

THE NATIONAL OUTLOOK and the Forward-Looking Central Banker

This morning I'd like to discuss with you three issues that are central to the conduct of monetary policymaking: (1) How the economy has been performing; (2) How I expect the economy to perform over the next year or so, and (3) How well this assessment of economic performance jibes with our commitment to price stability. To anticipate, I believe that our economy has been healthy recently, and that the economy should remain in good health in the near term. Looking forward a bit, I would emphasize that we have reached a juncture where we must be extremely vigilant for signs of emerging inflationary pressures.

During the first six months of 1996, the economy performed quite well. It wasn't always easy to see it through the disruptions caused by winter storms, government shutdowns, more winter storms, huge swings in stocks of inventories, and the GM strike, but with sufficient hindsight it's now clear. Real GDP grew at a 2 percent rate in the first quarter, and the advance estimate for the second quarter shows growth at roughly double that pace. On the

employment front, we added nearly one and one-half million jobs to the economy during the first half of this year and lowered the unemployment rate below 5-1/2 percent in the process.

Throughout this period of strong employment and output performance, the core rate of inflation remained remarkably well-behaved. The core consumer price index--the index excluding the prices of the volatile food and energy components--rose just 2.7 percent over the twelve months ending in June of this year, an encouragingly low inflation rate that we last saw (prior to the 1990s) in January of 1973, a year in which wage and price controls were in effect. To be sure, surges in oil and grain prices contributed to a small increase in overall consumer price inflation. But it appears that these industry-specific price disruptions will not feed into overall wages and prices, and will thus amount to only temporary disruptions in the longer-run trajectory of inflation.

With regard to employee compensation, the trend has been generally favorable as well. Overall compensation costs have

increased at about 3 percent over the past year, down from the 3.5 to 4 percent rates of the early 1990s. Modest increases in wages and atypically small increases in benefits costs, coupled with reasonable gains in productivity, particularly in the manufacturing sector, have kept producers' unit labor costs low, allowing the modest final price increases that we have seen in most industries.

Overall, then, growth in output and employment has been fairly robust so far this year, while inflation has remained under control.

Looking forward, I expect growth for employment and output to moderate somewhat. We have good reason to believe that the pace of economic activity will slow from the brisk pace of the second quarter of this year to a more modest rate of increase of perhaps 2.5 percent per year.

The reasons for the "slowdown"--and I use that word cautiously, because I mean by that only a somewhat slower rate of *increase* in real activity, *not* a decrease--are as follows. By mid-July, long-term credit market rates had risen about 1 percentage

point above their year-end 1995 levels. While long-term rates have fallen somewhat recently, we still expect the higher rates that have generally prevailed to restrain spending over the next six to twelve months on residential construction, on autos, and on other consumer durable goods. Higher interest rates have not yet had a clear and sustained effect on housing and autos purchases, but the rapid increases in rates of spending over the past four years on new houses and autos have likely left most consumers in the house that they desire with the desired number and style of automobiles. Purchases of these items may well continue at a healthy pace, but higher interest rates should at least keep these spending categories from growing. Add to this picture of the well-stocked consumer a relatively high consumer debt burden, and I find it hard to envision sustained rapid growth in these sectors.

I would expect the modest tightening of credit market conditions to have a similar effect on businesses. Spending on new business equipment--computers, business vehicles, and manufacturing equipment--has grown by 10 percent or better over

the past three years. With these recent additions to productive capacity in place, with somewhat higher borrowing rates, and with the expectation of slowing demand during the coming quarters, businesses will likely gauge further additions to their capacity as less profitable, thus reducing the growth rate of business investment.

Finally, while healthy U.S. income growth and spending have added substantially to the national income of our trading partners, foreign spending on U.S. goods and services has done relatively little to add to our income. The last three months' data have shown a steady worsening in our balance of trade, with imports of goods and services exceeding exports by almost \$11 billion in May, compared to \$6 billion to \$7 billion in late 1995. This pattern is unlikely to be reversed in the near term, given projections of fairly healthy growth in the U.S. coupled with only gradual recovery towards more robust growth among our trading partners.

In sum, reduced rates of growth from the most vigorous

sectors of the past year should slow the growth of spending and employment to a respectable but not overheated rate during the next year.

The prognosis for the New England region is similar to that for the nation. The 2 percent employment growth of the past two years has slowed a bit already to a more sustainable pace, and is likely to continue at that rate over the next year or so. Labor markets are fairly tight here as elsewhere, with some anecdotal evidence of increasing wages and salaries. Labor market pressures are tempered, however, by continuing concerns by workers over restructuring, damping desires to increase wages. As a result, strong but diminishing growth has been accompanied by only modest increases in prices, as has been the case for the rest of the country.

Here in Connecticut, the latest labor data show considerable job creation--more than 20,000 jobs added in 1995, with perhaps that many again forecasted for 1996, according to the New England Economic Project. While Connecticut still lags behind the

rest of New England, its recent growth is the strongest in several years, and consequently implies a Connecticut outlook as strong as it has been since the beginning of the recovery in 1993.

Should we be happy with an economy that will slow to a modest, perhaps 2-1/2 percent rate of growth? In answering this question, let me first say that I think it is important to be clear that the Fed has no desire to place arbitrary "speed limits" on the growth of the U.S. economy. We welcome additional growth, provided that it is consistent with our long-standing commitment to price stability, or more specifically with the Fed's commitment to hold the line against any increase in the inflation rate. Too much growth could strain the limits of our economy's capacity and cause us to lose ground on the inflation rate.

The Fed has consistently maintained its goal of price stability over the past 20 years, beginning with a significant and successful battle against high inflation in the late 1970s and early 1980s. The motivation for the great disinflation was that a low and stable rate of inflation is a necessary ingredient in the recipe for

healthy long-run growth and a high standard of living.

How does low inflation contribute to the long-run growth of the economy? Low rates of inflation raise the productivity of enterprises by reducing the amount of non-productive activity that goes to inflation-avoidance activities. When prices are stable or rising slowly, firms do not have the leeway to pass cost increases on in final prices. As a result, they are forced to respond to cost pressures by improving efficiency. In addition, maintaining a stable, low inflation rate reduces uncertainty about future inflation, which makes the real value of investments in long-term income commitments less risky and hence more valuable. More investment yields higher productivity and greater capacity, further contributing to a higher level of long-run economic prosperity.

These widely accepted linkages provide a firm foundation for the Fed's commitment to price stability. To date, we have seen no signs to suggest that our progress towards price stability has been eroded. But as policymakers we must be *forward-looking*; we must focus our attention on where inflation is likely to go over

the next year or more. Knowing that it takes monetary policy *months* to have any effect on the economy at all, and that policy's full effect on inflation may not be felt for two years or more, we must be concerned with potential inflation developments over this longer horizon. As Chairman Greenspan put it in his recent Humphrey-Hawkins testimony, the Fed has to "look beyond current data readings and base action on its assessment of where the economy is headed." Because of the time lag between making a policy decision and its effects on inflation, we need to focus on the inflation that we expect to occur over the next year, not on the inflation that didn't materialize in the past year.

Two observations give me cause for concern about the path of inflation over the next year or two. The first is that most measures of resource utilization have indicated an economy operating at, or slightly above, full capacity for the better part of two years now. The unemployment rate, which has averaged about 5-1/2 percent since year-end 1994, and the Federal Reserve Board's estimate of industrial capacity utilization both confirm

this assessment. Historically, when the economy has reached these levels of resource utilization, we have seen emergent wage and price pressures.

As I have suggested, we have been fortunate recently that these underlying demand pressures have been offset by labor productivity increases that reduce the overall cost of labor input to producers, and by unusually slow increases in benefits costs, which have yielded modest increases in total compensation costs. Both of these developments have allowed final goods providers to pass on relatively small price increases to consumers, and they have kept inflation from rising over the past year. But my view is that these restraints are temporary. We do not know when they will be lifted, but eventually they will, and at that point we may well begin to see the effects on inflation of the high levels of utilization already in place.

The second troublesome observation is that recent data shows some increase in wage inflation. The wage and salary component of the employment cost index, our most reliable

measure of compensation costs, rose at an annual rate of 3.7 percent in the first half of this year. This increase, a departure from the more subdued average pace of wage increase of just under 3 percent for the preceding four years, may indicate the initial influence of capacity constraints on wages and salaries. *Overall* compensation rose by less than wages and salaries, as increases in benefits were more subdued than previously. But without the above-normal increases in productivity experienced recently, labor cost pressures are likely to be passed on eventually by producers in the form of higher final goods prices.

These two developments suggest some worrisome upside risk to the inflation forecast. Thus, there is no question in my mind that this is a time when the Fed must be extraordinarily vigilant for signs of rising inflation over the monetary policy horizon. Should it become clear that the temporary restraints on inflation have begun to lift, I have no doubt that the Fed will act in advance to preserve the ground gained on the inflation front.

In thinking about how forward-looking monetary policy

works, it may be useful to look back to a recent example of a successfully implemented forward-looking policy. In early 1994, the unemployment rate stood a bit below 6-1/2 percent, growth exceeded potential, and the economy was expected to quickly reach capacity and to begin to exert upward pressure on inflation. The Fed decided to act in advance of realized inflationary pressures, raising the funds rate to ensure that the economy would subsequently slow to a sustainable, non-inflationary rate of growth for the remainder of 1994 and 1995. In the event, growth averaged 3.5 percent in 1994 and the unemployment rate fell to a low of 5.4 percent in December. Owing in part to the Fed's 300-basis-point increase in the federal funds rate over 1994 and early 1995, the economy slowed to a more sustainable rate of growth in 1995, stabilizing both the unemployment rate and the inflation rate.

What would have happened had the Fed tightened only upon seeing inflation in the lagging published measures? It is always extremely difficult and risky to paint such counterfactual pictures

of the economy. However, I think it is fair to say that without our forward-looking tightening, economic growth would have been notably faster, the unemployment rate lower, and inflation significantly higher than it is today. The Fed would ultimately have responded to faster growth and acted to curtail rising inflation, but it would likely have had a more difficult time in doing so. Guiding the economy back from a position of over-utilized capacity and rising inflation to a position of sustainable growth and stable inflation runs a risk of overshooting in the opposite direction. It seems to me that a better policy takes anticipatory actions to nip departures from the desired outcome in the bud, avoiding larger swings in employment and inflation.

To sum up, it seems to me that we have recently been blessed with an unusual blend of sensible monetary policy, excellent economic outcomes, and good luck. I think it is reasonable to expect the recent trends of steady growth and low inflation to continue. The key Fed contribution to this success story has been the beneficial effects on employment and growth

of low and stable inflation, made possible by a very successful strategy of forward-looking monetary policy. With some care and perhaps a bit more luck, I think we can continue to guide the economy along the “Goldilocks” path that we have enjoyed recently--not too hot, not too cold; just right.