Remarks by Vice Chair Alice M. Rivlin

Dilemmas facing United States policymakers
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I am delighted to have the opportunity to address this distinguished group of Canadian, hemispheric and world leaders. We meet at a crucial moment in economic history--a hopeful, but difficult and uncertain moment--in this historic and incredibly diverse city of Montreal.

I'd like to share some thoughts with you today about the dilemmas facing United States policymakers, especially monetary policymakers, as they try to figure out what to do--or not do--in the context of a rapidly evolving domestic, hemispheric and global economy.

So much has happened on the world economics scene in the last two years that it is hard to believe that all these major economic events have actually been crowded into such a short period. In just two years, we have had the financial crisis that started in Thailand and spread across Asia, leaving in its wake deep recession in economies that seemed to be among the most vigorous in the world. We have had the Russian default and the associated chaos in markets far across the globe that proved to be interrelated in more complex ways than anyone had suspected. We have had the Brazilian currency devaluation and its aftershocks, followed by recession in much of Latin America. We have seen the three major industrial areas of the world moving on very different tracks: surprising weakness in Japan; surprising strength in the United States; and Europe in the middle, growing only moderately and preoccupied with its big economic event--transition to monetary union.

That's an amazing amount of action-packed economic history for two years and it has generated a lot of debate about:

- Why the crisis happened and what might have been done to prevent it.
- Why the contagion was so rapid and how it could have been better contained.
- What might be done now by the international community to reduce the frequency, amplitude and spread of financial crisis in the future.

It has been hard to have a thorough and well-informed debate on these questions because events were moving so rapidly. In the middle of a storm, it's hard enough to keep the ship afloat and moving in the right direction, let alone have a serious discussion about how to redesign it so it will handle better on the next voyage. There is a sense now that the storm is ending, or at least that the winds are calmer for a while. The countries that were hit first--Thailand and Korea--are showing signs of economic recovery, and those hit more recently--Brazil and Mexico--have not been quite as badly battered by the storm as some had feared.

Economic historians will be analyzing these two years for a long time. What we don't know yet is whether the basic story, written a decade or so hence, will be an explanation of success or an expose of failure.

We can hope, indeed I believe it likely, that the basic story will be positive and that it will be a story of how the world economy was badly shaken in 1997 and 1998 but came out stronger in the end. If this is right, then:

- It will be said that the ship pitched and rolled but self-correcting mechanisms worked to steady it in the end.
- It will be said that the IMF and other international organizations took some risks and made a few mistakes, but proved essential to keeping the economic ship from foundering.
- It will be said that serious international debates in venues like this one led to modifications in the design of the ship and its handling that made international economic sailing smoother and less crisis-prone in the future.

Alternatively, although it now seems much less likely, the future story of what happened in these two years might still be a story of efforts that ultimately failed.

- It might be said that self-connecting mechanisms and international policies seemed to be working for a while--in June of 1999, for example, most observers thought the worst was over.
- But unfortunately, a new and unforeseen series of events roiled the markets, shook the confidence of investors, and started another typhoon that swept across the global seas and swamped the self-correcting market forces and the well-intentioned efforts of policymakers, both domestic and international. The negative scenario doesn't seem likely at present, but it is too soon to say for sure that it won't happen.

Two puzzling chapters of this still unwritten story are likely to get particular attention from future historians, although we don't yet know how those chapters will end or how they will relate to the rest of the world story:

- One is the chapter about why Japan's economy faltered so badly for so long.
- The other is the chapter about why the United States economy proved so strong for so long.

I won't pretend to have any special insight on Japan. The Japanese economy's long stall has multiple causes, and there are no obvious policy answers to turning it around. It is not yet clear whether the bottom has been reached and recovery is beginning, and if so how soon and how strongly growth will resume. What *is* clear is that Japan's economic health matters a lot, not just to the rest of Asia but to the whole world. A strong recovery in Japan in the near term would contribute mightily to the probability that future historians will be telling the tale of how the events of 1997-98 had a positive outcome and ultimately led to a stronger world economy.

The U.S. chapter is just as puzzling, but fortunately the puzzle is positive. It is far from clear why the U.S. economy has been performing so extraordinarily well in so many dimensions or how long it will last. What is clear is that it matters. If policymakers in the U.S. can figure out how to keep the strong performance of the U.S. economy going--and if our luck holds--the probability of there being positive outcomes of the financial crisis of 1997-98 for future historians to write about will be much enhanced. That's a major challenge for the Federal Reserve as well as other U.S. policymakers.

The U.S. has enjoyed an eight-year period of continuous growth in the 1990s. The surprising aspect of this upswing has not been its length so much as the fact that real growth has accelerated in the past two years to around 4 percent, while unemployment rates have now been below 5 percent for two years and below 4.5 percent for over a year. Such rapid growth and such tight labor markets used to be thought almost certain to generate inflation and create imbalances in the economy. Yet, inflation has remained quiescent--actually falling on most measures over the period. The most recent Consumer Price Index (CPI) shows some worrisome signs, but there is as yet no clear indication of resurgent inflation.

The sustained coexistence of strong growth, tight labor markets and low inflation raises the question of whether the U.S. is benefiting from a serendipitous combination of temporary forces that could easily reverse or whether some more fundamental change has occurred that will enable the U.S. economy to sustain higher growth rates in the future with less risk of accelerating inflation.

Unquestionably, some of the factors keeping U.S. inflation low have been byproducts of the global economic situation.

- Low prices of commodities resulting from weak demand around the world--reversed in part by the recent recovery of oil prices.
- Fierce global competition in just about all tradable goods and services putting downward pressure on everybody's ability to set prices.
- The strong U.S. dollar, itself partly a response to productive opportunities for investment in the U.S. and perceived risk in other parts of the world, has made imports cheap for U.S. consumers.

Some of these factors are likely to reverse as the world economy recovers. Some domestic anti-inflationary forces may be temporary as well, notably the reduction in the rate of growth in employer costs for health care that reflected the shift of the U.S. health care delivery system to "managed care."

But there are also reasons to believe that the U.S. economy is more productive, more competitive and less inflation-prone than it used to be and therefore that it can grow somewhat faster--at least for a while--than seemed possible a couple of years ago.

Productivity growth has accelerated in the last three years. Output per hour in non-farm business, which grew at an anemic average rate of one percent per year in the period 1973-95, picked up in 1996-98, reaching an astonishing (and doubtless unsustainable) four percent at the annual rate in the last two quarters.

It is by no means clear why this is happening or how long it will last. Technology clearly has something to do with it. Although the telecommunications and information management revolution started well before the 1990s, it may have been just at the right point by then to offer firms that are facing a combination of strong demand, tight labor markets and vigorous competition a way to increase their efficiency.

In the past, when unemployment remained low for an extended period, economists expected productivity to suffer because firms were forced to hire less skilled workers with less experience--workers whose productivity was likely to be low. However, recent experience suggests--but certainly does not yet prove--that two factors may have combined to change the expected impact of tight labor markets on productivity. One factor is the availability of new technology, especially computers and telecommunications technology. The other factor is the revolution in management attitudes and practices that has occurred since the 1980s. A whole generation of managers has been trained to think continuously about productivity and quality management. Buzzwords like reengineering and restructuring have not only gotten into the vocabulary of managers, but they have also infiltrated their thought processes and affected their behavior. The response of U.S. firms to shortages of skilled workers, and to increased competition at home and abroad, has apparently been to reorganize what they were doing and how they were doing it, substituting efficient new equipment for employees, training workers to use new equipment and techniques, and outsourcing to reduce costs. All of these actions have combined to increase productivity.

If these conjectures are right, or even partly right, then with well designed policies and continued good luck, the United States might be able to continue growing at a healthy rate without accelerating inflation for some time. It is not clear what growth rate is sustainable, but it might well be around 3 percent instead of about 2 percent as seemed more feasible a few years ago. A one percent upward shift in U.S. potential growth would clearly be good news, not only for us, but for sustained economic recovery in the hemisphere and the rest of the world as well.

The policy package most favorable to sustained U.S. growth is far more comprehensive than anything the Federal Reserve can contribute. It must involve:

- Improving education and training--in schools and on the job--to make possible continued improvement in worker productivity;
- Support of research and development to keep the technological revolution rolling;
- Continued openness of the economy and avoidance of relapses into protectionism; and
- Running fiscal surpluses at both the state and federal levels so that government is contributing to national saving and counteracting low saving rates in the private sector.

The role of the Federal Reserve must be--as it has been for some time--to keep weighing the risk that the economy will overheat. The risk is that inflation will begin to accelerate as increasingly tight labor markets finally set off an upward wage spiral that cannot be offset by productivity increases and some of the temporary factors that have held inflation in the U.S. down in the last couple of years begin to reverse.

That risk has to be weighed against the risk that the U.S. economy, under the impact of weak growth in the rest of the world, or some reversal of confidence by consumers or investors, will grow too slowly, endangering both U.S. prosperity and world economic recovery.

The balance of risks has shifted back and forth over the last couple of years and may, of course, shift again. A year ago, concern focused on possible overheating in the U.S. economy despite the negative effects of the Asian crisis on U.S. growth. The Russian default, the consequent world market turmoil and the Brazilian devaluation clearly shifted the risks in the other direction. The possibility seemed strong that spreading contagion in the markets and deepening recession in Latin America, possibly even doubling back to weaken Asia further, would lead to a serious slowdown in the U.S. Three interest rate cuts in rapid succession expressed the Fed's concern over this risk.

But now, as the world's confidence returns and the U.S. economy (and its stock market) appears still surprisingly strong, the balance of risks appears to be shifting again. The Federal Reserve's Open Market Committee at its last meeting signaled its return to concern about overheating and possible future inflationary pressure.

Members of the Federal Open Market Committee are frequently asked what relative weights they place on domestic and international questions in setting monetary policy. This question is not really a meaningful one for a very large economy in an intensely interrelated world. Trying to set policy so that the U.S. economy grows at its highest sustainable rate is an endeavor that satisfies both domestic and international objectives. The hard thing is to figure our how to do it. If we *can* do it, we will be contributing to the chance that future historians will be able to say that the events of 1997-99 had a positive outcome and led to a stronger, less turbulent world economy.

The United States by itself, however, can only make a modest contribution to the chances of positive outcomes for the world economy. These chances depend more heavily on effective international cooperation to:

- strengthen financial systems around the world so that they are more resilient to shocks;
- making markets work better so that both borrowers and lenders are better informed and more able to assess risks; and
- strengthening international financial institutions so that they are better able to foresee impending crises, provide early warning and apply preventive medicine and act swiftly to reduce contagion when something goes wrong.

These are the harder problems to which the international community must apply its energies if the turmoil of the last two years is to have positive and lasting consequences for the future.