

**The Bond Analysts Society of Boston**

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- o News on the economy surprisingly good
- o In fact - we seem to be enjoying the best of all worlds: solid above trend growth, for more than ~~3~~ quarters, low unemployment, all accompanied by low and, by some measures, falling unemployment *second half of 95 on*  
*bounced around a lot*
- o We at the Bank, as well as others, have been puzzled by this continued streak of good fortune - is it temporary, is it permanent - that's the \$64,000 question
- o In addressing this question, I like to divide things into what we do know, and what we don't
- o First, what we do know.
  1. Economy has grown at a pace of 3.5 percent (about double forecast) over last 4 quarters.
  2. Unemployment rate has fallen about half a point to 4.9 percent, when it was expected to be flat.
  3. Core inflation has declined 20 basis points to 2.4 percent over the past year, when it was expected to drift upwards.

4. We also know economy should continue to expand: people have jobs, consumer spending is heating up from its second quarter slump, the consumer is confident--spectacularly so--and, volatilities aside, consumer wealth from stock market "exuberance" over the past few years has increased substantially. Recent auto and other retail sales data also support the notion that the consumer is back in 1997.
5. Similarly, businesses are in good shape as well, and fundamentals suggest that investment in plant and equipment should continue to expand rapidly. Strong cash flows, the level of stock prices, and a relatively benign cost of capital all should spur firms to invest. Moreover, industrial production numbers show manufacturing continues to thrive--boding well for GDP growth in third quarter.
6. Even residential investment, which was expected to be a source of slowdown, continues to appear strong, supported by income growth and high affordability ratings.
7. We also know there are areas that will rein in growth and provide some much needed restraint. One of these is inventories--it's hard to put inventories under the category of things we know about since they are really difficult to forecast--but we do know they grew a lot in the first half of

the year. This growth was likely largely intended, given the economy's current strength, but that rate of growth likely won't be sustained.

8. The other area of restraint comes from net exports. Exports have given a tremendous boost to the economy, but their continued growth depends on the growth of our trading partners and the value of the dollar. Growth in many of our major trading partners is healthy, but not overly so, and for some--most notably Japan--it is weak. Foreign growth likely will not support the expansion in exports we've seen over the last 3 quarters--and it certainly won't if the price of such goods keeps increasing with the appreciation of the dollar.
  9. So that's what do know -- the economy is strong and likely to remain so for the remainder of the year, with all that implies about low unemployment rates.
- o What we don't know is why all this is happening without inflation raising its ugly head.
1. People who answer this question usually fall into one of two camps: those who believe our good fortune is temporary, and those who believe it's permanent. It shouldn't surprise you that I, as a conservative central banker, have taken the

middle road--there certainly are temporary factors at work, but I also think something more fundamental--but really difficult to document--may be going on as well.

2. First, the temporary factors. Two seem predominant. First, employers have directed increasing attention to minimizing the rate of growth in benefits costs, moving from defined benefit to defined contribution plans and putting enormous pressure on health care providers to reduce premiums. This has reduced the growth rate in overall compensation, thereby putting less pressure on profits and prices than might be expected at similar levels of unemployment.
3. Second, import prices are low given excess capacity abroad and the appreciation of the dollar. To the extent such prices set the competitive threshold in our domestic market, they also play a part in low inflationary growth.
4. Obviously, both benefit costs and import prices will rise at some point--the question is when. Moreover, it's not clear that either one of these factors, or both taken together, can account entirely for our recent economic success. Something fundamental may be going on.
5. Those who believe in fundamental change also point to two areas: growth in the economy's potential, and a change in

the long-term relationship of labor constraints and rates of inflationary growth. Let me discuss changes in potential first.

6. As you know, monetary policy plays little role in determining the economy's potential rate of growth--that is determined by the growth rates of both the labor force, and their productivity.
  
7. Not long ago, the labor force was expected to grow at close to 1 percent per year. Over the last year and a half, it has grown at an almost 1-1/2 percent pace. This doesn't represent population growth; but it does reflect the fact that population is being drawn back into the labor force (grew by .5 percent since beginning of 1996). The labor force can't increase forever, but it could rise long enough to raise potential GDP for several years to come, as it did in the 1970s and 1980s. Then we knew it was the baby boomers and women coming into the labor force; now the answer's not so clear.
  
8. What about productivity? Again there are two issues. First, is productivity mismeasured? The answer has got to be yes, due largely to problems in measuring output in the service sector. However, if potential growth goes up, so does actual growth. So the critical question remains--how

far above potential are we growing, if at all. The second issue related to productivity reflects the fact that over the last year and a half, productivity has grown at a 1.3 percent pace, or about .3 percentage points above its growth since the '70s. Productivity is notoriously volatile, so this increase could be cyclical and temporary, but it also might be longer-lived.

9. Now if we put changes in labor force and productivity together, we do see some suggestions that potential growth is higher than the 2 percent or so that was our past estimate. Let's say long-lived labor force growth and changes in productivity do add a few tenths to the estimate of potential; they don't, however, add the full percentage point or better necessary to bring the trend rate in line with actual growth. And the proof of this lies in the sharp decline in the unemployment rate since 1995 -- this would not have happened if trend and actual rates of growth were identical.
- o So this brings me back to my earlier position -- temporary factors don't provide the whole answer, and more permanent changes -- if they do exist -- don't seem strong enough either. Our current economic success has to be a combination of the two. Moreover, I think it's also affected by something else we don't know.

1. For the last 7 years, the United States has experienced declining rates of inflation. Not only that, but inflation is at levels we haven't seen since the 1960's and that doesn't even take into account issues of mismeasurement which arguably lower the inflation rate even further. I would argue we really don't know a lot about how our modern economy functions with no inflation.
2. Moreover, we are in a world in which low inflation is the rule not the exception, with nearly all industrialized countries experiencing rates of price growth at or lower than our own.
3. Questions abound here about how this worldwide low-inflation environment affects our economy. What is the feedback from low inflation to the real economy?
4. Are stable (or reasonably so) general prices an incentive to all types of businesses to keep costs as flat as possible? Do stable price levels encourage workers to be more productive knowing that wages will not rise simply because of inflation? Does global price restraint feed back to our own economy, even given the fact that imports are not a large share of our economy? Does the inflation-fighting credibility the Federal Reserve has built up over the years since the early 1980s help to reduce inflationary

expectations, and reduce real rates of interest at least at the long end of the yield curve, thereby spurring investment? I could think of lots of other questions, but my own sense is that the record of low inflation is making a difference, even though that is difficult to document.

Thus, I approach the current state of economic bliss with a sense of caution. The very success of our policies could lead to a call for less vigilance against inflation. That would be unwise. We don't know how this environment quantitatively makes a difference, but I believe it does, and I, for one, would remain vigilant on the inflation front to endeavor to continue this success.