The Federal Reserve Board

Testimony of Vice Chair Alice M. Rivlin

Appropriate monetary policy and the strong economy
Before the Committee on Banking and Financial Services, U.S. House of Representatives
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I would like to begin by expressing my appreciation to the Committee for holding this hearing to solicit a wide range of views on appropriate monetary policy at this extremely favorable moment in our economic history. All too often congressional hearings are called when something bad is happening. In a deteriorating situation, Congress finds it necessary to survey the damage, assess responsibility and call for better policies in the future.

At the moment, however, the economy as a whole is functioning amazingly well. Employment is high and rising, unemployment is low, incomes are increasing, profits are high, the Federal budget deficit is plummeting, state and local finances are increasingly strong, and inflation is benign. The overriding economic objective--shared by all participants in the economy--is to keep the good news flowing. We all want the economy to grow at its highest sustainable rate, to keep unemployment and inflation low, and above all, to avoid recession as long as possible.

Thoughtful people, at the Federal Reserve and elsewhere, have somewhat different views about why the economy is doing so well and how best to keep it going. Your invitation to share those views is timely, constructive and welcome.

I would like briefly to discuss three questions:

1. Why is the economy performing so well--and, in particular, why do we have so little inflation with such low unemployment?
2. Why is it so important, especially right now, to keep the economy growing at its highest sustainable rate and to avoid recession?
3. What policies--monetary and other economic policies--are most likely to keep economic performance high and sustained?

Why is the economy doing so well?
Most economists are frankly surprised that the economy has been able to grow fast enough to push unemployment rates below 5 percent without generating accelerating inflation. Until recently, most students of the economy thought that unemployment rates below 5.5 - 6.0 percent (estimates differed) for an appreciable period would lead to rising labor costs that would be passed on in higher prices and start a self-perpetuating wage-price spiral that would be hard to reverse. True, unemployment had been lower in the 1960s while inflation remained low, but the structure of the economy and the characteristics of the labor force subsequently changed in ways that seemed to make the economy more inflation-prone for given levels of unemployment. The experience of the period since about 1970 appeared to confirm that inflationary pressure emerged at unemployment rates appreciably higher than those of the 1960s.

Five years ago, most economists would have thought the Federal Reserve irresponsible and derelict in its duty if it had not used monetary policy to slow an economy operating at such a high level that unemployment remained under 5.5 percent for more than a short time. The inflation might not appear immediately, but it was thought to be inevitable, and allowing it to get up a head of steam before acting was taking a high risk of having to react more strongly, perhaps strongly enough to bring on a recession.

Nevertheless, the unemployment rate has been below 5.5 percent for over a year and below 5.0 percent in 1997 while inflation has shown no signs of picking up--indeed, producer prices have actually been falling. The Federal Reserve, except for a quarter point tightening of the federal funds rate in March (after months of inaction), has left the monetary levers alone. Is the Federal Reserve ignoring risks of future inflation?

The answer depends on whether the coexistence of higher growth and lower unemployment with benign inflation is explained by a fundamental improvement in the structure of the economy making it less inflation-prone, or by temporary factors that might return to "normal" and kick-off an inflationary wage-price spiral, or by some combination of the two. The honest answer is: We don't know yet.

One surprise has been that such tight labor markets have not resulted in more rapid increases in wages and other labor compensation. Part of the explanation, as Chairman Greenspan noted in his testimony on July 22, may lie in less aggressive behavior on the part of workers. Workers may be more reluctant than previously to bargain for higher compensation or to take drastic action, such as striking or quitting to look for a better job. They may be reluctant because they are insecure in the face of rapidly changing technology, for which they fear they may not have the right skills, because they have recent memories of company "downsizing," or because they are less likely than in previous tight labor markets to be members of a union. These explanations of less aggressive worker behavior are plausible, but likely to be temporary. Workers are not likely to get more insecure as low unemployment continues, and union strength is unlikely to ebb further.

Part of the explanation of moderate compensation increases may also lie in more aggressive employer resistance to labor cost increases than in previous cycles. Business owners and managers appear to believe strongly that they are operating in such a competitive environment--whether domestic or international--that they cannot pass cost increases on to their customers in higher prices because they would lose those customers to competitors overseas or down the street. Low import prices resulting from growing international competition and the strong dollar reinforce this perception. Domestic markets have also become more fiercely competitive as the result of deregulation, lower transportation and communication costs, and more competitive business attitudes. These competitive forces, well known to workers, may give employers a plausible reason--or at least an excuse--for strong resistance to wage and benefit demands.

The subdued inflation rate itself, moreover, has dampened inflationary expectations. These lower expectations contribute both to diminished compensation demands of workers and stiffer employer resistance to those demands. An important contribution to lower total compensation costs has also come from the slowdown in the rise of health benefit costs associated with the shift to managed care and the general reduction in the rate of health care inflation. It is not yet clear how much of this slowdown is temporary.

The other surprise is that prices have shown no reaction to the moderate compensation increases that have occurred. Increased foreign and domestic competitiveness is certainly part of the answer, but the remarkable fact is that this competition has not generally eroded profit margins. Persistent high profits suggest that, on the average, employers have been able to increase productivity enough to absorb larger compensation increases without comparable price increases. Whether they will be able to continue to do so is the crucial unanswered question facing monetary policy makers at the moment. Measured productivity has grown slowly for more than two decades and did not accelerate in this expansion as economists hoped it would. Nevertheless, output per hour seems to have picked up a little recently, which is surprising late in an expansion when productivity increase normally slows. If productivity growth were on the verge of sustained acceleration, a possibility discussed in Chairman Greenspan's testimony, it would greatly increase the chances of higher sustained growth without accelerating inflation. There are reasons to be optimistic, but only time will tell if the optimists are right.

Why is sustained growth so important now?
It is always desirable to live in an economy that is growing at a healthy rate. The general standard of living rises and average people are normally better off. Not only do private resources grow, giving consumers more and better choices, but public resources also grow, making it easier to solve public problems and improve national and community infrastructure. Healthy growth has to be sustainable, not bought at the price of environmental degradation or inflationary overheating that turns a boom into a bust.

Nevertheless, there are at least three reasons why it seems especially important for the United States in the next few years to do everything possible to keep the economy growing at a healthy sustainable rate and avoid recession.

Welfare reform
Recent legislation requires extremely ambitious state and Federal efforts to reduce dependency and channel large portions of the present and future welfare population into self-supporting jobs. For these efforts to be even moderately successful will require effective skill training and job placement, adequate child care and, above all, low unemployment rates and plentiful entry level jobs. If economic expansion continues and labor markets remain tight, there is a good chance that many families who would otherwise have depended on welfare can acquire the job skills and experience that can enable them to live more independent and satisfying lives. If the economy slides into recession before welfare recipients have time to establish new skills, work patterns and eligibility for unemployment benefits, welfare reform is almost certain to be a failure, if not an outright disaster.

Community development
Partnerships for community development are beginning to create new hope for some devastated areas of big cities, smaller towns and rural areas. Partners include business and community groups, financial institutions and governments. With continued economic growth and low unemployment, these efforts could transform many blighted areas into viable communities with decent housing and an economic base. Recession, especially a deep one, would dry up public and private resources and greatly reduce the chances of successful community development.

Preparing for more older people
Perhaps the biggest challenge to the U.S. economy (indeed to all industrial economies) over the next couple of decades is the prospective rise in the ratio of elderly to working age people. Barring a huge increase in working age immigrants or dramatic increases in the

length of working life, the number of retirees will rise much faster than the working population beginning early in the next century. No matter what combination of public and private pensions are used to sort out the claims of retirees to a share of the nation's output, the only way to guarantee a rising standard of living for both retirees and workers is to greatly increase the future productivity of that workforce. A high growth economy over the next decade could generate enough saving and investment to make that increased future workforce productivity feasible. Slower growth and repeated recessions could make the burden of an aging population far heavier and policy choices more contentious.

What policies are needed?

These three challenges to the American economy simply reinforce the need to keep the economy on the highest sustainable growth track attainable and to keep recessions as shallow and infrequent as possible. The biggest problem for monetary policy at the moment is that no one knows what growth rate is sustainable. It may be true that the structure of the economy has changed in ways that make a higher growth rate sustainable without inflation than we thought possible a few years ago--or it may not be true. The question turns on whether productivity growth has shifted up out of the doldrums of the last couple of decades. It's possible that it has, but by no means certain.

This leaves monetary policymakers with the difficult job of watching all the signs, weighing the risks and making a new judgment call every few weeks. At the moment, there seems to be little risk of the economy slowing down too much in the near term and sliding into recession. Growth has already slowed from its clearly unsustainable pace in the first quarter, but all the current signs point to continued economic expansion for the rest of this year and into the next. The risks seem higher on the other side--that many of the factors holding down inflationary pressures will prove temporary, that the rebound of productivity necessary for higher sustainable growth will not occur or not prove robust and durable. The Federal Open Market Committee has to weigh the risk of slowing the economy unnecessarily against the risk of waiting too long and having to put the brakes on harder later. Waiting longer may increase the possibility of overheating followed by recession. It's a tough call. I can't promise we will make the right decisions, but I *can* promise we will try.

It is important not to overestimate the role of monetary policy and the Federal Reserve. Monetary policy can help keep the economy from falling off the sustainable growth track in either direction--either by overheating and generating enough inflation to unbalance the economy and threaten growth or by chugging along too slowly with excessive unemployment. But monetary policy cannot do much to determine how high the sustainable growth rate is. How fast the economy can grow is determined by how rapidly the employed labor force is increasing and how fast the productivity of that workforce is growing. There are only two ways to get more output: either more people work or working people produce more (or both).

In the 1960s and 1970s, the American workforce was growing rapidly as the large baby boom generation reached working age and women, especially mothers, moved into the workforce in much larger proportions than previously. But those two trends have run their course. The labor force is likely to grow slowly over the next few years, about 1 percent per year. The main hope for increasing labor force growth, besides encouraging more immigration, is that continued tight labor markets plus increased flexibility in employment hours will gradually begin to reverse the trends to early retirement that has reduced labor force participation among older people. Continued employment opportunities combined with well-designed training programs, especially in computer related skills, could also attract into the labor force people who are not actively looking for work because they don't think they have the skills to get a "good" job--principally older workers and young people who have dropped out of school.

Indeed, the shortage of workers with modern technical skills may be the biggest problem facing the American economy at the moment, as well as its biggest opportunity. As long as labor markets stay tight, investment in skill training is likely to pay off handsomely both for individuals and for companies that can retain the trained workers long enough to benefit from their increased productivity. Public investment in training for workers with low skills--often unsuccessful when jobs are scarce--also stands a far better chance in tight labor markets of moving workers into jobs in which they can gain increasing skills, experience and higher wages. Continued low unemployment rates, plus public and private investment in skill training are essential, not only for successful welfare reform, but also for modernizing the skills of the portion of the workforce whose real incomes and opportunities have declined both relatively and absolutely in the last couple of decades.

The other key to productivity increase, of course, is continued investment, both public and private, in research and development and the technology and infrastructure needed for continuous modernization of the economy. Stable low inflation tends to foster long-term planning and investment by businesses and households. A high growth economy should generate more of the saving needed to finance the investment. Reducing the public dissaving inherent in running a deficit in the Federal budget also adds to national saving. Near term reform of social security and Medicare in ways that add to national saving, public and private, could make a significant contribution to future productivity increase and hence to raising the future rate of sustainable economic growth.

In summary, the objective of economic policy--monetary policy included--is to keep the economy on the highest sustainable growth path. No one knows exactly what that rate is right now, or what it can be in the future, but a combination of policies, intelligently pursued, can raise it as far as possible. These policies include:

- wise monetary policy that helps the economy expand, and keeps labor markets tight, without incurring excessive risk of accelerating inflation;
- investment in skills by individuals, firms and the public and non-profit sectors;
- increased saving (public and private) invested in research, technology and infrastructure.

The Federal Reserve will do its part, in the face of huge uncertainties, to steer an appropriate monetary policy. Fiscal and other policies, both public and private, are needed to take full advantage of the opportunity we have today to keep the American economy operating at a high level in the future.

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