\mansfld

Improving the Prospects for Prosperity

Jerry L. Jordan
President and Chief Executive Officer
Federal Reserve Bank of Cleveland

presented to
The Economic Club
Mansfield, Ohio

Noon
Friday, October 3, 1997
Holiday Inn
Mansfield, Ohio

Notes

Bill Jilek, president of Richland Bank in Mansfield, asked you to give this speech. He will be your host and will introduce you. You met him at our bankers meeting in Marion, Ohio on May 15, 1997. You might want to read the attached article about him and his bank from the August 1997 issue of *Ohio Banking News*.

The group is The Economic Club (not Economics Club or Economists Club) It is comprised of business leaders, not economists. The local banks have also invited their advisory boards and boards of directors to attend this meeting.

The meeting is at the Holiday Inn in downtown Mansfield on Park Avenue West. Scott has given Pat directions on how to find that street.

The luncheon begins at 12:00. You will be introduced about 12:25. You can speak for 20 to 30 minutes and then do Q & A. The meeting adjourns by 1:15.

Club meetings are organized by Suzanne Davis of the Mansfield Chamber of Commerce.

Introduction

Thank you, Bill. I'm pleased to have this opportunity to address the Economic Club.

I met Bill at a meeting of a group of bankers in Marion last May [5/15/97]. That was when Bill invited me to meet with the Economic Club.

That meeting with bankers was one of a series of meetings that the Federal Reserve Bank of Cleveland has periodically around the Fourth Federal Reserve District to exchange views with bankers. In addition to those bankers meetings, we actively seek input from our boards of directors and advisory councils, and through our conversations at meetings such as this. All of this is part of the Federal Reserve System's ongoing effort to stay actively in touch with the business and banking community. What we learn at such meetings helps us in our three roles of monetary policy, bank regulation, and provision of payments services.

My comments today are about "Improving the Prospects for Prosperity." My focus will be the longer-term -- specifically, what we have learned about economic policies that foster prosperity and about economic policies that hamper prosperity.

Time: (perspective of audience different than speaker)

Economist/North Dakota

No Forecasts/Statistics:

learned some time ago that there are 3 kinds of central

bankers:

1) those that are good with numbers;

2) those that are not good with numbers.

Used to think -- joke -- letter to returning directors.

In about 15 years, my two new granddaughters will be sitting in a classroom somewhere listening to a teacher trying to explain the 20th century. Of course, they'll be way ahead of the other kids because I've already explained it to them.

Much of this century involved a contest of ideas about the relationship between the individual and the state:

- in political affairs, a contest between democracy on one hand and various forms of dictatorships on the other;
- in economic affairs, a contest between markets and socialism.

In this final decade of the century, the contest is over; democracy and markets will be the dominant political and economic regimes of the 21st century.

About seven years ago, the then Finance Minister of newly liberated Czechoslovakia said that they were going to create a "market economy without adjectives." I'm sure people had at least two thoughts about that phrase. One was that they did not know what it meant. The second was that they did not think it would happen.

The events of this last decade of the century suggest that not only the Czech Republic, but also many other places, will have in the 21st century a "market economy without adjectives."

<u>A Contest Is Won</u>

In just about a month we will recognize the eighth anniversary of the dismantling of the Berlin Wall (November 9, 1989), symbolizing the failure of communist central planning and the demise of the Soviet Empire.

Imagine the reaction of students just a few years from now, in the early years of the next century, as high school teachers recite Winston Churchill's 1946 observation that an "iron curtain had descended through the middle of Europe."

On the other side of curtain there was a bleak scenario, where people were denied many rights:

- private property was illegal; people could not own apartments, shops, or farms; ["DUMB"]
- individuals could not buy products made in Western countries;
- workers could not change jobs or "go into business";
- people could not simply decide to move from one city to another; they were even forbidden from traveling outside the Soviet Union;

- people could not receive radio or TV news programs, newspapers, magazines, MTV, movies or any other information from the West.

Imagine the students' surprise in learning that a major city in the middle of Europe--Berlin--had a wall running through middle of it for more than 25 years that prevented people on one side from shopping, working, or even visiting friends and relatives on the other side. The reaction of the 21st century teenagers will undoubtedly be that such a regime was obviously "dumb and unworkable."

The crumbling of the Berlin Wall will be treated in history as a major political event, but equally intriguing are the underlying forces at work that produced the political event.

In his book, *Turmoil and Triumph*, former U. S. Secretary of State George Schultz described his first meeting with Mikhail Gorbachev.

Schultz explained to Gorbachev that the accelerating pace of technological change in information and communications was difficult for even the United States to keep up with, compared with places like Taiwan, Korea, Singapore and Hong Kong. Old Western Europe was falling behind the "Asian tigers," and for the socialist/communist, top-down, command-and-control economies, the situation was hopeless.

Gorbachev might have already recognized the power of such forces, and not long after taking power, he launched his Glasnost and Perestroika reforms in an ultimately futile attempt to put some flexibility into the Soviet economy.

After four decades of Soviet isolation, it finally seemed as though the political leaders one day simply said, "never mind -- it was all a big mistake," and the Iron Curtain suddenly collapsed--symbolized by the physical destruction of the

Berlin Wall.

The intrusions of the state in the economy were most extreme in the Soviet Union, but government suppression of personal and economic liberties occurred almost everywhere.

The 1930s was a watershed decade around the world. In the midst of a worldwide economic depression, the response of most countries was to greatly increase government intrusion into such decisions as what could be produced and where, how much things would cost, how much could be paid for labor, what interest rates could be paid or received, and even how much profit could be earned.

In U. S. monetary affairs for example,

- for more than 40 years, it was illegal for Americans to own gold; (I've tried to explain)
- for 50 years, the government set a maximum interest rate that people were allowed to earn on their savings;
- arbitrary regulations made it uneconomical for banks to issue traveler's checks;
- some institutions could make mortgage loans, but not car loans;
- some institutions offered savings accounts, but not checking accounts; withdrawals were made only in currency or in a check that you then deposited into another institution so you could write a check to pay for something;

- across the state line, you could make a withdrawal from your account, but you could not make a deposit. To each of these prohibitions, my granddaughters will say, “that’s dumb”.

But that is all in the past. For the future, allow me to suggest some specific rules for fiscal policy and monetary policy in the coming decades.

Clearly, political institutions encompass organizations and rules that affect prosperity.

•If rules improve markets---they enhance prosperity.

•If they interfere with markets---they hinder prosperity.

As we are trying to teach the newly liberated countries of the former Soviet Union, Government rules are essential to the functioning of a market economy; government provides the “economic infrastructure” essential to capitalism.

Examples of prosperity-enhancing rules are:
•Property rights
•Contract enforcement by impartial judicial system
•Freedom of speech and press
•Standards for weights and measures, generally accepted accounting principles

Examples of prosperity-hindering rules are:

- •Wage and price controls
- •Interest rate controls
- •Credit allocation and industrial policy
- •Controls on foreign-exchange transactions and capital flows
- •Trade restrictions, whether in the form of tariffs, quotas, or other barriers to free exchange of goods and services.

Unfortunately, policymakers often try to:

- •Help the already prosperous by restricting competition.
- •Help the less prosperous through wealth redistribution rather than wealth creation.
- •Gain political support through policies that help in the short run, but hurt in the long run.
- •Solve problems by imposing more rules.

The experience of the 20th century shows that successful policies are those that enhance the effectiveness of markets.

The three broad trends that are sweeping the world are deregulation, denationalization/privatization, tax reform/reduction [rel. size of government sector trending down].

Economic Policies of Government

Our experience of the past few decades has taught us specific ways that monetary and fiscal policies can improve the operation of markets and thereby enhance prosperity.

- • A good place to start is with clear rules that limit the use of discretion by monetary and fiscal policymakers. Activist, discretionary, stop-and-go monetary and fiscal policies of the past have done more harm than good.
- •

- •Under clear rules, households and businesses would face less uncertainty and make better decisions about consumption, saving, investment, and production. Also, fewer short-sighted, politically motivated policies would be imposed
- •Monetary policy should pursue sound money. It should seek to create conditions where businesses and households make decisions about the future

with confidence that the purchasing power of the currency will be about the same as at present.

Sound money enhances prosperity in several ways:

•It avoids capricious redistributions of wealth.

•It ensures that resources won't be wasted in an attempt to avoid redistribution.

•It encourages saving and investment (inflation interacts with the tax system to discourage saving and investment).

•It facilitates planning of production, consumption, and saving.

In an inflation-prone regime, business leaders say "we are losing (or not making enough) money, so we'll have to raise our prices." In a stable-money environment, they say, "we'll have to become more efficient and productive--and cut our costs."

The only sustainable pro-growth, pro-employment, policy is stable money. Throughout the world, where governments have mandated that their central banks maintain a sound currency, the mandate has increased the credibility of the commitment.

•Greater credibility facilitates achieving sound money by reducing the costs of transition.

Where governments have mandated that monetary authorities have no objectives regarding short-run growth of output, employment, or other real magnitudes, sound money has helped with all of these objectives in the long run.

•Attempting to use monetary policy to pursue them directly in the short run would impede their achievement in the long run.

A Fiscal Policy Regime

Our past experience has also taught us some things about fiscal policy. Governments are learning that they cannot manipulate a budget deficit for countercyclical purposes.

•There is no balanced-budget multiplier.

•There is no deficit-spending multiplier. Few people believe deficit spending has any lasting stimulative effect on economic activity: Any effect is transitory and quickly reversed.

Imagine an economics teacher in the 21st century explaining to incredulous students that back in the 20th century, conventional textbooks taught that increasing the relative size of the government sector was stimulative to the economy, and that deficit financing was even more stimulative!

Tax and spending proposals are now evaluated for their effects on incentives and resource allocation.

•They can affect incentives to work, save, and invest.

•They can shift resources between consumption and investment.

In these ways, government spending and taxing can change the long-run growth path of output and thus affect our standards of living over time. 1980's: Chairman of the U.S. Senate Finance Committee: encourage/discourage -- sin tax. (alcohol & tobacco)

Working, saving, investing, inventing, innovating, or owning and using productive resources -- (anti-social).

Politicians must learn to accept that:

•To tax something is to discourage it.

•The primary incidence of taxation should fall on consumed income.

•A tax burden on individuals can't be avoided by levying taxes on businesses. Only individuals ultimately pay taxes.

•Tax policies should be evaluated by considering whether individuals bear the tax in their roles as workers, consumers, or investors.

Policymakers and voters should not act on the myth that the burden of taxation is determined by the current level of tax revenues. The true tax burden is determined by the amount of government spending. Ultimately, all government expenditures must be financed by:

1. present or future explicit taxation;
2. government money creation-- inflation; or
3. unilateral transfers or gifts from foreign sources.

Actions that reduce current tax revenue without decreasing either present or future government expenditures, do not constitute a reduction in actual tax burdens.

Conversely, decisions that reduce either the current level or the growth of government expenditures, from what they otherwise would have been, are a genuine reduction in tax burdens, even if explicit tax revenue is not altered.

Deficit spending should not be thought of as an alternative to taxation.

•It is a method of deferring explicit taxation, or
•It can encourage taxing through inflation.
In that sense, inflationary monetary policy can be viewed as an instrument of taxation.

Conclusion

I'd like to leave you with a few general observations:
•Government does not cause growth to occur.
•Government does not create wealth.
    •Government intrusions that interfere with the functioning of markets lower our standards of living.
    •Often government regulations have reduced the natural discipline and regulation of market forces.

Rules that enhance the functioning of markets are much more essential to economic prosperity than are politically created and controlled organizations, no matter how well-intentioned their missions.

Back in the 1920s, the Italian dictator, Benito Mussolini

19th Century : Civil Liberties
20th Century : State
21st Century : Markets