

**Connecticut Business and Industry Association
Economic Summit and Outlook '97**

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Thank you very much. I am extremely pleased to be here this morning, as I was two years ago, to help the CBIA kick off the new year with what promises to be a thorough discussion of Connecticut's and the region's prospects for 1997. I'd also like to congratulate the winners of the PRIDE Award to be announced by the Greater Hartford Chamber of Commerce at your lunch today.

I believe that corporate partnerships with the public sector aimed at improving the community in which both are located are absolutely critical to ensuring that economic prosperity is shared as broadly as possible. In this day of shrinking government spending and the recognition that broad federal programs cannot address local problems as effectively as local people, private/public partnerships are key to the region's future success as are appropriate national economic policies. We at the Federal Reserve will do our best with monetary policy; the business and community groups in Connecticut and around the region must also do theirs if we are to realize our potential here in New England.

The national economy's performance last year was exceptional. In the first three quarters of 1996, real GDP grew at an almost three percent rate. Through all of 1996, well over two million new jobs were created. Reflecting this, the unemployment rate has been hovering around the low point reached during the peak of the 1980s expansion. Even with this pressure on resources, core inflation, that is inflation excluding the volatile food and energy components, remained at or around a level the U.S. has not seen since the mid 1960s. Moreover, the national budget deficit exerted the smallest drag on savings in over a decade, though trade deficits continued to be worrisome. All in all an impressive year, and made even more so by the fact that it reflects a continuation of a three-year period of really very favorable economic trends.

Here in Connecticut, the economy is--by many measures--in the best shape it's been in nearly a decade. To be sure, when you compare current employment levels with what they were in the late eighties, you could argue that the glass is only half full--

especially in the Hartford area. But, the glass is getting fuller. Statewide, the rate of employment growth over the past year--about 1 percent--matches its 25-year trend. And the rate of unemployment has been hovering at 5 percent or less. Job fairs and help-wanted signs are reappearing across the state. And in Hartford, we are hearing some sprinkles of good news about those pillars of the local economy, financial services and aerospace.

Can the local and national economies continue this performance? First, it should be noted that last year was bumpier than we tend to remember. At the beginning of the year, disruptions caused by government shutdowns and winter storms gave rise to concern that the economy was slipping into recession. By late spring and through the early fall, those concerns reversed; the economy seemed on the verge of growing too fast. The unemployment rate had fallen below historical estimates of the rate compatible with low and stable inflation, and the growth in wages and salaries had picked up. Most forecasters

thought it much more likely that inflation would increase than that it would fall. By the end of the year, however, the risks around the inflation forecast were more balanced; the economy had slowed to a sustainable pace, core inflation continued under control and the uptick in wages and salaries for the year seemed less alarming. Clearly from the perspective of a full year, economic nirvana was approached in 1996, but during the year swings in sentiment among market commenters and observers often revealed considerable uncertainty.

At this point, anyway, the outlook for 1997 seems more sanguine. Most forecasters expect that the current momentum can be maintained. Although data on the fourth quarter are incomplete, it appears that the economy continued to grow at a rate close to its long-run sustainable pace. By November, job creation slowed down to a rate more consistent with the growth in the labor force, and claims data and unemployment levels began to signal a bit less pressure in labor markets, though this should not be overstated.

Information from the spending or demand side of the economy confirms the picture given by the employment data. Though still only slightly better than anecdotal, recent reports about the Christmas season suggest that consumption bounced back from its surprisingly low rate of growth in the third quarter, but it did not bounce back too aggressively. Preliminary indicators of last month's retail sales suggest moderate growth in consumption in fourth quarter. Sources of weakness continue to be found in the external sector, where net export deficits were at record levels for the year as a whole, and in government spending which produced the very favorable deficit results I noted before.

In contrast, the interest sensitive sectors continued to be sources of strength. The most recent data on housing starts, building permits and overall construction spending are suggestive of a pace of overall construction activity that is growing at a slower rate, but is still growing and remains at a relatively high level. Business fixed investment was also a positive factor,

showing some moderation in growth rates but a continuation of its multi-year strength.

All in all, the economy will probably turn out to have been a sector-by-sector mixed bag in the fourth quarter, but as it was for the year as a whole. That is exactly what you'd expect when overall the economy was growing about at its long-term trend, as pockets of relative weakness help to mitigate pockets of relative strength.

The fourth quarter, and for that matter, all of 1996, is history; obviously future prospects are of much more interest. The best guess of most forecasters is that real GDP will continue to expand near its long-run sustainable pace of 2 to 2.5 percent. As a consequence, the unemployment rate will remain relatively stable at or near its recent low levels. High levels of consumer confidence and continued employment growth suggest that consumption should remain healthy even though the growth in residential investment has moderated. Business cash flows, together with the continuing drive to increase efficiency and

competitiveness, suggest that business investment may remain relatively strong. On the other hand, government spending and net exports could act as drags on the economy, given the prospects for laudable efforts on the national scene to achieve a balanced budget, and the effects of a stronger dollar and prospects for only moderate growth in many of our trading partners. Again, sectors of strength should continue to offset those of weakness.

That is not to say that there are no risks to the economy. Just to mention a couple, the rising burden of debt servicing for the consumer, including the rising delinquency rates on consumer debt indicate a potential downside risk to the consumption forecast. On the up side, the moderate level of long-term interest rates seen so far in this expansion may support more strength in the interest-sensitive sectors than expected. However, the risks that GDP will grow much faster or slower than the solid consensus forecast appear relatively low now. In fact, one measure of forecast uncertainty, the Survey of Professional

Forecasters, suggests that the risks around this outlook are much lower than normal.

However, even with this balanced growth forecast, inflation risk cannot be overlooked. Our labor resources are strained, at least by most conventional measures. Since the middle of last year the unemployment rate has remained below 5.5%. In the late 1980s when the economy reached today's levels of unemployment, both wage and price inflation accelerated. Although we have seen no hint of an increase in core inflation, wages over a longer period have shown some signs of accelerating. Over the last two years, the growth in average hourly earnings rose about half a percentage point. A better measure of wage inflation, contained in the Employment Cost Index, also edged up slightly.

However, these minor wage increases were not translated into price increases, and most forecasters expect that inflation will remain relatively mild, despite historical experience suggesting the opposite. Various reasons are given for this rather surprisingly

subdued inflation forecast, some of which have been characterized as basic changes in the way our economy works. In my view, none is completely satisfying over the longer run.

It has been argued that excess global capacity is holding down our inflation rate. Since the U.S. economy is becoming more open, the argument goes, U.S. producers are becoming more sensitive to foreign competition. Since many foreign producers are now facing a significant amount of excess capacity, they are less likely to face cost pressures that cause them to raise prices than are their U.S. counterparts. Moreover, the strengthening of the U.S. dollar has made imports relatively cheaper. If U.S. firms do raise prices in this environment, they risk losing market share. Thus, many are now arguing that U.S. inflation is not the threat it normally is at this level of unemployment because Germany, France, Japan, Canada, and Mexico all have significant excess capacity and favorable exchange rates.

The discipline from foreign producers logically has little effect on prices for nontraded goods, however. A large fraction of U.S.

production faces no foreign competitors; in fact, imports only constitute about 15 percent of GDP. There is very little foreign competition for construction, legal services, and most other services. Domestic, rather than foreign, capacity constraints should determine inflation in these markets.

Moreover, foreign firms that do compete in the U.S. often price to the U.S. market. When the U.S. economy is strong, they raise their U.S. prices and when it is weak they lower them, regardless of the capacity situation at home. Their U.S. prices react to demand for goods in the U.S., not just the cost of these goods at home. So while the foreign capacity argument is appealing, and may have an impact at the margin, it doesn't seem to be the whole answer and certainly has a transitory quality about it.

Others have argued that business investments in capital, and its efforts to restructure and downsize, have increased productivity to the point that increases in wage and other labor costs can be absorbed without increases in final prices. This

argument has some intuitive appeal, but unfortunately cannot be supported by the existing data. Measured productivity growth has been unusually weak, not strong, in this expansion. It is possible that productivity growth is mismeasured; most of the job growth in this expansion has been in the services sector, where the ability to measure productivity is poor at best. However, increases in total compensation costs have not been so large yet in this expansion for me to assume unmeasured high rates of productivity growth are the full answer to the very favorable inflation picture and forecast. Moreover, given the length of this expansion, I find it difficult to believe that unmeasured productivity will continue to grow at rates that outstrip the rate that overall compensation may grow. Unmeasured productivity increases may be helping now at the margin, but their contribution is also likely to be transitory.

A possibly more plausible explanation is that the labor market is not nearly as tight as it normally is when the unemployment rate is this low. For example, widespread publicity about

downsizing and diminished corporate security may have made workers feel less confident about changing jobs and demanding wage increases. In fact, other measures of labor market pressure--as imperfect as they are--do not indicate that the market is as tight as the unemployment rate does. The number of help wanted advertisements, which can reflect how hard it is for employers to find workers, is low given the current level of unemployment. The number of job leavers relative to the number of job losers, a measure of workers' confidence that they can find another job, is also low given the unemployment rate. The relationship between these other indicators of labor market tightness and inflation has not been as strong historically as that between the unemployment rate and inflation, but there is some evidence that they do play a role. Thus, there may be something to the argument that uncertainty in the labor market is restraining inflation, though whether such uncertainty will last is the real question.

Finally, the economy has also been the recent beneficiary of a couple of lucky breaks. Oil prices, for one, have been well

behaved. More importantly, for the past two years benefit costs have barely increased at all as medical insurance and workers' compensation costs have grown much more slowly and the cost of worker's compensation have declined. These costs may accelerate sooner or later; the question is when. Wages and salaries could also resume their upward climb this year as it is certainly more likely that these costs will increase than that they will decrease. Given this, and the uncertainty and potentially transitory nature of the other trends assumed to be containing inflation, my view is that there is still a risk of inflation that bears watching.

Now you probably all are thinking "Here's another Federal Reserve worry wart concerned about inflation that doesn't exist. The real problem is growth--why don't they do something about that?" In my view, the Federal Reserve's pursuit of low, stable rates of inflation over the last 15 years or so has been a key factor in supporting economic growth. Low inflation creates an environment in which it is possible for both consumers and

investors to pursue investment opportunities, rather than speculative excess. Since the last recession, which was mild for most of the U.S. except New England, the recovery has been dominated by business fixed investment and by consumer durable spending. Broadly speaking, businesses and consumers--despite assertions about job uncertainty--seem to have faith in continued economic growth; they are willing to spend, and increasingly willing to save and invest for their futures. Consumer debt burdens are an issue, but, by and large, consumer, banking, and corporate balance sheets are healthy, and U.S. business is competitive in world markets to a degree we could only imagine a decade or so ago. The trade deficit clearly is an issue, but the prospects for even lower federal deficits is certainly a positive. Low inflation is not the whole reason why all of this has happened, but it is a vital part of the picture.

Looking forward, I, for one, would be loathe to give up on the success on the inflation front that has been achieved to date. I recognize that in the short run inflation control can have its

costs, but higher rates of inflation surely have their costs--very large costs--as well. And I don't think we can rely on theories that suggest the fundamental nature of the nation's economic process has changed. Each of the theories being offered for inflation remaining contained have some validity, and acting together may answer the question of why inflation has been so well-behaved. But they may also be reflecting temporary rather than permanent conditions. Thus, I believe that carefully watching inflation is a must for the best the Federal Reserve can do. We must do so to address the important goals of economic policy--those of fostering growth and rising standards of living.

But what the Fed does in some sense is indirect; what citizens, businesses, and government do with their savings, investment and spending will have direct effects on particular sources of growth. That is why I am so heartened by the nature of your program today. States and regions need to address the problems that face them--the state of public education systems; the availability of funding for small and start-up businesses; how

to ease the agony of transition to a newer, more competitive economy for older industries; how to ensure that the regional infrastructure of transportation and utility services help support, rather than hinder growth, and on and on. This conference, and many like it around the region, are appropriately focused on what all of you can do to create opportunities for growth in your own area. I wish you well in your endeavor.