

**Current Perspectives  
On the Economy**

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Good afternoon. It's a pleasure to be with you to share some perspectives on the nation's economy. My focus today will be on the economic fundamentals -- that remarkable combination of solid growth, low unemployment, quiescent inflation, and a declining federal budget deficit--that have characterized the U.S. position over the last three or so years.

How have we been able to achieve such favorable performance, given that it is better than most forecasters predicted, or history suggested was likely? Certainly there are temporary factors at work, but I think it is also true that the underlying economic fundamentals of the U.S. economy have improved as well. Finally the current environment of very low rates of inflationary growth even in the face of high resource utilization is something the U.S. economy hasn't experienced since the early sixties. That, in itself, may be a significant factor in the solid strength of the real economy.

In assessing the current state of the real economy, I'd like to focus first on the favorable features of recent real economic performance. Over the past four quarters, the economy has grown at a pace of 3.4 percent, well ahead of what most forecasters expected. Reflecting this, and the fact that about 2.5 million net new jobs were added during the past year, the unemployment rate has fallen about half a point to 4.9 percent, whereas most forecasters had expected the rate to stay flat.

These signals of capacity constraint in the face of growth that continues above the long-term trend could signal higher

rates of inflationary growth. But, as yet, we see almost no signs of increasing price pressures. Core inflation has declined almost half a percentage point to 2.2 percent at an annual rate over the past year, and even decelerated in the third quarter. Here again, most forecasters were too pessimistic, expecting inflation to drift upwards.

Looking forward, the real fundamentals continue to look positive. Job growth and personal income are strong and these are the primary drivers of consumption. Consumer spending on automobiles and other retail areas has rebounded from its second quarter slump. In fact, over the course of this expansion, spending on durables has grown about twice as fast as consumer income and GDP.

Even residential housing investment, which was expected to be a source of slowdown during this year, continues to appear strong, supported by income growth, capital gains, and high levels of affordability. To be sure, the rate of personal bankruptcies has risen sharply over the past decade, which is worrisome. But the consumer's overall balance sheet remains in relatively good shape.

Similarly, most businesses are in good shape as well. Investment spending by firms is one of the principal stars of this business cycle expansion. Business purchases of plant and equipment also have grown more than twice as fast as GDP. Ordinarily, such aggressive spending might threaten the longevity of the expansion, as businesses' capital budgets outstrip their

cash flow by an excessive margin, inducing companies to curtail their orders in the future. During this expansion, however, capital budgets have remained modest compared to companies' cash flow. As earnings and profits have grown much more rapidly than GDP, the ratio of capital spending to cash flow has remained well within its historical tolerances for business cycle recoveries.

These fundamentals suggest that investment in plant and equipment should continue to expand. Strong cash flows, and a relatively benign cost of capital, aided in part by the good news on the federal deficit, should continue to spur firms to invest at least in the near term. Moreover, industrial production numbers indicate that manufacturing continues to thrive, boding well for GDP growth in the second half of the year.

There do appear to be two areas in the real economy that should provide some welcome restraint. One of these is inventories. Inventories are difficult to forecast, but we do know that inventory investment has grown rapidly for the past three quarters. Given the economy's current strength, there is not yet an overhang in inventories, but the recent growth rate likely won't be sustained.

Another area of restraint involves net exports. Although gross exports have given a tremendous boost to the economy, their continued growth depends on the growth of our trading partners and the value of the dollar. Prospects for real economic growth in many of our major trading partners seem healthy, but not overly so, and for some prospects have weakened. Partly for

these reasons, net exports may be a continuing drag on domestic GDP.

Even accounting for these sources of possible restraint, however, the real economy is strong and likely will remain so for at least the first half of next year.

Now let me turn to a key question for policy makers -- why is all of this happening without inflation heating up?

People who offer explanations to this question usually fall into one of two camps: those who believe this good fortune is temporary, and those who believe it is permanent. It shouldn't surprise you that I, as a central banker, take the middle road. There certainly are temporary factors at work, but I also think something more fundamental -- but very difficult to quantify -- may be going on as well.

Reviewing the transitory factors, two of them seem dominant. First, employers have devoted greater attention to minimizing the rate of growth in benefits costs, moving from defined benefit to defined contribution retirement plans and putting 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 such levels of unemployment.

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 may also have had a role in our recent low inflationary growth.

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 inflation success.

The more intriguing explanations are structural changes. Those who believe in the possibilities for a prolonged period of improved economic performance usually point to two areas: growth in the economy's potential, and a change in the long-term relationship between labor constraints and rates of non-inflationary growth.

I'll discuss changes in potential growth first. As you know, except in the very long run, monetary policy plays little role in determining the economy's potential rate of growth. Instead, that's determined by the growth rates of the labor force, and of workers' productivity.

Not long ago, the labor force was expected to grow at close to one percent per year. Over the past year and a half, it has grown at an almost 1.5 percent pace. This is only partly caused by population growth. Of the 2.5 million net new hires at an annual rate, roughly half came from an expansion in the population aged 16 to 64 who wanted a job; more than a third of those were net new immigrants. The other half was composed mostly of people coming back to the labor force, or entering it for the first time.

During the 1970s and '80s, we knew that the baby boomers and women were entering the labor force in large numbers. Those

forces were enough to raise potential GDP for years. Today, the demographic and social forces that might affect labor force participation are not so clear. We do know that ebullient demand for workers is digging deeper into the working-age population, which is both good news for the workers themselves, and an increasing challenge to business to train these new entrants for the demands of today's more highly skilled jobs. How long the recent rise in the labor force will continue is uncertain, but it could increase potential growth by a few tenths of a percentage point over the next few years.

What about productivity? Again there are two issues. First, is productivity mismeasured? The answer has got to be yes, due at least in part to problems in measuring quality changes in the service sector. It is widely accepted that there is a downward bias in measured productivity growth. However, if we get the measurements right and potential growth goes up, so does the measurement of the actual growth we've experienced, with little or no obvious implication for inflation pressures.

The critical question remains: How far above long-run potential are we growing, if at all? Over the past year-and-a-half, productivity has grown at a 1.5 percent pace, or about .5 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. Potential sources of high productivity growth include a return on the years of corporate restructuring and the increase in capital per worker

associated with the current investment boom, much of which is linked to information and communications technology. But again, the evidence suggests that any increase in long-run productivity growth would be moderate, on the order of a couple of tenths of a percentage point.

If we put changes in labor force and productivity together, we see some suggestion that potential growth is higher than the two plus percent that has been the estimate of many economists. Let's say long-lived labor force growth and changes in productivity do add a few tenths to the estimate of potential; that still does not add up to the full percentage point or better necessary to bring the rate of potential growth in line with the actual growth experienced over the past year and a half. In fact, the sharp decline in the unemployment rate since the end of 1995 is more consistent with a rate of potential growth of the low 2s.

This brings me to the possibility that the long-term relationship of labor constraints and rates of non-inflationary growth seen by some may have changed. It seems that what some economists regard as the traditional relationship between measures of labor capacity and inflation is less secure. The unemployment rate is lower than it has been for twenty years. Yet, unlike then, inflation has not increased -- indeed, the unemployment rate has been below 5.5 percent for almost a year and a half, and inflation has stabilized if not declined.

Has the level of unemployment consistent with stable

inflation declined? Is this a permanent situation created by a more competitive global business environment, or is it temporary, reflecting what some regard as normal variance in this relationship? Moreover, is the labor market really all that tight? Some suggest that indicators of capacity besides the unemployment rate are weaker than normal given this stage in the business cycle. For example, the raw number of help-wanted ads is low, given the current unemployment rate, suggesting that the great number of vacancies that force firms to bid up wages has not yet appeared, and the rate of job leavers versus losers until recently was lower than normal.

All of these forces, temporary and permanent, probably have combined to contribute to the current positive situation. However, temporary forces, such as lower benefit costs and import prices, certainly don't provide the whole answer. More permanent changes don't seem to tell the whole story either. My own sense is there is yet another factor we don't know much about that is a further source of strength for the real economy, and that is the effect of a continuing low inflation environment all by itself.

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. This low-inflation environment seems favorable not only for a continuation of that trend, but also for raising rates of growth as well. What is the feedback from low inflation to the real economy? Does it lower workers' wage demands even in the face of supply

shortages evidenced by low unemployment rates? Does global price restraint feed back to our own economy, even though imports are not a large share of our economy? Does the inflation-fighting credibility that the Federal Reserve has built 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? There isn't enough experience yet with low rates of inflationary growth to answer these questions.

But my own sense is that the recent low-inflation environment is making a difference, despite being difficult to quantify. Low inflation leads to lower inflation expectations, reinforcing the prospects for an overall environment ahead that rewards competitiveness and productive investment.

Thus, I approach current economic performance with a sense of caution--caution that the very success of our economy may lead to calls for less vigilance in the policies that have fostered such success. And caution seems more than warranted especially given the world wide market developments of the last several days. You've probably noted I have confined my remarks to the solid strength of the current U.S. economy. In that regard, I can only agree with Treasury Secretary Rubin when he focused on the fundamentals last night. The basics of the U.S. economy are strong. At this point, I see no reason why that should change.