

Perspectives on the National Outlook

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Good morning. My delegated task for today was to share some perspectives with you on the outlook for the national economy for the next decade. A trifle ambitious, I would say, and you'd have to take any projection made for so long a period with such a wide interval of confidence as to make it relatively meaningless, at least from the point of its likelihood. Thus, I thought I'd focus on the rest of 1996, and leave you with some thoughts on longer-run challenges.

It's hard to regard 1996 to date as anything but a fairly solid success from an economic point of view. It hasn't always been easy to see this through the disruptions caused by winter storms, government shutdowns, more winter storms, huge swings in stocks of inventories, and the GM strike, but it's now clear. Real GDP grew at a 2 percent rate in the first quarter, and the numbers for the second quarter show growth at more than double that pace. On the employment front, we added nearly 2 million jobs to the economy during the first eight months of this year and lowered the unemployment rate to 5.1 percent by August.

Throughout this period of strong employment and output performance, the core rate of inflation has remained remarkably well-behaved. The core consumer price index--the index excluding the prices of the volatile food and energy components--rose 2.7 percent over the twelve months ending in July of this year. To be sure, surges in oil and grain prices contributed to a small increase in overall consumer price inflation, but these industry-specific price disruptions may not feed into overall wages and prices, and will amount to only temporary disruptions in the longer-run trajectory of inflation.

Turning to employee compensation, the trend has been generally favorable as well, though, as I will note later, recent signs indicate some concerns here. Through the second quarter, overall compensation costs increased at about 3 percent over the past year. Atypically small increases in benefits costs, coupled with reasonable gains in productivity, particularly in the manufacturing sector, however, have kept

producers' unit labor costs low. This has allowed the modest final price increases that we have seen in most industries.

Looking forward, most analysts expect growth in employment and output to moderate somewhat, perhaps to a pace of 2.5 percent or slightly better later this year. The reasons for this "slowdown"--and I use that word cautiously, because I mean by that only a somewhat slower rate of *increase* in real activity--largely relate to the potential impact of higher interest rates and to the very length of this expansionary period. 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 bounced around recently, higher rates could restrain spending over the next six to twelve months on residential construction, on autos, and on other consumer durable goods. However, they haven't done so yet in any clear and sustained way. Housing starts and permits remain at relatively high levels, while auto and consumer durable sales have fallen off a bit, but only very recently.

Rapid increases in rates of spending over the past four years on new houses and autos, however, may have left many 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 it may be hard to sustain rapid growth in these sectors.

Modest tightening of credit market conditions could also 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 may gauge further additions to their capacity as

less profitable, thus reducing the growth rate of business investment.

However, business inventory spending, which has provided many of the surprises in the economic data over the last couple of years, may again act to propel growth. At this time, inventories relative to sales are at a low point. Is this intentional, reflecting the expectations of slower second-half growth, or are these inventory positions unintentional, reflecting the stronger-than-expected demand of the second half? If the latter is the case, inventory spending could well be a source of growth in the coming months.

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. This pattern may not be reversed in the near term, given projections of fairly healthy growth in the United States, 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 may well slow the growth of spending and employment to a respectable but not overheated rate during the next year. But there are risks here, and it is these risks themselves--that growth will be too strong and kindle the fires of inflation--that present the greatest challenges as we look forward.

Now some will say that to worry about too much growth is a foolish, if not harmful, notion. And I would agree that over the long term, high rates of growth, and low inflation can, do, and should coexist. But it is also true that too much strain on the economy's capacity in the short run can cause us to lose ground in the hard-fought battle against inflation, and that, in turn, can threaten our progress toward healthy long-term growth.

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 attention to price stability. In 1996, there have been few signs that our progress towards lower inflation 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."

Two observations suggest that this is a time during which we must be unusually vigilant for emerging inflationary pressures. 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. As one aspect of this, the unemployment rate has averaged about 5-1/2 percent since year-end 1994, and now stands at the lowest rate in years. 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 these restraints may well be temporary. We cannot know when they will change, but eventually they will; 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 show 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 will eventually be passed on by producers in the form of higher final goods prices.

These two developments, along with the inventory questions I talked about earlier, suggest that the risk in the inflation forecast lies mainly on the upside. Thus, there is no question in my mind that this is a time when the Fed must be quite vigilant for any sign of rising inflation over the monetary policy horizon.

Now, as I noted earlier, I'd like to switch to some long-term considerations regarding economic growth--appropriate I would say for a group of professionals from the life insurance industry. What is our economy likely to look like over the next decade, and what are the primary challenges facing us?

Technological change and the increasing pace of global competition have already created an environment in which economic growth depends on ever-increasing improvements in

efficiency and productivity. This is not likely to change over the next decade, nor should it. Technological innovation is the absolute prerequisite for growth, and we should find ways to speed its evolution if at all possible. Similarly, open trading and competition with the rest of the world heightens our knowledge and forces us to concentrate resources on products and processes where we have a comparative advantage. But both technological change and increasing global competition require investments--investments in physical capital to incorporate and diffuse new technologies and in human capital both to create a source of innovation and develop a work force skilled enough to handle new technologies. Will we be able to make these needed investments?

Increased investment in physical capital requires both sources of funds, and the expectation that the return from investment will be sufficient to reward the investor. Over the long run, this surely means that we as a nation must increase our rate of savings--or in the case of government, its rate of

dissaving--in order to increase private investment and reduce long-term interest rates. Much progress has been made on reducing the budget deficit, and there is seemingly a political commitment to make even more progress by the turn of the millennium. But we, as all developed nations, have an aging work force and a huge number of us will retire in the early years of the new century. At that point, deficits may well rise again as the government strains to pay social security and health care costs. Many project that unless major changes are made, the strain in terms of taxes on the current work force in the new millennium will be considerable. The time to start is now to reform these systems and create other economic incentives so less public funding is required and more private savings are generated.

Investments in human capital have to be made alongside investments in physical capital. Here I'm talking about improvements in education and training that are vital if we are to have the skilled work force we need for the future, and if we

are to make progress on the growing trend of income inequality in this country. This can't simply be a matter of throwing more government money at education--first, there isn't money to throw, but second, and more importantly, education and training can only be improved if the private and public sectors work together to ensure that education in school and on-the-job needs are linked in new and innovative ways. Here in Boston, many businesses like the Fed participate in a school-to-work program in conjunction with the Boston public schools. It's a small program so far, but we know it works--better than 90 percent of the graduates of our first couple of years went on to two- or four-year post-secondary education when hardly any were expected to before the fact. These students saw the relevance of education to future job success and they responded. We're trying to take this program to scale here in Boston, and make every student a skilled potential employee. That way everyone wins--the students, the businesses, and Boston itself.

In closing, let me reiterate the short-term view is positive. Healthy economic growth is likely. We must be vigilant on the inflation front, and steer the short-run path toward the long-run in an environment of low rates of inflation. However, we must also deal with the need to increase our investment in physical and human capital through rising rates of national saving and increased emphasis on education and training. Thank you.