GRAND RAPIDS ECONOMIC FORUM

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Fed's Role in Economic Development Affecting Local Industry

Good afternoon. I'm delighted to be here. As you may know, I'm here today as part of the Chicago Fed's efforts to communicate directly with businesses, communities and citizens in the Midwest. I'm here to learn from you your thoughts on the direction of the economy and to share some insights from the Fed's perspective.

I must say, I don't think that there is a better place to talk about the state of the economy. Grand Rapids is an interesting case study from a central banker's perspective. Your city's economic history has it all. You went from a frontier outpost in the mid-1800s to a booming furniture-making town in a few short decades. You saw the worst of the great depression of the 1930s, and the best of the great expansion of the 1990s. I was not surprised to learn that your motto is "strength in activity," because there are few cities that have flourished more due to innovation. Who would have thought that what was once a single-industry town specializing in furniture manufacturing would now be so economically diverse that the area's 10 largest employers represent eight different industries?

Helping to ensure that kind of economic vitality throughout the nation is the Fed's goal. Simply put, our mission is fostering a healthy, growing economy with price stability. That goal is behind everything we do. Part of this goal is to ensure greater public awareness of how the economy works. Unfortunately, most Americans don't have a lot of knowledge of the Federal Reserve System. In fact, I have had to explain to people, on more than one occasion, that the Federal Reserve is not a national bird sanctuary. You, of course, know that the Fed is our nation's central bank. And while Americans' knowledge about the Federal Reserve is still incomplete, public awareness of the Fed's role in the economy has increased in recent years.

The Federal Reserve was founded in 1913 during one of the more turbulent times in U.S. history. It was a period quite different from today. Our towns and cities had been linked by the transcontinental railway just a few decades earlier. America was newly industrialized and bursting at the seams with energy and expectations. At the same time, the U.S. had experienced a series of boom and bust cycles for several decades. There were frequent economic downturns, and expansions were too short lived to repair the damage done to peoples' lives. By the late 1800s and early 1900s, there were widespread social and economic problems, like the emerging phenomenon of big city poverty and numerous spells of high unemployment.

What a difference a century makes. Today, we're experiencing an expansion that has become the longest in our country's history, and the national unemployment rate is near a three-decade low. Back in the late 1800s, the state of our economy was symbolized by bank runs and bread lines. Now our economy is symbolized by images of parking lots overflowing with luxury cars, and new housing developments that sell out before there is time to plant a "for sale" sign out front.

Today I will talk about our economic expansion, and just what that means for us as a nation. In particular, I'm going to discuss how maintaining price stability is key to the Fed's mission of contributing to a higher standard of living for all Americans. To set the stage for our discussion, let me give you a brief overview of what exactly the Fed does. Our mission is to foster a safe and sound financial system and a healthy, growing economy. As opposed to the ups and downs of the late 1800s, our goal is sustained growth. The Fed pursues its mission through three main areas of responsibility. 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. Second, we're a bank regulator — we supervise and regulate banks and bank holding companies. Finally, but most important, we formulate national monetary policy.

The Chicago Fed is one of 12 regional Reserve Banks. We serve a five-state area consisting of the lower peninsula of Michigan as well as most of Indiana, Illinois, and Wisconsin, and all of Iowa. In addition to our head office in Chicago, we have a Branch in Detroit as well as check-processing centers in Indianapolis, Des Moines, Milwaukee and Peoria. Most people tend to think of monetary policy as a process that begins and ends in Washington, D.C. But, in fact, the Fed was intended to be regional in orientation at its founding, and it continues to be so today. Each of the presidents of the 12 Fed Banks participates on the Federal Open Market Committee, the Fed's main policymaking group.

As part of the policymaking process, we need to stay in touch with people living and working in our regions to supplement statistical data with up-to-the-minute information. That's why I'm here today. My ability to bring current information about the economy in action to our deliberations is one of the advantages of the Fed's regional system. Furthermore, having FOMC participants located outside the Washington beltway helps to keep the Fed insulated from the short-term political pressures that could distort the policymaking process. In short, the Fed's regional system allows it to get a better feel for the latest economic developments and helps it focus on policy not politics.

Given that background, let me turn to why the Fed is concerned with price stability — and to why price stability is so important in ensuring a healthy economy here in Grand Rapids and nationally. At first glance, inflation may not seem that sinister. After all, you might wonder, if both prices and wages are going up, why should it matter? But in fact, as the 1970s showed, high inflation, especially when it's volatile, can easily derail economic growth. Inflation disrupts growth by making the entire economy less efficient. The pricing mechanism, which should serve as a point of communication between consumers and producers, breaks down.

One way to imagine this is to think about a national rail system: when it works, and when it doesn't. Generally, trains come and go at high speeds, efficiently and safely. But some systems are less efficient than others. Sometimes there are problems with the signals. We've all heard of cases where cars were surprised at railroad crossings by malfunctioning gates, or when trains were not announced by either the crossing bells or the signals. And I know I've been on a train more than once that was delayed because of a signaling problem. When signals fail, trains start running late, people miss connections, and in the end, the entire system performs below its potential.

In the free market, price signals serve much the same purpose. Generally, goods and services change hands at high speeds, efficiently and smoothly, without direction by any government agency. Unless, of course, there is a problem with price signals. Then producers and investors misallocate. Customers and workers make ill-informed decisions. And the entire economy performs below its potential. Inflation distorts prices and interest rates, jamming the signals which we all depend upon to make decisions — decisions on when, where and how much to buy, sell, save and invest. That's why the Fed focuses on low inflation to meet its goal of a healthy growing economy. The Fed can't directly create growth. Growth can only be created by investment in human skills, physical capital and new technologies. All the Fed can do is facilitate investment — by creating an economic environment of low and stable prices — an environment of clear signals.

The signals have worked well in recent years. Over the course of the current expansion, the economy has run like a locomotive on a clear stretch of track, fueled by the hard work and ingenuity of the American people. The importance of keeping the economy on track and growing for as long as possible cannot be underestimated. Economic stability and the long expansions it fosters have an enormous impact on our nation. For example, look at the impact of the expansion on those living on the margin in America.

Historically, the previously unemployed and lower-income workers are not as well off as the rest of the population. But the current economic expansion has helped many make solid progress toward improving their lives. Our low inflation environment has provided the foundation for a sustained period of remarkably low unemployment, which has been below 5 percent for almost three years. This extended period of low unemployment has pulled many people into the workforce for the first time, as companies reach deeper into the labor pool.

Long, steady expansions greatly benefit America's poorer workers in many ways. The last-hired workers are often the first-fired. That's why short booms that quickly burn themselves out often do not provide enough time for new workers to get the experience and training they need to stay employed during harder times. Extended periods of economic growth, such as the one we're currently experiencing, mean that we have many Americans entering the job force who have never before had such opportunities — opportunities to work, to receive training, to invest in their own businesses, homes and families, and to break the cycle of poverty. I know that Michigan has excelled at responding to the demands of your flourishing economy — by investing heavily in worker training as well as encouraging people to move to your state.

We've discussed how the Federal Reserve fosters sustainable growth. We've discussed how our nation has benefited from those efforts. And perhaps, most importantly, we've discussed how price stability is key to those efforts. But how exactly, does the Fed achieve price stability? For example, how does the Fed know when growth is sustainable and when it's not?

Roughly speaking, our economy's maximum sustainable growth rate is determined by adding growth in the U.S. labor force and growth in productivity. The labor force has been growing at about one percent per year

— roughly equal to our population growth. Just a couple of years ago, most economists would have said that productivity was growing at about 1½ percent per year, giving us a potential growth rate in the U.S. of about 2½ percent. Today, many economists have higher estimates for potential growth, because of the higher productivity growth we've been experiencing. In fact, the average annual productivity growth over the past four years is one percentage point higher than it was during the previous quarter century — significantly increasing maximum sustainable growth during this period.

A major portion of the recent dramatic increase in productivity growth was due to the kind of innovative products and services provided by the technology industry. Technology is changing the way all of us do our jobs, the way businesses buy and sell from other businesses, and the way companies interact with their customers. We have vastly improved access to information that enables us to be more efficient and effective as we make business decisions.

But the increase in efficiency we've seen since the mid-1990s was not due simply to the highly publicized Internet and hi-tech computer applications. We learned to run our businesses smarter through improved management practices. And the U.S. labor market as an institution is functioning more efficiently than it used to. In the past, the low rates of unemployment we're currently experiencing would not have been considered sustainable year after year. We usually considered such low rates of unemployment as a sign of imbalances in the economy, as a sign that aggregate demand was outstripping aggregate supply. And the result was always the same. Bottlenecks emerged and inflation increased. Eventually, due to the higher inflation, growth would stall and the unemployment rate would go up. We're not sure how low an unemployment rate can be sustained in the U.S. economy today without inflation rising and growth being curtailed. But the old belief that a 6 percent or so unemployment rate was as low as we could go without problems arising is surely out of date.

Increased productivity growth raises our potential growth, which represents the supply of goods and services we produce domestically. There's evidence, however, that demand has been outstripping even this higher supply, and the presence of this imbalance has been an important factor in recent monetary policy discussions and decisions.

As you know, the Federal Open Market Committee has raised its target for the federal funds rate six times since last June, from 4¾% to 6½%. The first five of these moves were increases of one-quarter of a percentage point, while the most recent action taken on May 16 raised the target funds rate by half of a percentage point. The early steps in the latest tightening phase essentially reversed easing actions taken in late 1998. You will recall that financial markets became quite volatile following the Russian crisis in August 1998. In order to assure that the normal supply of financial liquidity to creditworthy borrowers was not impeded, the Fed lowered the funds rate target by three-quarters of a percentage point in three steps during the fall of 1998. By the spring of 1999, however, domestic financial markets had recovered and prospects for economic growth abroad had improved. Moreover, economic growth in the U.S. was quite brisk and potential inflationary risks were increasing. In late June of last year, the FOMC responded by raising its funds rate target, and that was the first of a series of pre-emptive actions taken to offset the significant risk of rising inflation.

After last month's increase, the FOMC stated that increases in demand remained in excess of even the rapid pace of productivity-driven gains in potential supply, exerting continued pressure on resources. If this disparity were allowed to continue, it could foster inflationary imbalances that would undermine the economy's outstanding performance. We also indicated that the balance of risks was still weighted mainly toward inflationary pressures. Given continued strong aggregate demand, the Federal Reserve will need to remain vigilant regarding actual and potential imbalances to ensure that the U.S. economy sustains its strong performance for years to come.

You might compare the issues facing the Fed to the challenges facing architects. Later today I'll have the opportunity to visit Steelcase's operations here in Grand Rapids. I'm told that Steelcase has restored an architecturally significant home designed by Frank Lloyd Wright. That home and the buildings I see every day in Chicago remind me of the challenges that architects face. One of the most famous buildings in Chicago is the Rookery, which is located close to the Chicago Fed's head office. Built by Daniel Burnham after the Great Chicago Fire, as part of his redesign of the city, the Rookery has always held a great significance for Chicagoans. When it was built, the Rookery was the tallest building in the world. About every 30 years or so, a new architect has altered the building to meet the needs of the time. Frank Lloyd Wright, for example, removed much of its original ornate ironwork and added marble staircases covered in intricate carving and painted gold leaf.

In redesigning the Rookery, Wright faced a challenging task to meet the needs of the time without sacrificing its core architectural integrity. Similarly, the Fed, in setting monetary policy, needs to keep the continually evolving nature of the economy in mind without losing its focus on price stability — the essential foundation for a healthy economy.

Both architects and policy makers need to maintain a focus on the fundamentals to ensure their decisions will stand the test of time. The Federal Reserve remains committed to maintaining its focus on price stability as the best way to foster sustained, healthy growth and a higher standard of living for everyone in our nation.