the national rate of 4.5 percent for August.
- The unemployment rate for Saginaw for August was a bit higher than the state at 3.9 percent. Michigan's unemployment rate for first nine months of 1998 is 3.8 percent.
- If that trend continues, Michigan's unemployment rate will be its lowest in 30 years and below the national average for the fifth year in a row.

III. National Economy

A. On the national level, as I'm sure you know, the FOMC recently eased the stance of monetary policy somewhat, reducing the intended federal funds rate from about 5 ? percent to 5 percent in a space of just over two weeks.

- As the FOMC noted on September 29th when it announced the first policy change, the action was taken to cushion prospective U.S. economic growth from the effects of increasing weakness overseas and less accommodative financial conditions domestically.
- Last week, the Fed announced a second policy action, including the reduction of the discount rate from 5 percent to $4\frac{3}{4}$ percent.

- At that time, the Federal Reserve noted that growing caution by lenders and unsettled conditions in financial markets more generally are likely to restrain aggregate demand in the future.

- These actions are expected to contribute to sustaining economic growth in the future with inflation remaining contained.

B. To understand where the U.S. economy is today, I think you have to consider where we've been. In the last few years, inflation and unemployment rates have been quite low.

- The Consumer Price Index (CPI) last year increased only 1.9 percent—the lowest since 1986. During the first nine months of 1998, the CPI has risen at a 1.4 percent annual rate.

- At the same time, the unemployment rate has fluctuated between 4? percent and 4 ? percent during the past twelve months. The last time unemployment rates were consistently this low was nearly three decades ago.

C. Given this experience in 1997 and earlier this year, a paramount concern of the FOMC was a possible rekindling of future inflationary pressures.

- Although inflation is currently low, monetary policy must always be forward-looking. Our concern about future inflation was generated in part by strong growth in real GDP during the last two years—3.9 percent in 1996 and 3.8 percent in 1997.

- During this period, consumer confidence was very high, employment and personal income were growing strongly, and financial wealth increased due to surging stock market values.

D. Not surprisingly, rising consumer expenditures were an important part of the increase in real GDP. At the same time, business investment was growing smartly for many similar reasons: financing was available, and growth prospects were strong.

E. Strong real GDP growth through 1997 suggested that the growth in aggregate demand couldn't be sustained at that pace over the long term. Unfortunately, excessive growth in aggregate demand is often accompanied by increasing rates of inflation.

- For this reason, as Chairman Greenspan has testified, the FOMC kept the inflation-adjusted real federal funds rate at a relatively high level in 1997.

- The goal of this moderately restrictive monetary policy was to have the economy gently return to its sustainable growth path, which economists generally estimate to be around 2 ? percent.

F. Beginning in mid-1997, however, other economic events began to unfold, which have since accumulated to the point of potentially restraining U.S. aggregate demand more than desired.

- The financial crisis that began in Thailand spread throughout East Asia.

- As expected as recently as the fall of 1997, U.S. export growth slowed due to lower demand in Asian countries and a strong dollar against Asian currencies.

G. Last year, the U.S. shipped 28 percent of its exports to Asia. That figure dropped to 24 percent during the first half of 1998.

- On the import side, we've seen an increase in Asian imports of about 6 percent in dollar terms compared to a year ago.

- The prices of these imports are well below year-ago levels. So the developments in Asia have helped to dampen inflationary pressures here in the U.S.

H. Even with this international drag on the U.S. economy, it was unclear as recently as this summer whether the Asian crisis would offset the strong economic fundamentals propelling the U.S. consumer and business sector forward. In some ways the Asian crisis has actually boosted domestic spending.

- The flow of international capital seeking a safe haven in the U.S. has contributed to a decline in medium- and long-term interest rates.

- The low rates have helped fuel buying of homes, consumer durables and business equipment.

- Consequently, the moderately restrictive monetary policy in place this past summer could still be viewed as balancing the economic risks facing our economy.

I. However, further developments overseas have added risks to our economy.

- The developments in East Asia were accompanied by further financial problems in Russia in August. The current situation in Brazil and other Latin American countries further added to the uncertainty.

- One indication of the increased risks in the global economy was the change in the world economic outlook by the International Monetary Fund.
  - Last May, the IMF forecast 3.1 percent world GDP growth during 1998. On September 30, The IMF revised its forecast to 2 percent.
  - The downward revision for world growth during 1999 was even more dramatic—from 3.7 percent to 2.5 percent.
  - And frankly, these projections are a bit optimistic compared to other business analysts' forecasts.

J. The full extent of the after-shocks to our domestic economy is hard to gauge.

- Financial developments have quickly turned investors away from additional risk-taking investments. Investors' appetite for risk has clearly declined.

- As managers of financial funds reweighted their portfolios towards less risky assets, market volatility increased. A world-wide financial flight to quality increased spreads between private bonds relative to U.S. Treasury securities, which are considered a safe haven.

- In this environment, there are growing concerns that credit-worthy borrowers may find it difficult to obtain credit for productive investment opportunities in the coming months. Some companies have cut back on their borrowing in the capital markets.

- And Federal Reserve surveys and other sources indicate that banks are less willing to lend to some borrowers.

- Although the jury is still out on these questions, the risks to the U.S. economy seem to have swung towards slower growth in aggregate demand.

K. Looking forward into 1999, the FOMC's monetary policy stance has evolved with these risks in mind.

- Financial market volatilities have already reduced consumer wealth substantially, and continuing pressures on corporate profit margins and widening risk spreads have increased the costs of capital investment.

- It will be difficult for the components of aggregate demand that strongly propelled the U.S. economy in 1996, 1997, and the first half of 1998, to continue to drive growth rates of spending at their previous extraordinarily high rates of increase.

L. Of course, everyone has been expecting consumer and business spending to slow in 1999. The risk, and it's only a risk at this point, is that this slowing will be too quick. In any event, these factors most likely will offset some of the potential inflationary consequences from tight labor markets.

M. For these reasons, in late September and again in mid-October, the FOMC moved to ease monetary policy somewhat.

- The Fed acted to cushion the effects on prospective economic growth. Monetary policy works like a time-release capsule, with a lag of a year or even longer. So it's necessary to anticipate developments rather than wait until after the fact.

- Given this background, the FOMC felt that events overseas and the resulting adjustments in U.S. financial markets meant that a moderate change in policy would be consistent with achieving the Fed's goal of low inflation and sustainable economic growth.

IV. Conclusion

A. In conclusion, I hope you have a better idea of how important it is for us to get input from real people living and working throughout the country — including those of you in this room.

- This is especially important since monetary policy must be forward looking. We need as much up-to-date information as possible so we can anticipate prospective developments in the economy.

- Our regional structure helps us in this task, enabling us to develop more effective policy and achieve our mission of fostering a healthy, growing economy with price stability.

B. Thank you.