

Remarks by
William J. McDonough
President
Federal Reserve Bank of New York
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It is an honor and privilege to accept this award from such an outstanding graduate school of business in this, the world's greatest city, a business school which has provided many fine graduates for the Federal Reserve Bank of New York. I am doubly rewarded by sharing the receipt of this honor with my friend and a truly outstanding investment banker, Lionel Pincus.

I was a member of the advisory committee at Northwestern University's Kellogg School of Management when Meyer Feldberg came to the United States and began at Kellogg a career which has been remarkably brilliant. His leadership at Columbia is extraordinary, but that should not be a surprise--he is an extraordinarily gifted man whose work ethic matches his great natural gifts. Like me, he has the delightful problem of being frequently called his wonderful wife's husband, but what more agreeable way to be reminded of the virtue of humility.

We in America find ourselves in an unusually positive--and unusually challenging--moment in our economic history. Not only are we in the eighth year of an economic expansion, but we have the lowest unemployment rate in three decades and the highest labor force participation rate of our adult population since the Second World War, when the labor force included all the millions of Americans in uniform.

The inflation rate has been trending down, something all economic models say is not possible when the economy is growing so rapidly and the unemployment rate is so low.

We are the envy of the world in creating this economic marvel. The market economy which we champion is acknowledged everywhere as the economic model, in fact, the only economic model which really works--and works well. Our challenge in this position of world leadership is to avoid American triumphalism and not to pretend that our economic model is perfect or that it can be applied in each and every detail in countries with very different histories, cultures and values. I believe that the main thing we have learned in the United States, and that is applicable elsewhere, is that the market place is better at allocating scarce resources than any version of a command economy, whether the commanders of those economies are party officials or finance ministry bureaucrats. The market does not always get it right, but it punishes mistakes quickly and relatively cleanly. Not many Edsels were produced. Although we, like many countries, had a property development boom in the 1980s which bankrupted developers and seriously weakened our banking system, we recognized it, fixed it and restored our banks so thoroughly that the American banking system has never been stronger.

A decade ago, many thought that one or more versions of the Asian economic model were preferable to the market model. Clearly, the lesson of the extended economic weakness in Japan and the crises in a number of Asian countries is that any version of a command economy seems to lead to overinvestment in government-preferred sectors of the economy and a weak financial system. The weak financial systems should not surprise us, since a characteristic common to all command economies is that the banking system is used as the channel by which the savings of the people are sent to the business sectors chosen, not by the market, but by politicians, elected or otherwise, and by public servants. When things go wrong, these "policy" loans become bad loans very quickly, seriously endangering the banks.

Although, as I saw ten days ago when I visited South Korea, the external sector of that country is turning around quickly and well, the restructuring of the domestic economy will be long and arduous. The country has the great fortune in having in President Kim Dae Jung a leader who is fully aware of the challenge of restructuring the Korean economy and who, I am convinced, is ready to meet that challenge with strong leadership and personal courage.

The world is also fortunate to have, as the new head of government in China, Premier Zhu Rongji. We have met a number of times, most recently two weeks ago, and each occasion has strengthened my belief that he has the ability to be successful in carrying out the huge task of transforming China's economy, weakened by highly inefficient state-owned enterprises, into an economy in which resources will be allocated more appropriately and methods of production and distribution will be modernized.

A challenge in many of these developing countries, including those of the former Soviet bloc, is the creation of a banking system in which real bankers make real decisions on the credit-worthiness of prospective borrowers. This practice really does not exist in a command economy of any nature, so, not surprisingly, there are very few, and, in some cases, no real bankers available. Creating a banking system that distributes capital strictly on the basis of credit-worthiness and a supervisory structure to oversee it is, I believe, the single biggest challenge in these countries, one which cannot be solved quickly.

In our own country, even with our relatively strict adherence to a market economy, we have two important structural problems that we need to confront. First, our households do not save enough to finance the investment we need to keep our economy growing and vibrant; we import year after year other nations' savings equal to about 2.5% of our gross domestic product. As a result, the United States leads the world in external indebtedness, a position of leadership in which we should take no pride. We manage our economy well enough to make the United States a preferred place to invest, but this need to import capital is a problem related to our very culture which over time we must solve. We have already taken the most obvious remedial step and we should be proud of it. We have ended three decades of public sector dissaving and balanced the federal budget. In fact, in this fiscal year and probably for the next few, the United States is in fiscal surplus at the national level and overall state and municipal level as well. But this relief will not last for long unless we take steps toward resolving imbalances in funding health care and social security. I hope we find the political will to do that.

Our other structural problem is that we have worsened the share of the income distribution going to the least fortunate 20% of our society. What can all of us do about that? The most obvious thing we should not do is to remove incentives from those who produce wealth by confiscatory taxation or ill-advised government interference in the economy. But there are things we can do.

I will start with what the Federal Reserve can do. As the central bank of the United States, the Federal Reserve has been entrusted with the conduct of monetary policy by the American people through their elected officials. We are a highly independent central bank, that is, independent from political interference by this or any other Administration. We report to the Congress, and, through the Congress, to the American people.

The laws under which the Federal Reserve operates set out a variety of goals, all of which come down to our having a mandate to promote sustained economic growth. We are, therefore, in the business of promoting growth and especially the creation of jobs. Note that I use the words "promoting growth". Monetary policy cannot by itself create growth; increases in the labor force and increases in productivity, output per worker, are the only sources of new growth. What we can do is provide an environment of price stability as the means to achieve our goal of sustained economic growth. Stated in negative terms, we avoid creating a financial environment in which resources are so stretched that inflation increases, which inevitably leads to an economic slowdown or recession.

Some central banks have an inflation target, a numerical goal. We define price stability in words: price stability, as Alan Greenspan has stated, is achieved when businesses and households make economic decisions without having to be concerned about inflation. In my view, we are in a period of price stability. The job of the Federal Reserve is to maintain price stability through the one instrument we have: control over short-term interest rates. We should raise them when and if it is appropriate--and we should lower them when and if that is appropriate. I assure you that, as the Vice Chairman of the Federal Open Market Committee, the monetary policy committee of the Fed, I will do everything in my power to keep us on the path that has served our economy so very well over recent years.

What is the connection between sustained economic growth with price stability and the least fortunate in our society? It is, in fact, very direct. The poor live basically on low, fixed incomes, such as welfare payments and relatively low-paying jobs. If inflation picks up, they have no power to increase their incomes and so they lose purchasing power as price increases accelerate. When the recession comes, they are the first to lose their jobs. They lose as inflation goes up, and then lose again as it is forced down. I know of no better reason for price stability than avoiding this whiplash, which primarily affects people who have more than their share of problems already.

The other direct relationship with helping the less fortunate is that a very low unemployment rate and high work force participation mean that employers must go and find workers even if such workers need more training than people with more education and more work experience. That brings into the labor force--and into fuller participation in the benefits of our great country--people in inner cities and poor rural areas who have not had this chance in the past.

There is a lot more that all of us fortunate enough to be here tonight can do for the less fortunate.

As senior officers of important organizations in this great city, we can assist in many ways and not just by making charitable contributions, no matter how needed and how important those are. We also must involve ourselves, and, through our example, encourage the people who work with us to do the same. I particularly commend those of you who have contributed to the now \$10.5 million fund to back community development corporations. Inner city communities need jobs, as well as better housing, better personal safety and better schools. In these areas, grass-roots community-based not-for-profit organizations make an important contribution.

My choice for greatest importance and greatest leverage of financial and personal effort is to get our backs behind the New York school system. With a courageous and gifted school commissioner and laws making it possible for him to have more influence, this is the time to increase school-support programs of all types, especially jobs for new graduates and internships during summer holidays. A young person working in our companies, motivated by association with the best of our people, is going to learn skills and habits which will last a lifetime, making that person a good candidate for long-term employment, with the possibility of rising to the very top. Note that in working directly to improve New York schools, we are helping to solve a real problem for all of our companies, the availability of an adequately trained work force.

America is a great and wonderful country. It is great and wonderful because the best of the people who live in it give others a chance to participate fully in our country's many benefits. The optimum way I can thank all of you for the great honor you have bestowed on me this evening is to devote myself more fully to that goal.

Thank you.
