

Remarks by Vice Chair Alice M. Rivlin

Renewed confidence and vitality of the U.S. economy and the Asian crisis

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I am delighted to accept the 1998 Distinguished Achievement Award of the Money Marketeers of NYU. The list of recipients of this award is a great list to be on! I am particularly honored to be introduced by Pete Peterson, a good friend of many years and a comrade in arms in the complex battles of the budget wars. Pete, as a member of the Board of the New York Fed, is also a fellow central banker, albeit a part-time one.

The best thing about this award is that it affords me the opportunity to exchange some thoughts with this lively group of market participants as we all try to puzzle out this surprising economy in which we are all involved.

Recent economic news has revealed two sets of economic surprises.

- First, the unexpected strength and resilience of the American economy, coupled with continued good news on the inflation front.
- Second, the equally unexpected seriousness of the Asian crisis, including the persistent weakness of the Japanese economy and the threat of contagion spreading to other parts of the developing or emerging market world.

These unpredicted developments have reminded all who needed reminding that a lot of things we all think we are pretty sure of don't turn out to be right. Whether the surprises are welcome or unwelcome, they should make us a bit more cautious about relying too confidently on forecasts.

A gratifying domestic surprise is that the economy is still exhibiting healthy broad-based growth -- indeed that growth has accelerated -- when, judging by past experience, we might have expected it to be running out of steam or exhibiting signs of strains, bottlenecks and imbalances. Even more astonishing, especially to the keepers of systematic macro-economic wisdom, is the persistence of moderate inflation with such tight labor markets for such a long time. Employers all complain about how hard it is to get workers, especially highly skilled workers, and wages are indeed rising, although not at a particularly rapid pace, but inflation remains moderate. Employers appear to be responding to tight labor markets by using workers more effectively and cutting non-wage costs, not by raising prices in what they perceive as highly competitive markets.

Some of our surprise at how well the domestic economy is functioning may simply be failure to recognize the good effects of sound economic policy decisions, both private and public. On the public side, Americans have gotten so cynical about politics and government that we find it hard to acknowledge that we often end up doing the right thing. Our complex and sometimes mysterious public decision making processes often generate good outcomes, sometimes even far sighted policies that are painful and unpopular in the near-term, but pay

off in the end.

One example, is the series of Federal Reserve decisions to raise interest rates to avoid an overheated economy in 1994. I was at the White House at the time and I know there was not a lot of enthusiasm there for the Federal Reserve raising rates and slowing the economy, although the White House was, of course, publicly careful to respect the independence of the central bank. There probably wasn't much enthusiasm in groups like this either. Four years later, with the economy still barreling ahead and inflation at bay, this set of decisions looks increasingly wise and farsighted.

Another example is the long series of painful decisions that moved the Federal budget from deficit to surplus. With hindsight, President Bush and the Congress, in 1990, get part of the credit -- although they certainly didn't get much at the time because recession hid their reductions in the structural deficit. President Clinton and the 1993 Congress also get high marks for policy that looks a lot better in retrospect than it seemed to the public at the time.

It is easy to forget now that the Clinton Administration's 1993 budget package was extremely controversial, passing by only one vote in each house after a lot of arm twisting. Moreover, at the time, it was not obvious that the critics were all wrong. Some argued that the deficit reduction was too rapid, that it might further sap the momentum of a sluggishly growing economy. Others argued that tax increases, especially at the high end of the income scale, would discourage growth and investment. I suspect most of the people in this room still believe that the modest upper-income tax increase enacted in 1993 was a mistake, but it's hard to argue with a straight face that it was bad for the economy. Moreover, the dreaded energy tax increase of 4.3 cents a gallon of gasoline, which many politicians feared would cause voter backlash, is now forgotten in the general plunge of gas prices at the pump.

The 1993 deficit reduction package was bold, but it didn't finish the job. Bringing the budget to surplus took several additional painful and acrimonious rounds of budget negotiations -- program by program, line by line, year by year. The process was not attractive. There was name-calling, posturing, finger pointing, and a desperately inconvenient shutdown of many government services. But out of the public eye, there was also hard serious work and well-crafted compromises on the part of legislators and Administration negotiators. Spending programs of all sorts -- military and civilian appropriations, grants to states and benefits to individuals -- were downsized and restructured. Fees for many government services were increased. Many Federal agencies were, if not "reinvented," at least made considerably leaner. The number of Federal employees was reduced significantly. And the effort paid off. Budget restructuring in combination with the high growth economy has moved the budget into surplus several years sooner than even the optimists dared to hope.

The fact that seemingly intractable budget deficits have been turned to small surpluses does not mean that we can declare victory and forget about fiscal policy. Indeed, the rapid prospective aging of the population combined with the low U.S. private saving rate make it imperative that we turn quickly to the next fiscal task, reforming social security and Medicare. We must put those programs on a firm foundation for the future and ensure that the government budget continues to add to, not subtract from, the pool of saving the nation needs to grow fast enough to keep both worker and retiree standards of living rising in the future.

The success of our political system in balancing the budget has not solved the long run budget problem, but it has considerably reduced the magnitude of the task remaining. It

should also enhance our confidence that problems like reforming social security and Medicare are not beyond the capacity of our political process, messy as it is, to resolve. They will require hard work and compromise -- and there will probably be a lot of posturing and accusation-trading in the process -- but I am far more hopeful than I was only a couple of years ago that the job will get done.

The other area in which the U.S. political process gets some points for good behavior is deregulation. If the U.S. economy is more competitive and less inflation prone than it used to be, some of the credit goes to the continued effort over a couple of decades to reduce regulatory interference with competition in airlines, railroads, trucking, telecommunications, and energy. Deregulation is difficult and some people always suffer in the short run. The reduction in geographic barriers to banking competition, and the rapid blurring of regulatory and legislative lines walling off different types of financial services from each other, have thrown the financial services industry into turmoil, but the result, when the dust settles, is likely to be a far more competitive and efficient financial services industry than we had before.

The private sector has also surprised the pundits with its vitality and flexibility of late. Ten or fifteen years ago, the older members of this audience were going to breast-beating conferences about "restoring American competitiveness." Global competition and the punishing high dollar of the mid-1980s made many of America's most prestigious companies fear for their lives. But painful decisions were made, often at great human and resource cost, that enabled U.S. industry not only to stay in the game, but to get back into the global leadership position that seemed for a time to be slipping away. A generation of business leaders restructured and downsized and tried new management ideas. A generation of MBA's learned a lot of buzz-words about continuous improvement and total quality management and wondered whether they meant anything real. Then they went out and tried to put them into practice, and found that some of them worked.

It is not easy to sort out causes and effects of the renewed confidence and vitality of the U.S. economy, although future economic historians are sure to come up with some interesting hypotheses, but at least for now, the U.S. economy seems to be more resilient and flexible, less inflation prone and more competitive (even in the fact of the high dollar) than most of us would have predicted a few years ago.

Does that mean the Federal Reserve can relax because there is no longer a threat of inflation? Surely not. Much of the good news on the inflation front has come from factors that are clearly not going to last forever and could even turn around quite rapidly. The dollar will not go on rising forever; the continuous downward pressure on import prices will at some point ease or reverse. The price of oil and other commodities (largely a result of the drop in Asian demand) will bottom out and begin to rise. Health care costs are not likely to rise as gently in the future as in the recent past. Labor shortages are likely to prove increasingly costly and disruptive and businesses are likely to run out of ways of offsetting increasing labor costs with other cost reductions.

The Federal Reserve is paid to worry about threats of inflation that could undermine the health of the economy and make growth unsustainable, and, at the moment, absent the imminent prospect of Asian spillover slowing growth to more sustainable levels, we would be worrying very hard indeed.

Americans would do well, if we want to keep the good news flowing, to make a strenuous

effort to avoid boastfulness and triumphalism. The business magazines are full of the writings of those who have yielded to the temptation to ascribe the current economy, not so much to a fortuitous and probably temporary combination of good policy and good luck, but to the triumph of some peculiarly American characteristics and institutions whose beneficial influences will keep carrying us on to greater heights forever.

But before we yield to those temptations, we ought to remind ourselves that back in the 1950s and 1960s, the United States also appeared to be a colossus astride the economic world. We had a backlog of technology invented and improved in the war years that we could apply to civilian uses, pent-up demand at home and abroad, and enormous confidence in our know-how, managerial skills and production methods. Only a few years later, however, we found ourselves mired in stagflation, reeling from higher energy prices and losing our self-confidence at home and abroad. Our business school gurus and management consultants were all rushing off to Japan and other centers of the so-called Asian miracle to learn how businesses and economies really ought to be run.

Some of those gurus and consultants came back to tell everyone who would pay their fees or buy their books that the secrets of successful Asian economies included:

- lifetime employment guarantees for workers;
- close interconnections between banks and groups of industrial companies;
- industrial policy in which the government picks the winners and makes sure they get financed.

But now the Asian economies are reeling from a series of financial shocks that amply illustrate how quickly triumph can turn to disaster in closely interrelated global markets. The gurus and consultants have a new vocabulary to describe the same phenomena:

- lifetime employment is called "inflexible labor markets;"
- the relations between banks and companies are called "inefficient capital markets;"
- and industrial policy is called "crony capitalism."

It should be enough to those tempted into triumphalism bite their tongues.

This brings me to the downside surprise -- the still unfolding financial and economic crisis in Asia. The Asian crisis has brought home to all of us that the extraordinary interlinking of markets and economies, which promises so much benefit, also has great potential for spreading destruction. The metaphor of contagion has been much used, but I think it is a good one because it suggests an approach to mitigating future crises. Human beings are far more vulnerable to the spread of viruses or infection when their immune systems are weak than when they are strong. The international community is unlikely to be able to enjoy the undoubted benefits of rising international trade and capital flows without periodic reversals and losses of confidence in one part of the world or another. But it can reduce the damage from contagion by strengthening national and international immune systems.

This will mean hard work within countries and in a variety of international groupings to improve the basic institutional infrastructure of the world's economies and the information available to markets about them. It will mean efforts to improve banking supervision, accounting systems, bankruptcy laws, transparency of fiscal and monetary policy. It will mean strengthening the International Monetary Fund and improving the mechanisms, once a crisis has started, for sharing the losses equitably among debtors and creditors, limiting the damage and getting economies functioning again.

These are not efforts that can be undertaken by governments alone or stand any chance of success if they are limited to public bodies. They will have to involve the people in this room -- the market participants -- who understand best where the weaknesses are through which contagion spreads and how to strengthen immune systems to minimize the damage and get the system working again.

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