MADISON ECONOMIC FORUM

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Economic Growth and the Importance of Price Stability

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

I always appreciate being given the opportunity to get out of Chicago to discuss the Federal Reserve and the importance of price stability to the economy. Madison and Chicago have a great deal in common. We are both blues towns. We are both fortunate to be situated on lakes. And, then of course, our cities share a passion for architecture.

Although Chicago can't boast of a conference center like this, built by Frank Lloyd Wright, it does have a number of great buildings. In fact, we're fortunate that the Chicago Fed's LaSalle Street home is surrounded by some of the best examples of 19th century and modernist buildings, from Burnham to Mies van der Rohe.

I hope all of you will have the opportunity some day to take a tour of the Federal Reserve Bank of Chicago, and perhaps see some of the great architectural works in the surrounding neighborhood. In fact, the Fed building itself is on one of the Chicago architectural tours. With its solid classical design, the Chicago Fed building embodies stability and that fits well with our mission: 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've 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 greatly 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; 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 the longest expansion in our country's history, and the national unemployment rate is at 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 it 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 the Fed does. Our mandated mission is to foster a safe and sound financial system and a healthy, growing economy. Our goal? Sustained growth, as opposed to the ups and downs of the late 1800s, which spurred Congress to create the Fed. 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.

Most people tend to think of monetary policy as a process that begins and ends in Washington, D.C. But, in fact, Congress designed the Fed to be regional in orientation, with Reserve Banks located throughout the U.S. The Chicago Fed serves a five-state area consisting of the southern two-thirds of Wisconsin as well as all of Iowa, and most of Indiana, Illinois, and Michigan. In addition to our head office in Chicago, we have regional offices in Milwaukee as well as in Detroit, Indianapolis, Des Moines, and Peoria.

Our Board of Directors at the Chicago Fed consists of nine business, community and labor leaders. It includes Jim Keyes, Chairman and CEO of Johnson Controls of Milwaukee, Wisconsin. 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 published statistical data with up-to-the-minute information.

That's why I'm here today. My ability to bring current information about the status of the economy to our deliberations is one of the advantages of the Fed's regional system. Furthermore, having FOMC participants located outside the Washington beltway helps 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 the Fed's focus on price stability and how this helps ensure a healthy economy here in Madison 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 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 sometimes there are problems. When signals fail, trains start running late, people miss connections, and in the end, the entire system performs below its potential.

In a free market, the efficiency of the economic system depends on the signals provided by prices. Generally, goods and services change hands at high speeds, efficiently and smoothly, without direction by any government agency. But when a problem with price signals occurs, producers and investors misallocate. Businesses and consumers make ill-informed decisions. And the entire economy performs below its potential. Inflation distorts prices and interest rates, jamming the signals. And yet, we depend on these signals 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. The current expansion has helped many previously unemployed and lower-income workers make solid progress toward improving their lives. Our low inflation environment has provided the foundation for a sustained period of remarkably low unemployment. In fact, the unemployment rate has been below 5 percent for over three years and it has been close to 4 percent for the past year. Extended periods of economic growth and low unemployment 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 Wisconsin has excelled at responding to the opportunities and challenges of your flourishing economy. By far the biggest challenge for employers has been the persistent workforce shortage across the state. Madison's 1.5 percent unemployment rate, for example, is one of the lowest in the country. In fact, Madison's labor markets have been so tight that the area's monthly unemployment rate has not topped 2.5 percent since early 1994. Wisconsin's unemployment rate was 3.0 percent in October, 0.9 percentage point lower than the national average. And over the past year, employment growth in the state was nearly identical to the national average.

What does that mean for the state? If strong growth is to continue, more and more of Wisconsin's working age people must participate in the economy in a meaningful way. In other words, they need to have the education and skills demanded by employers.

Wisconsin has been among the most innovative and progressive states in expanding education and skills. The W-2 program, for example, has been the prototype for welfare reform across the nation because it has been so successful in enabling public assistance recipients to enter the workforce and gain valuable skills. Some 75 percent of people who have left welfare since the inception of W-2 did so because they obtained jobs or had other income that allowed them to leave public assistance. More generally, education and training has been the hallmark of Wisconsin's workforce. In particular, Wisconsin's vocational education and community college systems are renowned, as is the state's pioneering school-to-work initiative.

Earlier today, I had the opportunity to visit Promega, a bio-technology company here in Madison. Promega has implemented an innovative program for attracting future employees to the bio-tech field by presenting special programs focused on technology topics to local high school and grade school students. As a result of programs like this, the proportion of Wisconsin's adult population with at least a high school degree—79 percent at last count—is significantly higher than both the nation and the industrial Midwestern states.

Despite these successes, the nation's shift toward the so-called "new economy" causes some anxiety among Midwesterners about the region's ability to sustain high income and growth into the future. How will Wisconsin and other Midwestern states keep its highly educated workers as well as attract such workers from outside the region? In this respect, Madison stands as something of a symbol of what can be accomplished. Madison has succeeded by combining a high quality of life with a concentration of innovative firms that provides the right jobs and job networking opportunities.

We've discussed how the Federal Reserve fosters sustainable growth. We've discussed how our nation benefits from those efforts. And perhaps, most importantly, we've discussed the pivotal role of price stability.

But how exactly does the Fed achieve price stability? For example, how does the Fed judge what growth rate is sustainable? Roughly speaking, we determine our economy's maximum sustainable growth rate 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.

Until a few years ago, productivity had been rising at an average of about 1½ percent per year for decades. That led most economists to believe that the potential growth rate in the U.S. was about 2½ percent. Today, many economists have higher estimates for potential growth because productivity growth has picked up significantly in recent years. In fact, productivity has risen at an annual rate of 3 percent since 1995, which is about twice as fast as the previous quarter century. And that translates into a significant increase in maximum sustainable growth during the most recent period.

Technological innovations spurred a significant portion of the recent dramatic increase in productivity growth. Technology changes 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 and implement business decisions. But the increase in efficiency we've seen since the mid-1990s can't be chalked up only to the Internet and hi-tech computer applications. We also 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, we couldn't sustain today's low rates of unemployment 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 we can sustain in the U.S. economy today without inflation rising and growth being curtailed. But the old belief that an unemployment rate of about 6 percent was as low as we could go without problems arising is surely out of date.

As I've said, increased productivity growth raises our potential growth, which represents the supply of goods and services we produce domestically. There's evidence, however, that demand was outstripping even this higher supply over most of the past two years. The presence of this imbalance was an important factor in recent monetary policy actions.

As you may recall, the Federal Open Market Committee raised its target for the federal funds rate six times between June 1999 and May 2000, from 4¾ percent to 6½ percent. At all four of its meetings since May, however, the FOMC has decided to leave the federal funds rate target at 6½ percent. The Committee continued to indicate that it believed the risks remained "weighted mainly toward conditions that may generate heightened inflation pressures in the foreseeable future."

Obviously, the Federal Reserve has evaluated many factors during its monetary policy discussions. For example, most of the available economic information since May has pointed to a moderation in demand growth from the frenetic pace we observed in late 1999 and early 2000. Combined with the boost to potential supply coming from increases in productivity growth, this meant that the imbalance between demand and potential supply narrowed considerably. Moreover, demand is likely to be tempered a bit further by recent tightening in financial market conditions. Indeed it's possible the economy could expand at a rate below potential for awhile.

At the same time, however, continued tight labor markets and higher energy prices still have the potential to raise inflation expectations. Thus far, productivity gains have helped contain higher labor costs. And there's very little evidence to date of any significant spillover from higher energy prices to so-called core measures of prices that exclude volatile food and energy prices, although we have seen such core inflation measures creeping up this year. On the whole, the economic environment seems to be in much better balance than it was in May, but the risk of heightened inflation pressures still dominates.

You might compare the issues facing the Fed to the challenges facing architects. Perhaps few architects understood as well as Wright how to mesh the competing demands of the trade. The design of this building, Monona Terrace, impresses me with its balance of functionality and respect for the natural environment. I know Wright's nearby German Warehouse and the Johnson Wax Administration Building are similarly lauded as successful studies in balance. In their case, they achieve balance of human and business needs—and still earn a timeless respect in the hearts of fans of architecture world-wide for their striking elegance.

So architects must meet the needs of the time without sacrificing 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.