

DRAFT - *Transcript of tape recording -- the final few minutes were not recorded.*
Jerry L. Jordan
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I want to spend a little time this evening talking with you about some things that are of a longer-term nature. Often at this time of the year people like to hear forecasts, well I used to do a lot of forecasting at my previous job, but I signed a contract saying I would never do that again. So if you came here tonight to hear an interest rate prediction, you are going to be disappointed. There are some implications to interest rates in what I have to say, but I don't predict numbers any more.

This time of the year in the fall people come back after Labor Day, the summer is behind you, the traditional family vacation time has ended, you start thinking about winding up the year, and looking out at the year ahead. The time people do budgets, profit plans, but also simply an assessment of where are we and how do things look based on starting point.

Four years ago, on November 9, 1989, we were looking at the tumbling of the Berlin Wall and on the 17th of November, the so-called Velvet Revolution in Czechoslovakia. There was a lot of worry at the time about the implications of this and what the Soviet response would be. How would we deal with this totally new era that we were going into since we had very little understanding of it?

Three years ago we were contemplating the implications of having Iraq position itself in Kuwait and the allies starting to mobilize for war, worrying about scud missiles, biological weapons, chemical weapons, and a lot of uncertainties. We had an oil shock going on at the time. People worried about the recession, they remembered the 1973 oil shock and recession, the 1979 and 1980 oil shock and recessions. So here we were, with lots of uncertainties.

Two years ago we saw the episode where Gorbachev was taken hostage by the thugs in Russia who decided they wanted to pull a coup with Yeltsin up on top of the tanks. That was kind of a scary environment. We didn't know what to make of all of that and what its aftermath and implications would be. It was hard to do planning then.

In September 1992, we saw the European exchange trade mechanism collapse. The hopes of a common central bank and a common currency of Europe evaporated overnight in a crisis. Those economies of the European community cost the central banks over a hundred billion dollars in just a few day's time. Then just a couple of months later in 1992, there was an election in the United States. We started thinking about the change in political power, the party dominating the White House as well as both Houses of Congress. Because there was a change in

the White House for the first time in twelve years, and the first time in a long, long time both Houses of the Congress and the White House were the same party, and we were trying to make sense of that and its implications.

Then this fall, the country was riveted for a few weeks on Michael Jordan's retirement. That tells us a lot about the world. I had actually thought in August that all of the emerging scandal which involved millions of teenagers around the world, brought together in solidarity over the accusations of Michael Jackson, as a world-changing sort of event. I was in Austria when that news broke. Every place all over the world people focused on Michael Jackson and Michael Jordan.

The same week that Michael Jordan announced his retirement, so did Bob Michael, after thirty years in the United States Congress. How many people knew that and the fact that the one story got a lot of attention and the other story did not? It says a lot about the world that we are living in, what's on people's minds, and that is good news. Those are the sort of things that do attract much attention from our media.

I've been at the Bank for almost two years and during that first year, but especially in the last year, there has been tremendous attention from the United States Congress on the Federal Reserve. They have introduced legislation recently to force us to stop clearing checks. Our role in the payments system was part of the original reason for creating the Fed eighty years ago. There is now legislation introduced by the Administration to take us out of the supervision and regulation business and consolidate that into a czar-of-banking kind of an agency. There is also legislation in both the Senate and the House to either remove the Reserve Bank Presidents from the Federal Open Market Committee process or to subject us to Presidential appointment and Senate confirmation. They are attacking us on all three of the basic businesses we are in--financial services, supervision and regulation, and monetary policy. There is legislation to change the composition of our Boards of Directors, to change the deliberation of the Open Market Committee, and to require more disclosure about the decisions that we make in the monetary policy process. When you look at all of this enormous flurry of activity with regard to the Federal Reserve, you have to ask the question, "what is bringing this all about and what is it that they are trying to address?"

So I stepped back and thought about putting together the remarks for this evening and I started to think about how the economy will end up in 1993? How does the situation look going forward--sort of an assessment of the problems.

Inflation is the lowest in thirty years and it has been declining for thirteen years and our goal is to take it down even further. Bond yields are the lowest since the early 1960s, short-term rates are even lower and are the lowest levels in about thirty-five years. Mortgage rates are the lowest since the middle 1960s. Home affordability is the best it has been in about 25 years. As a result, existing home sales are the highest in 15 years, new-home construction is up sharply for the first time in five years, about a 20% increase in housing starts. Domestic auto producers are having a booming year, taking back market shares from foreign

competition. We dropped about six percentage points of the share of the U.S. auto market. The foreign component has dropped by about 6 percentage points as the big three especially are reasserting themselves and having a tremendous year. For exports, business investment spending is exploding both for domestic and international purposes. Our capital goods industry is having probably one of the best time booms. Ohio is one of the biggest capital goods producing regions in the world. Our exports of capital goods, machine tools and all sorts of other things are increasing in double-digit annual rates, especially to Latin America and also to Europe. Productivity in the manufacturing sector rose to the highest level in the last decade. The level of our manufacturing productivity is substantially higher than Germany, Japan or any place else and is rising very sharply. Real output growth last year was 4%, the highest in four years and it looks like we will have another good quarter. Employment has increased almost two million people this year. Unemployment has dropped a full percentage point. And Congress is damn mad and determined to put a stop to all of this!

It is difficult for us to understand what is going on out there and it is difficult for us to explain it to a lot of people as to what our sense is and how we read the environment. But it is especially hard for us to understand what goes on in the minds of our elected leaders as to what the problem is and what it is that needs fixing. So I am going to talk about the way I, at least, view the policymaking arena as we finish the 20th century and some of the challenges that I see for us quite aside from the legislative initiatives I have outlined.

At the beginning of the century, the economically efficient marketplace that was natural to serve was often a town, a village, or a city. Seldom was it as large as what we would call a state or a province or certainly not a large country like the United States. Often even small countries were a relatively large area for most goods and services and today, of course, it is the world for so many goods and services. The naturally efficient marketplace has no borders any longer and we are still trying to understand the implications of that. Not just in financial services, which is the most obvious, but in a lot of other products and services. Certainly in all of the entertainment fields, communications fields, and so on.

As the century got started we measured the wealth of a nation in terms of tons of things and numbers of things. We set up a national income accounting system designed to count the number of logs, tons of iron ore and bauxite, copper ore, wheat, and so on. The idea was the more natural resources that you had, the more raw materials you had, the greater your chance of having prosperity and a higher standard of living. By that kind of logic, you would have expected by today that places like Russia, Brazil and Africa would be the richest places on the globe but it didn't work out that way. It turns out that natural resources and raw materials have nothing to do with the wealth of nations as the 20th century comes to an end. Instead, it is the knowledge-based or information-based industries where we see the true value added that goes into raising standards of living. There is some extraordinarily excited prospects ahead but we really don't know how to assess some of the implications of all of the things we are seeing now about the information highways, electronic technology.

It is easy for us to look around and see the places that have prospered very well and are quite small and often devoid of natural resources, like Switzerland, or most of the Far East Asian countries. Certainly Japan is larger but still without its financial resources they import 100% of their oil, 98% percent of their energy, iron ore, copper ore, food stuffs, etc.; the value added in Japan is human capital. It is their people and the quality of their educational institutions that determines their well being. That is something that we have to accept as a major challenge to us as we try and compete in this new kind of global economic village.

There have been two watershed decades in our thinking about what creates wealth in this decade and what is the right way to organize political and economic affairs. The first was in the global depression of the 1930s. It truly was a global depression. It was worse in the United States and some other places but virtually there was no place to escape. During that period we saw massive increases in the intrusion of government in our lives. Either government nationalized everything in sight and tried to run it as the collectivized enterprise in a command control setting, or they at least set up a pervasive regulatory environment where agencies decided what you could produce, where you could produce it, how much you could charge for your products, how much you could pay your workers, what interest rates you could pay, and what interest rates you could receive. They fragmented all kinds of industries in the United States and elsewhere around the world. The mindset for several subsequent decades was that governments cause growth, governments create wealth, and governments create jobs. We live with an economic paradox well into the 1970s, heading into the decade of the 1980s, with that being sort of the conventional wisdom. But the 1980s was the next watershed decade for the world. And again, it was a global depression for a lot of places. It was far worse outside the United States than it was in even some regions, including this one, which suffered greatly in the early 1980s. But it was far, far worse in other places like most of Latin America, certainly in Russia and Eastern Europe, places that were devastated by economic conditions. And out of it came a new thinking about the role of the state and economic growth, as well as economic prosperity. Those places that started to strengthen market institutions, reinforce private property rights, use the price system to just let markets decide where resources should be allocated and what should be produced, started getting the best results.

The process became one then of economic regeneration, sort of a biological analogy as to a renewal kind of a process. There were three basic components of that: one of them was deregulation. It actually started in the late 1970s back in Carter's Administration, but gained momentum in the decade of the 1980s. We then had denationalization of what the British popularized as privatization, of getting the ownership of the means of production out of the hands of the state. That is still predominately a worldwide trend. Third, tax reform and tax reduction, especially marginal tax rates on earned personal income, and except for some recent developments in the United States, you find no exception to that anywhere in the world. You do not find government reregulating industries or increasing the degree of regulation. You do not find governments nationalizing industries or taking control of them. They are either denationalizing, deregulating, or doing nothing. Most other places are still in the process of tax reform and tax reduction.

I don't think that that basic trend is going to be changed. It will be sustained in the future in the sense that it is being driven by global market forces. It's sort of like a mighty river that meanders and occasionally spills over its banks and goes on switching here and there, but that it's got an ultimate inevitability about it, that it will reach the sea at some point. In my mind that is a much more liberal economic order, a higher degree of economic stability and therefore prosperity than the world has ever seen.

I think, in time, we will start to think of the end of the 20th century and heading into the 21st century as the dawning of the golden age of capitalism. There's still a very good chance that when all is said and done and we look back on this period of time, we will think of the 1990s as being the most prosperous decade of the century, certainly rivaling the 1920s as a period of extraordinary prosperity. As recently as five years ago, it was estimated that less than 20% of the world's roughly five billion people lived in an economy that we would call democratic and market-oriented. Today, it's well over half of that depending on how you want to count various regions of China and India and various parts of the 15-odd republics of the former Soviet Union and their stage of evolution into a more democratic institution and market system. But we know the direction that they are going. And if they do so we know that markets have a much greater capability of generating wealth and prosperity than does the state, so the whole world is in the process of an age that I think none of us have the ability to anticipate its implications.

In a macroeconomic sense, I am increasingly convinced that we have entered into what I think of as a narrower corridor of major, macroeconomic variables--the ways that we measure economic activities. Think of it in terms of smaller amplitudes of the fluctuations of things like inflation rates, interest rates, output in employment growth rates, unemployment rates, exchange rates, and those other things that we became so concerned about in the 1970s and for much of the 1980s, and the inability to predict and react to those things. We have fewer degrees of freedom about the way that we conduct so-called macroeconomic policies that never before were constrained in ways that we never were before and this is healthy. This is forcing a convergence of economic policy actions of major countries around the world and institutions within those countries like the central bank or the fiscal authorities--agencies like the World Bank, International Monetary Fund, etc.

It's all being driven by the so-called globalization phenomena. That's a buzzword of about five years ago, e.g., globalization of goods markets, international trade, globalization of financial markets, globalization of asset markets, foreign investments, etc. Probably the most graphic example of the importance of this phenomenon was on October 19, 1987 when 28 stock markets around the world crashed on the same day. It was estimated in the United States alone, that a trillion dollars of wealth was wiped out in one session. There were all kinds of scary stories of what the implications were, it was 1929 all over again, and it was interesting to try to unravel what caused that and what were some of the implications of the aftermath.

No one has a convincing story, but one aspect of what was going on before the crash was that the United States and Germany, in particular, were getting increasingly vocal about coordinating economic policies. At that time, our Minister of Finance, James Baker in the Treasury Department, and Stoltenberg, the Minister of Economy in Germany, were shouting at each other on CNN and in the New York Times about coordinating and changing policies. The world saw these economies as out of sync; they didn't like the implications and they delivered a message that could not be ignored anywhere. So those ministers of finance shut up and were never heard from again.

It had been said for decades that when the United States sneezes, Europe or Japan catches pneumonia. And once upon a time we could practice sort of economic empiricism. We could pursue our economic policies for our own self interest and the rest of the world had to like it or lump it. They had to adjust to what we were doing. In the 1970s all of Europe and elsewhere worried about importing U.S. inflation after what we did in the 1960s. They were increasingly concerned that the United States really didn't care about the effects of its policies on the rest of the world. But today, the first thing we want to know when we get up in the morning is what happened earlier in Tokyo, Frankfurt, Paris, London and Rome and so on because the way New York opens depends crucially on what happened earlier in that same day in these other markets around the world. As things are shutting down in Los Angeles at 5:00 p.m., it's morning already in Sydney, Tokyo and Hong Kong. So it's a continuous open book. The financial markets really do not sleep in any serious sense. With the sustained progress we have had in the United States, moving in the direction of price stability, while maintaining a degree of growth and prosperity at the same time, we are seeing a vast increase in what I think of as the dollarization of the world.

It has long been the case that major international commodities like oil are denominated in dollars for international purposes. When the Japanese buy oil from Iran, they pay for it in dollars. But now in the last four years, especially since the Berlin Wall came down, it's right down to Federal Reserve Notes.

It's estimated that today 70% of the Federal Reserve currency outstanding is held outside the United States. The amount that we have printed and is in circulation is equal to about \$1,200 for every man, woman, and child in the country at all times. During the last four years, about 90% of the increase has gone outside the country. The world is using our currency as their currency. It started in such places as Argentina, and the Philippines and as the Wall came down we saw it in Poland, as well as other places in the former Soviet Union. Today we think there may be as much as 20 billion dollars of our currency in Russia alone and we don't know how much is in the Ukraine, Georgia and Azerbaijan and all of these other places. It has become the numeraire or the standard of value, the unit of account for all of these people. They may consummate or execute a transaction in the end in pesos, rubles, swatis or whatever else is the local currency unit, but they decide on how many of those based on what the current exchange rate is in terms of the U.S. dollar. In Russia they call them greenies. I may not know what a dollar is worth, but the Russians do and they care and it matters. What that

means, is when we conduct monetary policy in this country, we're conducting monetary policy for the world. What we do to our currency over time and its purchasing power affects the entire global economy.

Twenty two years ago, we unhooked the U.S. dollar from gold. In the Post World War II system, the U.S. dollar had been defined as 1/35 of an ounce of gold. Trying to prevent a repeat of the Great Depression, they thought that we needed to have an anchor of stability, a linkage to gold, something that was not a fiat or a political thing. And we defined, in setting up the governments of Germany and Japan after World War II, in units of the U.S. dollar. In 1945, Germany and Japan had a common currency. It was called the U.S. dollar, but we gave it a different name.

In Germany the Deutsche Mark was 1/4 of the U.S. dollar, and in Japan, the yen was 1/360 of a U.S. dollar. Does anyone know how McCarthy came up with 360 as the number of yen to the dollar? It's the most divisible of all numbers. So he didn't know what it would be. It's like the compass. If we don't know what we want to do with this, we might divide it by 15, 20 or by whatever kind of a number to get it right. Let's start off with 360. It lasted for a few decades and it was as good of a theory as any. That system served fairly well during sort of the reconstruction period of the first couple of decades after World War II. But it was not serving the purpose of the world and, into the 1960s, certainly constrained the politicians in the United States.

The Johnson Administration did not like the discipline imposed by the gold cover so they got rid of it because of a desire to finance the great society and the Vietnam War by basing our currency, and we lived through a long period, about 15 years or so, of a learning process of trying to find a new anchor for our currency. Policies were pretty bad during most of that period. But now, over the last 13 years, we started to make very substantial progress to once again reinstitute an environment where we have, in effect, a nominal anchor and one that I think we start to have more confidence in than we had even in the gold standard. You could get rid of the gold standard because it was a politically designed institution. The new discipline, the financial market vigilantes, is not a politically designed institution. It is a market-driven institution, and it is extraordinarily important to the way things are going to be done in the future.

Our view here is that the nations, or in this case the world's unit of account or standard of value, is just as important as the various weights and measures. Can you imagine if Congress were to hold hearings and say "well, over the next few years, how many inches should there be in a yard, or feet to a mile, or ounces to a pound?" What a silly idea. There are certain things that you want to know with a high degree of certainty. So we set up standard units of weights and measures that are not subject to change for any reason.

Suppose when the worker was paid after working all week long on Friday afternoon, you go to the plant gates or the office door to be paid and you spin the roulette wheel. How many units you got depended on where the wheel stopped.

Then you went into the shoe store, or the restaurant and when it came time to pay you spun the wheel. What a nutty world. It wouldn't work, of course. We want to have a high degree of predictability about the unit of account--the purchasing power of our currency.

The parents of a baby born today have to think in terms of 18 years from now, what's it going to cost to put this kid through college? Senator Sarbannes, earlier this year in some hearings in Congress said, "what's so wrong about 4% inflation? Four percent is not so high. None of my constituents are writing to me about 4%." Four percent cuts exactly in half the purchasing power of the dollar in 18 years, which means that the parents of a baby born today has to save exactly twice as much in order to pay for a year's college as they would if there was a stable purchasing power of the currency.

What we're trying to institute is a regime in which people can base their decisions on the expectations that in the future the most likely purchasing power of the currency, on average, is the same as it is today with the same degree of confidence that they think about the number of ounces in a pound or in a gallon and so on. But we don't have that world today. That is part of our challenge. How do we convince people that that is where we are headed?

In the 1950s and the early 1960s most people in the country treated increases in interest and inflation as something that was temporary knowing that they would go back down. Households and businesses based their decisions on the future, on the expectation that inflation and interest rates will go back down from where they are today. That has not been the case in the United States in a long time and it is not the case today. If you look at forecasts today of the blue-chip economists, the National Association of Business Economists, or all of the various organizations that summarize forecasts, if you look at the Michigan survey on household sentiment, if you look at the business roundtable leaders' projections for the next year and how they are basing their plans, they all suggest that inflation and interest rates will go up next year. But that's okay. They did it for the last three years and they were wrong. We've had 13 years of falling inflation and interest rates and still people are saying, "but this is as low as it gets." From here on, it's going up, even though they have consistently been wrong.

In addition, we look at other things--we look at the steepness of the yield curve, we look at the level of long-term government bonds, we look at record- and home-mortgage refinancing. Refinance now since rates aren't going any lower. We look at the record corporate calendar issue. If you need long-term money, get it now and get your bonds because from here on interest rates are going up.

As long as that is in people's minds, our job is not done. Our job is not to stabilize the consumer price index or any other particular measure. Our job is not to hit any kind of various monetary targets or other kinds of measures of monetary policy. Our objective is to influence the mindset of the American people, to create the environment where people once again can expect that any increase in inflation will be temporary...