DETROIT BRANCH COMMUNITY BANKING/BUSINESS LEADER FORUM

Flint, Michigan
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I. Introduction

A. Good afternoon. I appreciate the opportunity to be here to have the chance to hear your views, ideas and questions regarding the regional and national economy.

1. I'd like to thank each of you for taking the time to be here today.
2. In particular, I'd like to thank (add any acknowledgements as attendees are confirmed)

B. 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 with price stability. We have three main responsibilities:

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

C. 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.

1. The Chicago Fed is one of those 12 regional Reserve Banks and serves a five
2. state area consisting of the lower peninsula of Michigan as well as most of Indiana, Illinois, and Wisconsin, and all of Iowa.

3. 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, which is headed by David Allardice.

D. To start off, I'd like to take a couple of minutes to highlight the role of the Detroit Branch board of directors, who are with us today.

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

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

3. Each of the Fed Bank presidents participates on the Federal Open Market Committee, the Fed's main policymaking group.

E. As part of the policymaking process, we need to stay in touch with people living and working in the region to supplement statistical data with up-to-the-minute information.

1. All Fed Bank presidents have a number of sources for getting this information.

2. Perhaps the most important is the board of directors at each Bank and Branch, which are made up of leading private citizens in the region representing a cross-section of the local economy.

F. Our current Detroit Board has

1. Florine Mark from the service sector;

2. Stephen Polk from the publishing sector;

3. Denise Ilitch Lites from the food and real estate industries;

4. Irma Elders and Tim Leuliette from the automotive industry and venture capital;

5. and Richard Bell and David Wagner from banking.

G. The members of both the Chicago and Detroit boards play an important role in the policymaking process by helping us understand current conditions and the future outlook.

1. In addition, the Chicago board recommends a discount rate to the Federal Reserve Board of Governors every two weeks as required by law.

2. The members of the board provide a very valuable public service.

3. The Chicago Fed began operations 85 years ago, and I was interested to learn that our original directors were each paid $20 per meeting.

4. I won't tell you what the current stipend is, but I think it's safe to say that the current fee has not kept up with inflation—this is one area where the Fed has not had to be vigilant about emerging wage pressures.

5. My point is that the directors are very giving of their time and expertise, and we greatly appreciate their willingness to contribute their services.

6. They are an essential element of the Fed's regional structure, which helps to insulate us from narrow influences and facilitates our access to a broad range of information and ideas.

H. Our regional structure helps us track recent trends in the economy and that is the topic I'd like to discuss today.

1. 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.

2. 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.

3. Although the bulk of my speech will deal with the economy, first I'd like to tell you a little bit about the Federal Reserve and its work in preparing for Y2K.

II. Y2K

A. Obviously, given our role as the nation's central bank, we are focusing considerable attention on Y2K.

1. 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.

2. In fact, we're confident that the century date change will come and go with a minimum of disruption.

B. 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.

1. 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.

2. As a regulator, we're working closely with other regulators to review the preparedness of the financial institutions we supervise.

3. Regulators have already examined every bank twice, and we've found that 99 percent of banks are making satisfactory progress toward Y2K readiness.

C. There is an old saying that a person surprised is already half beaten.

1. We have certainly taken this to heart, and we have no intention of being surprised by anything Y2K has to offer.

2. But sound preparation is only part of the battle.

3. We must also encourage the public not to overreact.

4. There has been concern that popular misconceptions about Y2K could lead some people to withdraw unusually large sums of money from their bank accounts.

5. 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.

6. However, I would like to remind everyone that there is no safer place for your money than where it is, Y2K or not.

7. 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.

8. In short, we're confident that the Federal Reserve and the financial system will be fully prepared for the century rollover.

III. Economy

A. That brings me to my main topic - the national economy.

1. We've seen a rare combination of robust growth, and both low inflation and low unemployment during the past few years.

2. That trend has continued so far during 1999 as we've experienced a very good economic performance.

3. Real GDP growth has been solid, with strong consumer spending.

4. As you know, sales in the light vehicle industry have been particularly strong.

5. And sales of both new and existing homes have exceeded practically everyone's expectations, which in turn has kept items such as appliances, electronics and lawn furniture selling rapidly.

6. Both the inflation and employment pictures have been favorable as well.

7. The Consumer Price Index rose at an annual rate of 2.8 percent over the first nine months of '99, while the core CPI, which excludes volatile food and energy prices, was up at a 1.9 percent rate.

8. The unemployment rate so far this year has hovered at the lowest level in 29 years.

B. Like most economists, we anticipate that real GDP growth will moderate during 2000.

1. The core CPI rate of inflation may not be quite as low as this year, but the overall rate of inflation as measured by the CPI should moderate slightly as energy prices stabilize.

2. We expect that unemployment will continue to be low next year, with labor markets remaining tight.

C. The strength of the U.S. economy over recent years is evident by looking at the Midwest.

1. Most of our manufacturing industries, which in earlier days earned us the "Rustbelt" moniker, are running near capacity.

2. And strong employment growth earlier in the 1990s has pushed unemployment rates in the region much lower than the nation as a whole, where they remain today.

D. Michigan's economy is currently firing on all pistons.

1. Your September (preliminary) unemployment rate was 3._ percent (New number available 10/22), a full percentage point below the national average.

2. In fact, this is the best job market Michigan has seen since 1970.

3. Unemployment has been below the national average for most of the past four years.

4. Much of Michigan's impressive performance is due, of course, to booming vehicle sales.

5. Light vehicle sales were at a 16.7 million annual rate during the first three quarters of '99, well ahead of the prior record set in 1986.

6. The construction and service sectors have also been major contributors to growth in the Michigan economy.

7. The only major downside of the state economy is the shortage of workers that businesses say is holding back expansion plans.

E. Why is the national economy doing so well?

1. One key reason is the low inflation environment.

2. Obviously, the Fed can't create long-term growth directly. Growth comes from investment in human and physical capital.

3. The Fed can't train the workforce, and it can't build factories.

4. However, the Fed can facilitate the necessary investment by creating an economic environment of low and stable inflation.

F. As the 1970s showed, high inflation, especially when it's volatile, disrupts economic efficiency.

1. Inflation distorts prices, jamming the signals that consumers, businesses, 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.

G. 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.

1. Things have been going so well lately that some pundits have claimed we've entered a new economic era.

2. It is rare to see such low inflation during a period of such strong economic growth.

3. 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.

4. Some claim that there has been a fundamental shift in the economy.

5. In their view, 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.

6. Others argue that these prosperous times are little more than a run of good luck, due to a happy coincidence of temporary factors.

H. A number of temporary factors have played a role in restraining inflation.

1. Cheap oil, declining import prices and less dramatic growth in medical costs all helped hold down the inflation rate.

2. Unfortunately, several of these factors have started to swing the other way.

3. For example, medical costs have risen, as have oil prices.

4. And the dollar has declined recently, thereby increasing the prices of imported goods.

5. 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.

I. 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.

1. Fortunately, there is reason to think that our good performance also reflects more permanent changes that may be occurring in the economy.

2. 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.

J. 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.

   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. 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.

   4. But we have been below 6 percent since 1994, which has caused economists to re-examine the labor market to see if the threshold may have changed.

K. It's important to recognize that the labor market is more flexible and efficient than in the past. The growth of labor market intermediaries, especially temporary services firms, has made it possible to match firms and workers more quickly and easily.

   1. And the Internet has probably made job searching more efficient. 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.

   2. The more flexible labor market is a reflection of the creative problem-solving that is intrinsic to the American economy.

   3. But some of the credit for the low unemployment rate may go simply to a shift in demographics.

   4. The baby boomer cohort - the largest portion of the population - is now in its 40s and 50s.

   5. 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 20s, an age at which they were much more likely to be unemployed.

   6. 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.

L. 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.

   1. The increase has been dramatic.

   2. 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.

3. 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.

4. Certainly, if productivity growth has shifted into a higher gear of 2 percent, that 1994 assessment might now be a point too low.

5. 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.

M. It's also important to keep in mind, however, that the current productivity surge is only a few years old.

1. In fact, the early 1990s was a period of quite disappointing productivity growth.

2. Over the entire expansion that began in 1991, productivity growth has averaged only 1.1 percent per year.

3. 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.

4. Moreover, we've seen other periods during which productivity growth was strong for a few years only to see it drop back to lower levels.

5. Will that happen again or will the current strong run of productivity growth sustain itself a good while longer?

6. One encouraging consideration is that the recent speed-up in productivity comes so late in an expansion.

7. Productivity growth frequently increases rapidly as the economy comes out of a recession and firms try to employ idle resources.

8. The challenge is to keep up the pace further into an expansion once factories and workers are essentially fully employed.

9. At that point, increasing output would utilize less productive resources. We've met that challenge so far.

N. In fact, productivity has been accelerating.

1. The growth over the last four quarters has been about 2¾ 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.

2. Of course, it would be very speculative to suggest that productivity growth will continue to increase beyond its current rapid pace.

3. 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.

O. If we are experiencing a long-running productivity surge, there are several possible explanations.

1. Many economists have credited advances in information technology.

2. 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.

3. One theory is that information technology is only now boosting productivity because we're only now becoming skilled at utilizing software efficiently.

4. Such a theory is in keeping with historical precedent regarding the relationship between productivity and other technological advances such as electric motors.

5. 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.?

6. After all, we don't have a monopoly on the new technology.

7. Yet, Japan is in a long-running slump, and European growth has been tepid for years.

8. The answer may be that our economy is much more flexible, and that successful implementation of the new technologies requires a lot of flexibility.

P. 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 growth.

1. Global competitive pressures provided a wake-up call in the 1980s, and we are clearly running our businesses smarter.

2. By talking to business leaders at events such as this one, and visiting factories and farms here in the Midwest, I've seen many examples of this phenomenon.

3. Certainly that's something that's occurring here in Flint, given its location in the center of Michigan's high-tech manufacturing corridor.

IV. Conclusion

A. In conclusion, it's still too early to determine how long productivity will continue to increase at a high rate. However, the longer such growth continues, the more likely it is that it reflects a long-running change in the economy.

1. Everyone at the Fed is of course keeping this possibility in mind as we assess the myriad of economic data.

2. But, at the same time, we can't change how we conduct monetary policy based on an unproven hypothesis.

3. 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.

B. 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.

3. That new era wasn't the last, and this one won't be either.

4. Much as we may like to, we can't throw out the old rules - the parameters may have changed, but the rules still apply.

C. How would I describe the current economic expansion?

1. Well it seems appropriate here in Flint to use the automobile as a basis of comparison.

2. If the economy were a car, I'd have to say that it's a nice conservative family sedan, definitely domestic.

3. It served us well for years, with plenty of room for everyone. Then, just when we thought it had seen its best days, a neighborhood teenage car enthusiast got a hold of it.

4. Now it's still a nice conservative family sedan, but with great acceleration.

5. 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 much longer I can expect the car to keep running so well.

6. Thank you.