

SIOUX CITY ECONOMIC FORUM

Sioux City, Iowa
October 13, 1999



- 1. Good afternoon. It's a pleasure to be here today. I appreciate the opportunity to be here in "Sioux Land" to have the opportunity to hear your views, ideas and questions regarding the regional and national economy.
 - a. I'd like to thank each of you for taking the time to be here today. In particular, I'd like to thank Tom Dorr, president and CEO of Dorr's Pine Grove Farm in Marcus, Iowa, and a former director of the Chicago Fed; Jack Bernstein, president of State Steel Supply Company in Sioux City, and a former member of our Advisory Council on Agriculture, Labor, and Small Business; and Richard Waller, president and CEO of Security National Bank in Sioux City, and a member of our Community Bank Council. Rich was extremely helpful in working with us to organize our visit to Sioux City.
 - b. Tom is president and CEO of Dorr's Pine Grove Farm in Marcus, Iowa, and a former director of the Chicago Fed. I'd also like to acknowledge... (may be a former member of the Ag Council in attendance/will insert any other dignitaries as we confirm attendance).
- 2. As most of you probably know, the Federal Reserve's mission is to foster a safe and sound financial system and a healthy, growing economy.
 - a. To ensure that the central bank is in touch with all corners of the economy, the Fed was created with a system of 12 regional banks back in 1913.
 - b. The Chicago Fed serves a five-state area consisting of most of Indiana, Illinois, Michigan, Wisconsin, and all of Iowa. In addition to our head office, we have an office in Des Moines as well as in Indianapolis, Detroit, Milwaukee, and Peoria.

- c. We schedule forums such as this regularly throughout our district, so that we can solicit and respond to feedback from our customers and stakeholders.
3. Today, I'd like to discuss some of the recent trends in the national economy.
 - a. In particular, I'd like to focus on an issue that you might call the "productivity puzzle"—the recent strong increases in productivity numbers and the implications for policymakers.
 - b. It's issues like this that make it more challenging than ever for us at the Fed to develop monetary policy and for each of you to make the business decisions you face every day required.
4. Although the bulk of my speech will deal with the complex topic of the economy, I'd like to start off today by telling you a little bit about the Federal Reserve and its work in preparing for Y2K.
 - a. Obviously, given our role as the nation's central bank, we are focussing considerable attention on Y2K.
 - b. First of all, I'd like to reassure you that there is no truth to the rumor that the Fed is stockpiling slide rules, sundials, and adding machines. In fact, we're confident that the century date change will come and go with a minimum of disruption.
 - c. At the Fed we are addressing Y2K at all levels. We have three main areas of responsibility.
 - (1)First, we're a service provider: we provide financial services such as check processing and electronic payments to depository institutions and the U.S. government.
 - (2)Second, we're a bank regulator: we supervise and regulate state member banks and bank holding companies.
 - (3)Finally, but certainly not of least importance, we formulate national monetary policy.
 - d. We are committed to doing all we can to safeguard the operations of the U.S. financial system; and that's the reason Y2K is so important to the Federal Reserve System.
5. The Fed has already made significant progress in preparing for the rollover; all of our internal systems are prepared for Y2K and are already in production.
 - a. As a financial service provider, we're confident there will be no disruption in our ability to meet the needs of our customers - be they banks or the U.S. government.
 - b. As a regulator, we're working closely with other regulators to review the preparedness of the financial institutions we supervise.
 - c. Ultimately, it's up to the banks themselves to ensure that they are ready, yet the results of our Y2K exams so far indicate that the vast majority of institutions are making satisfactory progress.
 - d. There is an old saying that a person surprised is already half-beaten. We have certainly taken this to heart, and we have no intention of being surprised by anything Y2K has to offer.
6. But sound preparation is only part of the battle. We must also encourage the public not to over-react.

- a. There has been concern that popular misconceptions about Y2K could lead some people to withdraw unusually large sums of money from their bank accounts.
 - b. For this reason the Federal Reserve is making available to depository institutions more than enough cash to cover any unusually large demands by the public. However, I would like to remind everyone that there is no safer place for your money than where it is, Y2K or not.
 - c. Although you may want to have enough cash on hand for the long holiday weekend, remember that credit and debit cards, as well as checks, are expected to work over the New Year's holiday as they would at any other time of the year.
 - d. In short, we are confident that the Federal Reserve and the financial system will be fully prepared for the century rollover.
7. That brings me to my main topic—the economy.
- a. We've seen a rare combination of robust growth, and both low inflation and low unemployment during the past few years.
 - b. Moreover, our outlook for this year and the next is quite optimistic. We expect growth to moderate, but to remain quite good.
8. The strength of the U.S. economy in recent years is evident by looking at the Midwest.
- a. Most of our manufacturing industries, which in earlier days earned us the "Rustbelt" moniker, are running near capacity.
 - b. Sales of both new and existing homes in the Midwest have exceeded practically everyone's expectations, which in turn has kept items such as appliances, electronics and lawn furniture selling rapidly.
 - c. At the same time, strong employment growth earlier in the 1990s pushed unemployment rates in the region much lower than the nation as a whole, where they remain today.
9. In recent years, Iowa's economy has led the way among Midwest states in job growth and low unemployment.
- a. Iowa's unemployment rate was a remarkably low 2.7 percent as of August; and 35,000 jobs were created in the past year.
 - b. However, important sectors of Iowa's economy are experiencing problems.
 - (1) Factory exports were down 24 percent during the first half of 1999, with much of the decline centered in the farm equipment and machinery industries.
 - (2) The ag sector has been hit hard by low prices due to large meat and grain supplies and weakened foreign demand.
 - (3) The value of U.S. ag exports are down not only to Asia but to most other regions of the world.

- (4) Good grade farmland prices in Iowa are down, 3 percent versus one year ago as of July, according to the survey that our bank conducts on a quarterly basis.
 - c. The farm sector is experiencing very tough times, but the outlook for the region as a whole is much better than it was the last time there was such a severe ag slump in the early 1980s.
 - d. Other Midwestern sectors such as manufacturing are doing well so they are helping to absorb the shock for the region as a whole.
10. Why is the national economy doing so well?
- a. One key reason is the low inflation environment.
 - (1) Obviously, the Fed can't create long-term growth directly.
 - (2) Growth comes from investment in human and physical capital.
 - (3) And the Fed can't train the workforce, and it can't build factories.
 - b. However, the Fed can facilitate the necessary investment by creating an economic environment of low and stable inflation.
 - c. As the 1970s showed, high inflation, especially when it's volatile, disrupts economic efficiency.
 - (1) Inflation distorts prices, jamming the signals which consumers and investors depend on to make appropriate economic decisions.
 - (2) Since those dark days of stagflation 20 years ago when inflation was 13 percent, the Fed has made significant strides toward price stability.
 - (3) The challenge is to avoid unduly holding back the economy, but not to push aggregate demand beyond its limits either.
 - (4) As we now know, over-stimulating the economy would simply impede growth in the long term by inducing inflation.
11. The lower inflation we've achieved has provided the foundation for the strong real growth and low unemployment that are a hallmark of the current expansion.
- a. Things have been going so well lately that some pundits have claimed we've entered a new economic era.
 - b. It is rare to see such low inflation during a period of such strong economic growth.
 - (1) So it's understandable that there is a lot of talk about this economy being a newer and faster breed, and maybe even a different beast altogether.
 - c. Earlier today, I had an opportunity to visit the Gateway facility across the river in North Sioux City. In many ways, Gateway exemplifies the startling change and vigor that's so typical of the economy.
 - (1) The company began in 1985 as a two-person start-up in an Iowa farmhouse near Sioux City and grew into a Fortune 250 company with 18,000 employees across the world.

- (2) Who was the founder? A computer geek from the West Coast? No, a fourth-generation cattleman. You might say he took the bull by the horns and started a world class company.
- d. Gateway is an undeniable success story so far. And it's the change that's exemplified by Gateway that have led some to claim that there has been a fundamental shift in the economy—a change in the old rules.
- (1) Some say that American workers are just much more productive than they used to be, possibly due to advances in information technology, and therefore, we can throw out all the old rules of economics.
- (2) Others argue that these prosperous times are little more than a run of good luck, due to a happy coincidence of temporary factors.
12. A number of temporary factors have played a role in restraining inflation.
- a. Cheap oil, declining import prices, and less dramatic growth in medical costs have all helped hold down the inflation rate.
- b. Unfortunately, several of these factors have started to swing the other way.
- (1) For example, medical costs have risen, as have oil prices.
- (2) And the dollar has declined recently, thereby increasing the prices of imported goods.
- c. So far, these changes have not triggered a major increase in general inflation, but the full effects of such developments often aren't felt for many months.
13. If the good economic performance we've experienced the last several years were due only to the kind of temporary factors I just mentioned, we'd have cause to worry about the future.
- a. Fortunately, there is reason to think that our good performance also reflects more permanent changes that may be occurring in the economy.
- b. For instance, much research at the Fed and elsewhere has been directed toward understanding whether structural changes in the labor market may have lowered the unemployment rate that is consistent with stable inflation.
- c. A snapshot of the economy would always show some level of unemployment — the result of inevitable frictions in the labor market.
- (1) This is part of the ongoing process of matching people with jobs. The existence of this pool of job seekers is one reason there is a threshold of how low unemployment can go without inducing inflation.
- (2) Just a few years ago, an unemployment rate below 6 percent would have been seen by many as an indicator that the economy was operating beyond its potential and that a pickup in inflation was just around the corner.
- (3) But we have been below 6 percent since 1994, which has caused economists to reexamine the labor market to see if the threshold may have changed.

- d. It's important to recognize that the labor market is more flexible and efficient than in the past.
 - (1)The growth of labor market intermediaries, especially temporary services firms, has made it possible to match firms and workers more quickly and easily.
 - (2)And the Internet has probably made job searching more efficient.
 - (3)In fact, studies have shown that much of the decrease in unemployment is among the short-term unemployed; in other words, the low unemployment rate may be due in large part to the fact that more workers avoid periods of unemployment when changing jobs.
 - e. The more flexible labor market is a reflection of the creative problem solving that is intrinsic to the American economy. But some of the credit for the low unemployment rate may go simply to a shift in demographics.
 - (1)The baby boomer cohort — the largest portion of the population — is now in its forties and fifties. When unemployment was at the much higher levels we saw in the late 1970s and early 1980s, the baby boomers were in their teens and early twenties, an age at which they were much more likely to be unemployed.
 - (2)Now that they are older they are much less likely to experience unemployment. Since the baby boomer cohort is such a large portion of the population, they have an important impact on employment in the economy as a whole.
14. As I mentioned earlier, another important factor in the remarkable performance of our economy has been the increase in productivity growth over the past three years which has allowed the economy to grow at a faster pace without triggering inflation. The increase has been dramatic.
- a. Output per hour worked in the non-farm business sector has risen at an annual rate of about 2 percent since the fourth quarter of 1995, compared to an average annual increase of around 1 percent during the previous two decades.
 - b. 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.
 - (1)Certainly, if productivity growth has shifted into a higher gear of 2 percent, that 1994 assessment might now be a point too low.
 - (2)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.
 - c. Before getting too carried away with the implications of the improvement in productivity growth, I should note that some of the improvement is only because the statisticians at the Bureau of Economic Analysis have improved how they measure output.
 - (1)In fact, three or four tenths of the one percentage point increase are due to changes in how productivity is measured rather than to a true increase in productivity growth.
 - (2)Of course, that still leaves a significant portion that is a true improvement, one that still makes a big difference to the performance of the economy.

15. It also is important to keep in mind that the current productivity surge is only a few years old. In fact, the early 1990s were a period of quite disappointing productivity growth.
- a. Over the entire expansion that began in 1991, productivity growth has averaged only 1.1 percent per year.
 - (1) That's about the same as in the expansions of the 70s and 80s, and not nearly as high as the expansions in the 50s and 60s, which was the golden age of productivity growth.
 - b. Moreover, we've seen other periods of a few years in which productivity growth was strong only to see it drop back to lower levels. Will that happen again or will the current strong run of productivity growth sustain itself a good while longer?
 - c. One encouraging consideration is that the recent speed-up in productivity comes so late in an expansion. Productivity growth frequently increases rapidly as the economy comes out of a recession and firms try to employ idle resources.
 - d. The challenge is to keep up the pace further into an expansion once factories and workers are essentially fully employed.
 - (1) At that point, increasing output would utilize less productive resources. We've met that challenge so far.
 - e. In fact, productivity has been accelerating. The growth over the last four quarters has been about $2\frac{3}{4}$ percent. If that acceleration were to continue a bit longer — if productivity growth were to continue to increase to 3 percent or higher — economic growth could be sustained at even higher rates.
 - (1) Of course, it would be very speculative to suggest that productivity growth will continue to increase beyond its current rapid pace.
 - (2) But at the same time, there is nothing to suggest that it is about to drop back to the disappointing levels of the early part of this decade.
16. If we are experiencing a long-running productivity surge, there are several possible explanations.
- a. Many economists have credited advances in information technology. Of course if that's the case you may then wonder why productivity didn't improve years ago when computers first came on the scene.
 - b. One theory is that information technology is only now boosting productivity because we're only now becoming skilled at utilizing software efficiently. Such a theory is in keeping with historical precedent regarding the relationship between productivity and other technological advances such as electric motors.
 - c. Some skeptics wonder, if a new wave of technology is really propelling the economy into more prosperous waters, why is it only happening in the U.S.? After all, we don't have a monopoly on the new technology. Yet, Japan is in a long-running slump and European growth has been tepid for years.

- d. The answer may be that our economy is much more flexible and that successful implementation of the new technologies requires a lot of flexibility.
17. I'm personally intrigued by the idea that managerial improvements, independent of computer technology, could also be part of the explanation for the recent pickup in productivity.
- a. Global competitive pressures provided a wake-up call in the 1980s and we are clearly running our businesses smarter.
 - b. By talking to business leaders at forums such as this one, and visiting factories and farms here in the Midwest, I've seen many examples of this phenomenon.
 - c. As I mentioned earlier, Gateway is certainly a notable example of innovative practices in the PC industry.
 - d. These improvements aren't limited to the tech sector. Later today, I'll be visiting a dairy in Newkirk that is a leader in implementing new techniques and practices.
18. In conclusion, it's still too early to determine how long productivity will continue to increase at a high rate.
- a. However, the longer such growth continues, the more likely it is that it reflects a long-running change in the economy.
 - b. Everyone at the Fed is of course keeping this possibility in mind as we assess the myriad of economic data.
 - c. But, at the same time, we can't change how we conduct monetary policy based on an unproven hypothesis.
 - d. In other words, the possibility of higher productivity growth doesn't mean the end of the need for a vigilant Fed. In this age of faster modems and constantly increasing computer memory, we shouldn't confuse significant progress with limitless possibilities.
 - e. Economic history does have a tendency to repeat itself — what appears new is often just recycled.
 - (1)As I mentioned, we experienced similar strong productivity growth during the 1960s. But we now know that the "go-go 60s" quickly gave way to the "stagflation 70s."
 - (2)The mistake policymakers made then was to overestimate the trend in productivity growth and underestimate the potential for inflation.
 - f. That new era wasn't the last, and this one won't be either. Much as we may like to, we can't throw out the old rules—the parameters may have changed, but the rules still apply.
19. If you asked me to describe the current economic expansion as if it were a car, I would have to say that it's a nice conservative family sedan, definitely domestic. It served us well for years, with plenty of room for everyone.

- a. Then, just when we thought it had seen its best days, a neighborhood teenage car enthusiast got a hold of it. Now it's still a nice conservative family sedan, but with great acceleration.
- b. I'm delighted that the old car is running so well, but I'd love to know what that teenager did to the engine and how long I can expect the car to keep running.

Thank you.