

**"Building Economic Success Today:
Prescriptions for Economic Development"**

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It is a pleasure to be with you today, and to share with you my perspectives on the national and regional economies. I'd like to begin with where we've been recently and what that suggests about our near-term economic prospects - and then discuss briefly one of the issues that brings us together today - local economic development.

By all the standards traditionally used to evaluate economic policy, 1995 has to be seen as a good year. Real GDP grew about 2 percent. Inflation was well contained, with the CPI rising only 3 percent from the end of 1994 to the end of 1995, representing the fourth consecutive year in which inflation was 3 percent or less. One has to go back to the early 1960s to find a period in which inflation was so moderate for so long. The U.S. unemployment rate averaged 5.6 percent during 1995, lower than the average for the last five years, and considerably lower than the average for the five-year period preceding that. Again, one has to go back to the '60s to see such sustained low unemployment rates.

Beyond these broad measures, many of the key indicators of the underlying structure of the economy are also favorable. Rapid growth

in U.S. exports provides some confirmation that the competitiveness of U.S. industry has improved, although as long as our nation remains heavily dependent upon foreign savings, we will continue to experience large balance of payments deficits. Even here, however, there is reason for optimism. While the size of the federal deficit and the dissaving it represents remain a serious concern, the deficit has fallen in relation to overall economic activity from where it was in the 1980s and early 1990s. Assuming we can make further inroads, and that is obviously no small task or foregone conclusion at this point, this progress augurs well for the availability of funding for private investment and for future productivity growth. Finally, one can hardly ignore the buoyant financial markets, which have added to household wealth while facilitating corporations' ability to raise funds.

These favorable measures extend to Massachusetts as well. The recovery has been underway here for over four years. Most recently, job growth in the Commonwealth has been at the national pace and in line with historical trends. Local inflation has also been at about the national pace, and the unemployment rate is below the national level. Massachusetts has come back from the depths of the early 90s,

thanks to an entrepreneurial spirit that enables us to recreate our economy time and time again. It's tough to argue that 1995 wasn't a good year here as well as in the nation.

Most forecasters expect this situation to persist in 1996. Real GDP is expected to grow about 2 percent in 1996, with the U.S. unemployment rate remaining well below 6 percent and inflation about at 3 percent. If these forecasts are right, we will have extended the so-called soft landing and made the transition from a period of vigorous recovery as the economy absorbed the slack created during the recession of the early 1990s, to a more moderate rate of growth consistent with the growth in the economy's productive capacity and sufficient to keep labor markets reasonably tight without generating inflationary pressures.

Given this favorable state of affairs, why aren't people happier? Why is there a sense of uncertainty and uneasiness? Why is it difficult for many to perceive that economic conditions, at least in the aggregate, are pretty good?

One major reason is, I suspect, that our transition to a more moderate and sustainable growth path has not been smooth, and the

challenges to keeping it that way seem considerable. Growth in 1994 was very strong; and 1995 began with concerns that the economy might be on the verge of overheating. It soon became apparent, however, that some of the strength of 1994 had come at the expense of 1995. Growth slowed abruptly, from 4 percent in 1994 to less than half that in the first part of 1995. The economy then grew very rapidly in the third quarter of last year, and then slowed again in the fourth quarter. Despite these ups and downs, growth in 1995 though lower was not markedly different from its average over the past twenty years. The same patterns seem to be surfacing in 1996: the economy appeared weak in January and then bounced back in February.

These fits and starts have made some people anxious about the sustainability of the expansion. A slowing in growth tends to produce a string of unfavorable economic news, and even with reasonable levels of growth, not all sectors are growing, and within growing sectors, some firms have experienced flat or declining demand. Moreover, inherent in achieving such favorable, though bumpy, patterns of overall economic growth is the problem of how to keep them that way. And here the challenges to monetary policy are considerable.

One key to continued economic prosperity is continued economic growth. This can be spurred over the very short run by an increasingly accommodative monetary policy, but whether or not to engage in such a policy presents some difficult issues. At present, the economy has little slack at least using traditional measures. Faster growth could risk an acceleration of inflation.

Now some analysts claim that times have changed. They argue that global competition, the restructuring of industry, and the impact of technological change have made firms much more cautious about raising prices, and workers more wary about switching jobs or demanding higher wages. Thus, the unemployment rate that is compatible with stable inflation may be lower than in the past. Some have also suggested that productivity growth is greater than the measured figures show, which means that the economy could grow faster without generating inflationary pressures.

I am more sympathetic to these arguments than I used to be. The economy has been at the low end of the range that most economists thought compatible with stable inflation for a while, yet inflation has been well-behaved. But we must be cautious.

While the growth in labor compensation has been very moderate, some of this reflects smaller increases in health benefit costs. It is open to question whether this moderating influence will persist or whether it is just a temporary development due to a one-time restructuring in the health care industry. We also saw an unexpected bulge in bonuses at the end of 1995; and most recently oil prices have ticked up. Hourly wage costs have increased as well, though at a reasonably moderate pace. Are these signs harbingers of inflation or will they tick down into the pattern of slow growth we've seen recently? That's hard to say, but most forecasters see a flattening if not a small rise in the rate of inflation for 1996 and '97.

Finally, and to me most significantly, we saw the consequences of rapid growth in an economy with little slack as recently as the late 1980s. We had achieved, it seemed, a soft landing, with unemployment around 5.5 percent and inflation stable around 4 percent. The Federal Reserve was cautiously raising short-term interest rates, to keep the economy on a course of noninflationary growth, when the stock market crash of 1987 raised concerns about a possible recession. We held back a bit, the economy rebounded, the

unemployment rate fell still lower and inflation took off, setting the stage for the 1990-91 recession.

And it is inflation itself that will be most destructive to economic growth over the longer term. Since at least the early 1960s, whenever unemployment rates and inflation have both been low at the same time, what brought this situation to an end was not the economy running out of steam and sliding into recession. Rather, the problem has been that growth accelerated, straining labor and other resources, and creating inflationary pressures that ultimately led to recession. Thus, while it is easy to argue that monetary policy should be more supportive of growth, if we're not very careful, actions in this direction can have exactly the opposite consequences. Finding the balanced path is a challenge for us at the central bank, to say the least.

Another reason for the skepticism with which the public seems to regard pronouncements that the economy is doing well may be that the fruits of economic progress are not being shared by all. Inequality has increased, with the big losers being men with only high school educations. Technological change, the shift from manufacturing to services, and increased competition from low-wage parts of the world

have all contributed to a decline in real wages for unskilled and semi-skilled men, even as the wages of women and those better educated have stabilized or risen.

In my view, extreme and ever widening differences between the "haves" and "have nots" of society are inimical to the very idea of democracy and potentially a threat to its existence. We can and should guard against them.

But even among those who do not lie at the extremes, anxiety levels have risen. As companies in all industries have sought to become more efficient, people in professions and positions where life tenure was once considered the norm have found themselves vulnerable to layoff. Although most displaced workers do find new employment, they can experience sizable salary decreases, with older and less educated workers suffering the greatest difficulties. Over time, as people come to accept that the labor market has become more uncertain and plan their lives accordingly, the prospect of layoffs may become less traumatic; but in the meantime, I believe there are many who feel that the system has let them down and that implicit contracts have been broken.

Monetary policy's role in addressing these issues is critically important but limited in scope. Keeping the economy growing at a sustainable pace helps to ensure that new jobs are created. Keeping inflation down helps people to plan for their future and prevents distortions that divert investment into unproductive activities. In other words, the ultimate goal of monetary policy is to provide an environment favorable to long-term job growth and productivity gains. But this is hardly a satisfactory prescription for those of you in this audience seeking a remedy to the anxieties and slow growth that have hit this region, so let me reflect on issues to do with local economic development, borrowing on work done at the Bank and in other arenas.

Local economic development depends on local job growth, pure and simple. That, in turn, depends both on the broader economic climate and on well-conceived state and local development policies. We have choices here, but I would argue that to be successful we must choose policies that recognize the realities of the "new" economy in which we find ourselves. What are the characteristics of this economy?

- It's an economy in which a fundamental shift is taking place from

physical effort to knowledge and intelligence as the primary source of value, productivity, and economic growth. It's an economy in which many of the ultimate products are not simply a finished good for sale, but involve an ongoing flow of knowledge-based services as well. And finally, it's an economy whose markets are not regional or national, but international in scope.

- An economy that, therefore, must harness the knowledge and intelligence, as well as the physical labor, of all workers from the R&D lab to the factory floor; from client contact to final output.

- It's a "high-tech" economy, not just in terms of specific "high tech" products but in terms of process, with an emphasis, even within mature industries, on adaptation and innovation.

Economic development policies consistent with this new economy should focus on savings and investment; on improving skills, quality, and product development; on reorganizing the internal operations of firms for continuous improvement, and on reorienting firms to new global markets.

Traditional economic development policies have been oriented around low costs - taxes, energy costs, and wages are the key

examples. But despite what appear to be powerful counter-examples of states using strong cost incentives - carefully structured deals - to "win" giant multi-national manufacturing plants, it can be short-sighted to think solely in terms of smokestack-chasing. There are down-sides to depending on one giant employer, or in thinking that attracting one big firm can "save" a region.

Certainly costs matter. No region can afford to be way out of line, and I applaud the work that has been done in Massachusetts, specifically, and New England, in general, to cut the cost of doing business here. But we must remember that New England was never a low cost area; we never enjoyed comparatively cheap labor, cheap materials or cheap energy costs; but we did have an abundance of brain power and sources of financial capital, resources in which we arguably remain at the top.

Many people think of the new knowledge-based economy as capable of being located anywhere, but the new economy can actually highlight the importance of geographic regions. This is because the totality of an area's resources enhances business capability to deliver the combinations of products and ideas that are the unique hallmarks

of this new economy. These resources include the skills and knowledge embedded in the work force, the existing network of firms producing goods and services, the stability of financial and capital markets, and knowledge about and ease in dealing with international markets, as well as the more familiar physical networks for transportation, communication, power distribution, and waste disposal. In the new economy, a region's competitive advantage must be based on the adaptability, responsiveness, and innovation potential of its resources, rather than solely on low costs.

Thus, it is this broad range of resources that we must work on if New England in general, and Massachusetts, specifically, are to excel. Time is too short this afternoon to opine on all aspects of this task, but let me hit a couple. Obviously, human capital is the most critical ingredient, and enhancing the quality of that capital could be the most vital task facing any of us, whether we're corporate leaders, public officials, or simply citizens who want to live in a growing, vital area.

Such enhancement has to be a key element in any economic development policy. If we expect workers at all levels to contribute their knowledge and intelligence to production activities, they must

have the tools - education and training - to open up those possibilities. If a locality wants to be a site where firms are growing - with in-place firms healthy and firms with growth potential choosing to locate there - the local work force must be attuned to the knowledge economy. They must be skilled, able to learn, and have a strong work ethic, so they are both willing and able to adapt to growing industries.

Active cooperation or collaboration between local businesses and local educational institutions can be the focal point of efforts to promote a region's adaptability to the new economy. Such a partnership of business and educational institutions develops joint decision-making capabilities and teamwork to make things happen - whether it's training or apprenticeship programs, incubators, venture capital funds, or industrial extension to encourage the spread of new technologies.

The field of education and training also offers great opportunity for cooperation between the private and the public sectors. In Boston, for example, the private sector has worked with the Boston Public Schools to set goals and measure performance through the agreements reflected in the Boston Compact. With 700 firms working together,

3,300 jobs were provided last summer, and, perhaps more importantly, a school-to-work program that is reaching 1,000 high school students already is being built. Across the state, local school-to-work partnerships are now getting off the ground. Business people should respond to opportunities to help set curricula in new school-to-work programs, to develop partnerships with individual schools, and to introduce to school management such insights from the corporate world as the importance of establishing goals and measuring and rewarding strong performance.

In addition to enhancing the knowledge and flexibility of the local work force, forward-looking economic development policies must also recognize and build on the existing skills base in local supplier networks. Even as the local manufacturing or export base shifts, the experience and reputation of local supply and service firms may be a regional draw. Some of the key skills are not just in the work force, but in the ability of firms to shift markets and build new product development into their daily operations. New firms can and will benefit from the productive relationships among supplier and buyer firms that are enhanced by proximity.

Finally, even mature industries have high-tech elements characterized by rapid technological change, relatively high R&D expenditures, and dependence on relatively highly skilled workers. Integrating new technologies into maturing sectors can foster innovation that leads to new and improved products, new markets, and the retention and expansion of the job base. How can development policies facilitate the introduction of new technologies into mature industries? Well, I'm sure it's not the whole answer, but I have been impressed by the work done at the University of Massachusetts to avail local businesses of technological help in creating new processes and reinventing old ones.

Economic development policy must be proactive if it truly wants to bolster local competitive advantage and long-term economic development. Lower costs are part of the answer. But they're not the whole answer. Simply lowering costs does not address issues of work force quality and technological change that underlie business performance. Proactive and innovative programs, however, can increase labor productivity, can help to motivate workers, improve efficiency, and increase the quality of the work force. In the new

economy, that is the surest way to create the "good jobs" everyone is seeking.

Much has been done in this arena, but it is time to redouble our efforts. The macroeconomic environment is favorable. The Commonwealth is recovering. Local business leaders and educators - those of you assembled in this room today - have unique expertise and local knowledge to contribute to the ongoing process of developing and adapting flexible economic development policies that can respond to this wide range of changing external forces. It is up to us as business leaders, educators, and policymakers to make the investment in tomorrow's work force and tomorrow's entrepreneurs that will ensure our long-term economic success, locally, regionally, and as a nation.