Perspectives on The U.S. Economy: From Vermont to the World A Symposium

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Good afternoon. It's a pleasure to be with you today to share some views on the nation's economy.

My task today is to begin our panel with some thoughts on the overall U.S. economy. To get right to the point--it doesn't get much better than this. In 1996, overall GDP growth picked up to better than three percent over the four quarters, or more than a little better than most estimates of the economy's long-run potential. Reflecting this, and the fact that more than two and a half million jobs were created during the year, the unemployment rate dropped to an average of about 5.3 percent over the second half of the year. These signals of labor market tightness in the face of continuing above trend growth clearly sound inflation alarm bells. But as yet, signs of increasing price pressures are few. Consumer price index growth was low for 1996, as were other measures of price change, rising, depending on the measure, somewhere between 2.5 - 3.0%; one has to go back to the halcyon days of the '60s to find such an extended period of low unemployment and inflation. Solid growth, low unemployment, quiescent inflation--a sure recipe for economic nirvana. With 1996 as a background, the most pressing question has to be whether this will last?

Here the news as most forecasters see it remains favorable as well. Recent revisions to the fourth quarter GDP bode well for the economy in the beginning of this year. The strength in final sales and the weakness in inventory investment last quarter diminish the possibility of an inventory correction slowing the economy in the near-term. Moreover, other data so far this quarter also portray a robust economy. Employment in the first two months has grown at almost a 300,000 job per month pace--or better than 50,000 jobs over the increases most often seen in the last half of 1996. Other labor market data, such as the low level of initial claims for unemployment insurance, corroborates this strength in the labor market. Although areas of relative weakness are expected this quarter, like a widening trade deficit and continued weakness in government spending, the sketchy data we have on retail sales and durable goods orders for this quarter suggest continued strength in consumption and business fixed investment. The economy continues to expand fairly rapidly.

For the year as a whole, the best bet is that the pace of economic growth will slow down -- the question is by how much. Exports are expected to grow more slowly, in part due to the recent run up in the dollar. Residential investment should not be a source of strength, looking more like it did in the second half of last year than the first half. Reductions in government spending are also expected to have a restraining effect. The best guess is that the economy will slow down, but best guesses can be wrong.

If the best guess is wrong are we more likely to err on the upside or the downside? On the upside, the favorable financial climate and strong employment picture might boost consumption and investment more than anticipated. Residential investment may also be more resilient than expected. The one area where the risks could be on the downside involves the country's growing trade deficit affected as it is in the short run by relative patterns of growth among our trading partners and by exchange rates. On balance, however, if there is a risk to our best guess, it seems skewed toward more growth rather than less. Not a problem you might say, unless the economy's resources begin to show signs of strain. The current best guess for inflation in 1997 is that it will stay about where it was in 1996, but here also the risks seem skewed to the upside.

So far in this expansion, we have managed to dodge the inflation bullet, even in the face of labor market tightness that by historical measures should have been associated with rising inflation. Inflation and the imbalances it so frequently generates, in turn, have most often brought expansions to an end--so if the 1996 track record is to continue in 1997 and beyond, inflation control is critical.

Explanations abound as to why inflation has remained restrained as labor markets have tightened, but three possibilities get most attention. First, some believe that corporate downsizing and emphasis on efficiency in the face of fiercely competitive markets have made workers uncertain about job security and their ability to change jobs easily. Thus, wages are showing less upward pressure than occurred previously at similar levels of labor market tightness. This idea has much intuitive merit and is supported by labor market indicators other than the unemployment rate, such as data on job leavers and help-wanted ads. However, worker uncertainty cannot last forever, given the healthy pace of job creation and, very recently, these other measures have begun to tighten a bit. Moreover, the growth in overall compensation costs has been held down until recently in part because of even lower growth in health and other benefits costs. At some point, such costs will begin to escalate from this reduced pace. Indeed, wages and total compensation have begun to accelerate recently, albeit moderately.

Some observers have argued that higher rates of productivity growth explain why inflation remains subdued. This argument is difficult to document since measured aggregate productivity has been low, not high, over the years of this recovery. Nonetheless, this argument certainly has intuitive appeal, given numerous anecdotes of cost-cutting efficiencies and new ways of doing business, both here in New England and nationwide. If productivity is mismeasured, however, GDP growth has been as well. This would be welcome news, but it tells us relatively little about the economy's future ability to restrain inflation, particularly if wage and other costs begin to accelerate.

Still others find the answer to why inflation remains subdued in the external sector. They argue that the increased openness of the U.S. economy at a time of relatively slack conditions in our major trading partners has created a competitive situation in which U.S. firms believe they might lose market share as soon as they raise prices. In addition, excess foreign capacity can help to ease domestic supply pressures. Again, this argument has appeal. Traded goods, i.e., both exports and imports, comprise a bigger share of the U.S. GDP than they did two or three decades ago. Imports have satisfied a large fraction of the increase in U.S. demand during the past year or so, and non-oil import prices have fallen with the dollar's appreciation over the past 18 months. In addition, excess capacity in overseas labor markets, combined with new communications technologies, may make it possible for U.S. firms to take advantage of certain kinds of foreign-based labor -- for example, software technicians in short supply domestically.

Nevertheless, a sizeable portion of U.S. GDP faces no foreign competition. Nontraded goods and services are by far the largest share of the nation's economy; price moderation in such goods relates to domestic rather than foreign economic conditions. Even among traded goods, foreign producers price in response to conditions in the United States, not solely on the basis of their own costs. Moreover, it is difficult to assess what impact an excess supply of foreign labor has on domestic market conditions, except to add to the labor market uncertainty discussed earlier. Finally, with at least modest growth expected for all our major trading partners, foreign excess capacity may dwindle over time.

Taken together, these explanations could have contributed to the surprisingly low inflation the United States has experienced over the past year and they may continue to influence trends in 1997. However, questions exist about whether any of these explanations are persuasive, either individually or collectively, over the longer term, so continued vigilance is in order.

The past year has been about as good as it gets, and there is a reasonable chance this economic fair weather will continue in 1997. My own view is, however, that it's sensible to weigh the risks -- in particular the risk of inflation -- very carefully this year.

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