Speech by

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I am pleased to be here this morning to address the Annual Outlook Conference of the Mortgage Bankers Association. I am delighted that mortgage banking continues to be an innovative and strong industry in the economy. The long-run growth record of your industry is clearly very impressive the mortgage bankers share of the primary mortgage market is now around 50 percent, up from below 20 percent in the mid-1970s.

In my remarks this morning, I would like to step back a bit from current developments in the economy and financial markets, and offer a somewhat longer term perspective on the role of monetary policy in achieving and maintaining a noninflationary growth environment. I also will touch on another subject of importance to us all, the economic and financial well-being of weaker segments of our society and the challenges we face in promoting growth and job opportunities in our cities and local communities.

I am quite encouraged by the recent cyclical performance of the economy. Monetary restraint in 1994 brought about a much needed slowing in aggregate demand that had started to run well

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ahead of the economy s potential. Such restraint was clearly needed to contain emerging inflationary pressures and to consolidate progress in reducing inflation since the early 1980s. The transition to sustainable growth now seems to have been completed, with only limited potential at present for accelerating inflation. While monetary policy must and will continue to be disciplined, the long-sought soft landing appears to have been achieved.

One of the most heartening features of the current expansion is the continuing good news on inflation. In fact, recent inflation rates are the lowest in a generation. Consumer price inflation is now running below 3 percent a year, and with very small increases in labor costs due both to strong productivity growth and modest growth of compensation I do not see conditions in place for much deterioration in the near future.

I am convinced that much of our success in containing inflation in recent years reflects monetary policy actions that pre-empted inflationary pressures before they actually showed up in general prices. The pre-emptive policy approach was highlighted in early 1994 when the Fed began firming monetary conditions because of our concerns over inflation re-emerging. While there was no apparent acceleration in actual price inflation at that time, the buildup of underlying inflationary pressures was evident in various forward looking indicators and forecasts of the economy.

The main reason we need a pre-emptive approach is that monetary policy works with uncertain and long time lags. Estimates of these lags vary widely, but most of the effect of monetary policy on economic activity seems to take place within one to two years, and its impact on inflation usually takes longer. Thus, I think the appropriate horizon for Federal Reserve policymakers is one to three years.

The inflation experience of the last two decades has strengthened the case for a pre-emptive approach to monetary policy. Specifically, that experience indicates that an overheating economy has a much stronger effect in raising inflation than subpar growth has in lowering inflation. This asymmetry reinforces the need for pre-emptive monetary policy actions because failure to contain inflationary pressures at an early stage makes it much tougher to deal with inflation at a subsequent stage.

The historical inflation experience also has built up broad professional and public support for the need to achieve and maintain low inflation or price stability. Most elected officials, economists, and the general public have become much more aware that the economic and social costs of even moderate rates of inflation are pretty substantial. These costs result from a variety of sources: deleterious effects of uncertain future prices on long-run business decisions and economic growth; problems caused by inflation for nominal contracts; distortions associated with the interaction between inflation and the tax system; and, more generally, the reduced effectiveness of the price and market systems.

While it is difficult to quantify the adverse effects of inflation on the economy, empirical analysis suggests that such effects can be quite significant. For example, estimates of the costs of a persistent 10 percent inflation are from 2 to 5 percent of GDP. In today s prices, this amounts to a range of about $150 billion to $350 billion for the U.S. economy a sizeable cost even for the largest economy in the world.

If anything, such quantifications understate the overall costs of inflation since they cannot capture various broader, noneconomic aspects of the inflation problem. For example, by depreciating the value of the dollar over time, inflation makes our currency less reliable as a standard for measurement of real values of goods, services, and assets in the United States and around the world.

I also believe that inflation has a serious social cost because it falls particularly hard on the less fortunate in our society, the last to get employment and the first to lose it. Such people do not have the economic clout to keep their income streams steady, or even buy necessities, when a bout of inflation leads to a boom-bust scenario for the economy. As a consequence, they suffer disproportionately when the bust comes.

Heightened awareness of the costs of inflation has increased the intensity with which inflation is disliked not just by economists and policymakers, but also by participants on Wall Street and

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the general public on Main Street. Today, one almost never hears the arguments that were so commonplace in the 1960s and the 1970s, about low or moderate rates of inflation being needed to grease the wheels of commerce and industry. Indeed, such views are rejected by recent empirical investigations.

Against the background of generally low inflation and broad public support for policies that rigorously contain inflation, the recurring congressional debate on the appropriate objectives of monetary policy has experienced a recent revival.

Senator Mack has introduced a bill to make price stability the primary long-term goal of monetary policy and Congress is likely to hold hearings on this issue in coming months.

There is no question in my mind that the primary long-term goal of monetary policy should be price stability which is best defined as a situation in which inflation is not a consideration in household and business decisions. For me personally, the goal of stable prices has been the prism for making monetary policy choices. Moreover, for some time now monetary policy has consistently pursued that goal, which is a key factor in the long-run downward track that inflation has been on since the early 1980s.

Nevertheless, a legislative mandate in favor of long-term price stability would help clarify the priorities for policy goals and strengthen our commitment to price stability. By providing a long-term anchor for monetary policy, an explicit commitment to price stability also would help improve the credibility of policy, as well as the Fed s accountability.

With or without a formal legislative commitment, I am convinced that monetary policy must continue to aim at fostering sustainable economic growth, with inflation trending lower and, eventually, giving way to price stability. While recent price performance has brought us pretty close to functional price stability, I think we are not quite there yet. Inflation, as measured by standard price indexes, is now the lowest since the late 1960s, but people still worry about its consequences and about future uncertainty of prices. And these concerns influence their day-to-day spending, saving and investment decisions.

I want to stress that price stability is not a one-time objective, but an ongoing goal. Judging from the significant remaining inflation premiums embodied in long-term interest rates and from surveys of inflation expectations, the job is not yet complete. But even as we succeed in achieving true price stability, there will be no room to relax our guard. Past successes will not be worth anything if we become complacent about future inflation.

Many analysts seem to think that establishing price stability as the primary goal of monetary policy means that the Federal Reserve would no longer be concerned about output or job growth, or that it would have no responsibility for coping with cyclical weakness of the economy. I believe that view to be simply wrong. Instead, a clear official mandate for price stability will allow the Fed more explicitly to address cyclical problems.

In my view, a stable economic and financial environment will almost certainly enhance the capacity of monetary policy to fight occasions of cyclical weakness in the economy. With no significant

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inflation premiums in long rates and the public s hostile attitude toward inflation, monetary policy would be able to ease in the short run without risking an immediate surge in inflationary expectations. Indeed, there was considerable room for monetary policymakers to do just that in the low inflation environment of the 1950s and the early 1960s.

All too often, commentators argue as if Federal Reserve policy aimed at containing inflationary pressures is tantamount to pursuing real growth targets limited to 2 - 2 1/2 percent. The Fed, of course, has no such targets, and does not believe that looking at actual or prospective real growth, by itself, tells you much about the underlying inflationary pressures.

In trying to determine the extent of future inflation, we must look at a variety of indicators of demand pressures and supply developments in the economy. As you know, the list of these indicators is long and includes such things as measures of the degree of tightness in labor markets, industrial capacity utilization rates, estimates of the gap between actual and potential GDP, developments in commodity prices and monetary aggregates, the extent of foreign competition, and the behavior of the yield curve. While some indicators have proven more useful than others, there is no straightforward summary measure that provides a reliable overall assessment of the many complex and diverse influences on inflation.

More fundamentally, I believe, there is no conflict between real growth and price stability, and the assumption that efforts to contain inflationary pressures will depress economic growth is clearly not borne out by historical experience. In the very short run, say within a year, expansionary

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monetary policy may stimulate the economy. But economists, in an amazing degree of accord in a profession which thrives on controversy, agree that higher inflation does not boost output and employment on a sustainable basis. Any temporary rise in output and employment is more than fully offset as inflation is brought back under control.

From a longer term perspective, the economy s performance depends on a variety of technological, economic, and social factors, and within that context, price and financial stability is a key ingredient for enhancing economic growth. In fact, there is now mounting evidence that lower inflation leads to higher long-run growth. Recent empirical work not only finds a durable relationship between lower inflation and higher **levels** of GDP and productivity, but also suggests that lower rates of inflation are closely associated with faster **growth** rates of GDP and productivity. In particular, the postwar history of the United States indicates a strong and statistically robust negative correlation between inflation and real GDP growth, as well as between inflation and productivity growth.

The statistical evidence has not yet established that the negative correlation represents a causal relationship running from inflation to GDP or productivity growth. But such a causal link is entirely consistent with the various costs of inflation. In any event, I am persuaded by common

sense and casual empiricism that lower inflation almost certainly benefits long-run growth, even if it is not possible to pin down the size of the effect involved.

One of the main linkages between price changes and the economy is that low inflation feeds lower interest rates and lower capital costs, and thereby spurs long-run productivity and economic growth. Lower interest rates result not only from reducing or eliminating inflationary expectations, but also from increased efficiency of capital markets.

I certainly don t need to tell this audience that the housing market is one of the most important channels through which lower interest rates influence the economy. Housing affordability, a key to broadening economic opportunity, is closely connected to long-term interest rates since the qualifying income to buy a house is determined by long rates. By lowering mortgage rates, the decline in the trend rate of inflation has greatly enhanced housing affordability over the last ten years or so. For example, with the thirty-year mortgage rate dropping from 12 1/2 percent in 1985 to 7 1/4 percent at present, the qualifying income for a $100,000 home mortgage has fallen from about $46,000 in 1985 to about $29,000 today. As a consequence, about twelve million additional households now meet the income standard that was beyond their reach in 1985.

Whatever the precise effects of lower inflation on economic growth, I think there is broad agreement that price stability is essential for maintaining a stable financial environment and for the successful long-run economic performance of the economy. Only with long-run price stability can the economy expect to achieve the highest possible levels of productivity, real income, employment, and living standards.

The process through which price stability enables the economy to deliver the highest sustainable levels of jobs and economic performance is complex and involves all facets of society. Price stability reduces uncertainty and gives people confidence in the future. It allows economic resources to be allocated more efficiently on their real merits, rather than on their advantages as inflation or speculative hedges. It induces households to save more because they don t have to worry about inflation eating up their savings. By reducing uncertainty about future returns and by eliminating inflation premiums in long rates, price stability also encourages businesses to invest in long-term, growth-oriented projects.

As critical as monetary policy is for containing inflationary expectations and for stabilizing the price level, it cannot ensure, by itself, a stable economic and financial environment, and maximumsustainable long-run economic growth. For that, we must also do something about the significant structural problems facing the economy. In particular, as a nation, we continue to con-

sume far too much and save too little to sustain a healthy economy over the long run. About the only effective way to increase national saving is to reduce the federal deficit, which is a major drain on private savings.

I remain hopeful that Congress and the President will agree on a program to put the deficit on a downward path. This action is indispensable for the long-run health of our economy.

In addressing our structural problems and the effectiveness of various social spending programs, we face some very difficult choices. The context of these choices brings me to my next topic, the growing disparity between the haves and the have-nots. I fully share the view that the overall

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economy works best with minimal government interference and that social programs which don t work clearly need to be fixed. But fixing the programs should not mean ending them, because the unsatisfied real needs of many people in our country are, sadly, growing. Exposing individuals least able to compete to the winds of the markets raises serious social and fairness concerns.

We must be particularly careful not to shortchange investment in human capital, especially in the form of education and training. Such an approach will deepen the ongoing trend toward disparity between the haves and have-nots. Over the last twenty years or so, gains from advances in growth and prosperity have not been widely shared, and the less educated and poor segments in our society have actually lost ground. Since 1973, for example, real incomes for households in the bottom fifth of the population have fallen about 15 percent, while those in the top fifth have enjoyed real income gains of 25 percent.

Because of their negative effects on political and social cohesion, the widening disparities clearly are not conducive to strong economic performance of the economy. In the long run, I am convinced, economic growth can be sustained only if the growing economic pie is shared by all parts of society rich and poor, urban and rural, skilled and less skilled people of all hues and all backgrounds. Only under those conditions will each of the varied parts of our society have a stake in its future economic development.

While the role of the public sector in creating jobs and economic opportunity is important, government action alone is not sufficient. Private sector participants need to redouble their efforts to

bring job growth and economic prosperity to all levels of our society. This is a task the government simply cannot and should not shoulder alone.

Private sector involvement is important for reasons of raw self-interest. A recent report of the Committee for Economic Development makes a persuasive case along these lines. It makes abundantly clear why each of us particularly those who are business leaders has a stake in the inner cities. I share many of the views expressed in the CED report and commend it to you along with its recommendations for greater involvement between businesses and community groups for rebuilding areas where economic blight is most concentrated.

I know that you, as mortgage bankers, have particularly strong interests in community development and progress. I also know that many of you are involved, as we are at the Federal Reserve Bank of New York, in a wide range of educational and community development initiatives, and that banks have accomplished a great deal in activities encouraged by the Community Reinvestment Act. I am sure, too, that many in this audience generously support development efforts through philanthropic and civic organizations.

Indeed, many successes have emerged from partnerships between businesses and community groups around the nation. And there is a broad range of programs and initiatives that the private sector might undertake which can make a critical difference in a number of areas. It can, for example, provide part of the financing required for community development, and I believe that

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financial institutions in particular can and should play a greater role in this area. Communities need access to capital to improve their infrastructure, create housing, and attract the businesses that create jobs.

Private sector businesses, through their active involvement, can help established community groups to leverage the necessary resources both financial and nonfinancial to initiate specific development projects as well as comprehensive community-building strategies. The private sector can also provide technical assistance to community-based organizations on financial analysis, strategic planning, computer system design and other needs. Similarly, it can play an important role in training our future work force by getting involved with the retraining of workers and our public schools.

It is not my objective to offer a comprehensive agenda for your community involvements, and many of you already are engaged individually and through your institutions in these efforts. My concern is that we not be complacent about the challenge of sustaining our communities and neighborhoods a challenge that has never been more important than it is today.

I encourage you to expand the role you and your institutions play in addressing the growing needs of inner cities and other poor communities. Only by working together to enhance economic opportunity for weaker segments of our society can we ensure sustained economic development of the whole society and our own quality of life.

Thank you.