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Remarks by

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It is again a pleasure to be with you While there is scarcely a shortage of banking issues to be addressed, I believe it might be helpful today to focus my remarks on the economic context in which you are operating I would like to offer some thoughts on the current situation and then spend a little time on certain longer-run challenges facing our nation Although the U S economy has recorded some notable achievements over the past few years, there is nonetheless much left to be accomplished

Without question 1994 was a year of remarkable progress Real gross domestic product expanded by four percent over the course of the year--the best gain in some time, and one that surpassed most expectations Importantly, we saw an accelerated expansion of employment Cumulatively, payrolls have now increased roughly 6 million over the past couple of years, belying, in dramatic fashion, the notion that had developed earlier in this decade, that our economy had lost its ability to generate jobs And, although the unemployment rate rose last month, it generally has been on a downtrend since mid-1993

The economic gains have been broad They have encompassed almost all major segments of industry and all parts of the country The expansion in recent quarters has been paced by growth of business investment and exports, and as a consequence, we have seen a significant upturn in job creation in manufacturing, which, as you know, had been lagging earlier in the 1990s Manufacturing output increased 6-1/2 percent last year, and measured factory employment rose almost 300,000 I say "measured" because it has been true for some time now that manufacturers have relied to an increasing degree on workers supplied by temporary help firms which are recorded separately in the service industry But it is clear that last year

saw a marked gain in the overall factory workforce Moreover, the latest figures on payroll employment indicate that manufacturers continued to hire at a significant pace in January With order backlogs still growing, firms have become more confident that they will be able to maintain production at high levels

Geographically, contractions in some sectors such as defense and finance have left their negative imprint on certain locales, but rising activity and improving job opportunities have characterized most areas of the country Notably, California--accounting for roughly an eighth of the nation's economy--appears to be in the process of turning around Moreover, the gains in employment have benefited all major demographic segments of the labor force as well

Of crucial importance to the sustainability of these gains, they have been achieved without a deterioration in the overall inflation rate The Consumer Price Index rose 2 7 percent last year, the same as in 1993 Inflation at the retail level, as measured by the CPI, has been a bit less than 3 percent for three years running now--the first time that has occurred since the early 1960s This is a signal accomplishment, for it marks a move toward a more stable economic environment in which households, businesses, and governmental units can plan with greater confidence and operate with greater efficiency When we consider the probable upward bias of the CPI, it would appear that we have gotten close to achieving effective price stability, though we're not there yet

Some economic indicators and anecdotal reports lately have suggested that activity is slowing The evidence on this score, however, remains mixed Nonetheless, some slowing in economic expansion from last quarter's torrid pace would be welcome A

moderation is necessary if we are to avoid an intensification of inflation pressures that ultimately would threaten the expansion

I have little doubt that a key ingredient in maintaining the highest possible levels of productivity, real incomes, and living standards is the achievement of price stability Thus, I see it as crucial that we extend the recent trend of low and, hopefully, declining inflation in the years ahead The prospects in this regard are fundamentally good, but there are reasons for some concern, at least with respect to the nearer term Those concerns relate primarily to the fact that resource utilization rates already have risen to high levels by recent historical standards For example, capacity utilization rates in many industries are at, or above, their late 1980s peaks And, even with last month's rise in joblessness, the current unemployment rate is close to the average of the late eighties You'll recall that, in that period, wages and prices accelerated appreciably

Despite the rapid pace of hiring, the survey readings on consumers' views of whether jobs are easy to get fall far short of the previous cyclical peak in 1989 Moreover, there is evidence that the number of people voluntarily leaving their jobs is subnormal currently This suggests that the deep-seated fear of job insecurity that developed in the early 1990s has not fully dissipated despite ample evidence of strong job growth recently

Some analysts attribute this phenomenon to workers' concerns about losing health insurance and, for some, pension coverage if they change jobs Whatever the cause, the lingering sense of insecurity doubtless has been a factor damping wage growth and overall labor costs Since the latter, on a consolidated basis, account for roughly two-thirds of overall costs in our economy, slower wage growth

combined with strong cyclical productivity growth has restrained increases in unit labor costs and hence in prices of final goods and services

However, as overall output growth of necessity slows in an environment of high resource utilization, so will cyclical productivity growth Moreover, if labor market tightness assuages fears of job insecurity, pressures to raise wages will intensify and unit labor costs could accelerate In the later stages of previous business cycles, profit margins were squeezed, but some of the underlying unit labor cost increases were nonetheless passed through into final goods prices and inflation picked up Thus far in the current cycle, any tendency toward the emergence of this kind of process has been muted by a prevailing concern among firms that, despite capacity pressures, enough slack remains in the system, and unit costs are sufficiently subdued, to foster competitive inroads on those who try to price above the market But this form of discipline may also become less effective as pressures on resources persist

Clearly, one factor in judging the inflationary risks in the economy is the potential for expansion of our productive capacity If "potential GDP" is growing rapidly, actual output can also continue to grow rapidly without intensifying pressures on resources In this regard, many commentators, myself included, have remarked that there is something of a more-than-cyclical character to the evident improvement of America's competitive capabilities in recent years Our dominance in computer software, for example, has moved us back to a position of clear leadership in advanced technology after some faltering in the 1970s But, while most analysts have increased their estimates of America's long-term productivity growth, it is still too soon to judge whether that improvement is a few tenths of a percentage

point annually, or even more, perhaps moving us much closer to the more vibrant pace that characterized the early post-World War II period It is fair to note, however, that the fact that labor and factory utilization rates rose as much as they did in the past year does argue that the rate of increase in potential output is appreciably below the 4 percent GDP growth rate of 1994

Knowing in advance our true growth potential obviously would be useful in setting policy, because history tells us that economies that strain labor force and capital stock limits tend to engender inflationary instabilities which undermine growth Moreover, in such an environment asset prices can begin to rise unsustainably, contributing to an unstable financial and economic environment It is true, however, that in modern economies output levels may not be so rigidly constrained in the short run as they used to be when large segments of output were governed by facilities such as the old open hearth steel furnaces that had rated capacities that could not be exceeded for long without breakdown Rather, the appropriate analogy is a flexible ceiling that can be stretched when pressed, but, as the degree of pressure increases, the extent of flexibility diminishes It is possible for the economy to exceed "potential" for a time without adverse consequences by extending workhours, by deferring maintenance, and by forgoing longer-term projects Moreover, as world trade expands, access to foreign sources of supply augments to a degree the flexibility of domestic productive facilities for goods and some services But there is a limit as to how far the ceiling can be stretched

Aggregative indicators such as the unemployment rate and capacity utilization, may be suggestive of emerging inflation and asset price instability problems But, they cannot be determinative

History shows clearly that given levels of resource utilization can be associated with a wide range of inflation rates Consequently, one must look beyond broad indicators to gauge the inflationary tendencies in the economy

In this context, aggregate measures of pressure in labor and product markets do seem to be validated by finer statistical and anecdotal indications of tensions In the manufacturing sector, for example, purchasing managers report slower supplier deliveries and increasing shortages of materials Indeed, firms appear to have been building their inventories of materials in recent months so as to ensure that they will have adequate supplies on hand to meet their production schedules These pressures have been mirrored in a sharp rise over the past year in the prices of raw materials and intermediate components There are increasing reports that firms are considering marking up the prices of final goods to offset those increased costs In the labor market, anecdotal reports of "shortages" of workers and upward pressures on costs have become more common It was to contain these price pressures that we tightened monetary policy further earlier this month

Fiscal actions will also be important in keeping inflation subdued There can be no doubt that the persistence of large federal budget deficits represents in the minds of many individuals a potential risk While we clearly have avoided it in recent years, history is replete with examples of fiscal pressures leading to monetary excesses and then to greater inflation Currently, I strongly suspect that investors here and abroad are exacting from issuers of dollar-denominated debt an extra inflation risk premium that reflects not their estimate of the most likely rate of price level increase over the life of the obligation, but the possibility

that it could prove to be significantly greater This risk premium places an additional burden on cash flows and creates an inhibition to capital investments

But the influence of the fiscal imbalance of the federal government on capital formation is broader than that The federal deficit drains off a large share of a regrettably small pool of domestic private saving, thus contributing further--and perhaps to an even greater degree--to the elevation of real rates of interest in the economy Admittedly, there is some uncertainty about the causes of what seem to be relatively high real long-term rates around the world, as was noted by leaders of the largest industrial nations at their summit meeting last year But the vast majority of analysts would agree that in the United States the current sizable federal deficits, and the projected growth of those deficits over the decades ahead are a significant element in the story

I'm sure that you are aware of the general picture with respect to the flows of saving and investment in the economy but it may be worth spending a few minutes to review the recent data To begin with, over the past couple of decades there has been a dramatic decline in net domestic saving excluding the federal government as a ratio to net domestic product The ratio last year appears to have been roughly 6 percent, as compared with more than 9 percent, on average, during the 1960s and '70s In the past few years, net business saving has moved up, as corporate profitability has experienced a cyclical improvement, but the personal saving rate has been running at its lowest levels in nearly half a century The causes of the low private saving rate are hotly debated by economists, and it is fair to say that they are not yet understood Americans have not always been low savers but--for whatever reasons--that has

been the pattern recently and it is a reality with important implications for the financial markets

If we were a high saving nation, we might be in a position to better tolerate the federal fiscal imbalance But the federal deficit has generally been absorbing half or more of the available domestic saving since the early 1980s Even with the decline in the federal deficit last year, it amounted to almost 45 percent of domestic nonfederal saving

How, then, one might ask, has it been possible for the United States to experience the impressive growth in business fixed investment that it has of late? There are a number of arithmetic components to the answer, but I shall focus on two particularly central points The first is that, while gross investment has been rising rapidly and has been accounting for a substantial share of GDP, net investment has only recently reached appreciable dimensions The difference between gross and net investment is, of course, depreciation, and the fact is that depreciation has been rising steeply because of the shift in the composition of the capital stock toward equipment--especially computers--with shorter useful lives Another ingredient in the reconciliation of the domestic saving and investment balance is saving from abroad Our nation has been running persistent and often sizable deficits in its current account position vis-a-vis the rest of the world, a measure of new foreign savings injected into the U S Once a leading provider of capital to other nations, we have become a net importer of capital

In today's more open and integrated international capital markets, it is easier to finance investment abroad And economic efficiency may be served by the tendency for capital to flow across borders to where the potential returns on real investment appear

highest and the risks the lowest But this does not mean that we should view the pattern of U S external deficits as sustainable in the long run Looking back at the history of the past century or more, the record would suggest that nations ultimately must rely on their domestic savings to support domestic investment

The challenge for the U S over the coming decades is clear We must sustain higher levels of investment if we are to achieve healthy increases in productivity and be strong and successful competitors in the international marketplace To support that investment, we shall need to raise the level of domestic saving Absent a rise in private saving, it will be necessary to eliminate the structural deficit in the federal budget Indeed, it has long been my judgment that it would be wise to target achievement of at least a modest surplus down the road

If the Congress and the states were to approve a balanced budget amendment the need for aiming at a structural surplus would become even more important Unless there were a surplus to provide some cushion, the inevitable cyclical fluctuations in economic activity would create pressures either to set aside the requirements of the amendment or to take budgetary actions that are inimical to economic stability It should not be necessary to raise taxes or cut spending in response to a transitory weakening of the economy

I recognize that the achievement of structural balance, let alone surplus, is no small political challenge Moreover, as the Kerrey-Danforth entitlement commission recently documented, the problem that must be addressed is not one with a 2002 end-point The outlook is for a mounting fiscal imbalance during the twenty-first century, given current programs and likely population and labor force trends We should not be seduced by the mounting trust fund surpluses

today into thinking that we can postpone dealing with the entitlement gap, the cost of waiting is going to be far more painful adjustments, which could be avoided by moderate actions legislated today to become effective after the turn of the century

In sum, the recent performance of the macroeconomy has been encouraging But much of the improvement is in the nature of cyclical developments and we all have our work cut out for us if we are to extend these gains and foster long-term trends that enhance the welfare of all of our citizens The central role of the Federal Reserve today is to ensure that our economy remains on a sustainable, noninflationary path For fiscal policy, a crucial focus should be continuing the process of budgetary consolidation and rectifying the secular shortfall in domestic saving that is limiting the growth of our nation's productive potential