

LATIN AMERICAN CEOS
KELLOGG SCHOOL OF MANAGEMENT

Evanston, Illinois
August 4, 1999



I. Thank you

- A. Personal interest in international arena — served as deputy U.S. trade representative.
- B. Always a pleasure to continue interaction with Northwestern — professor of strategy and international management, prior to coming to the Chicago Fed.
- C. Talk today about what the Fed does and this wonderfully vibrant economy we're currently experiencing

II. Fed

- A. Fed's mission: foster healthy growing economy via stable financial system.
- B. Founded in 1913 by Act of Congress
- C. 12 Regional Reserve Banks (CHART ONE – map of Fed districts)
- D. Monetary policy/ Sup & Reg/ Financial services (CHART TWO – listing of services)
- E. Chicago Fed territory — Illinois, Indiana, Iowa, Wisc., Michigan
 - 1. Head office in Chicago, branch in Detroit, check processing centers in Des Moines, Milwaukee, Indianapolis and Peoria.

F. FOMC — responsible for monetary policy

1. Made up of seven members of the Federal Reserve Board and 12 Reserve Bank Presidents — four of which vote on a rotating basis.
2. I'm a voting member this year.

G. Fed's regional structure means System gets constant flow of economic intelligence from the regions.

1. Perspective isn't limited to Washington, D.C., "beltway."
2. Always find these types of sessions useful — interested in your thoughts/ideas on economy.

III. Economy

A. Overview (CHART THREE)

1. Portrait of current expansion: robust growth, and both low inflation and low unemployment.
 - a. Real GDP grew more than 4 percent last year and about 3 ? over the first half of 1999.
 - b. Driven by strong consumer spending.
2. FOMC actions
 - a. Last fall reduced interested rates from 5½ to 4¾.
 - b. Since then, financial strains are less in the U.S., and the outlook for foreign economies improved.
 - c. FOMC increased Fed Funds a quarter of a percentage point to 5 percent in June.
 - d. Committee noted that it would remain vigilant for any actual or potential signs of inflationary pressures in order to ensure that economic growth continues.

B. Why is the economy doing so well in so many ways?

1. Low inflation environment is a big part of it.
 - a. Growth can only be created by investment in human and physical capital.
 - b. High, volatile inflation disrupts this investment process and economic efficiency.
 - 1) Inflation distorts prices, jamming the signals which consumers and investors depend on to make appropriate economic decisions.
 - c. The Fed can't create long-term growth directly.
 - 1) The Fed can't train the workforce, and it doesn't build factories.
 - 2) Fed economists did try to build a widget factory once, but the employees didn't like it because they only had jobs in theory.
 - 3) Because the Fed can't make investment directly, Fed *facilitates* investment ... by creating an economic environment of low and stable inflation.

- 4) Compared to 1970s, when inflation was 13 percent, Fed has made significant strides toward price stability.
- d.) The challenge is to avoid holding back the economy, but not to push aggregate demand beyond its limits either.
 - 1) As I said, Fed goal—maximum sustainable growth and a higher standard of living, over the long term.
 - 2) The key word here is “sustainable.” Short bursts of growth that quickly burn themselves out don’t accomplish our long-term objective.
 - 3) Achieving this balance is not an easy job — but it’s interesting work and I enjoy it immensely.
2. Could temporary factors be creating this low inflation, low unemployment, high growth economy?
 - a. Certainly through the end of last year we saw cheap oil (CHART FOUR), declining import prices (CHART FIVE), and less dramatic growth in medical costs.
 - b. But the longer the economy continues on its current trajectory, the more difficult it is to attribute our good fortune to temporary factors alone.
3. Permanent changes could also be occurring.
 - a. Structural changes in the labor market may have lowered the unemployment rate consistent with stable inflation.
 - 1) A snapshot of the economy would always show some level of unemployment — the result of inevitable frictions in the labor market.
 - 2) The existence of this pool of job seekers is one reason there is a threshold of how low unemployment can go without inducing inflation.
 - 3) We used to think 6 percent was the threshold.
 - 4) We have been below 6 percent since 1994; economists are reexamining the labor market to see if the threshold may have changed.
 - a) The growth of labor market intermediaries — eg. temporary services firms (CHART SIX); the internet.
 - b) So, more people avoid long periods of unemployment when changing jobs.
 - b. Changing demographics.
 - 1) Baby boomers (larger portion of population) are middle aged, the age at which they are least likely to experience unemployment.
 - 2) Share of labor force between 16 and 24 (CHART SEVEN)
4. Some have suggested that increased productivity growth is allowing the economy to grow at a faster pace without triggering inflation.
 - a. In fact, productivity has increased dramatically during the past three years.
 - 1) Output per hour worked in the non-farm business sector has been rising at around 2

percent per year, compared to an average annual increase of around 1 percent during the previous two decades.

- 2) When I came to the Fed in late 1994, potential long-term GDP growth was thought to be around 2 percent annually — 1 percent due to growth in productivity and 1 percent due to growth in the labor force.
 - 3) If productivity growth has shifted into a higher gear of 2 percent, that 1994 assessment might now be a point too low. The human impact of such a change would be enormous: a productivity growth rate of 2 percent would allow the average family's standard of living to double in half the time that it would take at a productivity growth rate of 1 percent. That's 35 years instead of 70.
- b. But if we look at the data for productivity growth over the entire expansion, the evidence for a longer-term productivity surge isn't particularly strong. (CHART EIGHT)
- 1) Since the expansion began in 1991, productivity growth has averaged only 1.1 percent per year.
 - 2) That's about the same as in the other expansions of the 70s and 80s, and not nearly as high as the expansions in the 50s and 60s.
 - 3) So burst of productivity over the past three years is far from unprecedented.
- c. What is encouraging, however, is that the recent speed-up in productivity comes so late in an expansion.
- 1) Productivity commonly increases rapidly as the economy comes out of a recession and firms try to employ idle resources.
 - 2) The challenge is to keep up the pace further into the expansion once factories and workers are essentially fully employed. At that point, increasing output would utilize less productive resources.
 - 3) We've met that challenge so far.
- d. Is info technology influencing changes in productivity?
- 1) Arguments against:
 - a) Why didn't productivity improve years ago when computers first came on the scene?
 - b) Why isn't it happening abroad?
 - 2) Counter arguments:
 - a) We're *only now* becoming skilled at utilizing software efficiently.
 - b) IT can influence productivity increases more in US than Europe because our economy is more flexible.

IV. Michael Moskow's take

- A. International experience should make us a little more skeptical of attributing the recent large acceleration in productivity growth solely to advances in technology.

- B. At the same time, I'm personally intrigued by the idea that managerial improvements, independent of computer technology, could also be part of the explanation for the recent pick up in productivity.
1. Global competitive pressures provided a wake-up call in the 1980s and we are clearly running our businesses smarter.
 2. Manufacturing firms have revolutionized how workers do their jobs since the mid-1980s.
- C. Still too early to determine how long productivity will continue to increase at a higher rate. However, the longer such growth continues, the more evidence we have.
1. Everyone at the Fed is of course keeping this possibility in mind as we assess the myriad of economic data. But, at the same time, we can't change how we conduct monetary policy based on an unproven hypothesis.
 2. In other words, the possibility of higher productivity growth doesn't mean the end of the need for a vigilant Fed.
- D. What does this mean for Latin America?
1. Despite strong U.S. economy, investors have been cautious about investing internationally and taking on risk after last fall's turmoil.
 2. Still, Latin America is very important trading area for U.S. (CHART NINE)
 - percentages
 - for example, large number of parts made in machiladoras in Mexico
 3. U.S. deficit has been rising: US exports decrease as growth of foreign GDP slows; imports increase as US GDP growth picks up (CHARTS TEN AND ELEVEN) See Dan Sullivan's comment on Charts 9 & 11 below.*
 4. International financial crisis has started to ease (CHART TWELVE)
 5. I want to hear your perspective on this but my understanding is that...
 6. Mexico
 - Recently privatized banking system is fragile and still hasn't gained international confidence due to history of bad investments
 - But economy on whole looking better and this year's increases in oil prices have added to export performance.
 7. Brazil and Argentina
 - International investors are cautious about the strength of economy fundamentals because of political distractions like ...
 - Brazil's recent cabinet reshuffling
 - October electoral campaign in Argentina and campaign-related talk about debt moratorium

8. General climate for international investment:
 - First signs of recovery in SE Asia are helping confidence
 - But if China reneges on promise not to devalue, problems could spill over to rest of SE Asia.
 - OPEC is holding firm on production restraints for now, some pressures on OPEC to relax production restrictions
9. I'm hopeful that over time trade restrictions will decrease internationally and that this will lead to faster growth outside U.S as well. This is because a reduction in trade restrictions would permit more flexibility while adding stability to the international economy:
10. Interested in hearing your comments and questions.

**Charts 9 & 11 overlap: ie, the foreign GDP growth series plotted in Chart 9 is the same as the series on the bottom left of chart 11 and the exports growth series on chart 9 is related to the net exports series on the top left of chart 11 (net exports = exports – imports = real trade deficit). This isn't necessarily a problem, but in putting up the charts, you may want to point out the overlap and/or just focus on the series in chart 11 that are new (the spreads).*